

Small Business, Entrepreneurship, and Franchises

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Learning Objectives

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What you will be able to do once you complete this chapter:

- 1 Define what a small business is and recognize the fields in which small businesses are concentrated.
- 2 Identify the people who start small businesses and the reasons why some succeed and many fail.
- 3 Assess the contributions of small businesses to our economy.
- 4 Judge the advantages and disadvantages of operating a small business.
- 5 Explain how the Small Business Administration helps small businesses.
- 6 Appraise the concept and types of franchising.
- 7 Analyze the growth of franchising and franchising's advantages and disadvantages.

Did You Know?

Today, Five Guys Burgers and Fries has more than 600 franchised restaurants in North America, a number that will double in the near future as franchisees continue to open units.

Franchising Feeds Growth of Five Guys Burgers and Fries

Five Guys Burgers and Fries has a simple recipe for success in the hotly competitive casual restaurant industry: Serve up popularly priced, generously sized meals in a family-friendly atmosphere. Founders Jerry and Janie Murrell opened their first burger place in 1986 near Arlington, Virginia. Naming the growing chain for their five sons, the husband-and-wife team eventually opened four more restaurants in Virginia.

The Murrells limited their menu to all-American favorites such as juicy hamburgers with a choice of 15 free toppings, crispy fries, hot dogs, grilled cheese sandwiches, and soft drinks with free refills. They cooked every order individually and used only fresh, high-quality ingredients for the best flavor. For example, they refused to use frozen meat, cooked their fries in pure peanut oil for extra crunch, and ordered hamburger buns baked to their own specifications. The owners were so focused on flavor that they tested dozens of condiments and brands to find the very tastiest. The combination of quality food and friendly service set the restaurants apart from the many competitors in the burger world.

By 2002, sales were stronger than ever, and the five-restaurant chain had attracted a loyal following of burger lovers from all around the metropolitan DC area. To expand more quickly, Five Guys added franchising to its business menu, charging entrepreneurs a one-time fee and a small percentage of each restaurant's revenue in exchange for the right to use the brand, its menu, and its proven processes and procedures. Within 18 months, Five Guys had 300 franchised restaurants. Today, it has more than 600 franchised restaurants in North America, a number that will double in the near future as franchisees continue to open units.

Because quality and service are so important to the company's success, all Five Guys restaurants receive two visits a week from mystery shoppers who check that their orders are cooked properly and the service is friendly. When a restaurant scores high on these evaluations, each staff member receives a cash bonus. Instead of paying for splashy ad campaigns, Five Guys spends \$8 million or more yearly on such employee rewards—an important investment in maintaining the company's image and competitive edge.¹

Just as Jerry and Janie Murrell's empire grew from one restaurant in Arlington, Virginia, most businesses start small. Unlike Murrell's empire, most small businesses that survive usually stay small. They provide a solid foundation for our economy—as employers, as suppliers and purchasers of goods and services, and as taxpayers.

In this chapter, we do not take small businesses for granted. Instead, we look closely at this important business sector—beginning with a definition of small business, a description of industries that often attract small businesses, and a profile of some of the people who start small businesses. Next, we consider the importance of small businesses in our economy. We also present the advantages and disadvantages of smallness in business. We then describe services provided by the Small Business Administration, a government agency formed to assist owners and managers of small businesses. We conclude the chapter with a discussion of the pros and cons of franchising, an approach to small-business ownership that has become very popular in the last 40 years.

Define what a small business is and recognize the fields in which small businesses are concentrated.

Small Business: A Profile

The Small Business Administration (SBA) defines a **small business** as “one which is independently owned and operated for profit and is not dominant in its field.” How small must a firm be not to dominate its field? That depends on the particular industry it is in. The SBA has developed the following specific “smallness” guidelines for the various industries, as shown in Table 5.1.² The SBA periodically revises and simplifies its small-business size regulations.

Annual sales in millions of dollars may not seem very small. However, for many firms, profit is only a small percentage of total sales. Thus, a firm may earn only \$40,000 or \$50,000 on yearly sales of \$1 million—and that *is* small in comparison with the profits earned by most medium-sized and large firms. Moreover, most small firms have annual sales well below the maximum limits in the SBA guidelines.

The Small-Business Sector

In the United States, it typically takes four days and \$210 to establish a business as a legal entity. The steps include registering the name of the business, applying for tax IDs, and setting up unemployment and workers’ compensation insurance. In Japan, however, a typical entrepreneur spends more than \$3,500 and 31 days to follow 11 different procedures (see Table 5.2).

A surprising number of Americans take advantage of their freedom to start a business. There are, in fact, about 29.6 million businesses in this country. Only just over 17,000 of these employ more than 500 workers—enough to be considered large.

Interest in owning or starting a small business has never been greater than it is today. During the last decade, the number of small businesses in the United States has increased 49 percent. For the last few years, new-business formation in the United States has broken successive records, except during the 2001–2002 and 2008 recessions. Recently, nearly 627,200 new businesses were incorporated. Furthermore, part-time entrepreneurs have increased fivefold in recent years; they now account for one-third of all small businesses.³

According to a recent study, 70 percent of new businesses survive at least two years, about 50 percent survive at least five years, and 31 percent survive at least seven years.⁴ The primary reason for these failures is mismanagement resulting

Table 5.1 Industry Group-Size Standards

Small-business size standards are usually stated in number of employees or average annual sales. In the United States, 99.7 percent of all businesses are considered small.	
Industry Group	Size Standard
Manufacturing, mining industries	500 employees
Wholesale trade	100 employees
Agriculture	\$750,000
Retail trade	\$7 million
General and heavy construction (except dredging)	\$33.5 million
Dredging	\$20 million
Special trade contractors	\$14 million
Travel agencies	\$3.5 million (commissions and other income)
Business and personal services except	\$7 million
• Architectural, engineering, surveying, and mapping services	\$4.5 million
• Dry cleaning and carpet cleaning services	\$4.5 million

Source: <http://www.sba.gov/contractingopportunities/officials/size/summaryofssi/index.html> (accessed June 13, 2010).

small business one that is independently owned and operated for profit and is not dominant in its field

Table 5.2 Establishing a Business Around the World

The entrepreneurial spirit provides the spark that enriches the U.S. economy. The growth will continue if lawmakers resist the urge to overregulate entrepreneurs and provide policies that foster free enterprise.

	Number of Procedures	Time (days)	Cost (US\$)	Minimum Capital (% per capita income)
Australia	2	2	402	0
Belgium	7	56	2,633	75.1
Canada	2	3	127	0
Denmark	4	4	0	52.3
France	10	53	663	32.1
Germany	9	45	1,341	103.8
Greece	16	45	8,115	145.3
Ireland	3	12	2,473	0
Italy	9	23	4,565	49.6
Japan	11	31	3,518	71.3
Netherlands	7	11	3,276	70.7
New Zealand	3	3	28	0
Norway	4	24	1,460	33.1
Portugal	11	95	1,360	43.4
Spain	11	115	2,366	19.6
Sweden	3	16	190	41.4
Switzerland	6	20	3,228	33.8
United Kingdom	6	18	264	0
United States	5	4	210	0

Sources: World Bank (2004); as found in *Inside the Vault*, Federal Reserve Bank of St. Louis, Fall 2004, 1.

from a lack of business know-how. The makeup of the small-business sector thus is constantly changing. Despite the high failure rate, many small businesses succeed modestly. Some, like Apple Computer, Inc., are extremely successful—to the point where they can no longer be considered small. Taken together, small businesses are also responsible for providing a high percentage of the jobs in the United States. According to some estimates, the figure is well over 50 percent.

Industries that Attract Small Businesses

Some industries, such as auto manufacturing, require huge investments in machinery and equipment. Businesses in such industries are big from the day they are started—if an entrepreneur or group of entrepreneurs can gather the capital required to start one.

By contrast, a number of other industries require only a low initial investment and some special skills or knowledge. It is these industries that tend to attract new businesses. Growing industries, such as outpatient-care facilities, are attractive because of their profit potential. However, knowledgeable entrepreneurs choose areas with which they are familiar, and these are most often the more established industries.

Small enterprise spans the gamut from corner newspaper vending to the development of optical fibers. The owners of small businesses sell gasoline, flowers, and coffee to go. They publish magazines, haul freight, teach languages, and program computers. They make wines, movies, and high-fashion clothes. They build new homes and restore old ones. They fix appliances, recycle metals, and sell used cars. They drive cabs and fly planes. They make us well when we are ill, and they sell us the products of corporate giants. In fact, 74 percent of real estate, rental, and leasing industries; 61 percent of the businesses in the leisure and hospitality services; and

86 percent of the construction industries are dominated by small businesses.⁵ The various kinds of businesses generally fall into three broad categories of industry: distribution, service, and production.

Distribution Industries This category includes retailing, wholesaling, transportation, and communications—industries concerned with the movement of goods from producers to consumers. Distribution industries account for approximately 33 percent of all small businesses. Of these, almost three-quarters are involved in retailing, that is, the sale of goods directly to consumers. Clothing and jewelry stores, pet shops, bookstores, and grocery stores, for example, are all retailing firms. Slightly less than one-quarter of the small distribution firms are wholesalers. Wholesalers purchase products in quantity from manufacturers and then resell them to retailers.

Service Industries This category accounts for more than 48 percent of all small businesses. Of these, about three-quarters provide such nonfinancial services as medical and dental care; watch, shoe, and TV repairs; haircutting and styling; restaurant meals; and dry cleaning. About 8 percent of the small service firms offer financial services, such as accounting, insurance, real estate, and investment counseling. An increasing number of self-employed Americans are running service businesses from home.

Production Industries This last category includes the construction, mining, and manufacturing industries. Only about 19 percent of all small businesses are in this group, mainly because these industries require relatively large initial investments. Small firms that do venture into production generally make parts and subassemblies for larger manufacturing firms or supply special skills to larger construction firms.

The People in Small Businesses: the Entrepreneurs

The entrepreneurial spirit is alive and well in the United States. A recent study revealed that the U.S. population is quite entrepreneurial when compared with those of other countries. More than 70 percent of Americans would prefer being an entrepreneur to working for someone else. This compares with 46 percent of adults in Western Europe and 58 percent of adults in Canada. Another study on entrepreneurial activity for 2002 found that of 36 countries studied, the United States was in the top third in entrepreneurial activity and was the leader when compared with Japan, Canada, and Western Europe.⁶

Small businesses typically are managed by the people who started and own them. Most of these people have held jobs with other firms and still could be so employed if they wanted. Yet owners of small businesses would rather take the risk of starting and operating their own firms, even if the money they make is less than the salaries they otherwise might earn.

Researchers have suggested a variety of personal factors as reasons why people go into business for themselves. These are discussed below.

Characteristics of Entrepreneurs

Entrepreneurial spirit is the desire to create a new business. For example, Nikki Olyai always knew that she wanted to create and develop her own business. Her father, a successful businessman in Iran, was her role model. She came to the United States at the age of 17 and lived with a host family in Salem, Oregon, attending high school there. Undergraduate and graduate degrees in

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Identify the people who start small businesses and the reasons why some succeed and many fail.



Meet Sir Richard Branson, founder and chairperson of the Virgin Group. Born in 1950, Richard set up *Student* magazine at age 16. Then, at age 20, he founded Virgin as a small mail-order record retailer. Today, Virgin is a leading venture capital organization and is one of the world's most recognized and respected brands. Sir Branson established Branson School of Entrepreneurship to identify and support the most promising young entrepreneurs to launch successful businesses of their own.

computer science led her to start Innovision Technologies while she held two other jobs to keep the business going and took care of her four-year-old son. Recently, Nikki Olyai's business was honored by the Women's Business Enterprise National Council's "Salute to Women's Business Enterprises" as one of 11 top successful firms. For three consecutive years, her firm was selected as a "Future 50 of Greater Detroit Company."

Other Personal Factors

Other personal factors in small-business success include

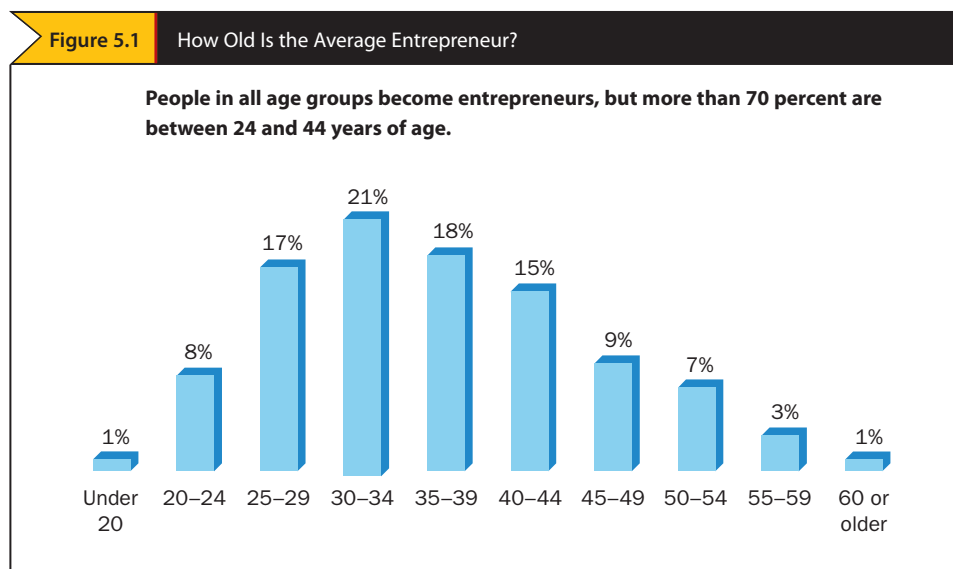
- Independence
- A desire to determine one's own destiny
- A willingness to find and accept a challenge
- Family background (In particular, researchers think that people whose families have been in business, successfully or not, are most apt to start and run their own businesses.)
- Age (Those who start their own businesses also tend to cluster around certain ages—more than 70 percent are between 24 and 44 years of age; see Figure 5.1.)

Motivation

There must be some motivation to start a business. A person may decide that he or she simply has "had enough" of working and earning a profit for someone else. Another may lose his or her job for some reason and decide to start the business he or she has always wanted rather than to seek another job. Still another person may have an idea for a new product or a new way to sell an existing product. Or the opportunity to go into business may arise suddenly, perhaps as a result of a hobby. For example, Cheryl Strand started baking and decorating cakes from her home while working full time as a word processor at Clemson University. Her cakes became so popular that she soon found herself working through her lunch breaks and late into the night to meet customer demand.

Women as Small-Business Owners

- Women are 51 percent of the U.S. population, and according to the SBA, they owned at least 50 percent of all small businesses in 2008.
- Women already own 66 percent of the home-based businesses in this country, and the number of men in home-based businesses is growing rapidly.



Source: Data developed and provided by the National Federation of Independent Business Foundation and sponsored by the American Express Travel Related Services Company, Inc.

- According to the SBA, 9.1 million women-owned businesses in the United States provide almost 27.5 million jobs and generate \$3.6 trillion in sales.
- Women-owned businesses in the United States have proven that they are more successful; more than 40 percent have been in business for 12 years or more.
- According to Dun and Bradstreet, women-owned businesses are financially sound and credit-worthy, and their risk of failure is lower than average.
- Compared to other working women, self-employed women are older, better educated, and have more managerial experience.
- Just over one-half of small businesses are home based, and 91 percent have no employees. About 60 percent of home-based businesses are in service industries, 16 percent in construction, 14 percent in retail trade, and the rest in manufacturing, finance, transportation, communications, wholesaling, and other industries.⁷



Leanna Archer—A child entrepreneur. Thirteen-year-old Leanna Archer, child entrepreneur, owner, and CEO of Leanna's Hair Inc., developed and runs her own natural hair care products company, which she founded at age nine in New York. She invented a line of five green hair care products whose profits she plans to use for tuition at Harvard University.

Teenagers as Small-Business Owners

High-tech teen entrepreneurship is definitely exploding. “There’s not a period in history where we’ve seen such a plethora of young entrepreneurs,” comments Nancy F. Koehn, associate professor of business administration at Harvard Business School. Still, teen entrepreneurs face unique pressures in juggling their schoolwork, their social life, and their high-tech workload. Some ultimately quit school, whereas others quit or cut back on their business activities. Consider Brian Hendricks at Winston Churchill High School in Potomac, Maryland. He is the founder of StartUpPc and VB Solutions, Inc. StartUpPc, founded in 2001, sells custom-built computers and computer services for home users, home offices, small businesses, and students. Brian’s services include design, installation of systems, training, networking, and on-site technical support. In October 2002, Brian founded VB Solutions, Inc., which develops and customizes Web sites and message boards. The firm sets up advertising contracts and counsels Web site owners on site improvements. The company has designed corporate ID kits, logos, and Web sites for clients from all over the world. Brian learned at a very young age that working for yourself is one of the best jobs available. According to Brian, a young entrepreneur must possess “the five P’s of entrepreneurship”—planning, persistence, patience, people, and profit. Brian knows what it takes to be a successful entrepreneur. His accolades include Junior Achievement’s “National Youth Entrepreneur of the Year” and SBA’s 2005 “Young Entrepreneur of the Year” awards.⁸

In some people, the motivation to start a business develops slowly as they gain the knowledge and ability required for success as a business owner. Knowledge and ability—especially, management ability—are probably the most important factors involved. A new firm is very much built around the entrepreneur. The owner must be able to manage the firm’s finances, its personnel (if there are any employees), and its day-to-day operations. He or she must handle sales, advertising, purchasing, pricing, and a variety of other business functions. The knowledge and ability to do so are acquired most often through experience working for other firms in the same area of business.

Why Some Entrepreneurs and Small Businesses Fail

Small businesses are prone to failure. Capital, management, and planning are the key ingredients in the survival of a small business, as well as the most common reasons for failure. Businesses can experience a number of money-related problems.

Table 5.3

U.S. Business Start-ups, Closures, and Bankruptcies

	New	Closures	Bankruptcies
2009	NA	NA	60,840
2008	627,200 ^e	595,600 ^e	43,546
2007	663,100 ^e	571,300 ^e	28,322
2006	670,058	599,333	19,695
2005	644,122	565,745	39,201

e = Advocacy estimate. For a discussion of methodology, see Brian Headd, 2005 (<http://www.sba.gov/advo/research/rs258tot.pdf>).
NA = Not available.

Source: Small Business Administration, Office of Advocacy, *Frequently Asked Questions*, July 2009, <http://www.sba.gov/advo> (accessed June 13, 2010).

It may take several years before a business begins to show a profit. Entrepreneurs need to have not only the capital to open a business but also the money to operate it in its possibly lengthy start-up phase. One cash flow obstacle often leads to others. Moreover, a series of cash flow predicaments usually ends in a business failure. This scenario is played out all too often by small and not-so-small start-up Internet firms that fail to meet their financial backers' expectations and so are denied a second wave of investment dollars to continue their drive to establish a profitable online firm. According to Maureen Borzacchiello, co-owner of Creative Display Solutions, a trade show products company, "Big businesses such as Bear Stearns, Fannie Mae and Freddie Mac, and AIG can get bailouts, but small-business owners are on their own when times are tough and credit is tight."

Many entrepreneurs lack the management skills required to run a business. Money, time, personnel, and inventory all need to be managed effectively if a small business is to succeed. Starting a small business requires much more than optimism and a good idea.

Success and expansion sometimes lead to problems. Frequently, entrepreneurs with successful small businesses make the mistake of overexpansion. Fast growth often results in dramatic changes in a business. Thus, the entrepreneur must plan carefully and adjust competently to new and potentially disruptive situations.

Every day, and in every part of the country, people open new businesses. For example, 627,200 new businesses recently opened their doors. At the same time, however, 595,600 businesses closed their business and 60,840 businesses (in 2009) declared bankruptcy (see Table 5.3).⁹ Although many fail, others represent well-conceived ideas developed by entrepreneurs who have the expertise, resources, and determination to make their businesses succeed. As these well-prepared entrepreneurs pursue their individual goals, our society benefits in many ways from their work and creativity. Billion-dollar companies such as Apple Computer, McDonald's Corporation, and Procter & Gamble are all examples of small businesses that expanded into industry giants.

3

Assess the contributions of small businesses to our economy.

The Importance of Small Businesses in Our Economy

This country's economic history abounds with stories of ambitious men and women who turned their ideas into business dynasties. The Ford Motor Company started as a one-man operation with an innovative method for industrial production. L.L. Bean, Inc., can trace its beginnings to a basement shop in Freeport, Maine. Both Xerox and Polaroid began as small firms with a better way to do a job. Indeed, every year since 1963, the President of the United States has proclaimed National Small Business Week to recognize the contributions of small businesses to the economic well-being of America.

Providing Technical Innovation

Invention and innovation are part of the foundations of our economy. The increases in productivity that have characterized the past 200 years of our history are all rooted in one principal source: new ways to do a job with less effort for less money. Studies show that the incidence of innovation among small-business workers is significantly higher than among workers in large businesses. Small firms produce two-and-a-half times as many innovations as large firms relative to the number of persons employed. In fact, small firms employ 40 percent of all high-tech workers such as scientists, engineers, and computer specialists. No wonder small firms produce 13 to 14 times more patents per employee than large patenting firms.

Consider Waymon Armstrong, the owner of a small business that uses computer simulations to help government and other clients prepare for and respond to natural disasters, medical emergencies, and combat. In presenting the 2010 National Small Business Person of the Year award, Karen Mills, Administrator of the U.S. Small Business Administration, said, “Waymon Armstrong is a perfect example of the innovation, inspiration, and determination that exemplify America’s most successful entrepreneurs. He believed in his brainchild to the point where he deferred his own salary for three years to keep it afloat. When layoffs loomed for his staff after 9/11, their loyalty and belief in the company was so great that they were willing to work without pay for four months.”

“Waymon’s commitment to his employees and to his business—Engineering & Computer Simulations, Inc.—demonstrates the qualities that make small businesses such a powerful force for job creation in the American economy and in their local communities,” said Mills. “It’s the same qualities that will lead us to economic recovery. We are especially proud that his company benefited from two grants under SBA’s Small Business Innovation and Research Program.”¹⁰

According to the U.S. Office of Management and Budget, more than half the major technological advances of the 20th century originated with individual inventors and small companies. Even just a sampling of those innovations is remarkable:

- Air conditioning
- Airplane
- Automatic transmission
- FM radio
- Heart valve
- Helicopter
- Instant camera
- Insulin
- Jet engine
- Penicillin
- Personal computer
- Power steering

Perhaps even more remarkable—and important—is that many of these inventions sparked major new U.S. industries or contributed to an established industry by adding some valuable service.

Providing Employment

Small firms traditionally have added more than their proportional share of new jobs to the economy. Seven out of the ten industries that added the most new jobs were small-business-dominated industries. Small businesses creating the most new jobs recently included business services, leisure and hospitality services, and special trade contractors. Small firms hire a larger proportion of employees who are younger workers, older workers, women, or workers who



Innovate or die contest. Aquaduct is the brainchild of five California-based design students who want to provide clean water to 1.1 billion people in the world who don’t have access to clean drinking water. This pedal-powered bike transports and filters water without burning fossil fuels or wood, thus reducing CO₂ emissions.



Getting personal. For those who like dealing with people, small business is the place to be. Here, a business-owner-manager provides personal service to a happy customer.

prefer to work part time. Furthermore, small businesses provide 67 percent of workers with their first jobs and initial on-the-job training in basic skills. According to the SBA, small businesses represent 99.7 percent of all employers, employ more than 50 percent of the private workforce, and provide about two-thirds of the net new jobs added to our economy.¹¹ Small businesses thus contribute significantly to solving unemployment problems.

The business cycle, as discussed in Chapter 1, is an important factor in the net creation or loss of jobs. During the 2008–2009 recession, businesses with fewer than 20 employees began losing jobs as early as mid-2007. From 2008 to mid-2009, these smallest businesses accounted for 24 percent of the net job losses, while those with 20–499 employees accounted for 36 percent; the remaining 40 percent of job losses were in larger firms with more than 500 employees.¹²

Providing Competition

Small businesses challenge larger, established firms in many ways, causing them to become more efficient and more responsive to consumer needs. A small business cannot, of course, compete with a large firm in all respects. However, a number of small firms, each competing in its own particular area and its own particular way, together have the desired competitive effect. Thus, several small janitorial companies together add up to reasonable competition for the no-longer-small ServiceMaster.

Filling Needs of Society and Other Businesses

Small firms also provide a variety of goods and services to each other and to much larger firms. Sears, Roebuck & Co. purchases merchandise from approximately 12,000 suppliers—and most of them are small businesses. General Motors relies on more than 32,000 companies for parts and supplies and depends on more than 11,000 independent dealers to sell its automobiles and trucks. Large firms generally buy parts and assemblies from smaller firms for one very good reason: It is less expensive than manufacturing the parts in their own factories. This lower cost eventually is reflected in the price that consumers pay for their products.

It is clear that small businesses are a vital part of our economy and that, as consumers and as members of the labor force, we all benefit enormously from their existence. Now let us look at the situation from the viewpoint of the owners of small businesses.

4

Judge the advantages and disadvantages of operating a small business.

The Pros and Cons of Smallness

Do most owners of small businesses dream that their firms will grow into giant corporations—managed by professionals—while they serve only on the board of directors? Or would they rather stay small, in a firm where they have the opportunity (and the responsibility) to do everything that needs to be done? The answers depend on the personal characteristics and motivations of the individual owners. For many, the advantages of remaining small far outweigh the disadvantages.

Advantages of Small Business

Small-business owners with limited resources often must struggle to enter competitive new markets. They also have to deal with increasing international competition. However, they enjoy several unique advantages.

Personal Relationships with Customers and Employees For those who like dealing with people, small business is the place to be. The owners of retail shops get to know many of their customers by name and deal with them on a personal

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basis. Through such relationships, small-business owners often become involved in the social, cultural, and political life of the community.

Relationships between owner-managers and employees also tend to be closer in smaller businesses. In many cases, the owner is a friend and counselor as well as the boss.

These personal relationships provide an important business advantage. The personal service small businesses offer to customers is a major competitive weapon—one that larger firms try to match but often cannot. In addition, close relationships with employees often help the small-business owner to keep effective workers who might earn more with a larger firm.

Ability to Adapt to Change Being his or her own boss, the owner-manager of a small business does not need anyone's permission to adapt to change. An owner may add or discontinue merchandise or services, change store hours, and experiment with various price strategies in response to changes in market conditions. And through personal relationships with customers, the owners of small businesses quickly become aware of changes in people's needs and interests, as well as in the activities of competing firms.

Simplified Record Keeping Many small firms need only a simple set of records. Record keeping might consist of a checkbook, a cash-receipts journal in which to record all sales, and a cash-disbursements journal in which to record all amounts paid out. Obviously, enough records must be kept to allow for producing and filing accurate tax returns.

Independence Small-business owners do not have to punch in and out, bid for vacation times, take orders from superiors, or worry about being fired or laid off. They are the masters of their own destinies—at least with regard to employment. For many people, this is the prime advantage of owning a small business.

Other Advantages According to the SBA, the most profitable companies in the United States are small firms that have been in business for more than ten years and employ fewer than 20 people. Small-business owners also enjoy all the advantages of sole proprietorships, which were discussed in Chapter 4. These include being able to keep all profits, the ease and low cost of going into business and (if necessary) going out of business, and being able to keep business information secret.

Disadvantages of Small Business

Personal contacts with customers, closer relationships with employees, being one's own boss, less cumbersome record-keeping chores, and independence are the bright side of small business. In contrast, the dark side reflects problems unique to these firms.

Risk of Failure As we have noted, small businesses (especially new ones) run a heavy risk of going out of business—about two out of three close their doors within the first six years. Older, well-established small firms can be hit hard by a business recession mainly because they do not have the financial resources to weather an extended difficult period.

Sustaining the Planet

Tips from the Environmental Protection Agency

The Environmental Protection Agency's Small Business Gateway offers a multitude of resources and ideas for small businesses going green. The site offers links to state and local environmental experts plus the latest information about complying with environmental laws and regulations. Take a look: <http://www.epa.gov/smallbusiness/>.

Limited Potential Small businesses that survive do so with varying degrees of success. Many are simply the means of making a living for the owner and his or her family. The owner may have some technical skill—as a hair stylist or electrician, for example—and may have started a business to put this skill to work. Such a business is unlikely to grow into big business. In addition, employees’ potential for advancement is limited.

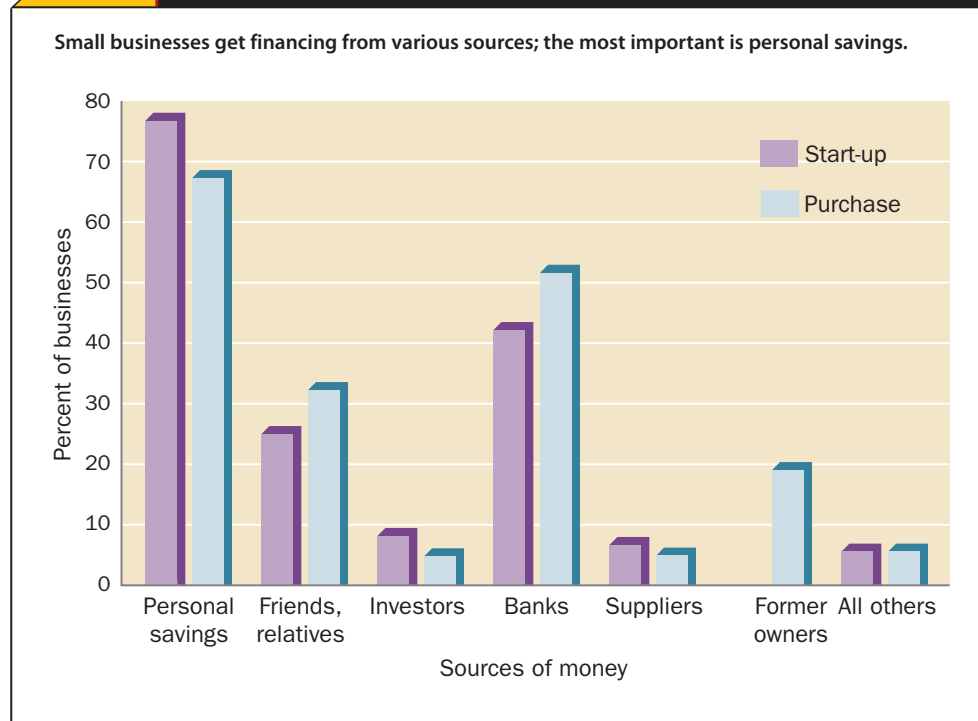
Limited Ability to Raise Capital Small businesses typically have a limited ability to obtain capital. Figure 5.2 shows that most small-business financing comes out of the owner’s pocket. Personal loans from lending institutions provide only about one-fourth of the capital required by small businesses. About 50 percent of all new firms begin with less than \$30,000 in total capital, according to Census Bureau and Federal Reserve surveys. In fact, almost 36 percent of new firms begin with less than \$20,000, usually provided by the owner or family members and friends.¹³

Although every person who considers starting a small business should be aware of the hazards and pitfalls we have noted, a well-conceived business plan may help to avoid the risk of failure. The U.S. government is also dedicated to helping small businesses make it. It expresses this aim most actively through the SBA.

Developing a Business Plan

Lack of planning can be as deadly as lack of money to a new small business. Planning is important to any business, large or small, and never should be overlooked or taken lightly. A **business plan** is a carefully constructed guide for the person starting a business. Consider it as a tool with three basic purposes: communication, management, and planning. As a communication tool, a business plan serves as a concise document that potential investors can examine to see if they would like to invest or assist in financing a new venture. It shows whether a business has the potential to make a profit. As a management tool, the business plan helps to track, monitor, and evaluate the progress. The business plan is a living document; it is modified as the entrepreneur gains knowledge and experience. It also serves to establish time

Figure 5.2 Sources of Capital for Entrepreneurs



Source: Data developed and provided by the National Federation of Independent Business Foundation and sponsored by the American Express Travel Related Services Company, Inc.

business plan a carefully constructed guide for the person starting a business



Prep Your Elevator Pitch

Imagine that you've just stepped into an elevator with a potential investor. You have a mere 60 seconds to pitch your business idea before the ride is over and the doors open. Are you ready?

Successful entrepreneurs are always perfecting their "elevator pitch," a quick, to-the-point summary of the business proposition. In just a minute or two, you should be able to clearly and succinctly explain what your business is about and the opportunity or problem you're addressing. Practice until you can project confidence and high energy without appearing rushed or overly aggressive. Just as important, a good elevator pitch should end with a "call to action," such as asking for a meeting to discuss more details.

"Entrepreneur Idol" Jordan Leahy knows how to make every second count. A student at the University of

Wisconsin–Whitewater, Leahy recently won the Northwestern University "elevator pitch" competition with a one-minute summary of his newest business venture. In addition to a cash prize, Leahy won an internship at a venture-capital firm. The day after his win, he received a call from one of the judges, a potential investor who requested more details about the business idea. That's the point of having your elevator pitch ready: "You never know when or where you'll meet your next investor," Leahy explains.

Sources: Scott Austin, "How to Pitch a Venture Capitalist on a Napkin," *Wall Street Journal Blog*, January 11, 2010, http://blogs.wsj.com/venturecapital/2010/01/11/how-to-pitch-a-venture-capitalist-on-a-napkin/?mod=rss_WSJBlog; "UW-Whitewater Student Entrepreneur Wins 'Entrepreneur Idol' Elevator Pitch Competition," *WisBusiness.com (Wisconsin)*, November 24, 2009, <http://www.wisbusiness.com/index.html?Article=177894>; Scott Andron, "Entrepreneurs Seek Success in a Minute," *Miami Herald*, November 20, 2009, <http://www.miamiherald.com/business/small-business/story/1342790.html>; Daisy Wademan Dowling, "How to Perfect an Elevator Pitch about Yourself," *Harvard Business Review Blog*, May 4, 2009, <http://blogs.harvardbusiness.org/dowling/2009/05/how-to-perfect-an-elevator-pit.html>.



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lines and milestones and allows comparison of growth projections against actual accomplishments. Finally, as a planning tool, the business plan guides a businessperson through the various phases of business. For example, the plan helps to identify obstacles to avoid and to establish alternatives. According to Robert Krummer, Jr., chairman of First Business Bank in Los Angeles, "The business plan is a necessity. If the person who wants to start a small business can't put a business plan together, he or she is in trouble."

Components of a Business Plan

Table 5.4 shows the 12 sections that a business plan should include. Each section is further explained at the end of each of the seven major parts in the text. The goal of each end-of-the-part exercise is to help a businessperson create his or her own business plan. When constructing a business plan, the businessperson should strive to keep it easy to read, uncluttered, and complete. Like other busy executives, officials of financial institutions do not have the time to wade through pages of extraneous data. The business plan should answer the four questions banking officials and investors are most interested in: (1) What exactly is the nature and mission of the new venture? (2) Why is this new enterprise a good idea? (3) What are the businessperson's goals? (4) How much will the new venture cost?

The great amount of time and consideration that should go into creating a business plan probably will end up saving time later. For example, Sharon Burch, who was running a computer software business while earning a degree in business administration, had to write a business plan as part of one of her courses. Burch has said, "I wish I'd taken the class before I started my business. I see a lot of things I could have done differently. But it has helped me since because I've been using the business plan as a guide for my business." Table 5.5 provides a business plan checklist. Accuracy and realistic expectations are crucial to an effective business plan. It is unethical to deceive loan officers, and it is unwise to deceive yourself.

Table 5.4 Components of a Business Plan

1. *Introduction.* Basic information such as the name, address, and phone number of the business; the date the plan was issued; and a statement of confidentiality to keep important information away from potential competitors.
2. *Executive Summary.* A one- to two-page overview of the entire business plan, including a justification why the business will succeed.
3. *Benefits to the Community.* Information on how the business will have an impact on economic development, community development, and human development.
4. *Company and Industry.* The background of the company, choice of the legal business form, information on the products or services to be offered, and examination of the potential customers, current competitors, and the business's future.
5. *Management Team.* Discussion of skills, talents, and job descriptions of management team, managerial compensation, management training needs, and professional assistance requirements.
6. *Manufacturing and Operations Plan.* Discussion of facilities needed, space requirements, capital equipment, labor force, inventory control, and purchasing requirement.
7. *Labor Force.* Discussion of the quality of skilled workers available and the training, compensation, and motivation of workers.
8. *Marketing Plan.* Discussion of markets, market trends, competition, market share, pricing, promotion, distribution, and service policy.
9. *Financial Plan.* Summary of the investment needed, sales and cash flow forecasts, breakeven analysis, and sources of funding.
10. *Exit Strategy.* Discussion of a succession plan or going public. Who will take over the business?
11. *Critical Risks and Assumptions.* Evaluation of the weaknesses of the business and how the company plans to deal with these and other business problems.
12. *Appendix.* Supplementary information crucial to the plan, such as résumés of owners and principal managers, advertising samples, organization chart, and any related information.

Source: Adapted from Timothy S. Hatten, *Small Business Management: Entrepreneurship and Beyond*, 4th ed. Copyright © 2009 by Houghton Mifflin Company, 93–118. Reprinted with permission.

Table 5.5 Business Plan Checklist

1. Does the executive summary grab the reader's attention and highlight the major points of the business plan?
2. Does the business-concept section clearly describe the purpose of the business, the customers, the value proposition, and the distribution channel and convey a compelling story?
3. Do the industry and market analyses support acceptance and demand for the business concept in the marketplace and define a first customer in depth?
4. Does the management team plan persuade the reader that the team could implement the business concept successfully? Does it assure the reader that an effective infrastructure is in place to facilitate the goals and operations of the company?
5. Does the product/service plan clearly provide details on the status of the product, the time line for completion, and the intellectual property that will be acquired?
6. Does the operations plan prove that the product or service could be produced and distributed efficiently and effectively?
7. Does the marketing plan successfully demonstrate how the company will create customer awareness in the target market and deliver the benefit to the customer?
8. Does the financial plan convince the reader that the business model is sustainable—that it will provide a superior return on investment for the investor and sufficient cash flow to repay loans to potential lenders?
9. Does the growth plan convince the reader that the company has long-term growth potential and spin-off products and services?
10. Does the contingency and exit-strategy plan convince the reader that the risk associated with this venture can be mediated? Is there an exit strategy in place for investors?

Source: Kathleen R. Allen, *Launching New Ventures: An Entrepreneurial Approach*, 4th ed. Copyright © 2006 by Houghton Mifflin Company, 197. Reprinted with permission.

5

Explain how the Small Business Administration helps small businesses.

Small Business Administration (SBA) a governmental agency that assists, counsels, and protects the interests of small businesses in the United States

The Small Business Administration

The **Small Business Administration (SBA)**, created by Congress in 1953, is a governmental agency that assists, counsels, and protects the interests of small businesses in the United States. It helps people get into business and stay in business. The agency provides assistance to owners and managers of prospective, new, and established small businesses. Through more than 1,000 offices and resource centers throughout the nation, the SBA provides both financial assistance and management counseling. Recently, the SBA provided training, technical assistance, and education to more

than 3 million small businesses. It helps small firms to bid for and obtain government contracts, and it helps them to prepare to enter foreign markets.

SBA Management Assistance

Statistics show that most failures in small business are related to poor management. For this reason, the SBA places special emphasis on improving the management ability of the owners and managers of small businesses. The SBA's Management Assistance Program is extensive and diversified. It includes free individual counseling, courses, conferences, workshops, and a wide range of publications. Recently, the SBA provided management and technical assistance to nearly 1 million small businesses through its 1,100 Small Business Development Centers and 12,400 volunteers from the Service Corps of Retired Executives.¹⁴

Management Courses and Workshops The management courses offered by the SBA cover all the functions, duties, and roles of managers. Instructors may be teachers from local colleges and universities or other professionals, such as management consultants, bankers, lawyers, and accountants. Fees for these courses are quite low. The most popular such course is a general survey of eight to ten different areas of business management. In follow-up studies, businesspeople may concentrate in-depth on one or more of these areas depending on their particular strengths and weaknesses. The SBA occasionally offers one-day conferences. These conferences are aimed at keeping owner-managers up-to-date on new management developments, tax laws, and the like. The Small Business Training Network (SBTN) is an online training network consisting of 83 SBA-run courses, workshops, and resources. Some of the most requested courses include Entrepreneurship, Starting and Managing Your Own Business, Developing a Business Plan, Managing the Digital Enterprise, Identify Your Target Market, and Analyze Profitability. Find out more at <http://www.sba.gov/training>. Recently, more than 240,000 small-business owners benefited from SBA's free online business courses.

SCORE The **Service Corps of Retired Executives (SCORE)**, created in 1964, is a group of more than 12,400 businesspeople including more than 2,000 women who volunteer their services to small businesses through the SBA. The collective experience of SCORE volunteers spans the full range of American enterprise. These volunteers have worked for such notable companies as Eastman Kodak, General Electric, IBM, and Procter & Gamble. Experts in areas of accounting, finance, marketing, engineering, and retailing provide counseling and mentoring to entrepreneurs.

A small-business owner who has a particular problem can request free counseling from SCORE. An assigned counselor visits the owner in his or her establishment and, through careful observation, analyzes the business situation and the problem. If the problem is complex, the counselor may call on other volunteer experts to assist. Finally, the counselor offers a plan for solving the problem and helping the owner through the critical period.

Consider the plight of Elizabeth Halvorsen, a mystery writer from Minneapolis. Her husband had built up the family advertising and graphic arts firm for 17 years when he was called in 1991 to serve in the Persian Gulf War. The only one left behind who could run the business was Mrs. Halvorsen, who admittedly had no business experience. Enter SCORE. With a SCORE management expert at her side, she kept the business on track. In 2009, SCORE volunteers served more than 523,800 small-business people like Mrs. Halvorsen through its 800 branches. The 12,400 counselors provided 203,000 face-to-face counseling sessions, 119,000 online counseling sessions, and more than 49,500 online workshops to more than 201,000 workshop participants. Since its inception, SCORE has assisted more than 8.5 million small-business people with online and face-to-face small business counseling.¹⁵

Service Corps of Retired Executives (SCORE) a group of businesspeople who volunteer their services to small businesses through the SBA



Building a Business with SCORE's Help

Tony Clarke was looking to start a microbrewery in San Diego. Janice Selfridge wanted to get her Beacon, New York, art conservation company ready for future growth. Both succeeded in building their businesses with the expert advice and guidance of SCORE volunteers.

Tony Clarke is a former Navy pilot with a taste for handcrafted artisanal beers. When Clarke retired, he decided to brew and sell his own beers. He visited the SBA Web site in search of information about preparing a business plan and noticed a link to get assistance from SCORE. Clarke began attending SCORE workshops and receiving free individualized counseling from a local SCORE volunteer. "It was through SCORE that I met a lender who was open to financing a start-up," he says. Today Clarke's Airedale Brewing Company is

growing quickly, selling specialty beers and ales through local taverns, hotels, restaurants, and liquor stores.

Janice Selfridge's Hudson Valley Fine Art Conservators is another SCORE success story. Selfridge used her background in fine art to start a business restoring historic paintings and frames. Her customers are individuals and museums that need paintings or frames cleaned and repaired. Over the course of a year, SCORE counselors helped Selfridge sharpen her management skills and plan for marketing to attract new customers. With help from SCORE, Selfridge's company is on the road to higher revenues and profits.

Sources: "Airedale Brewing Company: SCORE Helps Former Navy Pilot Reach His Dream of Becoming a Microbrewer," *SCORE Success Stories*, May 7, 2009, http://www.score.org/success_airedale.html; "The Beer Necessities," *Riviera*, May/June 2009, 110; "Success Stories: Airedale Brewing Company," *SCORE San Diego Chapter*, n.d., https://www.score-sandiego.org/about_successstory.asp?ID=10 (accessed July 26, 2010); <http://www.airedalebrewing.com/about.shtml>; "Garrison Fine Art Restorer Janice Selfridge Receives Putnam SCORE Award," *Putnam Country News & Recorder*, April 8, 2009, 11.

Help for Minority-Owned Small Businesses

Americans who are members of minority groups have had difficulty entering the nation's economic mainstream. Raising money is a nagging problem for minority business owners, who also may lack adequate training. Members of minority groups are, of course, eligible for all SBA programs, but the SBA makes a special effort to assist those minority groups who want to start small businesses or expand existing ones. For example, the Minority Business Development Agency awards grants to develop and increase business opportunities for members of racial and ethnic minorities.

Helping women become entrepreneurs is also a special goal of the SBA. Emily Harrington, one of nine children, was born in Manila, the Philippines. She arrived in the United States in 1972 as a foreign-exchange student. Convinced that there was a market for hard-working, dedicated minorities and women, she launched Qualified Resources, Inc. *Inc.* magazine selected her firm as one of "America's Fastest Growing Private Companies" just six years later. Harrington credits the SBA with giving her the technical support that made her first loan possible. Finding a SCORE counselor who worked directly with her, she refined her business plan until she got a bank loan. Before contacting the SBA, Harrington was turned down for business loans "by all the banks I approached," even though she worked as a manager of loan credit and collection for a bank. Later, Emily Harrington was SBA's winner of the local, regional, and national Small Business Entrepreneurial Success Award for Rhode Island, the New England region, and the nation! For several years in a row, Qualified Resources, Inc., was named one of the fastest growing private companies in Rhode Island. Now with more than 100 Women's Business Centers, entrepreneurs like Harrington can receive training and technical assistance, access to credit and capital, federal contracts, and international markets. The SBA's Online Women's Business Center (<http://www.sba.gov/aboutsba/sbaprograms/onlinewbc/index.html>) is a state-of-the-art Internet site to help women expand their businesses. This free, interactive Web site offers women information about business principles and practices, management techniques, networking, industry news, market research and technology training, online counseling, and hundreds of links to other sites, as well as information about the many SBA services and resources available to them.

Small-Business Institutes *Small-business institutes (SBIs)*, created in 1972, are groups of senior and graduate students in business administration who provide management counseling to small businesses. SBIs have been set up on more than 520 college campuses as another way to help business owners. The students work in small groups guided by faculty advisers and SBA management-assistance experts. Like SCORE volunteers, they analyze and help solve the problems of small-business owners at their business establishments.

Small-Business Development Centers *Small-business development centers (SBDCs)* are university-based groups that provide individual counseling and practical training to owners of small businesses. SBDCs draw from the resources of local, state, and federal governments, private businesses, and universities. These groups can provide managerial and technical help, data from research studies, and other types of specialized assistance of value to small businesses. In 2010, there were more than 1,100 SBDC locations, primarily at colleges and universities, assisting people such as Kathleen DuBois. After scribbling a list of her abilities and the names of potential clients on a napkin in a local restaurant, Kathleen DuBois decided to start her own marketing firm. Beth Thornton launched her engineering firm after a discussion with a colleague in the ladies room of the Marriott. When Richard Shell was laid off after 20 years of service with Nisource (Columbia Gas), he searched the Internet tirelessly before finding the right franchise option. Introduced by mutual friends, Jim Bostic and Denver McMillion quickly connected, built a high level of trust, and combined their diverse professional backgrounds to form a manufacturing company. Although these entrepreneurs took different routes in starting their new businesses in West Virginia, all of them turned to the West Virginia Small Business Development Center for the technical assistance to make their dreams become a reality.

SBA Publications The SBA issues management, marketing, and technical publications dealing with hundreds of topics of interest to present and prospective managers of small firms. Most of these publications are available from the SBA free of charge. Others can be obtained for a small fee from the U.S. Government Printing Office.

SBA Financial Assistance

Small businesses seem to be constantly in need of money. An owner may have enough capital to start and operate the business. But then he or she may require more money to finance increased operations during peak selling seasons, to pay for required pollution control equipment, to finance an expansion, or to mop up after a natural disaster such as a flood or a terrorist attack. For example, the Supplemental Terrorist Activity Relief program has made \$3.7 billion in loans to 8,202 small businesses harmed or disrupted by the September 11 terrorist attacks. In October 2005, the SBA guaranteed loans of up to \$150,000 to small businesses affected by Hurricanes Katrina and Rita. Since the 2005 hurricanes, SBA has made more than \$4.9 billion in disaster loans to 102,903 homeowners and renters in the Gulf region. Businesses in the area received 16,828 business disaster loans with disbursements worth \$1.5 billion.¹⁶ In 2010, the SBA offered economic injury loans to fishing and fishing-dependent small businesses as a result of the Deepwater BP spill that shut down commercial and recreational fishing waters. According to the SBA Administrator Karen Mills, “SBA remains committed to taking every step to help small businesses deal with the financial challenges they are facing as a result of the Deepwater

The SBA's Teen Business Link. This link provides information to young entrepreneurs about starting a business and other important business start-up questions.

small-business institutes (SBIs) groups of senior and graduate students in business administration who provide management counseling to small businesses

small-business development centers (SBDCs) university-based groups that provide individual counseling and practical training to owners of small businesses



Making music at the Modesto Academy of Music & Design.

After giving private piano lessons for more than 25 years, Pam Tallman of Modesto, California, used an SBA loan to help finance the purchase of a building to open the academy. The school offers music, art, design, and computer classes for students aged two years and older.

BP oil spill.”¹⁷ The SBA offers special financial-assistance programs that cover all these situations. However, its primary financial function is to guarantee loans to eligible businesses.

Regular Business Loans Most of the SBA’s business loans are actually made by private lenders such as banks, but repayment is partially guaranteed by the agency. That is, the SBA may guarantee that it will repay the lender up to 90 percent of the loan if the borrowing firm cannot repay it. Guaranteed loans approved on or after October 1, 2002, may be as large as \$1.5 million (this loan limit may be increased in the future). The average size of an SBA-guaranteed business loan is about \$300,000, and its average duration is about eight years.

Small-Business Investment Companies **Venture capital** is money that is invested in small (and sometimes struggling) firms that have the potential to become very successful. In many cases, only a lack of capital keeps these firms from rapid and solid growth. The people who invest in such firms expect that their investments will grow with the firms and become quite profitable.

The popularity of these investments has increased over the past 30 years, but most small firms still have difficulty obtaining venture capital. To help such businesses, the SBA licenses, regulates, and provides financial assistance to **small-business investment companies (SBICs)**.

An SBIC is a privately owned firm that provides venture capital to small enterprises that meet its investment standards. Such firms as America Online, Apple Computer, Federal Express, Compaq Computer, Intel Corporation, Outback Steakhouse, and Staples, Inc., all were financed through SBICs during their initial growth period. SBICs are intended to be profit-making organizations. The aid that SBA offers allows them to invest in small businesses that otherwise would not attract venture capital. Since Congress created the program in 1958, SBICs have financed more than 102,000 small businesses for a total of about \$50.6 billion. In 2009, SBIC benefited 1,477 businesses, and 24 percent of these firms were less than two years old.¹⁸

State of Small Business During the Recession

Celebrating the 47th annual observance of National Small Business Week in May 2010, President Obama stated,

Our nation is still emerging from one of the worst recessions in our history, and small businesses were among the hardest hit. From mom-and-pop stores to high tech start-ups, countless small businesses have been forced to lay off employees or shut their doors entirely. In these difficult times, we must do all we can to help these firms recover from the recession and put Americans back to work. Our government cannot guarantee a company’s success, but it can help create market conditions that allow small businesses to thrive.

My Administration is committed to helping small businesses drive our economy toward recovery and long-term growth. The American Recovery and Reinvestment Act has supported billions of dollars in loans and Federal contracts for small businesses across the country. The Affordable Care Act makes it easier for small business owners to provide health insurance to their employees, and gives entrepreneurs the security they need to innovate and take risks. We have enacted new tax cuts and tax credits for small firms. Still, we must do more to empower these companies. Small businesses are the engine of our prosperity

venture capital money that is invested in small (and sometimes struggling) firms that have the potential to become very successful

small-business investment companies (SBICs) privately owned firms that provide venture capital to small enterprises that meet their investment standards

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*and a proud reflection of our character. A healthy small business sector will give us vibrant communities, cutting-edge technology, and an American economy that can compete and win in the 21st century.*¹⁹

As if the recession was not enough, in the states near the Gulf of Mexico, many small businesses suffered financial losses following the April 20, 2010, Deepwater BP oil spill that shut down commercial and recreational fishing along the coasts. According to the SBA Administrator, Karen Mills, “With the region still recovering from previous devastation and the national recession of the last couple of years, it’s critical that we take every step we can to provide small businesses with resources to make it through this latest crisis so that they can continue to drive local economic growth and provide good-paying jobs.” The SBA is offering working capital loans up to \$2 million at an interest rate of 4 percent with terms up to 30 years.²⁰

We have discussed the importance of the small-business segment of our economy. We have weighed the advantages and drawbacks of operating a small business as compared with a large one. But is there a way to achieve the best of both worlds? Can one preserve one’s independence as a business owner and still enjoy some of the benefits of “bigness”? Let’s take a close look at franchising.

Franchising

A **franchise** is a license to operate an individually owned business as if it were part of a chain of outlets or stores. Often, the business itself is also called a *franchise*. Among the most familiar franchises are McDonald’s, H&R Block, AAMCO Transmissions, GNC (General Nutrition Centers), and Dairy Queen. Many other franchises carry familiar names; this method of doing business has become very popular in the last 30 years or so. It is an attractive means of starting and operating a small business.

What Is Franchising?

Franchising is the actual granting of a franchise. A **franchisor** is an individual or organization granting a franchise. A **franchisee** is a person or organization purchasing a franchise. The franchisor supplies a known and advertised business name, management skills, the required training and materials, and a method of doing business. The franchisee supplies labor and capital, operates the franchised business, and agrees to abide by the provisions of the franchise agreement. Table 5.6 lists the basic franchisee rights and obligations that would be covered in a typical franchise agreement.

Types of Franchising

Franchising arrangements fall into three general categories. In the first approach, a manufacturer authorizes a number of retail stores to sell a certain brand-name item. This type of franchising arrangement, one of the oldest, is prevalent in sales of passenger cars and trucks, farm equipment, shoes, paint, earth-moving equipment, and petroleum. About 90 percent of all gasoline is sold through franchised, independent retail service stations, and franchised dealers handle virtually all sales of new cars and trucks. In the second type of franchising arrangement, a producer licenses distributors to sell a given product to retailers. This arrangement is common in the soft drink industry. Most national manufacturers of soft drink syrups—The Coca-Cola Company, Dr. Pepper/Seven-Up Companies, PepsiCo, Royal Crown Companies, Inc.—franchise independent bottlers who then serve retailers. In a third form of franchising, a franchisor supplies brand names, techniques, or other services instead of a complete product. Although the franchisor may provide certain production and distribution services, its primary role is the careful development and control of marketing strategies. This approach to franchising, which is the most typical today, is used by Holiday Inns, Howard Johnson Company, AAMCO Transmissions, McDonald’s, Dairy Queen, Avis, Hertz Corporation, KFC (Kentucky Fried Chicken), and SUBWAY, to name but a few.

6

Appraise the concept and types of franchising.

franchise a license to operate an individually owned business as though it were part of a chain of outlets or stores

franchising the actual granting of a franchise

franchisor an individual or organization granting a franchise

franchisee a person or organization purchasing a franchise

Table 5.6 Basic Rights and Obligations Delineated in a Franchise Agreement

Franchisee rights include:
1. use of trademarks, trade names, and patents of the franchisor.
2. use of the brand image and the design and decor of the premises developed by the franchisor.
3. use of the franchisor's secret methods.
4. use of the franchisor's copyrighted materials.
5. use of recipes, formulae, specifications, processes, and methods of manufacture developed by the franchisor.
6. conducting the franchised business upon or from the agreed premises strictly in accordance with the franchisor's methods and subject to the franchisor's directions.
7. guidelines established by the franchisor regarding exclusive territorial rights.
8. rights to obtain supplies from nominated suppliers at special prices.
Franchisee obligations include:
1. to carry on the business franchised and no other business upon the approved and nominated premises.
2. to observe certain minimum operating hours.
3. to pay a franchise fee.
4. to follow the accounting system laid down by the franchisor.
5. not to advertise without prior approval of the advertisements by the franchisor.
6. to use and display such point-of-sale advertising materials as the franchisor stipulates.
7. to maintain the premises in good, clean, and sanitary condition and to redecorate when required to do so by the franchisor.
8. to maintain the widest possible insurance coverage.
9. to permit the franchisor's staff to enter the premises to inspect and see if the franchisor's standards are being maintained.
10. to purchase goods or products from the franchisor or his designated suppliers.
11. to train the staff in the franchisor's methods to ensure that they are neatly and appropriately clothed.
12. not to assign the franchise contract without the franchisor's consent.

Source: Excerpted from the SBA's "Is Franchising for Me?" <http://www.sba.gov> (accessed June 10, 2010).

7

Analyze the growth of franchising and franchising's advantages and disadvantages.

The Growth of Franchising

Franchising, which began in the United States around the time of the Civil War, was used originally by large firms, such as the Singer Sewing Company, to distribute their products. Franchising has been increasing steadily in popularity since the early 1900s, primarily for filling stations and car dealerships; however, this retailing strategy has experienced enormous growth since the mid-1970s. The franchise proliferation generally has paralleled the expansion of the fast-food industry. As Table 5.7 shows, three of *Entrepreneur* magazine's top-rated franchises for 2010 were in this category.

Of course, franchising is not limited to fast foods. Hair salons, tanning parlors, and dentists and lawyers are expected to participate in franchising arrangements in growing numbers. Franchised health clubs, pest exterminators, and campgrounds are already widespread, as are franchised tax preparers and travel agencies. The real estate industry also has experienced a rapid increase in franchising.

Also, franchising is attracting more women and minority business owners in the United States than ever before. One reason is that special outreach programs designed to encourage franchisee diversity have developed. Consider Angela Trammel, a young mother of two. She had been laid off from her job at the Marriott after 9/11. Since she was a member of a Curves Fitness Center and liked the concept of empowering women to become physically fit, she began researching the cost of purchasing a Curves franchise and ways to finance the business. "I was online looking for financing, and I linked to Enterprise Development Group in Washington, DC. I knew that they had diverse clients." The cost for the franchise was \$19,500, but it took \$60,000 to open the doors to her fitness center. "Applying for a loan

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to start the business was much harder than buying a house,” said Trammel. Just three years later, Angela and her husband, Ernest, own three Curves Fitness Centers with 12 employees. Recently, since giving birth to her third child, she has found the financial freedom and flexibility needed to care for her busy family. In fact, within a three-year period, the Trammels grew their annual household income from \$80,000 to \$250,000.²¹ Franchisors such as Wendy’s, McDonald’s, Burger King, and Church’s Chicken all have special corporate programs to attract minority and women franchisees. Just as important, successful women and minority franchisees are willing to get involved by offering advice and guidance to new franchisees.

Herman Petty, the first African-American McDonald’s franchisee, remembers that the company provided a great deal of help while he worked to establish his first units. In turn, Petty traveled to help other black franchisees, and he invited new franchisees to gain hands-on experience in his Chicago restaurants before starting their own establishments. Petty also organized a support group, the National Black McDonald’s Operators Association, to help black franchisees in other areas. Today, this support group has 33 local chapters and more than 330 members across the country. “We are really concentrating on helping our operators to be successful both operationally and financially,” says Craig Welburn, the McDonald’s franchisee who leads the group.

Dual-branded franchises, in which two franchisors offer their products together, are a new small-business trend. For example, in 1993, pleased with the success of its first cobranded restaurant with Texaco in Beebe, Arkansas, McDonald’s now has more than 400 cobranded restaurants in the United States. Also, an agreement between franchisors Doctor’s Associates, Inc., and TCBY Enterprises, Inc., now allows franchisees to sell SUBWAY sandwiches and TCBY yogurt in the same establishment.

Are Franchises Successful?

Franchising is designed to provide a tested formula for success, along with ongoing advice and training. The success rate for businesses owned and operated by franchisees is significantly higher than the success rate for other independently owned small businesses. In a recent nationwide Gallup poll of 944 franchise owners, 94 percent of franchisees indicated that they were very or somewhat successful,



How sweet it is. Cold Stone Creamery opened its first store in 1988 and started franchising in 1995. Today, about 1,400 stores have opened in the United States, Puerto Rico, Guam, Japan, and Korea. In 2006, Cold Stone was ranked #11 in *Entrepreneur* magazine's Fastest Growing Franchising.

only 5 percent believed that they were very unsuccessful or somewhat unsuccessful, and 1 percent did not know. Despite these impressive statistics, franchising is not a guarantee of success for either franchisees or franchisors. Too rapid expansion, inadequate capital or management skills, and a host of other problems can cause failure for both franchisee and franchisor. Thus, for example, the Dizzy Dean's Beef and Burger franchise is no longer in business. Timothy Bates, a Wayne State University economist, warns, "Despite the hype that franchising is the safest way to go when starting a new business, the research just doesn't bear that out." Just consider Boston Chicken, which once had more than 1,200 restaurants before declaring bankruptcy in 1998.

Advantages of Franchising

Franchising plays a vital role in our economy and soon may become the dominant form of retailing. Why? Because franchising offers advantages to both the franchisor and the franchisee.

To the Franchisor The franchisor gains fast and well-controlled distribution of its products without incurring the high cost of constructing and operating its own outlets. The franchisor thus has more capital available to expand production and to use for advertising. At the same time, it can ensure, through the franchise agreement, that outlets are maintained and operated according to its own standards.

The franchisor also benefits from the fact that the franchisee—a sole proprietor in most cases—is likely to be very highly motivated to succeed. The success of the franchise means more sales, which translate into higher royalties for the franchisor.

To the Franchisee The franchisee gets the opportunity to start a business with limited capital and to make use of the business experience of others. Moreover, an outlet with a nationally advertised name, such as Radio Shack, McDonald's, or Century 21 Real Estate, has guaranteed customers as soon as it opens.

If business problems arise, the franchisor gives the franchisee guidance and advice. This counseling is primarily responsible for the very high degree of success enjoyed by franchises. In most cases, the franchisee does not pay for such help.

The franchisee also receives materials to use in local advertising and can take part in national promotional campaigns sponsored by the franchisor. McDonald's and its franchisees, for example, constitute one of the nation's top 20 purchasers of advertising. Finally, the franchisee may be able to minimize the cost of advertising, supplies, and various business necessities by purchasing them in cooperation with other franchisees.

Disadvantages of Franchising

The main disadvantage of franchising affects the franchisee, and it arises because the franchisor retains a great deal of control. The franchisor's contract can dictate every aspect of the business: decor, design of employee uniforms, types of signs, and all the details of business operations. All Burger King French fries taste the same because all Burger King franchisees have to make them the same way.

Contract disputes are the cause of many lawsuits. For example, Rekha Gabhawala, a Dunkin' Donuts franchisee in Milwaukee, alleged that the franchisor was forcing her out of business so that the company could profit by reselling the downtown franchise to someone else; the company, on the other hand, alleged

© AP Images/PRNewFoto/Cold Stone Creamery

that Gabhawala breached the contract by not running the business according to company standards. In another case, Dunkin' Donuts sued Chris Romanias, its franchisee in Pennsylvania, alleging that Romanias intentionally underreported gross sales to the company. Romanias, on the other hand, alleged that Dunkin' Donuts, Inc., breached the contract because it failed to provide assistance in operating the franchise. Other franchisees claim that contracts are unfairly tilted toward the franchisors. Yet others have charged that they lost their franchise and investment because their franchisor would not approve the sale of the business when they found a buyer.

To arbitrate disputes between franchisors and franchisees, the National Franchise Mediation Program was established in 1993 by 30 member firms, including Burger King Corporation, McDonald's Corporation, and Wendy's International, Inc. Negotiators have since resolved numerous cases through mediation. Recently, Carl's Jr. brought in one of its largest franchisees to help set its system straight, making most franchisees happy for the first time in years. The program also helped PepsiCo settle a long-term contract dispute and renegotiate its franchise agreements.

Because disagreements between franchisors and franchisees have increased in recent years, many franchisees have been demanding government regulation of franchising. In 1997, to avoid government regulation, some of the largest franchisors proposed a new self-policing plan to the Federal Trade Commission.

Franchise holders pay for their security, usually with a one-time franchise fee and continuing royalty and advertising fees, collected as a percentage of sales. As Table 5.7 shows, a SUBWAY franchisee pays an initial franchise fee of \$15,000 and an annual fee of 8 percent of gross sales. In Table 5.7, you can see how much money a franchisee needs to start a new franchise for selected organizations. In some fields, franchise agreements are not uniform. One franchisee may pay more than another for the same services.

Even success can cause problems. Sometimes a franchise is so successful that the franchisor opens its own outlet nearby, in direct competition—although franchisees may fight back. For example, a court recently ruled that Burger King could not enter into direct competition with the franchisee because the contract was not specific on the issue. A spokesperson for one franchisor contends that the company “gives no geographical protection” to its franchise holders and thus is free to move in on them. Franchise operators work hard. They often put in 10- and 12-hour days, six days a week. The International Franchise Association advises prospective franchise purchasers to investigate before investing and to approach buying a franchise cautiously. Franchises vary widely in approach as well as in products. Some, such as Dunkin' Donuts and Baskin-Robbins, demand long hours. Others, such as Great Clips hair salons and Albert's Family Restaurants, are more appropriate for those who do not want to spend many hours at their stores.

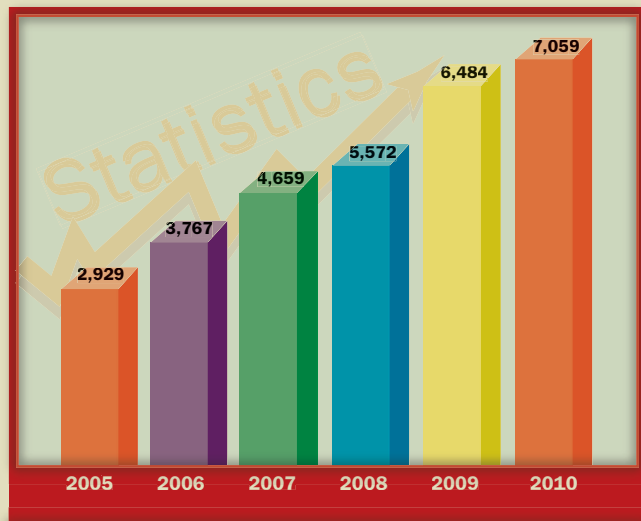
Global Perspectives in Small Business

For small American businesses, the world is becoming smaller. National and international economies are growing more and more interdependent as political leadership and national economic directions change and trade barriers diminish or disappear. Globalization and instant worldwide communications are rapidly shrinking distances at the same time that they are expanding business opportunities. According to a recent study, the Internet is increasingly important to small-business strategic thinking, with more than 50 percent of those surveyed indicating that the Internet represented their most favored strategy for growth. This was more than double the next-favored choice, strategic alliances reflecting the opportunity to reach both global and domestic customers. The Internet and online payment systems enable even very small businesses to serve international customers. In fact, technology now gives small businesses the leverage and power to



The growth of franchising. Franchising is designed to provide a tested formula for success, along with ongoing advice and training. The franchisor, such as TGIF or KFC, supplies a known and advertised business name, management skills, the required training and materials, and a method of doing business. Franchising, however, is not a guarantee of success for either franchisees or franchisors.

SUBWAY's Foreign Franchising Around the World



Source: <http://www.entrepreneur.com/franchises/subway/282839-0.html> (accessed August 26, 2010).

reach markets that were once limited solely to large corporations. No wonder the number of businesses exporting their goods and services has tripled since 1990, with two-thirds of that boom coming from companies with fewer than 20 employees.²²

The SBA offers help to the nation's small-business owners who want to enter the world markets. The SBA's efforts include counseling small firms on how and where to market overseas, matching U.S. small-business executives with potential overseas customers, and helping exporters to secure financing. The agency brings small U.S. firms into direct contact with potential overseas buyers and partners. The SBA International Trade Loan program provides guarantees of up to \$1.75 million in loans to small-business owners. These loans help small firms in expanding or developing new export markets. The U.S. Commercial Service, a Commerce Department division, aids small and medium-sized businesses in selling overseas. The division's global network includes more than 100 offices in the United States and 151 others in 80 countries around the world.²³

Consider Daniel J. Nanigian, President of Nanmac Corporation in Framingham, Massachusetts. This company manufactures temperature sensors used in a wide range of industrial applications. With an export strategy

aimed at growing revenues in diverse foreign markets including China, the Nanmac Corporation experienced explosive growth in 2009. The company nearly doubled its sales from \$2.7 million in 2008 to \$5.1 million in 2009. The company's international sales, at \$300,000 in 2004, reached \$700,000 in 2009 and were expected to reach \$1.7 million in 2010. Its administrative, sales, and manufacturing employees have increased by 80 percent.

The company has a strong presence in China and is expanding in other markets, as well, including Latin America, Singapore, and Russia. Under Nanigian's guidance, the company has developed creative solutions and partnerships to help maximize its presence internationally. As part of its China strategy, Nanmac partners with distributors, recruits European and in-country sales representatives, uses a localized Chinese Web site, and relies for advice on the export assistance programs of the Massachusetts Small Business Development Center Network's Massachusetts Export Center. The strategy, along with travel to China to conduct technical training seminars and attend trade shows and technical conferences, has helped to grow Nanmac's Chinese client list from 1 in 2003 to more than 30 accounts today. Mr. Nanigian received SBA's 2010 Small Business Exporter of the Year Award.²⁴

International trade will become more important to small-business owners as they face unique challenges in the new century. Small businesses, which are expected to remain the dominant form of organization in this country, must be prepared to adapt to significant demographic and economic changes in the world marketplace.

This chapter ends our discussion of American business today. From here on, we shall be looking closely at various aspects of business operations. We begin, in the next chapter, with a discussion of management—what management is, what managers do, and how they work to coordinate the basic economic resources within a business organization.

Five Guys Burgers and Fries

Five Guys Burgers and Fries will only consider prospective franchisees who have strong personal finances and sufficient capital to open and operate at least five restaurants in their territory. Franchisees must also have a solid business background and previous management experience. Above all, franchisees must be completely committed to the company's standards of food quality and customer service. To ensure that every unit from Swampscott to Seattle cooks up the same juicy burgers and friendly service, the company awards cash bonuses to the staff of restaurants that earn high scores in twice-weekly checks by mystery shoppers.

For long-term growth, Five Guys is planning to build on its current franchising success by expanding in the European market. Will the company's restaurants be as popular overseas as they have been with U.S. burger lovers and franchisees?

Questions

1. If you were working on a business plan for opening a Five Guys franchise in your area, what critical risks would you list? How would you plan to deal with those risks?
2. Do you agree with Five Guys' policy of spending millions to reward good customer service rather than promoting itself through traditional advertising campaigns?

SUMMARY

Summary

1 Define what a small business is and recognize the fields in which small businesses are concentrated.

A small business is one that is independently owned and operated for profit and is not dominant in its field. There are about 23 million businesses in this country, and more than 90 percent of them are small businesses. Small businesses employ more than half the nation's workforce, even though about 70 percent of new businesses can be expected to fail within five years. More than half of all small businesses are in retailing and services.

2 Identify the people who start small businesses and the reasons why some succeed and many fail.

Such personal characteristics as independence, desire to create a new enterprise, and willingness to accept a challenge may encourage individuals to start small businesses. Various external circumstances, such as special expertise or even the loss of a job, also can supply the motivation to strike out on one's own. Poor planning and lack of capital and management experience are the major causes of small-business failures.

3 Assess the contributions of small businesses to our economy.

Small businesses have been responsible for a wide variety of inventions and innovations, some of which have given rise to new industries. Historically, small businesses have created the bulk of the nation's new jobs.

Further, they have mounted effective competition to larger firms. They provide things that society needs, act as suppliers to larger firms, and serve as customers of other businesses, both large and small.

4 Judge the advantages and disadvantages of operating a small business.

The advantages of smallness in business include the opportunity to establish personal relationships with customers and employees, the ability to adapt to changes quickly, independence, and simplified record keeping. The major disadvantages are the high risk of failure, the limited potential for growth, and the limited ability to raise capital.

5 Explain how the Small Business Administration helps small businesses.

The Small Business Administration (SBA) was created in 1953 to assist and counsel the nation's millions of small-business owners. The SBA offers management courses and workshops; managerial help, including one-to-one counseling through SCORE; various publications; and financial assistance through guaranteed loans and SBICs. It places special emphasis on aid to minority-owned businesses, including those owned by women.

6 Appraise the concept and types of franchising.

A franchise is a license to operate an individually owned business as though it were part of a chain. The franchisor provides a known business name, management skills, a

method of doing business, and the training and required materials. The franchisee contributes labor and capital, operates the franchised business, and agrees to abide by the provisions of the franchise agreement. There are three major categories of franchise agreements.

7 Analyze the growth of franchising and franchising's advantages and disadvantages.

Franchising has grown tremendously since the mid-1970s. The franchisor's major advantage in franchising is fast and well-controlled distribution of products with minimal capital outlay. In return, the franchisee has the

opportunity to open a business with limited capital, to make use of the business experience of others, and to sell to an existing clientele. For this, the franchisee usually must pay both an initial franchise fee and a continuing royalty based on sales. He or she also must follow the dictates of the franchise with regard to operation of the business.

Worldwide business opportunities are expanding for small businesses. The SBA assists small-business owners in penetrating foreign markets. The next century will present unique challenges and opportunities for small-business owners.

Key Terms

You should now be able to define and give an example relevant to each of the following terms:

small business (137)	Service Corps of	small-business development	franchise (153)
business plan (146)	Retired Executives	centers (SBDCs) (151)	franchising (153)
Small Business	(SCORE) (149)	venture capital (152)	franchisor (153)
Administration	small-business institutes	small-business investment	franchisee (153)
(SBA) (148)	(SBIs) (151)	companies (SBICs) (152)	

Review Questions

1. What information would you need to determine whether a particular business is small according to SBA guidelines?
2. Which two areas of business generally attract the most small businesses? Why are these areas attractive to small business?
3. Distinguish among service industries, distribution industries, and production industries.
4. What kinds of factors encourage certain people to start new businesses?
5. What are the major causes of small-business failure? Do these causes also apply to larger businesses?
6. Briefly describe four contributions of small business to the American economy.
7. What are the major advantages and disadvantages of smallness in business?
8. What are the major components of a business plan? Why should an individual develop a business plan?
9. Identify five ways in which the SBA provides management assistance to small businesses.
10. Identify two ways in which the SBA provides financial assistance to small businesses.
11. Why does the SBA concentrate on providing management and financial assistance to small businesses?
12. What is venture capital? How does the SBA help small businesses to obtain it?
13. Explain the relationships among a franchise, the franchisor, and the franchisee.
14. What does the franchisor receive in a franchising agreement? What does the franchisee receive? What does each provide?
15. Cite one major benefit of franchising for the franchisor. Cite one major benefit of franchising for the franchisee.

Discussion Questions

1. Most people who start small businesses are aware of the high failure rate and the reasons for it. Why, then, do some take no steps to protect their firms from failure? What steps should they take?
2. Are the so-called advantages of small business really advantages? Wouldn't every small-business owner like his or her business to grow into a large firm?
3. Do average citizens benefit from the activities of the SBA, or is the SBA just another way to spend our tax money?
4. Would you rather own your own business independently or become a franchisee? Why?

Video Case 5.1

Murray's Cheese: More Cheese Please

Murray's Cheese began in New York's Greenwich Village in 1940, as a wholesale butter and egg shop owned by a Jewish veteran of the Spanish Civil War named Murray Greenberg. When the current president Rob Kaufelt purchased the shop in 1991, it was little more than a local hole-in-the-wall. Kaufelt and his staff made the decision to focus on high-quality gourmet cheeses from around the world. Today, people come from all over to sample Murray's cheeses and to take classes or attend its Cheese U bootcamp to learn about cheese. Although Murray's has extended its product line to include gourmet meats, crackers, olives, and dried fruit, cheese remains its core product. In fact, Murray's Cheese has been voted by *Forbes* as "the best cheese shop" and it is expanding to three other stores. Its success prompted Kroger to seek it out as a partner in its chain of supermarkets, a step that included intensively training Kroger employees in the fine points of selling Murray's products and the creation of a 300-page cheese service guide for them.

"We are little and they are very big," says Murray's managing director, Liz Thorpe, in speaking of Kroger. "So it's a very interesting model for us. We've begun operating cheese shops in Kroger delis that are similar to our New York shops. This allows us to bring our knowledge and expertise on sourcing, production selection, education, and customer service to a different format.... We're actually going to be opening 50 of these shops in the next 36 months."

Murray's is still small, with about 70 employees, and has an advertising budget of zero dollars. Instead of advertising, Murray's relies on providing great customer service and creating positive word of mouth to promote its products and to secure its reputation. Personal selling is key. The company recruits salespeople who are passionate about both cheese and people and trains them carefully. The key is to inform customers about the store's many unique products and persuade them to taste and then purchase. The staff enjoys

listening to customers, gaining an understanding of their interests, and trying to find the right product to satisfy their needs. Their efforts often succeed in getting customers to purchase more and to make repeat buys.

All customers get to taste free samples of cheese before they buy it. "We like knowing the folks who walk in our door and having everyone taste the cheese," said the managing director. "It's part of the shopping experience. That said, we are getting more sophisticated about how we communicate with people. E-mail marketing continues to be really critical, and we're starting to take advantage of social networking outlets like Twitter. For people who are into cheese and into Murray's, it's a great way for them to be directly tapped into knowing what's going on right this second."

What continues to appeal to sophisticated shoppers about Murray's is that cheese is an affordable luxury. A wine and cheese party for a dozen people, for instance, can fit almost any budget, and Murray's salespeople are happy to provide suggestions and samples to assist in the selection. Murray's manager also credits popular media like the Food Network with helping to popularize food in general, and cheese in particular. After all, he says, cheeses "don't have to be improved upon or fortified. They are naturally good for you."²⁵

Questions

1. How does Murray's overcome one of the most common limitations facing small companies, its nonexistent advertising budget?
2. What are some of the advantages of being a small business that Murray's can (or does) take advantage of? What disadvantages might it face as a small firm?
3. Do you think the partnership with Kroger will have a negative or a positive effect on the unique experience customers expect from Murray's? Why?

Case 5.2

Tumbleweed Tiny House Company

The average American home is between 2,000 and 2,500 square feet in size. Jay Shafer's handcrafted 89-square-foot house on wheels is so small he can almost parallel-park it. Ecological concerns have combined with an uncertain real estate market to give a big boost to the small-house movement, which promotes simple living in tiny spaces. A growing number of people are happily living in houses ranging from just 70 to 800 square feet, small enough to fit on a flatbed truck and pull into a field or farmstead.

One of the pioneer builders of such tiny homes is the Tumbleweed Tiny House Company, the brainchild of Shafer,

a 40-something professor-turned-designer who has lived in three of his own creations over the last several years. His young do-it-yourself company, until recently a one-person operation, builds and provides plans for several different models and sizes of tiny houses. The homes are fully equipped but scaled-down, with kitchens and baths, windowed sleeping lofts under peaked roofs, front porches, and lots of ingenious storage space. The houses are designed to hook up to public water and waste lines; many buyers use them as primary homes, but they can also serve as studios, guest rooms, weekend getaways, or home offices.

Shafer was inspired to found the company about 15 years ago, when he was teaching drawing at the University of Iowa. "I was living in an average-sized apartment and I realized I just didn't need so much space," he says. After a false start living in an uninsulated Airstream trailer, he decided to build his own 100-square-foot house from scratch. He parked it on a friend's farm because minimum-size housing standards prevented him from putting it on a city lot. Not long after, Gregory Paul Johnson, a friend who later founded the Small House Society, asked Shafer to build him a similar home, and Tumbleweed Tiny House Company was born.

Shafer and his company have been featured in *This Old House* magazine, *The New York Times*, *USA Today*, *Time*, *The Los Angeles Times*, *The Wall Street Journal*, numerous public radio programs, and *The Oprah Winfrey Show*. He has sold more than a dozen homes and 50 sets of plans for the different models on view at his Web site; plans cost about \$1,000 a set and the houses cost from \$20,000 to \$90,000 to build (the services of a professional contractor are recommended). Shafer also conducts workshops on tiny-house living, sometimes travels around the country with his house, and maintains a blog and active discussion board on his Web site.

He has big plans for Tumbleweed, but rapid expansion doesn't fit his very personal business philosophy. "We

are still in our infancy and still building our foundation for growth," he explains on his Web site. "We have a business plan that we are adhering to. Everything in due time." Among his future dreams are finding partners to represent Tumbleweed homes (real estate license required), partners to build them (licensed contractors only need apply), and makers of products like solar panels and lumber for incorporation into his homes (but nothing that would require redesigning any Tumbleweed products). In the long term, Shafer would even like to see a whole village of Tumbleweed homes, "even if it's just three houses." For now, though, like its products, Tumbleweed remains a small and very carefully built affair.²⁶

For more information about this company, go to <http://www.tumbleweedhouses.com>.

Questions

1. Do you think Shafer's plan to grow his small business slowly is a good one? Why or why not?
2. What economic and social factors seem to have aided Tumbleweed's success so far? Which potential business challenges should Shafer consider as he plans for the future?
3. Do you think a company like Tumbleweed could go global? Why or why not?

Building Skills for Career Success



1 JOURNALING FOR SUCCESS

Discovery statement: One of the objectives in this chapter was to make you aware of the advantages and disadvantages of owning a franchise.

Assignment

1. Assume that after evaluating your skills, experience, and financial situation, you have decided to purchase a franchise in your community. Identify and describe sources where you can obtain information on what the franchise package should contain.
2. List at least five reasons why you should choose franchising rather than starting a new, independent business.
3. Identify issues you need to be aware of as a franchisee.
4. Make a list of possible advantages and disadvantages of the franchise you are considering. What are your rights and your obligations as a franchisee?

2 EXPLORING THE INTERNET

Perhaps the most challenging difficulty for small businesses is operating with scarce resources, especially people and money. To provide information and point small-business operators in the right direction, many Internet sites offer

helpful products and services. Although most are sponsored by advertising and may be free of charge, some charge a fee, and others are a combination of both. The SBA within the U.S. Department of Commerce provides a wide array of free information and resources. You can find your way to the SBA through <http://www.sbaonline.sba.gov> or <http://www.sba.gov>. Visit the text Web site for updates to this exercise.

Assignment

1. Describe the various services provided by the SBA site.
2. What sources of funding are there?
3. What service would you like to see improved? How?

3 DEVELOPING CRITICAL-THINKING SKILLS

Small businesses play a vital role in our economy. They not only contribute to technological innovation and to the creation of many new jobs but also ensure that customers have an alternative to the products and services offered by large firms. In addition, by making parts for large firms at a lower cost than the large firms could make the parts themselves, they help to keep the lid on consumer prices. Regardless of our need for them, many small businesses fail within their first five years. Why is this so?

Assignment

1. Identify several successful small businesses in your community.
2. Identify one small business that has failed.
3. Gather enough information about those businesses to answer the following questions:
 - a. What role do small businesses play in your community?
 - b. Why are they important?
 - c. Why did the business fail?
 - d. What was the most important reason for its failure?
 - e. How might the business have survived?
4. Summarize what you have learned about the impact of small businesses on your community. Give the summary to your instructor.

4 BUILDING TEAM SKILLS

A business plan is a written statement that documents the nature of a business and how that business intends to achieve its goals. Although entrepreneurs should prepare a business plan *before* starting a business, the plan also serves as an effective guide later on. The plan should concisely describe the business's mission, the amount of capital it requires, its target market, competition, resources, production plan, marketing plan, organizational plan, assessment of risk, and financial plan.

Assignment

1. Working in a team of four students, identify a company in your community that would benefit from using a business plan, or create a scenario in which a hypothetical entrepreneur wants to start a business.
2. Using the resources of the library or the Internet and/or interviews with business owners, write a business plan incorporating the information in Table 5.4.
3. Present your business plan to the class.

5 RESEARCHING DIFFERENT CAREERS

Many people dream of opening and operating their own businesses. Are you one of them? To be successful, entrepreneurs must have certain characteristics; their profiles generally differ from those of people who work for someone else. Do you know which personal characteristics make some entrepreneurs succeed and others fail? Do you fit the successful entrepreneur's profile? What is your potential for opening and operating a successful small business?

Assignment

1. Use the resources of the library or the Internet to establish what a successful entrepreneur's profile is and to determine whether your personal characteristics fit that profile. Internet addresses that can help you are <http://www.smartbiz.com/sbs/arts/ieb1.html> and <http://www.sba.gov> (see "Start your Business" and "FAQ"). These sites have quizzes online that can help you to assess your personal characteristics. The SBA also has helpful brochures.
2. Interview several small-business owners. Ask them to describe the characteristics they think are necessary for being a successful entrepreneur.
3. Using your findings, write a report that includes the following:
 - a. A profile of a successful small-business owner
 - b. A comparison of your personal characteristics with the profile of the successful entrepreneur
 - c. A discussion of your potential as a successful small-business owner

Running a Business PART 2

Graeter's

Graeter's: A Fourth-Generation Family Business

Graeter's, headquartered in Cincinnati, is a small, privately owned fourth-generation family business that has been making premium ice cream for about 140 years. Though the company has grown and expanded, particularly in the last ten years (it is now worth \$20 million), its small-batch manufacturing remains similar to an original handmade process, and each machine still churns out only about two gallons every 20 minutes. Compared to the competition, which mass produces its ice cream, Graeter's takes time with every batch and packs it by hand. Two brothers and a cousin, all great-grandsons of the founders, share responsibility for the firm's day-to-day operations and its future direction.

"Even though I have the title of CEO, in a family business titles don't mean a whole lot," says CEO Richard Graeter II. "The functions that I am doing now as CEO, I was doing as executive vice president for years . . . It really was and remains a partnership with my two cousins . . . Our fathers brought us into the business at an early age . . . One summer I was on the maintenance crew, another summer I worked at the store, another summer I worked up in the bakery, and my cousins all did the same thing. We were just around this business all of our lives. I think most important is we saw our fathers and their dedication and the fact that, you know, they came home later, they came home tired, they got up early and went to work before we ever

got up to go to school in the morning, and you see that dedication and appreciate that—that is what keeps your business going.”

GROWING THE BUSINESS

From one small store in 1870, Graeter’s has expanded to a few dozen small stores in Ohio, Kentucky, Indiana, Texas, and Colorado; an online retail operation that ships ice cream overnight to 48 states; and multi-state distribution to about 1,700 supermarkets through big supermarket chains like Kroger’s. The kitchen in the back of the original store has grown to three factories; the newest is an \$11 million Cincinnati plant being built to support the expanded distribution the company is planning. Because the new factory will create 50 new jobs, the city helped pay for the land and lent money for the construction.

What Graeter’s no longer has, however, is a franchise operation. It had licensed a handful of franchise operators over the past 20 years, which were quite successful, and at one time the owners thought of franchising as a good expansion strategy. One franchise operation had even opened its own factory. Recently, however, the company repurchased all the stores of its last remaining franchisee. “When you think about Graeter’s,” says the CEO, “the core of Graeter’s is the quality of the product. You can’t franchise your core. So by franchising

our manufacturing, that created substantial risk for the organization, because the customer doesn’t know that it is a franchise . . . They know it is Graeter’s . . . You really have to rely on the intention and goodwill of the individual franchisees to make the product the way you would make it, and that is not an easy thing to guarantee.”²⁷

Questions

1. Graeter’s current management team—Richard, Robert, and Chip Graeter—took the business over from their parents, who did not have a formal succession plan in place to indicate who would do what. Do you think the current team should have such a plan specifying who is to step into the business, when, and with what responsibilities? Why or why not?
2. Graeter’s has recently hired management consultants to help improve its hiring and training processes and especially to assist in the continued expansion of its distribution chain. “I think my cousins and I all have come to realize we can’t do it alone,” says the CEO. Why do you think the management team made this decision? Does bringing these outsiders into the firm make Graeter’s less of a family company than it has been?
3. Do you think Graeter’s made the right decision to close its franchise operation? Why or why not?

Building a Business Plan PART 2



To access the online *Interactive Business Plan*, go to www.cengagebrain.com.

After reading Part 2, “Business Ownership and Entrepreneurship,” you should be ready to tackle the company and industry component of your business plan. In this section, you will provide information about the background of the company, choice of the legal business form, information on the product or services to be offered, and descriptions of potential customers, current competitors, and the business’s future. Chapter 4 in your textbook, “Choosing a Form of Business Ownership,” and Chapter 5, “Small Business, Entrepreneurship, and Franchises,” can help you to answer some of the questions in this part of the business plan.

THE COMPANY AND INDUSTRY COMPONENT

The company and industry analysis should include the answers to at least the following questions:

- 2.1. What is the legal form of your business? Is your business a sole proprietorship, a partnership, or a corporation?
- 2.2. What licenses or permits will you need, if any?
- 2.3. Is your business a new independent business, a takeover, an expansion, or a franchise?
- 2.4. If you are dealing with an existing business, how did your company get to the point where it is today?
- 2.5. What does your business do, and how does it satisfy customers’ needs?

- 2.6. How did you choose and develop the products or services to be sold, and how are they different from those currently on the market?
- 2.7. What industry do you operate in, and what are the industry-wide trends?
- 2.8. Who are the major competitors in your industry?
- 2.9. Have any businesses recently entered or exited? Why did they leave?
- 2.10. Why will your business be profitable, and what are your growth opportunities?
- 2.11. Does any part of your business involve e-business?

REVIEW OF BUSINESS PLAN ACTIVITIES

Make sure to check the information you have collected, make any changes, and correct any weaknesses before beginning Part 3. *Reminder:* Review the answers to questions in the preceding part to make sure that all your answers are consistent throughout the business plan. Finally, write a summary statement that incorporates all the information for this part of the business plan.

The information contained in “Building a Business Plan” will also assist you in completing the online *Interactive Business Plan*.