Entrepreneurial Startup 2024

BA 220

Contents

Chapter 1: The Business Plan

Learning Objectives

1) Describe the different purposes of a business plan
2) Describe and develop the components of a brief business plan
3) Describe and develop the components of a full business plan

Unlike the brief or lean formats introduced so far, the business plan is a formal document used for the long- range planning of a company's operation. It typically includes background information, financial information, and a summary of the business. Investors nearly always request a formal business plan because it is an integral part of their evaluation of whether to invest in a company. Although nothing in business is permanent, a business plan typically has components that are more "set in stone" than a business model canvas, which is more commonly used as a first step in the planning process and throughout the early stages of a nascent business. A business plan is likely to describe the business and industry, market strategies, sales potential, and competitive analysis, as well as the company's long-term goals and objectives. An in-depth formal business plan would follow at later stages after various iterations to business model canvases. The business plan usually projects financial data over a three-year period and is typically required by banks or other investors to secure funding. The business plan is a roadmap for the company to follow over multiple years.

Some entrepreneurs prefer to use the canvas process instead of the business plan, whereas others use a shorter version of the business plan, submitting it to investors after several iterations. There are also entrepreneurs who use the business plan earlier in the entrepreneurial process, either preceding or concurrently with a canvas. For instance, Chris Guillebeau has a one-page business plan template in his book The $100 Startup.[1] His version is basically an extension of a napkin sketch, without the detail of a full business plan. As you progress, you can also consider a brief business plan (about two pages)—if you want to support a rapid business launch—and/or a standard business plan.

As with many aspects of entrepreneurship, there are no clear hard and fast rules to achieving entrepreneurial success. You may encounter different people who want different things (canvas, summary, full business plan), and you also have flexibility in following whatever tool works best for you. Like the canvas, the various versions of the business plan are tools that will aid you in your entrepreneurial endeavor.

Business Plan Overview

Most business plans have several distinct sections. The business plan can range from a few pages to twenty-five pages or more, depending on the purpose and the intended audience. For our discussion, we'll describe a brief business plan and a standard business plan. If you are able to successfully design a business model canvas, then you will have the structure for developing a clear business plan that you can submit for financial consideration

BUSINESS PLAN	
√	Executive Summary
√	Business Description
√	Market Strategies
√	Marketing Plan
√	Competitive Analysis
√	Operations and Management Plan
√	Financial Analysis
√	Design and Development Plan

Figure 1. Most business plans include the same important sections. (Attribution: Copyright Rice University, OpenStax, under CC BY 4.0 license)

Both types of business plans aim at providing a picture and roadmap to follow from conception to creation. If you opt for the brief business plan, you will focus primarily on articulating a big-picture overview of your business concept

The full business plan is aimed at executing the vision concept, dealing with the proverbial devil in the details. Developing a full business plan will assist those of you who need a more detailed and structured roadmap, or those of you with little to no background in business. The business planning process includes the business model, a feasibility analysis, and a full business plan, which we will discuss later in this section. Next, we explore how a business plan can meet several different needs.

Purposes of a Business Plan

A business plan can serve many different purposes—some internal, others external. As we discussed previously, you can use a business plan as an internal early planning device, an extension of a napkin sketch, and as a follow-up to one of the canvas tools. A business plan can be an organizational roadmap, that is, an internal planning tool and working plan that you can apply to your business in order to reach your desired goals over the course of several years. The business plan should be written by the owners of the venture, since it forces a firsthand examination of the business operations and allows them to focus on areas that need improvement.

Refer to the business venture throughout the document. Generally speaking, a business plan should not be written in the first person.

A major external purpose for the business plan is as an investment tool that outlines financial projections, becoming a document designed to attract investors. In many instances, a business plan can complement a formal investor's pitch. In this context, the business plan is a presentation plan, intended for an outside audience that may or may not be familiar with your industry, your business, and your competitors.

You can also use your business plan as a contingency plan by outlining some "what-if" scenarios and exploring how you might respond if these scenarios unfold. Pretty Young Professional launched in November 2010 as an online resource to guide an emerging generation of female leaders. The site focused on recent female college graduates and current students searching for professional roles and those in their first professional roles. It was founded by four friends who were coworkers at the global consultancy firm McKinsey. But after positions and equity were decided among them, fundamental differences of opinion about the direction of the business emerged between two factions, according to the cofounder and former CEO Kathryn Minshew. "I think, naively, we assumed that if we kicked the can down the road on some of those things, we'd be able to sort them out," Minshew said. Minshew went on to found a different professional site, The Muse, and took much of the editorial team of Pretty Young Professional with her.[2] Whereas greater planning potentially could have prevented the early demise of Pretty Young Professional, a change in planning led to overnight success for Joshua Esnard and

The Cut Buddy team. Esnard invented and patented the plastic hair template that he was selling online out of his Fort Lauderdale garage while working a full-time job at Broward College and running a side business. Esnard had hundreds of boxes of Cut Buddies sitting in his home when he changed his marketing plan to enlist companies specializing in making videos go viral. It worked so well that a promotional video for the product garnered 8 million views in hours. The Cut Buddy sold over 4,000 products in a few hours when Esnard only had hundreds remaining. Demand greatly exceeded his supply, so Esnard had to scramble to increase manufacturing and offered customers two-for-one deals to make up for delays. This led to selling 55,000 units, generating $700,000 in sales in 2017.[3] After appearing on Shark Tank and landing a deal with Daymond John that gave the “shark” a 20-percent equity stake in return for $300,000, The Cut Buddy has added new distribution channels to include retail sales along with online commerce. Changing one aspect of a business plan—the marketing plan—yielded success for The Cut Buddy.

If you opt for the brief business plan, you will focus primarily on articulating a big-picture overview of your business concept. This version is used to interest potential investors, employees, and other stakeholders, and will include a financial summary “box,” but it must have a disclaimer, and the founder/entrepreneur may need to have the people who receive it sign a nondisclosure agreement (NDA). The full business plan is aimed at executing the vision concept, providing supporting details, and would be required by financial institutions and others as they formally become stakeholders in the venture. Both are aimed at providing a picture and roadmap to go from conception to creation.

Types of Business Plans

The brief business plan is similar to an extended executive summary from the full business plan. This concise document provides a broad overview of your entrepreneurial concept, your team members, how and why you will execute on your plans, and why you are the ones to do so. You can think of a brief business plan as a scene setter or—since we began this chapter with a film reference—as a trailer to the full movie. The brief business plan is the commercial equivalent to a trailer for Field of Dreams, whereas the full plan is the full-length movie equivalent.

Brief Business Plan

As the name implies, the executive summary summarizes key elements of the entire business plan, such as the business concept, financial features, and current business position. The executive summary version of the business plan is your opportunity to broadly articulate the overall concept and vision of the company for yourself, for prospective investors, and for current and future employees.

A typical executive summary is generally no longer than a page, but because the brief business plan is essentially an extended executive summary, the executive summary section is vital. This is the “ask” to an investor. You should begin by clearly stating what you are asking for in the summary.

In the business concept phase, you’ll describe the business, its product, and its markets. Describe the customer segment it serves and why your company will hold a competitive advantage. This section may align roughly with the customer segments and value-proposition segments of a canvas.

Next, highlight the important financial features, including sales, profits, cash flows, and return on investment. Like the financial portion of a feasibility analysis, the financial analysis component of a business plan may typically include items like a twelve-month profit and loss projection, a three- or four-year profit and loss projection, a cash-flow projection, a projected balance sheet, and a breakeven calculation. You can explore a feasibility study and financial projections in more depth in the formal business plan. Here, you want to focus on the big picture of your numbers and what they mean.

The current business position section can furnish relevant information about you and your team members and the company at large. This is your opportunity to tell the story of how you formed the company, to describe its legal status (form of operation), and to list the principal players. In one part of the extended executive summary, you can cover your reasons for starting the business: Here is an opportunity to clearly define the needs you think you can meet and perhaps get into the pains and gains of customers. You also can provide a summary of the overall strategic direction in which you intend to take the company. Describe the company’s mission, vision, goals and objectives, overall business model, and value proposition.

Rice University’s Student Business Plan Competition, one of the largest and overall best-regarded graduate school business-plan competitions, requires an executive summary of up to five pages to apply. Its suggested sections are shown below.

Section	Description
Company summary	Brief overview (one to two paragraphs) of the problem, solution, and potential customers
Customer analysis	Description of potential customers and evidence they would purchase product
Market analysis	Size of market, target market, and share of market
Product or service	Current state of product in development and evidence it is feasible
Intellectual property	If applicable, information on patents, licenses, or other IP items
Competitive differentiation	Describe the competition and your competitive advantage
Company founders, management team, and/or advisor	Bios of key people showcasing their expertise and relevant experience
Financials	Projections of revenue, profit, and cash flow for three to five years
Amount of investment	Funding request and how funds will be used

Table 1. Suggested Executive Summary Components for Rice University Business Plan Competition.[4]

Full Business Plan

Even full business plans can vary in length, scale, and scope. Rice University sets a ten-page cap on business plans submitted for the full competition. The IndUS Entrepreneurs, one of the largest global networks of entrepreneurs, also holds business plan competitions for students through its Tie Young Entrepreneurs program. In contrast, business plans submitted for that competition can usually be up to twenty-five pages. These are just two examples. Some components may differ slightly; common elements are typically found in a formal business plan outline. The next section will provide sample components of a full business plan for a fictional business.

Executive Summary

The executive summary should provide an overview of your business with key points and issues. Because the summary is intended to summarize the entire document, it is most helpful to write this section last, even though it comes first in sequence. The writing in this section should be especially concise. Readers should be able to understand your needs and capabilities at first glance. The section should tell the reader what you want and your "ask" should be explicitly stated in the summary.

Describe your business, its product or service, and the intended customers. Explain what will be sold, who it will be sold to, and what competitive advantages the business has.

Executive Summary for La Vida Lola (fictional business)

1) **The Concept**: La Vida Lola is a food truck serving the best Latin American and Caribbean cuisine in the Atlanta region, particularly Puerto Rican and Cuban dishes, with a festive flair. La Vida Lola offers freshly prepared dishes from the mobile kitchen of the founding chef and namesake Lola González, a Duluth, Georgia, native who has returned home to launch her first venture after working under some of the world's top chefs. La Vida Lola will cater to festivals, parks, offices, community and sporting events, and breweries throughout the region.
2) **Market Advantage**: Latin food packed with flavor and flair is the main attraction of La Vida Lola. Flavors steeped in Latin American and Caribbean culture can be enjoyed from a menu featuring street foods, sandwiches, and authentic dishes from the González family's Puerto Rican and Cuban roots. Millennial foodies craving ethnic food experiences and Latin food lovers are the primary customers, but anyone with a taste for delicious homemade meals in Atlanta can order. Having a native Atlanta-area resident returning to her hometown after working in restaurants around the world to share food with area communities offers a competitive advantage for La Vida Lola in the form of founding chef Lola González.
3) **Marketing**: The venture will adopt a concentrated marketing strategy. The company's promotion mix will comprise a mix of advertising, sales promotion, public relations, and personal selling. Much of the promotion mix will center around dual-language social media.
4) **Venture Team**: The two founding members of the management team have almost four decades of combined experience in the restaurant and hospitality

industries. Their background includes experience in food and beverage, hospitality and tourism, accounting, finance, and business creation.

5) **Capital Requirements**: La Vida Lola is seeking startup capital of $50,000 to establish its food truck in the Atlanta area. An additional $20,000 will be raised through a donations-driven crowdfunding campaign. The venture can be up and running within six months to a year.

Business Description

This section describes the industry, your product, and the business and success factors. It should provide a current outlook as well as future trends and developments. You also should address your company's mission, vision, goals, and objectives. Summarize your overall strategic direction, your reasons for starting the business, a description of your products and services, your business model, and your company's value proposition. Consider including the Standard Industrial Classification/North American Industry Classification System (SIC/NAICS) code to specify the industry and insure correct identification. The industry extends beyond where the business is located and operates, and should include national and global dynamics

Industry Analysis and Market Strategies

Here you should define your market in terms of size, structure, growth prospects, trends, and sales potential. You'll want to include your TAM and forecast the SAM. (Both these terms are discussed in Conducting a Feasibility Analysis.) This is a place to address market segmentation strategies by geography, customer attributes, or product orientation. Describe your positioning relative to your competitors' in terms of pricing, distribution, promotion plan, and sales potential.

Competitive Analysis

The competitive analysis is a statement of the business strategy as it relates to the competition. You want to be able to identify who are your major competitors and assess what are their market shares, markets served, strategies employed, and expected response to entry? You likely want to conduct a classic SWOT analysis (Strengths Weaknesses Opportunities Threats) and complete a competitive-strength grid or competitive matrix. Outline your company's competitive strengths relative to those of the competition in regard to product, distribution, pricing, promotion, and advertising. What are your company's competitive advantages and their likely impacts on its success? The key is to construct it properly for the relevant features/benefits (by weight, according to customers) and how the startup compares to incumbents. The competitive matrix should show clearly how and why the startup has a clear (if not currently measurable) competitive advantage. Some common features in the example include price, benefits, quality, type of features, locations, and distribution/sales. Sample templates are shown in Figure 11.17 and Figure 11.18. A competitive analysis helps you create a marketing strategy that will identify assets or skills that your competitors are lacking so you can plan to fill those gaps, giving you a distinct competitive advantage. When creating a competitor analysis, it is important to focus on the key features and elements that matter to customers, rather than focusing too heavily on the entrepreneur's idea and desires

Operations and Management Plan

In this section, outline how you will manage your company and describe its organizational structure. Here you can address the form of ownership and, if warranted, include an organizational chart/structure. Highlight the backgrounds, experiences, qualifications, areas of expertise, and roles of members of the management team. This is also the place to mention any other stakeholders, such as a board of directors or advisory board(s), and their relevant relationship to the founder, experience and value to help make the venture successful, and professional service firms providing management support, such as accounting services and legal counsel.

Marketing Plan

Here you should outline and describe an effective overall marketing strategy for your venture, providing details regarding pricing, promotion, advertising, distribution, media usage, public relations, and a digital presence. Fully describe your sales management plan and the composition of your sales force, along with a comprehensive and detailed budget for the marketing plan.

Financial Plan

A financial plan seeks to forecast revenue and expenses; project a financial narrative; and estimate project costs, valuations, and cash flow projections. This section should present an accurate, realistic, and achievable financial plan for your venture and include sales forecasts and income projections, pro forma financial statements, a breakeven analysis, and a capital budget as you identify your possible sources of financing.

Chapter 1: Multiple Choice

1) According to chapter 1, the business plan is a(n) _____ for the company to follow over multiple years.
   a) Outline
   b) Roadmap
   c) Strategy
   d) Template
2) According to chapter 1, in this section of a full business plan, you should address your company's mission, vision, goals, and objectives.
   a) Business Description
   b) Competitive Analysis
   c) Executive Summary
   d) Operations and Management Plan
3) According to chapter 1, in this section of a full business plan, you can address the form of ownership.
   a) Business Description
   b) Competitive Analysis
   c) Industry Analysis and Market Strategies
   d) Operations and Management Plan[5]

Chapter 1: Short Answer

1. According to chapter 1, explain the purposes of a business plan for internal and external constituents.
2. According to chapter 1, describe the focus and aim differences between a brief versus full business plan.
3. According to chapter 1, describe the seven (7) sections for a Full Business Plan

Chapter 2: Creating a Feasibility Analysis

Learning Objectives

1) Describe the purpose of a feasibility analysis
2) Describe and develop the parts of a feasibility analysis
3) Understand how to apply feasibility outcomes to a new venture

As the name suggests, a feasibility analysis is designed to assess whether your entrepreneurial endeavor is, in fact, feasible or possible. By evaluating your management team, assessing the market for your concept, estimating financial viability, and identifying potential pitfalls, you can make an informed choice about the achievability of your entrepreneurial endeavor. A feasibility analysis is largely numbers driven and can be far more in depth than a business plan. It ultimately tests the viability of an idea, a project, or a new business. A feasibility study may become the basis for the business plan, which outlines the action steps necessary to take a proposal from ideation to realization. A feasibility study allows a business to address where and how it will operate, its competition, possible hurdles, and the funding needed to begin. The business plan then provides a framework that sets out a map for following through and executing on the entrepreneurial vision.

Organizational Feasibility Analysis

Organizational feasibility aims to assess the prowess of management and sufficiency of resources to bring a product or idea to market (Figure 3). The company should evaluate the ability of its management team on areas of interest and execution. Typical measures of management prowess include assessing the founders' passion for the business idea along with industry expertise, educational background, and professional experience. Founders should be honest in their self-assessment of ranking these areas

Figure 2. An analysis of organizational feasibility focuses on resource needs and management capabilities. (attribution: Copyright Rice University, OpenStax, under CC BY 4.0 license)

Resource sufficiency pertains to nonfinancial resources that the venture will need to move forward successfully and aims to assess whether an entrepreneur has a sufficient amount of such resources. The organization should critically rank its abilities in six to twelve types of such critical nonfinancial resources, such as availability of office space, quality of the labor pool, possibility of obtaining intellectual property protections (if applicable), willingness of high-quality employees to join the company, and likelihood of forming favorable strategic partnerships. If the analysis reveals that critical resources are lacking, the venture may not be possible as currently planned.[6]

Financial Feasibility Analysis

A financial analysis seeks to project revenue and expenses (forecasts come later in the full business plan); project a financial narrative; and estimate project costs, valuations, and cash flow projections.

The financial analysis may typically include these items:

- A twelve-month profit and loss projection
- A three- or four-year profit-and-loss projection
- A cash-flow projection
- A projected balance sheet
- A breakeven calculation

The financial analysis should estimate the sales or revenue that you expect the business to generate. A number of different formulas and methods are available for calculating sales estimates. You can use industry or association data to estimate the sales of your potential new business. You can search for similar businesses in similar locations to gauge how your business might perform compared with similar performances by competitors. One commonly used equation for a sales model multiplies the number of target customers by the average revenue per customer to establish a sales projection:

$$T \times A = S$$

Target(ed) Customers / Users × Average Revenue per Customer = Sales Projection

Another critical part of planning for new business owners is to understand the breakeven point, which is the level of operations that results in exactly enough revenue to cover costs. It yields neither a profit nor a loss. To calculate the breakeven point, you must first understand the two types of costs: fixed and variable. Fixed costs are expenses that do not vary based on the amount of sales. Rent is one example, but most of a business's other costs operate in this manner as well. While some costs vary from month to month, costs are described as variable only if they will increase if the company sells even one more item. Costs such as insurance, wages, and office supplies are typically considered fixed costs. Variable costs fluctuate with the level of sales revenue and include items such as raw materials, purchases to be sold, and direct labor. With this information, you can calculate your breakeven point—the sales level at which your business has neither a profit nor a loss.[7] Projections should be more than just numbers: include an explanation of the underlying assumptions used to estimate the venture's income and expenses.

Projected cash flow outlines preliminary expenses, operating expenses, and reserves—in essence, how much you need before starting your company. You want to determine when you expect to receive cash and when you have to write a check for expenses. Your cash flow is designed to show if your working capital is adequate. A balance sheet shows assets and liabilities, necessary for reporting and financial management. When liabilities are subtracted from assets, the remainder is owners' equity.

Market Feasibility Analysis

A market analysis enables you to define competitors and quantify target customers and/or users in the market within your chosen industry by analyzing the overall interest in the product or service within the industry by its target market. You can define a market in terms of size, structure, growth prospects, trends, and sales potential. This information allows you to better position your company in competing for market share. After you've determined the overall size of the market, you can define your target market, which leads to a total available market (TAM), that is, the number of potential users within your business's sphere of influence. This market can be segmented by geography, customer attributes, or product- oriented segments. From the TAM, you can further distill the portion of that target market that will be attracted to your business. This market segment is known as a serviceable available market (SAM).

Projecting market share can be a subjective estimate, based not only on an analysis of the market but also on pricing, promotional, and distribution strategies. As is the case for revenue, you will have a number of different forecasts and tools available at your disposal. Other items you may include in a market analysis are a complete competitive review, historical market performance, changes to supply and demand, and projected growth in.

Applying Feasibility Outcomes

After conducting a feasibility analysis, you must determine whether to proceed with the venture. One technique that is commonly used in project management is known as a go-or-no-go decision. This tool allows a team to decide if criteria have been met to move forward on a project. Criteria on which to base a decision are established and tracked over time. You can develop criteria for each section of the feasibility analysis to determine whether to proceed and evaluate those criteria as either "go" or "no go," using that assessment to make a final determination of the overall concept feasibility. Determine whether you are comfortable proceeding with the present management team, whether you can "go" forward with existing nonfinancial resources, whether the projected financial outlook is worth proceeding, and make a determination on the market and industry. If satisfied that enough "go" criteria are met, you would likely then proceed to developing your strategy in the form of a business plan.

Chapter 2: Multiple Choice

1) According to chapter 2, a feasibility analysis ultimately tests the _____ of an idea, a project, or a new business.
   a) Genuineness
   b) Reality
   c) Success
   d) Viability
2) According to chapter 2, the _____ analysis enables you to define competitors and quantify target customers.
   a) Financial
   b) Market
   c) Organizational Feasibility
3) According to chapter 2, with the financial feasibility analysis, the organization should typically include how many items.
   a) 3
   b) 5
   c) 7
   d) 9
4) According to chapter 2, this financial information lets the owner know how much you need before starting your company.
   a) Balance sheet
   b) Breakeven point
   c) Market share
   d) Projected cash flow

Chapter 2: Short Answer

1. According to chapter 2, explain the purposes of the feasibility analysis.
2. According to chapter 2, explain how the organizational, financial, and market feasibility analysis differ.
3. According to chapter 2, explain what is involved in the breakeven point.

Chapter 3: Designing a Startup Operational Plan

Learning Objectives

1) Identify the major areas of operations management (money, methods, machines, people, and leadership)
2) Recognize relevant parts of a operational needs checklist

From the start, every entrepreneur needs a business plan. Your business plan will keep you focused on the very early stages of the business, when it is easy to be distracted. A written business plan can help redirect you back to your original idea. Business plans can be divided into four different types: operational, strategic, tactical, and contingency. In this section, the focus will be on the operational plan, the activities that an entrepreneur-owner absolutely needs to do. The core business activities and how those activities interface with customers are key to a business's long-term success. Business plans are discussed in more detail in Business Model and Plan.

Operational Business Plan

In the early 1900s, the mechanical engineer and management consultant Frederick Taylor introduced scientific management techniques into manufacturing industries. Since then, operational planning has evolved into a major component of successfully managing a business. An operational business plan details the what, when, who, how long, with what, and how much of company activities. This type of plan may list specific functions: What the activities of the business are, when those activities occur, who is responsible for various tasks, how long each activity will occur, what tools or equipment are required, and how much time and funding are needed.

Operational business plans should be flexible enough to allow for challenges that will occur. Some changes must be made on a daily or even an hourly basis. Other changes may be necessary only occasionally throughout the year. However, the purpose of the operational plan is to provide direction and guidance. This way, everyone in the business knows their specific assignments, who is responsible for individual tasks, and when major events occur.

Creating a table or chart in an Excel or other spreadsheet format can help your planning and scheduling. This type of schedule displays every functional position, the hours that each position has to be covered, and which employee is assigned to that function at what time. The manager can look at this schedule and know that each function has been assigned to an employee during a definite time period. If the work is not being completed, this type of schedule can help a manager make an informed decision about whether to hire more employees. Furthermore, if a problem occurs, the manager knows which employee(s) were working at that station when the problem occurred and can go directly to the employee(s) for information. When an employee is unable to fulfill a shift, the manager can change the schedule quickly to ensure that every task is being completed and every position is attended to.

Individual schedules and assigned work stations can also be displayed in a worksheet. This allows the manager to schedule an employee for the proper number of hours per week and helps budget payroll expenses. Employees know where they are expected to be and when they are scheduled to take lunch or dinner breaks, and the manager knows where the employee should be. When operational questions arise, the manager knows who was scheduled to be at the site and can go directly to that employee.

Using tools such as spreadsheets for scheduling and managing day-to-day operations brings organization and stability to daily operations. Managers know that each task has a person assigned to it, and employees know where they should be or what they should be doing throughout the day. Complex businesses with many employees and many functions need more planning and structure. Businesses with very few employees can be less structured. However, a written plan should list most tasks and activities that need to be accomplished, who will do them, and when.

For tasks requiring attention on a monthly, quarterly, or annual basis, a simple organizer/calendar can be an excellent tool to help organize and remind you of what needs to be done and when. Tasks that you must complete on time throughout the year include payroll tax deposits and reports, insurance renewal applications, permits and license renewals, employee training and recertification requirements, and account billing to certain customers. A calendar also can help you schedule advertising and marketing activities. Some events occur regularly each year at the same time or within a known timeframe. This can help remind you when to start your advertising and marketing campaigns.

You can plan for major maintenance and repair in advance or keep track of scheduled price increases, pay raises, adding or removing menu items, rearranging shelving for seasonal products, and major cleaning or maintenance activities.

As you start your business, you may need to make some adjustments to your operational plan. An entrepreneur might overlook factors that occur regularly. Or a new entrepreneur may have considered some factors to be minimally influential when in fact they may be significant. Entrepreneurs might give high priority to influences that never materialize. Once the business is open, customers and competitors may not behave as expected. Employees may have skill sets that were omitted from the written plan, or they may lack needed skill sets. Even a well-written operational plan will most likely need to be tweaked shortly after operations start. But if you formulate your plan correctly at the beginning, your functional operational plan should rarely need a complete overhaul.

Control

One element that should be included in every operational plan is control. In an operational plan, a marketing plan, an employee development plan, or any other type of plan used in business, control refers to the measurement of outcomes and an evaluation of the activities that led to those outcomes. The control element of a business plans answers the questions, “Have we accomplished what we wanted to accomplish?” and “Have we met our goals within the time frame that we wanted?” Without measuring performance outcomes, the entrepreneur does not know if the business is operating as expected, worse than expected, or better than expected.

If a business performs better than expected, the entrepreneur must consider if the original expectations were too low or if some other factor contributed to the better-than-expected performance. On the other hand, if the business performed worse than expected, two reviews must be conducted. First, why are outcomes less than expected and what can be changed to improve performance? Second, how do lower outcomes affect the viability of the business?

Comparing actual outcomes with expected outcomes is a form of internal comparison called baselining. Baselining is important because the entrepreneur must conduct a self-evaluation on what the business has done versus what it can or should do. An entrepreneur can decide to adjust a business's capability after conducting a baseline study. However, internal comparisons should be coupled with an external analysis, called benchmarking. By comparing your business with a close competitor's or with the industry average, you can get a better idea of how your business fits into the larger market.

Industry Benchmarks

If a basketball team scores sixty-eight points, do they win? If a baseball team scores four runs, do they win? If a soccer team scores five goals, have they lost? The answer to all three questions is simple: We need more information. Without knowing the other team's score, we don't know if a team has won or lost. There must be some other score for comparison; otherwise, the points scored are meaningless.

Similarly, businesses need to compare their individual performances with some external performance measurement. The comparison with an industry average, a leader within the industry, or a market segment is called benchmarking. Benchmarking allows a direct comparison of your company with the collective whole of the industry or market, or with an industry leader. By looking at several performance measurements, you can see if your company is performing at a level that will sustain itself over the long term or if your company's local market is atypical compared with another company's market. If the performance level of a startup company does not match the industry average or the industry leader, that does not mean that the company is poorly managed or cannot be profitable. Underperforming industry leaders indicates only that your company is not the same as those leaders. Frequently, benchmarking against a local market area is better than benchmarking against national leaders or the industry as a whole.

Operations Management

Operations management can be summed up in three words: Get it done! The foundation of operations management is the theory of scientific management. As we have seen, Frederick Taylor developed scientific management to introduce organization, scheduling, coordination, standardization, and cooperation among workers into the production process. Taylor saw a production plant as a large, multifaceted organization with many interrelated activities that should function as one large machine. The activities of each worker within one group had to be coordinated with other workers' activities within that same group. Each worker group had to be coordinated with other worker groups. Worker groups were clustered into larger cohorts. To keep materials moving through the manufacturing process, activities had to be planned, scheduled, and monitored.

Whether you are working in a manufacturing environment in which raw materials are converted into finished products or in a service environment in which customers receive experiences, these five components of operations management—organization, scheduling, coordination, standardization, and cooperation—must be the foundation your firm's activities. To have productive outcomes, the firm must have important inputs: money, methods, machines, people, and leadership. (Figure 4)

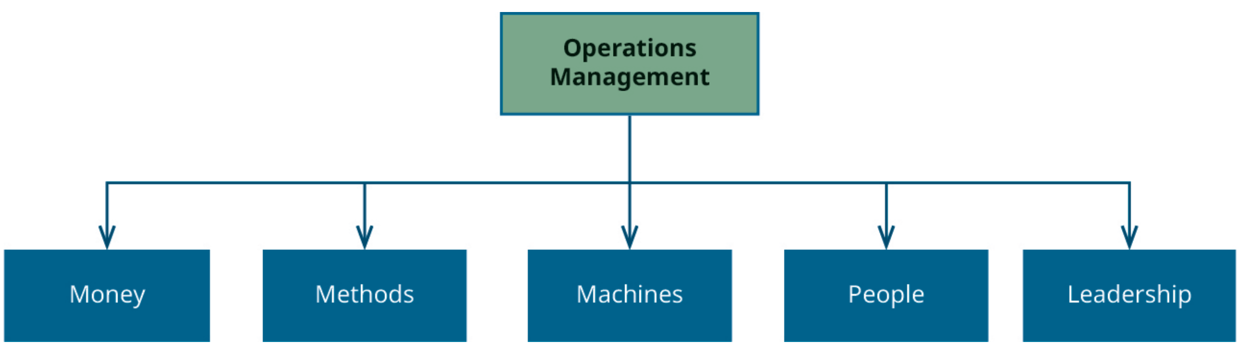

Figure 3. Money, methods, machines, people, and leadership form the foundation of operations management. (attribution: Copyright Rice University, OpenStax, under CC BY 4.0 license)

Money

Three terms—money, cash, and currency—are often used interchangeably, but each has its own distinct meaning and application. Money is any legal instrument that can be used in the exchange of goods and services. Money includes paper money or coins, but it also includes checks or money orders. In developing countries, money might be any physical item that is considered valuable to people wanting to exchange some goods or services. Most money, though, is in the form of cash.

Cash typically refers to physical money or currency, but it also includes deposits in an account (checking, savings, or certificate of deposit) at a financial institution. For example, customers can pay for their purchases with paper money, coins, checks, debit cards, or credit cards. The paper money and coins are taken to the bank for deposit. The debit card and credit card transactions are debited to the business's checking account by its bank. The cash balance of the business increases by the amount of the deposits, regardless of the form of the deposit. The cash balance is shown on the company's balance sheet and is the amount of money the company has available to pay its debts and obligations.

Currency is paper money or coins printed or minted, issued, and backed by a national government. Currency is divided into denominations or units in both paper and coin formats. With the expansion of international trade, along with the expansive movement of people among countries, it is important for an entrepreneur to know how global markets affect the value of money. Each national government decides what denominations of currency to produce. The value of a national currency is determined by the ability to exchange it for another national currency. Raw materials and supplies that originate in another country may increase in price significantly because of a decline in value of the US dollar or an increase in value of the country of origin's money. Likewise, raw materials and supplies may have a price decrease because of shifts in the value of money.

Knowing and understanding how international monetary policies and activities affect a local entrepreneur can be critical to long-term growth and survivability. You must have a clear understanding of projected costs of materials as well as enough funds available at the right time to meet your financial obligations.

Liquidity is a measure of a company's ability to meet its immediate and short-term (i.e., due within one year) debts and obligations. It's a way of describing how well you can cover your current liabilities using your current assets. When a company is liquid, it can meet its financial obligations on time, typically on a very short timeline. If the company pays its bills on time, the risk to lenders is lower, so lenders charge lower interest rates; insurance companies may set lower premiums; and vendors may offer cash discounts for early payments. Maintaining liquidity is vital to the success of a small business, as it may have limited access to other financial options.

Other sources of cash include credit accounts such as a line of credit, a company credit card, accounts payable, loans, or your own reputation and goodwill. A line of credit (LOC) is an agreement between a bank and a depositor in which the bank makes available a maximum amount of money the depositor can borrow at any time during the term of the loan. The borrower pays a fee during the term, whether or not there is an outstanding balance, and also pays interest when there is a balance on the loan. All of these sources of cash are more cumbersome and involve more planning and preparation than liquid accounts. However, these nontraditional money sources are typically necessary for a new business owner in order to pay for business activities before the company begins collecting money from its own paying customers. Mismanaging these short-term debt accounts can easily become a burden on a small business. To better manage the financial obligations of the business, the entrepreneur needs to know which financial tools are available, how to use them, and which tool to use for which purpose. Financing is the use of money to conduct company activities. Payment sources for business activities and resources should match the life expectancy of the resource. Long- term debts—such as for land, buildings, equipment, and machinery—should be paid off through long-term financial instruments that are known as secured debt. Ordinarily, a loan used to purchase long-term assets will have a shorter life than the assets. For example, a machine that is expected to be useful for ten years should be financed with a loan that is paid in full in less than 120 months (ten years × twelve months). The purpose of long-term debt is to create revenue that exceeds the loan payment and interest. In this arrangement, the asset pays for itself by generating more cash than is needed to pay the principal of the loan, interest on the balance, costs to operate the equipment, and any additional insurance required or taxes assessed against the equipment.

Short-term or current liabilities, such as payroll, taxes, insurance, and all other operational activities, should be paid for through short-term cash resources. Most short-term payment obligations occur each week (payroll) or at least each month (insurance, rent). Short-term cash resources include sales, accounts receivables, down payments, and line of credit.

Confusing long- and short-term financing strategies jeopardizes the financial stability of the company. Mismanagement of finances could create a situation in which the company is unable to pay its bills on time. When a company cannot pay its short-term obligations, it may not be able to oper ate much longer.

Managing cash collected and spent is one of the two most important responsibilities of the entrepreneur. A positive cash flow exists when cash received exceeds cash spent. A negative cash flow occurs when cash received is less than cash disbursed. All companies and organizations will experience a negative cash flow at some time. However, good managers will have a savings account or access to other cash in order to meet current financial obligations. What is important, though, is to have a positive cash flow over the long term.

Paying bills is not fun, especially when you have little cash to work with. Three popular methods of paying bills include credit, cash on delivery, and deposits on account. An entrepreneur’s vendors may use all three payment methods. Likewise, the entrepreneur can use all three to collect monies from customers.

When bills are due and the company does not have enough cash to pay the bills or the timing is inconvenient, the company must use credit. Credit is the promise to pay later for something already acquired. Short-term credit may come with no interest charges or fees, such as accounts payable. Vendors will routinely allow established customers to take possession of inventory or products without paying for them at the time of delivery. Payment for products is due on a specific day or after a defined period of time.

Often, a vendor will offer terms of payment at the end of the billing cycle. For example, if the terms are net thirty, purchases that a small business makes during one month are expected to be paid for in full at the end of the next month. Payments made after the due date are subject to a penalty and interest. Sometimes a vendor will offer an incentive to pay early, such as a 2 percent discount if the payment is made in less than fifteen days.

Many startup businesses must make payments at the time of delivery, a form of transaction known as cash on delivery (COD). When the delivery is made, the delivery driver or the online agent will release the product to the customer once payment has been received. This payment method can burden a startup that does not have liquidity. On the other hand, a startup business can reduce its losses by requiring COD payments from its new customers, as it receives payments and has the funds to pay its own obligations.

For unique or specialized products, some vendors will require a deposit from the customer before the product is made. This deposit reduces the financial risk to the vendor for a custom product that may be difficult to resell if the original customer backs out of the purchase. It also provides cash to the producer, who needs to buy raw materials to make the finished product. For the startup entrepreneur, paying for products beforehand could strain the cash available for ongoing operations. However, if the entrepreneur’s customers provide a down payment before the product is produced, the entrepreneur secures a noninterest loan from the customer.

All three of these payment methods are used in business transactions. Cash generated during each financial cycle must equal to or exceed the expenses paid during each cycle. Otherwise, the company may find itself without any money and be unable to afford to stay in business.

Methods

The study of how work is performed is called ergonomics. It involves designing, in, and coordinating tools and equipment so that the movement of workers who use them is safe and efficient, and products flow through the appropriate work stations in a timely and efficient manner.

Work methods are perhaps most important when complex machinery and equipment are involved. A progressive movement of products from one stage to the next should reduce the employees’ time and effort, which reduces costs. Raw materials should be delivered to the location nearest where it will be used. Moving and storing large inventories at each point of assembly is easier and more efficient than storing parts at another location and moving them to work stations when they are needed. Timely delivery of inventory is equally important. Delivery of materials at the moment they are needed is called the just-in-time strategy. If component failure is detected, the point at which the part was assembled can be identified, and the deficiency quickly corrected.

Service industries also apply the assembly line approach.[8] When workers become proficient at their tasks, they can perform the minimum actions needed to complete a task without sacrificing quality.[9] The assembly line approach has given birth to another ergonomic philosophy, lean project management.[10]

Many fast-food restaurants, such as McDonald's and Subway, use the assembly line approach to prepare food quickly and correctly. For example, in making hamburgers, one employee selects the bun, puts the appropriate meat patty on it, and then pushes it to the next worker, who may add onions, cheese, tomato, and lettuce before passing the order to the next station. Once the hamburger is complete, it is passed along to the last worker, who wraps the food and places it in a bag or on a tray.

When employees' tasks are limited to very few functions, repetition of movement makes their work quicker. This specialization results in higher quality. Specialization allows each worker to increase productivity, improve efficiency, and reduce mistakes. This division of labor has become a major component in Western economic models. Adam Smith first explained it in his work The Wealth of Nations (1776), using pin makers as his illustration. Smith theorized that reducing the number of tasks required of each pin maker would enable each worker to improve his efficiency of motion, resulting in both uniformity in quality and higher production levels.

This increase in quality and quantity of work increases the productivity and profitability of the worker. Collaboration among workers who work in close proximity occurs naturally. A weakness that materializes with one worker may be canceled out by an increase in another worker's efforts. However, human labor continues to be replaced by machinery and electronic instruments developed during the Industrial Revolution and the modern technology revolution. Nevertheless, human labor is essential on the production line, whether in creating or assembling products or performing services.

Machines

Beginning in the late eighteenth century, the Industrial Revolution shifted work from muscular power to mechanical power. Ever since, humans have used machinery to perform tasks greater than what they could achieve by themselves or using large animals. Machines provide consistency of work and higher volumes than human workers at lower costs per unit made. However, the initial outlay of cash for machinery can be large.

For a startup entrepreneur, purchasing machinery can be a difficult, time-consuming, and complicated task. First, one must look at the total costs of ownership (TCO), which is the comprehensive cost of owning large capital items, including initial direct costs, operating direct costs, and indirect costs. Maintaining and repairing operational equipment is difficult, especially when production schedules demand the machine to be operational. Poor planning can be very costly, especially for a startup business, because your ability to produce and deliver products on time reflects on your reliability to both your customers and your employees.

When making equipment purchase decisions, you should consider all the costs associated with the purchase plus the machine’s ability to produce income or lower costs. Such expenses include not only the purchase price but also delivery, installation and setup, calibration, and operational expenses. You should also consider the interest paid on the loan as part of the cost of acquiring the equipment, a factor that many new business owners overlook, but one that a good accountant should be aware of.

Hidden costs to major purchases periodically involve certain operating costs. Too often, new business owners focus on the purchase price, sometimes referred to as the sticker price, rather than on the total costs associated with equipment. Major equipment may require special delivery methods and other shipping costs. Once it is delivered to the site, it may have to be installed by skilled technicians. In some situations, the site flooring may need reinforcing to carry the new weight load, or the electrical supply may need to be upgraded to handle the necessary current. Local, state, or federal inspections may be required to obtain a permit to operate the equipment. Sometimes, liability insurance policies require inspections and permits in addition to government permits. All of these extra expenses add to the overall costs of acquiring the equipment. Many times, these expenses are considered sunk costs, never to be recovered in resale of the equipment or in producing more units.

Purchasing machinery and other major equipment is classified as a capital purchase or capital expense. A capital expense is a major purchase of a functional asset that is expected to last longer than three years or that still has financial value after being fully depreciated. Capital items, which include buildings, equipment, machines, and furnishings, are best purchased using borrowed funds so that the business can use its cash to pay for operational expenses, which are those associated with daily, ongoing activities of the business, such as inventory, office supplies, wages, insurance, and utilities. When an asset is used as collateral for a debt, the lender places a lien on the asset. The debt then becomes a secured debt, backed by the resale value of the asset. To ease the financial burden of major purchases, depreciation, a reduction in the value of an asset, is calculated as an expense on the income statement, which reduces taxable income and lowers taxable liability.

As a general practice, the payment schedule of a capital expense should be equal to or less than the life expectancy of the equipment. For example, a business may purchase an offset printer that is expected to last twenty years and then finance it through a loan to be paid off before the twenty years are up. Although having the debt paid off before an asset is fully depreciated is ideal, in some instances terms of the loan may extend beyond the depreciation schedule.

Machines have limits to their performance. Absolute capacity is the highest volume of units that a machine can produce within a specified time period. Operational capacity is the number of units you can reasonably expect to be produced within a specified time period. The difference between the two is operational reserve. Because machines may need to be warmed up, materials loaded and unloaded, moving joints lubricated, belts and hoses checked and repaired, or other operational functions performed, machines cannot operate at absolute capacity for an extended length of time.

In calculating production levels, it is easy to overestimate the number of units produced. For an offset printer to work properly, paper has to be loaded, the rollers must be inked, feeder clamps may need adjusting, and one or two test sheets need to be printed to check for ink coverage and crispness of the image. All of these necessary activities take time, but they actually are unproductive. Because each business will have unique requirements and influences upon capacity, the best method is to track your own performance over time and calculate the average. Otherwise, getting input from one of your advisors or a friendly competitor would be sufficient for planning and budgetary purposes.

Machines cost money to operate. Improvement in efficiencies and in production volume is a major motivation in purchasing new equipment. You should consider the increase in units produced, operational costs per unit, decrease in waste, and improvement in quality of products. A grocery store owner who has an old freezer that still keeps food at the required temperature may decide it is worth replacing. Buying a new freezer, with all of the associated costs and improvements in efficiency, has no impact on the number of food items taken out of it and sold. Only the difference in actual cost of electricity between the two units can be considered. However, a die machine that reduces waste and improves the number of molded pieces produced per hour may be worth the investment.

All machines break down, usually at an inconvenient time and place. Trying to repair equipment when it is needed is like a road crew trying to fix potholes without shutting down traffic. Therefore, scheduling production time, the amount of time that a machine is actually producing products that are to be sold (also called up time), and down time, the time when production is not occurring due to repair, restocking inventory, or unscheduled work, are critical areas for management. A schedule of regularly planned maintenance that includes preventive repairs and inspections will reduce unexpected down time and equipment failures.

Scheduling repairs before they are necessary keeps equipment running efficiently and smoothly, helps reduce costs over the long term, and allows for better management of expenses. Unexpected equipment failures not only interrupt operations but can delay delivery of products and services to customers. This can diminish your reliability and negatively affect customers’ confidence in your trustworthiness, potentially affecting future sales.

Every machine will become obsolete at some time and will need to be replaced. Having the latest, greatest piece of equipment may be a temptation that your bank account cannot afford. Replacing equipment, whether major industrial equipment that needs professional installation or office equipment that can be set up by employees, is a critical decision. Too often, the criteria for selecting new equipment are the same criteria used to describe the old equipment’s ability. Using old job requirements for new equipment may be acceptable in an industry that undergoes very few changes over a very long time. However, most industries change drastically and need up-to-date equipment.

Customer demands within an industry also may change significantly over time, just as a company’s specific needs may shift appreciably. To meet external customers’ new wants and the company’s new internal needs, machinery with new technology and more advanced construction may be mandatory. You should plan three to five years into the future for major purchases of equipment, machinery, tools, facilities, and skill levels. The question is not “What do I need today?” but “What will I need five years from today?”

Trading in outdated equipment may have value that is not always recognized in financial documents. When sales representatives of major manufacturers need to meet quotas, they may be willing to offer a very positive financing plan to place their equipment in your business while removing a competitor’s machine. But you should avoid making the mistake of ignoring your current vendor. Your current machine supplier may be very eager to keep customers and may offer to take your old equipment as a trade-in, which lowers the purchasing price of new equipment. Or your current supplier may be able to offer better terms than competitors or provide supplies as a reward for loyalty. All of these choices eventually lower both purchase and operating costs of new equipment.

To upgrade or keep the old machinery, to buy or lease, to sell or trade in, these are just a few of the questions that business owners contend with in making major purchases. Paying for big ticket items through vendor financing might be easier than borrowing from traditional banks. But when making major equipment purchases, always keep the professional sales representatives close. Their industry insight and knowledge could be more beneficial to you than the equipment itself. People are more flexible, more knowledgeable, and especially more valuable than machines.

People

Searching, recruiting, hiring, and supporting a workforce can be some of the most rewarding and frustrating interactions that a new business owner deals with. Selecting the right people at the beginning can be the difference between succeeding or failing in the early years of a business. Many experienced business owners will say that waiting to hire the right person is better than hiring the wrong person now.

For the new entrepreneur, hiring people you know is appealing because it is easy, they are typically very amenable in the startup stages, and they share in the excitement of the new business. Nepotism is the hiring of family members and close friends, usually based on their relationship to the entrepreneur rather than on their ability to perform the job. Spousal support and involvement are important in the early stages of a business. Spouses routinely become employees of the new business. Many times, the wife is an unpaid employee if her husband starts the new company.[11] Her commitment may vary from a sporadic involvement to a few hours per month or per week. Women entrepreneurs, however, are less likely to have their husbands participate in the business, especially if the husband is unpaid.[12] [13] [14]

Hiring other family members or friends because of their availability and personal commitment is enticing. Yet hiring family and friends just because they are willing and available can backfire and may produce more long- term harm than good. Sometimes hiring people close to you may discourage qualified candidates from seriously pursuing employment with your new business. Seeing that previous hiring decisions were based upon personal relationships is a discouragement to skilled personnel. Terminating employment of a family member can be truly difficult, especially if that family member is an immediate family member such as parent, spouse, child, or sibling. Difficulties within the family and the business are possible if the situation occurs.

Moreover, failing to terminate a family member for cause will predictably destroy morale among nonfamily employees, especially skilled employees.

As a business is getting started, having someone is sometimes better than having no one. At other times, having no one is better than having the wrong one. Eventually, however, the ability to do a job supersedes who the employee is. Furthermore, traditional employees hired from the marketplace eventually will resent seeing more favoritism and leniency granted to family members than to nonfamily members. There is a stark difference between the integration of family and non-family members in a startup environment. The career path is usually short, with favoritism towards family members or longtime friends.[15] A delicate balance between family and nonfamily employees is difficulty to achieve, and new entrepreneurs do not need the additional distractions caused by rifts between family and nonfamily staff members.

Friends from previous employment, college, high school, or the old neighborhood are also popular sources for employees. In the early stages, the entrepreneur has so many issues to tackle and tasks to complete that hiring people they know seems like an easy solution. People build personal relationships through social and personal interactions, outside the needs of the new business. They establish friendships along personal commonalities such as attending the same school or being in the same club or on the same team, not along the subordinate-supervisor spectrum. A sure way to end a good friendship is to hire a friend who is unqualified for the job and place them in a supervisory role. Hiring a friend as a subordinate could lead to a confrontation that could cost the new entrepreneur the support of friends and family.

Every new owner must be willing to move past the startup phase and into the growth stage, where skills become more important than personal relationships. This natural progression in business maturity requires skilled workers to perform their tasks effectively. Those skills come at a price that may be difficult to match in the early stages of the business, but in the long run, skilled workers will produce more revenue than it costs to employ them. Also, customers expect more from established businesses than they do from an initial startup business.

Entrepreneurs must hire employees who complement them, not only in skills but also in personalities. In all of its various phases—from inception through startup, growth, and expansion—every business faces situations and obstacles that require an assortment of skills and talents to resolve. Some situations demand a strong, direct, or even confrontational approach, which can be comfortable for an extrovert. Other situations may need to be handled more softly and indirectly. An introverted employee who naturally is slow to react may take a passive approach that would be more appropriate in some settings.

A small business can strengthen its staff by hiring people with an assortment of backgrounds and experiences. The collective experiences of the whole staff benefit the business in ways that may not always be easily identifiable. Employees who fit together make a nice place to work and an enjoyable experience for customers.

Sales Force

Decisions involving a sales force may be some of the most critical decisions made, perhaps even more important than organizational structure and tax status. The sales force triggers the activities that generate revenue, which brings the business to life and sustains it. Without the sales spark, the business becomes a lifeless organization doomed to closure.

A sales force must fit within the overall operational and marketing strategy of the business. The product must be fully developed, its benefits to the customers clearly defined, and the primary target market selected before a sales force is needed. Furthermore, company goals of minimum production levels must be established, and a target revenue high enough to cover expenses needs to be calculated. It is imperative that each of these goals is patently understood and achievable for both the sales force and the company before the sales force is assembled.

The first consideration is identifying the stage of the company. Some entrepreneurs have a true startup business beginning from scratch, whereas others enter entrepreneurship through the purchase of an existing business with established customers and cash flow. The organization, structure, and role of the sales force will depend upon whether the business is in the startup, growth, mature, or decline stage). As the business progresses through each stage, requirements and abilities of the company change as does the external environment of the market.

Deciding whether to self-perform sales or outsource the sales function should be done very carefully and should include research into the tax implications and benefits of using employees versus independent contractors.[16] Self-performing involves the employees doing most of the work in a business. Outsourcing is the hiring of an outside company or third party to perform a specific task, job, or process, or to manufacture goods. Each option has benefits and limitations. The entrepreneur must consider many factors, ranging from financial strength to market knowledge to sales support capabilities. Hiring sales personnel as employees means the entrepreneur must use time and money to recruit, hire, train, supply with equipment and office materials, and regularly pay the sales force. Outsourcing the sales function to independent contractors may be a viable option, as the entrepreneur would have minimal upfront investment and they would be paid a commission only when they make a sale. Outsourcing is a preferred selection for businesses that are financially straining under cash flow, while self-performing sales is preferred for established, growing companies.[17],[18]

Pay is always a touchy topic. Determining a person's compensation and income gives the entrepreneur a great deal of power and control over the sales force. It is a very important responsibility that ought to be handled with great care. Issues regarding pay affect not only the employees' or contractors' livelihood, but also the company's financial health and reputation. Furthermore, there are numerous laws and regulations, at both federal and state levels, that place the burden of doing it right upon the employer.

Sales force personnel who are employees must be paid with regular wages. Sometimes, a commission or bonus is paid if sales quotas are met. Regular wages, along with employer-matching payroll taxes and employee benefits, increase fixed expenses to the business. This arrangement may not be sustainable for a startup business. Yet the entrepreneur-employer can benefit from this arrangement by retaining control over employees' schedules and routines, earning loyalty from staff, and receiving immediate market feedback from the employee.

Outsourced or independent contractor sales reps are paid on commission. This arrangement adds a variable expense to the business, an expense that should only be recognized after a sale is made. In most situations involving outsourced independent contractors, the employer is not responsible for payroll taxes. A word of caution, though, to all beginning entrepreneurs: Determining whether someone is an employee or an independent contractor can become complicated. The burden of doing it right is on the employer. And not doing it correctly can add significant expenses to the business in the form of fines and penalties.

An important factor to contemplate when deciding what type of sales force to have is knowing your position in the market and your market's characteristics. If you are selling to other businesses, business to business, you will have to understand their decision-making processes and buying criteria if you expect to make any sales. On the other hand, selling direct to the consumer, business to customer, has a wholly different marketing strategy.

For the nonmarketing entrepreneur, learning about marketing basics ought to be placed on the “to do” list so that conversations with sales force personnel will be productive.

An additional market consideration is the sales territory. If you define territories by geographic markers, does each territory have the same potential number of customers? What is the variance in size and the distance from the home office? A similar set of questions arises if the sales force is established along product lines.

How are the product lines alike? How are they different? When sketching out the sales force organization and responsibilities, it would be highly advantageous to receive input from potential sales reps or more experienced entrepreneurs who already know how to setup this division of your business.

Agreements made with the sales force must be honored, so make any agreement only after very carefully thinking through scenarios and obtaining insight from trusted advisors. The reputation of the business with employees and customers alike is at stake when employers do not honor agreements with employees, especially those employees who are the face and voice of the business to the market. If a sales rep, employee, or independent contractor decides to separate from your business, they could take their customers’ business with them to their next place of employment. Although you could take legal action against a former employee who does this, the bottom line is that you have lost a sales rep and a customer. Avoiding that situation is best for everyone, especially you, the entrepreneur.

Getting the right sales people in place is critical. Having them work in a positive and effective environment is a necessity that cannot be ignored.

Leadership

Terms commonly associated with a leadership position include owner, manager, supervisor, team lead, leader, and boss. Many of these terms are used interchangeably, even though they have some minor differences in meaning, but normally one person will function as both leader and manager in a small business. Some entrepreneurs may be able to switch between these two roles flawlessly and fluidly, so that their followers and even they themselves are unaware that the roles are being filled simultaneously.

Nevertheless, some traits and behaviors are associated more closely with leadership than with management.

A key difference between leaders and managers is their role in initiating action. Management is typically concerned with administering and directing an organization’s activities. This includes planning, scheduling, coordinating, overseeing, and inspecting tasks performed by staff. The manager ensures that employees who have been hired to perform duties perform those duties as expected and at a level of quality and quantity acceptable.

A leader, on the other hand, instills within others a desire to perform. This is more of an internal motivation, a psychological approach, which the leader develops via words and actions. Like the results of the manager’s approach, the results of motivation will be evident in the employees’ performance. The difference lies within the minds and souls of employees.

Employees will work for their manager because they are obligated to on the basis of assigned roles and positions of authority. Employees will work for a leader because they want to achieve the same goals and accomplish tasks to satisfy themselves as well as their leader.

Operational Needs

When starting your business, the first question you need to ask is whether anyone wants to buy your product or service. Creating a new product or service is easy. In fact, 70 percent to over 95 percent of new products introduced every year are classified as failures.[19] With more than 30,000 new products introduced every year, you could reasonable guess that between 21,000 and 27,000 are failures.[20] On the contrary, only 5 percent to 30 percent of new products are successful. So the question is valid: Will anyone buy my product or service?

With such a low success rate, you will need to conduct careful research and small trial runs to determine the viability of your new products. You need to know not only whether anyone will buy your products but whether customers will pay your price, so that the business can make a profit, or at least break even. You need to ask these two very important questions up front, because if the answer to either one is “No,” you have no need to do anything else.

A second series of questions that you need to address focus on the location of the company’s operations. Where will you locate your business? Will you rent or buy a building or facility? Does your facility need to have easy access in a high-traffic area? Or can it be in a quieter area, where costs are lower? In addition to access and costs, will your business be located within a competitor’s influence? It would be unfortunate if you negated all the positive factors of your great product and viable business plan by selecting the wrong location.

Besides deciding on a proper location, you also need to consider the size of your facility. Selecting a structure that is too small from the very beginning may handicap any growth in the early stages of your business.

Having to move to a larger facility soon after beginning operations could be detrimental to your operations. On the other hand, selecting a facility that is too large puts pressure on cash flow, as you will pay rent or a mortgage for an unproductive building space. Finding the balance between “big enough to grow into” and “small enough to afford with low sales” is a predicament faced by many business owners, whether new entrepreneurs or seasoned veterans.

You will need to make similar decisions about furniture, equipment, and furnishings. These items are available for purchase or lease. Sometimes a lease is better, as the initial payments may be lower but over time, buying equipment and furniture can help improve cash flow once the items are paid for. However, deciding on how much, what quality, and what size can be difficult. Good equipment sales representatives can be a big help in making equipment decisions.

To get started, you will need to determine the proper inventory levels. How long is the shelf-life of your inventory? Some products have a long shelf-life, whereas others may perish quickly. Ask yourself “How much do I need?” and “When will I need it?”

Before beginning a business, you may need licenses and permits. Buildings must be inspected and approved prior to occupation for business activities. Building permits may require electrical, plumbing, HVAC, and structural inspections of building systems and physical features. Accounts for water, gas, and trash pickup must be made prior to occupying a facility. This checklist summarizes the operational needs you should consider when launching a venture: *Note: depending on your entrepreneurial venture, not all may be necessary or other ideas must be considered*.

- ▫ Determine the legal organization of your business for tax purposes (sole proprietorship, partnership, or corporation). Select the legal structure of your business for operations and management control [limited liability company (LLC), general partnership or limited partnership, C-corporation, or S-corporation.
- ▫ Decide on a name for your company. The company name becomes its official legal name for federal and state purposes. A corporate name can be anything that is currently not in use by another company. A trade name may be different from the official name. The trade name should reflect the product or industry
- ▫ You and any other principals of your business write and approve articles of incorporation, bylaws, or management agreements.
- ▫ File organizational papers with the secretary of state (SOS) or its corresponding office in the state in which the company is founded. The SOS returns the registration or charter documents to the company.
- ▫ You and other principals make cash payments to the company for starting the bank account.
- ▫ Obtain a federal employers identification number (FEIN) from the Internal Revenue Service. This is the company’s federal tax number for income and payroll taxes and filings.
- ▫ Obtain a state employer’s identification number from your state’s employment commission. This is the company’s state tax number for filing unemployment and sales tax reports and payments.
- ▫ Be sure your trade name or assumed name certificate is filed and approved by the appropriate county and state offices if it is different from the corporate name.
- ▫ Secure your business phone number, website, email, and domain name. Order your business cards.
- ▫ Open a bank checking account with the appropriate corporate and trade name, authorized signers on the signature card, and all other documents that your bank requires to open a business account. Order debit cards or credit cards as necessary. Deposit your startup funds. Set up and test your business deposit processes.
- ▫ Both you and your officers and partners sign agreements regarding the business.
- ▫ Buy or lease your office space. Your local or city government will grant you a certificate of occupancy to occupy the building. You may need additional inspections before final approval: building, fire, health, and plumbing.
- ▫ Open utilities, water, electric, gas, garbage, and phone accounts.
- ▫ Post required notices in a prominent place according to regulations. Common locations are near the time clock, break rooms, front cash register, or other public location.

- Apply for and post as required your license for business, either by federal, state, county, or municipal government.
- Apply for and post as required your license and permits for employees or specific types of products or services.
- Obtain insurance for your building, liability for business, and worker’s insurance. Some states allow businesses to exempt themselves from workers’ compensation with proper notice to employees.
- Order and install furniture, office equipment, shelving, and so on.
- Order your inventory and make your product list with pricing, price sheets, or menu boards.
- Recruit and hire your employees. Training and certification may be required for specific functions such as bartenders, cooks, drivers, forklift operators, or first aid personnel. Be sure employees’ training in specific job functions is completed before opening. The first day of operations is typically a low-key event to ensure that everything is working as planned and that your staff know their roles and responsibilities. This gives you time to correct any weaknesses or shortcomings before the general public is aware that your business is open.
- Set the grand opening several days to a few weeks after the actual opening of business. Invited guests may include investors, city officials, family members, special customers, former employers, business neighbors, and competitors

Chapter 3: Multiple Choice

1) According to chapter 3, he introduced scientific management techniques into manufacturing industries.
   a) Edward Deming
   b) Frederick Taylor
   c) Henry Ford
   d) Peter Drucker
2) According to chapter 3, this involves comparing actual outcomes with expected outcomes.
   a) Baselining
   b) Benchmarking
   c) Controlling
   d) Standardizing
3) According to chapter 3, this area of operational management can be some of the most rewarding and frustrating interactions that a new business owner deals with.
   a) Leadership
   b) Machines
   c) Methods
   d) Money
   e) People
4) According to chapter 3, this percentage of new products introduced every year are classified as failures.
   a) 10% to 30%
   b) 30% to 50%
   c) 50% to 70%
   d) 70% to 90%

Chapter 4: Business Structures – Part 1

Learning Objectives

1) Understand why a business's purpose is an important role in the initial business structure decision
2) Identify major types of business structures (corporation, LLC, partnership, sole proprietorship, joint venture)
3) Distinguish between for-profit and not-for-profit purposes and structures

The structure of a new business creates the legal, tax, and operational environment in which the business will function. In order to choose a business structure, entrepreneurs need to have a clear understanding of the type of business they seek to establish, the purpose of the business, the location of the business, and how the business plans on operating.

For example, a business that plans to qualify as a nonprofit—Section 501(c) of the Internal Revenue Code—will be treated differently from a business that aims to earn a profit and distribute the profits to its owners. Therefore, the first step in any entrepreneurial endeavor is to establish the nature and purpose of the business.(Figure 5)

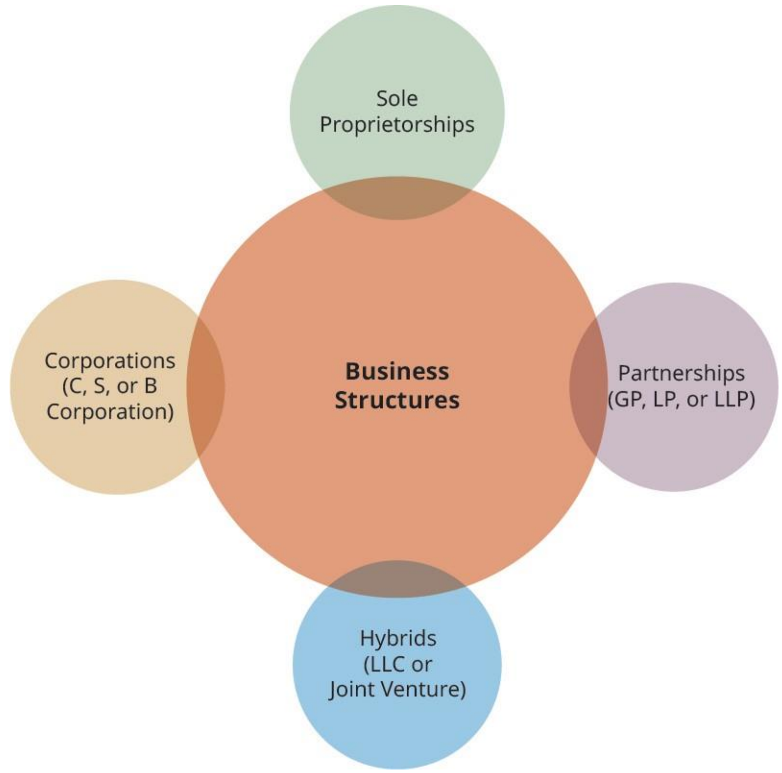

Figure 4. There are several basic business structures: sole proprietorships, partnerships, corporations, and hybrid forms. Partnerships may be structured as a general partnership (GP), a limited partnership (LP), or a limited liability partnership (LLP). Hybrids are usually formed as a limited liability company (LLC) or a joint venture (JV). The designations of "C" and "S" corporations refer to which chapter of the Internal Revenue Code they appear in; B corporations are structured to meet standards of serving certain social purposes. (attribution: Copyright Rice University, OpenStax, under CC BY 4.0 license)

One of the most important initial decisions an entrepreneur must make, from a legal perspective, is the legal organization of a business, called the business structure or entity selection. The choices are varied, with several basic entities, each with several variations, resulting in multiple permutations.

Many business ventures, regardless of humble beginnings, may have the potential to evolve into significantly larger business ventures. This is what makes the initial decisions so important. The founders should think through every step of business development, beyond the inception or formation, and consider the possible paths of the business. How an entrepreneur organizes the business, or which business structure they choose, will have a significant impact on both the entrepreneur and the business.

Business structure options include traditional choices such as corporations, partnerships, and sole proprietorships, and hybrid entities such as limited liability companies (LLCs), limited liability partnerships (LLPs), and joint ventures (JVs). Each structure carries different requirements to set up, different requirements to fulfill (such as taxes and government filings), and varying ownership risks and protections. Entrepreneurs should consider these factors as well as the expected business growth in selecting a structure, while being aware that the structure can and should change as the business venture grows.

For example, if you think you want to share authority, responsibilities, and obligations with other people, your best choice would likely be a partnership, in which other people contribute money and help manage the business. Alternatively, if you prefer to manage the business yourself, a better choice for you might be a single-member LLC, assuming you can borrow money from a lender if needed. Conversely, if you think your idea is so popular that you may grow rapidly and want the ability to raise capital by selling interests in your business through equity or debt, then a corporation would be your best choice. You should obtain legal and tax advice about your structure.

Establishing a Business Purpose

A clear understanding of the business purpose helps direct the entrepreneur toward the most appropriate business structure. The business purpose is the reason the entrepreneur forms the company and determines who benefits from it, whether it is the entrepreneur, customers, or some other entity. (The business purpose is different from a business mission or vision.) Drafting the expectations of the entrepreneur and how the business will operate, with a careful analysis of how the business will generate cash flows, realize profits, and to whom the business will owe its primary obligations, is the start of determining the appropriate business structure. A written business plan (see Business Model and Plan) will help the entrepreneur develop the best legal structure in which the business is to operate because the legal structure of the business should be tied to the nature of the business.

Once the entrepreneur is clear on the nature and purpose of the business, consideration of the business structure follows. The first consideration is whether the entity is being created to produce a profit for its owners or shareholders, or whether it will be structured as a not-for-profit entity. A second factor is the state of incorporation, as state law defines each business's creation, with different states permitting different types of entities and various legal protections. Additional considerations include how the structure facilitates bringing in new investors, allows the owners to transfer profits out of the business, and supports a potential subsequent sale of the entity. Taxation is also a crucial aspect of business success, and the business structure or entity directly affects how it is taxed.

For-Profit versus Not-for-Profit Businesses

Owners form businesses for one of two purposes: to make a profit or to further a social cause without taking a profit. In either case, there are multiple options in terms of how a business is structured. Each structure carries its own tax consequences determined by the owners' financial requirements and how the owners want to distribute profits. The structure, in turn, determines the appropriate income tax return form to file.

Characteristics of For-Profit Businesses

A for-profit business is designed to create profits that are distributed to the owners. There are multiple entity structures used in for-profit business entities including corporations, LLCs, partnerships, and sole proprietorships. Many for-profit business owners seek some form of limited liability, and thus form a corporation or an LLC, each of which carries with it specific legal attributes. Additionally, for-profit business entities are subject to a variety of local, state, and federal taxes and filings. Liability and tax issues will be discussed later in this chapter.

For-profit businesses are commercial entities that generally earn revenue through the sales of products or services, whereas nonprofits are organized for social purposes. Nonprofits are allowed to provide assets or income to individuals only as fair compensation for their services. For-profit businesses can be either privately owned (such as an LLC) or publicly owned and traded (such as a corporation). Publicly held and traded corporations sell stock or interests, and must abide by special rules to protect shareholders, whereas privately owned businesses may be less regulated. Regulations may vary by state and by type of incorporation.

Characteristics of Not-for-Profit Organizations

A not-for-profit organization (NFPO) is usually dedicated to serve the public interest, further a particular social cause, or advocate for a common shared interest. They must follow particular regulations regarding eligibility, government lobbying, and tax-deductible contributions. In financial terms, a not-for-profit organization uses its surplus revenues to achieve its ultimate objective, rather than distributing its income to the organization's shareholders, partners, or members. Common examples of not-for-profits include educational organizations such as schools, colleges, and universities; public charities such as the United Way; religious organizations such as places of worship; foundations; trade organizations; and issue-advocacy groups. Other organizations also considered NFPOs include nongovernmental organizations, civil society organizations, foundations that provide funding for various activities, and private voluntary organization.[21]

Nonprofits are usually tax-exempt as categorized by the US Internal Revenue Service (IRS), meaning they do not pay income tax on the money they receive for their organization. These types of organizations are created under state law (but also subject to federal and local laws) and are typically created for the common good.

To operate as a not-for-profit business, most states require that the entrepreneur create a corporation that has the specific purpose of acting in the public interest. This type of corporation does not have owners but has directors charged with running the organization for the public good, subject to bylaws. Some states only require a minimum of one director, whereas other states may require three or more directors. This is an important consideration for an entrepreneur because the nonprofit corporation will need the approval of all of the directors, and not just one person for its creation. Careful vetting of the directors is the best policy of any entrepreneur since directors have a duty to the corporation.

Because state laws vary, a not-for-profit corporation created for the common good in one state needs permission from another state to operate in that state. The permission is typically an approval from the other state's secretary of state memorialized in the form of official documents or permits. When operating in different states, the entrepreneur needs to make sure that the business follows all laws, rules, and regulations for each state.

Another issue to consider is the creation of a not-for-profit business organization for a particular purpose. One example of a special-purpose organization is an alumni organization, usually incorporated as a 501(c)(3) nonprofit, which incorporates to raise money for a college or university for a specific reason, such as student scholarships. Alternatively, a booster club may incorporate to receive donations for a single function, such as the women's soccer team. These organizations may need additional approvals prior to the creation or start of operations, depending upon state and local legal requirements. Each state typically has different requirements; depending on the federal tax regulation under which the entrepreneur is attempting to qualify, there may be additional federal regulations. This is why the entrepreneur needs to fully understand the purpose of the business they are starting and the legal operating environment before selecting the business structure. While NFPOs play an important role, most entrepreneurs form for-profit businesses; therefore, the remainder of this chapter will focus primarily on for-profit business entities.

Corporations

Learning Objectives

1) Distinguish between C Corporations, S Corporations, and B Corporations
2) Distinguish between privately and publicly held corporations
3) Explain how corporations are taxed

A corporation is a complex business structure created by filing the appropriate documents with the state of incorporation (Figure 6). They are created when the original incorporators (owners) file a formal document called the articles of incorporation, or other similar documentation, with a state agency, often the secretary of state's office or the state division of corporations. Corporations operate as a separate legal entity apart from the owners. The owners are called shareholders and can be individuals, other domestic or foreign corporations, LLCs, partnerships, and other legal entities. Corporations may be for-profit or not-for-profit, as discussed previously.

Incorporating a company means that the corporation operates as an entity that has some of the same rights as an individual. For example, individuals and corporations can sue and be sued, and corporations have the rights to own property, to enter into and enforce contracts, to make charitable and political donations, to borrow and lend money, and to operate a business as if the corporation were an individual. Most states require a corporation to be registered in that state in order to conduct business operations and to enter into and defend lawsuits in that state, especially if the business was incorporated in a different state. Registration is not the same as forming the initial corporation; it is simply the process of filing informational documents by entities that have already been incorporated in another state. States also tax the operations or sales a corporation makes in the state in which it has certain operations.

STATE OF [STATE]
CERTIFICATE OF INCORPORATION
A STOCK CORPORATION

The undersigned Incorporator, desiring to form a corporation under pursuant to the General Corporation Law of the State of [State], hereby certifies as follows:

1. The name of the Corporation is ______________________________.
2. The Registered Office of the corporation in the State of [State] is located at ______________ (street), in the City of ________ , County of _____________ Zip Code _______. The name of the Registered Agent at such address upon whom process against this corporation may be served is ______________________________.
3. The purpose of the corporation is to engage in any lawful act or activity for which corporations may be organized under the General Corporation Law of [State].
4. The total amount of stock this corporation is authorized to issue is ______________ shares (number of authorized shares) with a par value of $ ___________ per share.
5. The name and mailing address of the incorporator are as follows:
   Name ______________________________
   Mailing Address ______________________________
   ______________________________ Zip Code ________

By: ______________________________
Incorporator

Name: ______________________________
Print or Type

Figure 5. This is a sample short form of the document that is filed with the Secretary of State's Office to form a corporation. (attribution: Copyright Rice University, OpenStax, under CC BY 4.0 license)

Overview of Corporations

Corporations are the only type of entity that the law allows to sell shares of stock. No other entity, like an LLC or a partnership, may do so. Those individuals or other entities that buy stock become shareholders and own the corporation. Some corporations have millions of shareholders, and others have as few as one. State incorporation laws vary: Some require at least three shareholders, but others allow a one-owner business to incorporate. Thus, an entrepreneur may start a company as the sole owner of the company and later incorporate and sell shares of stock or bonds to other investors in the company.

Corporations sell, or issue, stock to raise capital, or money, to operate their businesses. The holder of a share of stock (a shareholder) purchases a piece of the corporation and has a claim to a part of its assets and earnings. In other words, a shareholder is now an owner of the corporation. Thus, a share of stock (also called equity) is a type of security that signifies proportionate ownership in the issuing corporation. Stocks are bought and sold predominantly on stock exchanges, although there can also be a private sale between a seller and a buyer. These transactions have to conform to a very complex set of laws and government regulations (e.g., the Federal Securities Acts of 1933/34), which are meant to protect investors.

Use of a corporation allows the entrepreneur to shield themselves, and other owners, from personal liability for most legal and financial obligations. The benefit of limited liability is one of the primary reasons entrepreneurs incorporate. However, the administration of a corporation requires more formality than other types of entities, such as sole proprietorships and partnerships. A corporation must follow the rules for such entities. The requirements include maintaining bylaws, holding annual shareholder and director meetings, keeping minutes of shareholder and director major decisions, ensuring that officers and directors sign documents in the name of the corporation, and importantly, maintain separate bank accounts from their owners and keep detailed financial and corporate records. A failure to follow the rules could lead to the loss of limited liability, known as “piercing the corporate veil.”

Most corporations use a three-part (or tripartite) approach to ownership and management.. After the corporation is created and operations start, the shareholders typically elect a board of directors, and the board has oversight responsibilities for the operations of the company. The board then appoints officers who are responsible for the day-to-day operations of the corporation.

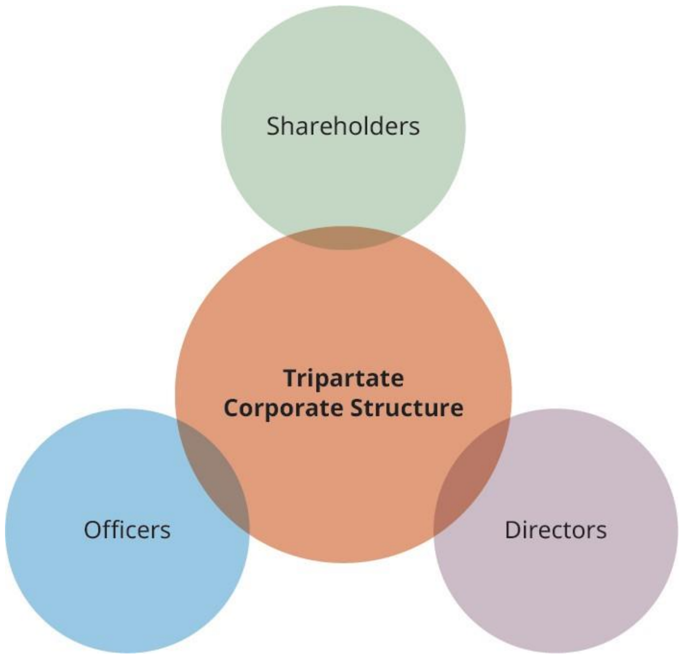

Figure 6. In a tripartite approach, three groups are involved in owning and managing a corporation. Shareholders elect directors who appoint officers. Shareholders are owners, and directors/officers may be, and typically are, shareholders. (attribution: Copyright Rice University, OpenStax, under CC BY 4.0 license)

For small organizations, state law allows shareholders to directly manage a company without using a board of directors. This type of corporation is a closed corporation or a closely held corporation, and is common for entrepreneurial startups. State incorporation law, coupled with federal tax law under the IRS, regulates the formation and operation of a closely held corporation. The basic rules state that, generally, a closely held corporation is a corporation that has more than 50 percent of the value of its outstanding stock owned (directly or indirectly) by five or fewer individuals at any time during the last half of the tax year.

C Corporations, S Corporations, and B Corporations

The categorization of corporations as either C corporations or S corporations is largely a tax distinction. An S corporation is a “pass-through” entity, where shareholders report and claim the business’s profits as their own and pay personal income taxes on it. Alternatively, the government taxes a C corporation at the corporate level, and then levies taxes again on the owners’ personal income tax returns if corporate income is distributed to the shareholders as dividends.

Conversely, the distinction between B corporations and C or S corporations is not one based on taxes at all, but rather on purpose and approach. A certified B corporation is a business that meets a very high standard of social and environmental performance, public transparency, and accountability to balance profit with social purpose. B corporations can also be C corporations or S corporations. Figure 8 summarizes these types of corporations.

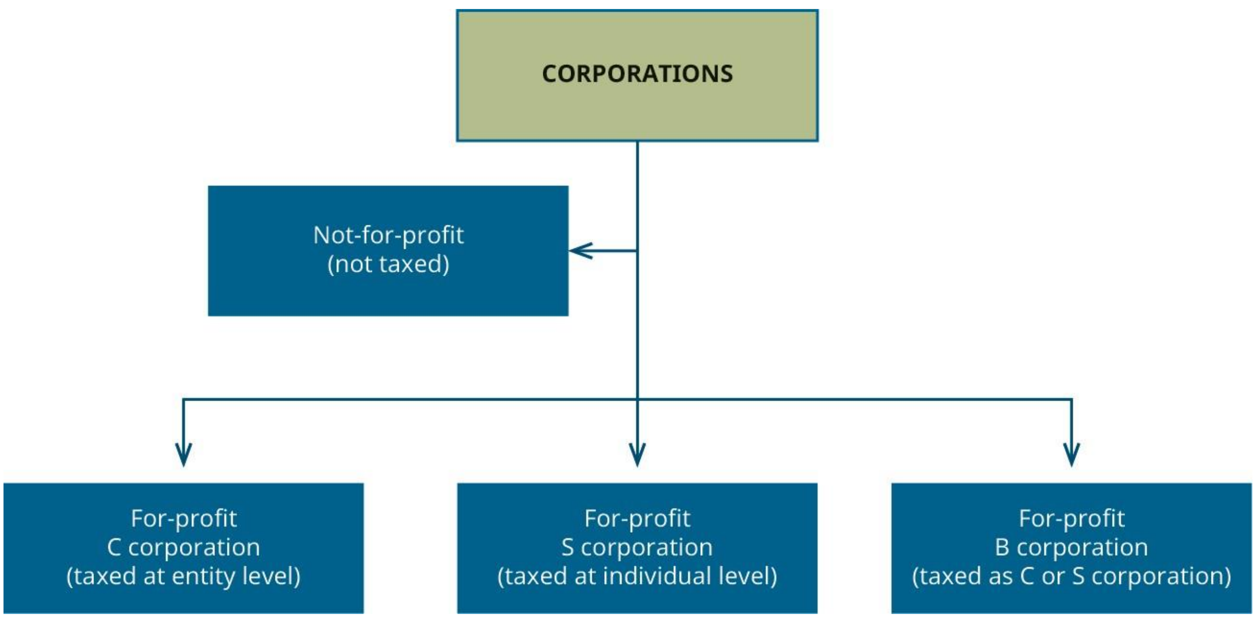

Figure 7. C corporations, S corporations, and B corporations are all types of for-profit corporations, in contrast to a not-for-profit corporation. (attribution: Copyright Rice University, OpenStax, under CC BY 4.0 license)

The Unique Nature of B Corporations and/or Benefit Corporations

A new form of nontraditional, for-profit corporation is the benefit corporation, which may or may not also be a B corporation. While B corporations and benefit corporations share some common goals, B corporations go through a certification process. Becoming a certified B corporation is a formal process that involves compliance with various standards and an audit of this compliance (managed by the B corporation organization).[22] The essence of these new B corporations is that "they recognize the imperative to do no harm and create positive impact throughout the value chain."[23] According to the B corporation organization, these certified businesses are legally required to consider the impact of their decisions on their workers, customers, suppliers, community, and the environment. As of 2019, there are approximately 3,000 certified B corporations in sixty-five countries, covering 150 different industries.[24] The B corporation certification is somewhat like a seal of approval for businesses voluntarily trying to be socially responsible. A benefit corporation is a corporation recognized by a governmental agency under state law (about thirty states now recognize benefit corporations with legal requirements of higher purpose, accountability, and transparency) but does not carry the certification of a B corporation. However, in terms of purpose as related to corporate social responsibility, the two entities are very similar.

The benefit corporation's objective is directed toward maximization of benefits for all stakeholders, meaning that the company benefits any person with an interest or concern in the business. It does not only maximize stockholder profits. Maximization of stakeholder benefits is directed through the corporate charter of a benefit corporation. The state of incorporation directs how benefit corporations are created, but generally, this "new governance model broadens the perspective of traditional corporate law by incorporating concepts of purpose, accountability, and transparency with respect to all corporate stakeholders, not just stockholders."[25] This means that the use of this type of business structure needs to be carefully considered by the entrepreneur because the responsibility of the business will include consideration of the stakeholders outlined in the corporate charter, not just the profit maximization for the shareholders.

Privately Held versus Publicly Held Corporations

Terminology relating to whether a company is publicly or privately owned can sometimes be confusing. For example, large corporations such as Exxon or Amazon are private corporations, but their stock is publicly held. This means that any member of the investing public can own stock in the corporation. A true public corporation is, in reality, a quasi-governmental entity, an entity owned or sponsored by the government.

Government-owned corporations include the US Postal Service, the Corporation for Public Broadcasting, AmeriCorps, and Amtrak. Government-sponsored corporations include Freddie Mac and Fannie Mae, mortgage-related entities. A privately held corporation, common in Europe, is a company that does not allow members of the investing public to own stock. The founder's family or friends, or perhaps a private group of investors such as a venture capital firm, may hold it. Examples include Facebook before it went public in 2012, or Cargill or Mars.

Publicly Traded Corporations

A publicly held corporation is, as described, an entity in which members of the investing public own the stock. A term commonly applied to such corporations is a publicly traded corporation, meaning that the stock can be bought and sold in the public marketplace, such as the New York Stock Exchange. A publicly traded corporation has more access to investors and thus more capital, but it must operate under a formal set of rules established by the Securities and Exchange Commission and Congress, assuming the shares are sold publicly in the United States. Audits of publicly traded companies also have to follow the rules of the Public Company Accounting Oversight Board (PCAOB). "The PCAOB oversees the audits of public companies and broker-dealers in order to protect investors and the public interest by promoting informative, accurate, and independent audit reports."[26] Following the SEC and PCAOB rules emphasizes investor protection but can be complex, as it increases both startup and operating costs for the venture due to increased regulation and reporting.

A publicly traded company is required to have a board of directors with a dual mandate to both consult with management regarding the strategic direction of the company and oversee company performance. The board of directors does not manage the company, and the members are separate from management.[27] The board will have numerous committees to assist in its functionality, and one of the committees is the audit committee. The audit committee of a publicly traded company must hire an outside auditor approved by the PCAOB to audit the books of the publicly traded company. Further, the chief executive office and chief financial officer of the publicly traded company must sign a certification of earnings report, guaranteeing their truthfulness. The rules and regulations with which compliance is required are more demanding for a publicly traded company than for a privately held or closely held company.

Closely Held Corporations

A closely held corporation, also known as a close corporation, is the same as a privately held corporation for the purposes of securities laws. However, the concept has a secondary meaning related to management structure. A close corporation is also a management structure for a corporation that is often selected by small companies that use the less-formal management style of a general partnership yet retain the limited liability of a corporation. In essence, there are fewer formalities for a close corporation, and it allows greater control for the small group of shareholders.

A close corporation is required to have an annual shareholder meeting and keep corporate minutes. All of this detail is required to be recorded in the corporate records, even if there is just one shareholder. Sole proprietors using a corporation as a business structure must follow the rules regarding corporations in the state in which they were incorporated. Some states may even dissolve a corporation that does not have an annual meeting or keep proper corporate records. When a corporation is dissolved, the shareholders become personally liable for corporate debts, and shareholders' limited liability is lost. Managing a closely held company requires the entrepreneur to follow state guidelines while operating the corporation accordingly.

The shares of a closely held corporation are not traded on the open market and typically have just a few shareholders. Closely held corporations have fewer reporting requirements than publicly traded companies and typically are not required to have audited financial statements, unless the corporate charter says otherwise. Audited financial statements are costly and are required for publicly traded companies. The audited financial statements help investors buying and selling stock in the stock market value shares and are not necessarily needed for a closely held corporation. However, it is difficult to value a closely held corporation because there is no ready market for the ownership shares.

Not-for-Profit Corporations

Nonprofit corporations are created in one a state but may operate or solicit donations in other states. A nonprofit corporation operating or soliciting donations in multiple states needs to register to operate as a nonprofit corporation in every state in which it operates.

Not-for-profit corporations are organized in a similar fashion to for-profit corporations, with a board of directors and officers, but they have no shareholders, stock, or owners. The stakeholders of a non-for-profit corporation play an important role, monitoring overhead and allocation of funds. Since most of the funds are donations and are tax deductible, public watchdogs may monitor the financial statements of federally tax- exempt organizations. The fact that the Internet provides easy access to financial data related to federally tax- exempt nonprofits provides watchdog organizations easy access to financial data and the ability to analyze the operations and compensation for the nonprofit's organizers and employees.

Overview of Corporate Taxation

All for-profit corporations are subject to income tax at the federal level, and usually at the state level as well. Regardless of tax elections, both C- and S corporations are subject to taxation.

Tax planning is a major issue for most corporations and may explain some key decisions, such as where they are located. That could involve decisions about which state the corporate headquarters are in, or even in which nation the headquarters are located. This is because tax laws may vary significantly by both state and nation.

The current federal income tax rate for corporations in 2019 is 21 percent, down drastically from 35 percent, which was the rate prior to 2018. Many states add a state-level income tax, ranging from 2 percent to 12 percent, while some states such as Texas do not have a corporate income tax in an effort to attract corporations to the state.[28]

Taxation of C Corporations

C corporations pay corporate income taxes on profits made. Individual shareholders are also subject to personal income taxes on any dividends they receive. Most attorneys and accountants refer to this concept as the double taxation disadvantage. However, the historical tax disadvantage has been recently reduced because of the decrease in the income tax rate paid by C corporations by the Tax Cuts and Jobs Act.[29] This decrease, in turn, reduces the double tax disadvantage. Further, the ability to retain and reinvest profits in the company at a lower corporate tax rate is an advantage.

A C corporation does come with a degree of added formality, or as some may refer to it, red tape. According to most states' corporation laws, as well as federal tax and securities laws, the corporation must have company bylaws and must file annual reports, financial disclosure reports, and financial statements. They must hold at least one meeting each year for shareholders and directors where minutes are taken and maintained to display transparency. A C corporation must also keep voting records of the company's directors and a list of the owners' names and ownership percentages.

Despite the tax implications, the C corporation structure is the only one that makes sense for most large US businesses because it allows for the wide-scale sale of a large amount of stock to the general investing public without limits. A C corporation can have an unlimited number of shareholders that are individuals or other business entities, and are either US citizens or foreign nationals.

Taxation of S Corporations

As previously discussed, the S corporation is a corporate entity in which the firm's profit is passed through its stockholders (shareholders), usually in proportion to their investment—this is known as pass-through taxation. Essentially, this amounts to tax management by the corporate owners. The IRS taxes the corporate profits at the personal income tax rates of the individual shareholders. S corporations (S stands for "small"), also called subchapter

S corporations, must comply with several important restrictions with which entrepreneurs must comply.

S corporations have a limit on shareholders. Unlike with C corporations, the Internal Revenue Code limits the number of S corporation shareholders to 100 or fewer, and owners can only be individuals, (or estates and certain types of tax-exempt entities). Additionally, the individual shareholders must also be US citizens or legal permanent residents. Furthermore, S corporations may only have one class of stock, whereas C corporations may have multiple classes. For example, in a C corporation, there might be voting shares, nonvoting shares, common shares (the type most people buy), and preferred shares (which are repaid first in the event of bankruptcy).

Sole Proprietorships

Learning Objectives

1) Understand why a business's purpose is an important role in the initial business structure decision
2) Identify major types of business structures (corporation, LLC, partnership, sole proprietorship, joint venture)
3) Distinguish between for-profit and not-for-profit purposes and structures

A sole proprietorship is a business entity that is owned and managed by one individual and has very little formal structure and no mandatory filing/registration with the state. This type of business is very popular because it is easy and inexpensive to form. The owner, called a sole proprietor, is synonymous with the business and is therefore personally liable for all debts of the business. Sole proprietors do not pay separate income tax on the company, instead reporting all losses and profits on their individual tax returns.

Overview of Sole Proprietorships

Entrepreneurs solely operating their own businesses are called sole proprietors. According to the Tax Foundation, there are more than 23 million sole proprietorships in the US, far more than any other type of business entity.[30] This statistic means that the sole proprietorship is by far the most common business structure, even though the business is not legally separate from its owner. The primary reason that many entrepreneurs choose the sole proprietorship format is that they do not have to make a choice, get professional advice, or spend any money. An entrepreneur who just starts doing business is automatically a sole proprietorship unless they elect to become a different type of entity and file that paperwork. An entrepreneur who becomes a sole proprietor does not necessarily have to go to an attorney or an accountant, or file any documents, making a sole proprietorship quick, easy, and cheap to form and operate.

Another development related to the decision to be a sole proprietor is the rapid growth of the gig economy. Some individuals prefer to work on their own rather than become a full-time employee. Being a gig worker falls somewhere between being a business owner and being an employee, so many gig workers, ranging from drivers for a ride-sharing company to instructional designers, operate as de facto contractors who are sole proprietors.

However, there remains a debate about whether these gig workers should be deemed sole proprietors. Recently, California passed a new law, signed by Governor Gavin Newsom, which extends wage and benefit protections to many thousands of workers who were previously self-employed sole proprietors working in the gig economy. The new law is based on the presumption that when workers are misclassified as independent contractors rather than as employees, they lose basic benefits such as a minimum wage, paid sick days, and health insurance.

The sole proprietorship is the simplest method to operate a business—often under the owner's name—and the owner is typically taxed directly by the IRS by attaching a Schedule C (Profit or Loss) form to the owner's individual tax return. In order to document one's income, instead of being provided a Form W-2 from one's employer, many self-employed individuals receive one or more 1099-MISC (Miscellaneous Income) forms from clients, which typically demonstrate that the taxpayer is operating a sole proprietorship. Sole proprietors are allowed to deduct their business expenses related to their income and, as both employer and employee, are required to pay the full amount of employment taxes for Social Security and Medicare.

An owner can also operate under a DBA or “doing business as” filing. A DBA is filed at the relevant state or local government office where the sole proprietor wants to operate under an assumed name. Technically, this is not a new organization: It is just a different name. Any business entity may file for a DBA to operate under an assumed name, and many individuals operate under a DBA to indicate the type of services they are providing, such as Smith’s Roofing Company. It is not uncommon for an individual to name a sole proprietorship using LLC or Co. in its name; however, an individual operating under a DBA or assumed name is not provided any of the protections provided to a corporation of LLC, even if Inc. or LLC is used in the assumed name. A sole proprietor needs to consider the impact of using an assumed name prior to creating a DBA.

Advantages and Disadvantages of Sole Proprietorships

The sole proprietor is personally liable for everything. A sole proprietor is the investor, owner, and manager of the business enterprise. The sole proprietor is personally liable for all of the taxes and any unpaid debts of the business venture. The sole proprietor also has no business to sell and can sell only assets related to the business. The sole proprietorship is the easiest business to start but has almost no differentiation from the individual starting the business.

Taxation of Sole Proprietorships

A sole proprietorship is not taxed as an entity. All profits pass through to the owner who pays individual income taxes on all profits earned. It does not matter whether the owner takes the money out of the business or leaves it in the business; all profits are taxed to the individual owner. This is an area that requires significant planning and may be a potential disadvantage, depending on how the individual owner’s personal rate compares to the corporate rate.

Chapter 4: Multiple Choice

1. According to chapter 4, this type of business requires creating and filing a statement with the state.
    a. Corporation
    b. Not-for-profit
    c. Partnership
    d. Sole proprietorship
2. According to chapter 4, this is the type of business shields the business and owners from personal liability.
    a. Corporation
    b. Not-for-profit
    c. Partnership
    d. Sole proprietorship
3. According to chapter 4, this is the only type of business meets a very high standard of social and environmental performance.
    a. B Corporation
    b. C Corporation
    c. Not-for-profit
    d. S Corporation
4. According to chapter 4, this is type of business requires to have a board of directors with a dual mandate to both consult with management regarding the strategic direction of the company and oversee company performance.
    a. Closely held corporations
    b. Not-for-profit
    c. Privately held corporations
    d. Publicly traded corporations
5. According to chapter 4, this type of business is very popular within the gig economy.
    a. Corporation
    b. Not-for-profit
    c. Partnership

d. Sole proprietorship

Chapter 4: Short Answer

1. According to chapter 4, explain the characteristic differences between a for-profit and not-for-profit.

2. According to chapter 4, describe the tripartite corporate structure.

3. According to chapter 4, explain the differences between a C, S, and B Corporation.

4. According to chapter 4, explain the advantages and disadvantages of sole proprietorships.

Chapter 5: Business Structures – Part 2

Learning Objectives

1) Describe the ownership structure of a partnership
2) Describe the ownership structure of a joint venture
3) Summarize the advantages and disadvantages of partnership and joint venture structures

Partnerships and Joint Ventures

A partnership is a business entity formed by two or more individuals, or partners, each of whom contributes something such as capital, equipment, or skills. The partners then share profits and losses. A partnership can contract in its own name, take title to assets, and sue or be sued.

A joint venture is, in essence, a temporary partnership that two businesses form to gain mutual benefits, such as sharing of expenses and to work toward shared goals and the associated potential revenue. Joint ventures share costs, risks, and rewards. A joint venture, for example, can help speed up expansion of your business by gaining access to additional equity, new markets, or new technology. Partnerships and joint ventures share many similarities, but they do have some important differences.

Overview of Partnerships

State law governs the formation and operation of all partnerships. It would be too lengthy to cover the laws of all fifty states; therefore, this section contains some generalizations that may vary according to jurisdiction.

Federal law has very limited applicability to partnerships, primarily in the area of federal income taxation. A general partnership is created when two or more individuals or entities agree to work together to operate a business for profit. A partnership generally operates under the terms of a written partnership agreement, but there is no requirement that the agreement be in writing. In many instances, the only requirement is that two or more parties come together to operate a business for profit.

Entrepreneurs need to be careful because a general partnership can be informally created by the actions of two or more people or entities pursuing a business for profit while sharing management duties. State courts may deem these actions the creation of an informal or even formal partnership. For this reason, if two entities or people come together to purse a joint business operation or strategy, the parties should document the pursuit of the business venture in a written agreement. Many state laws require that some forms of a partnership use a formal written partnership agreement or articles of partnership. If the venture is of a shorter duration, it might be better to enter into an agreement documenting a joint venture. In either case, the entrepreneur needs to have a clear understanding of the exact business relationship before embarking on a new venture, and a partnership agreement can and should outline those details.

A partnership agreement addresses many important topics, including the monetary investment of each partner, their management duties and other obligations, how profits or losses are to be shared, and all the other rights and duties of the partners.

Partnerships can take many forms, including general partnerships (GPs), limited partnerships (LPs), limited liability partnerships (LLPs), and, in some states, limited liability limited partnerships (LLLPs). All states require the registration of any limited liability entity. In GPs, liability of the owners is considered “joint and several,” meaning that not only is the partnership entity liable, so too is each general partner.

The liability of partners, therefore, may be limited by the creation of an LP. A limited partnership requires at least one general partner and one or more limited partners. A limited partner’s liability is typically capped at their investment, unless they take on the duties of a general partner. The general partner is personally liable for all of the operations of the LP.

LPs have been around for many years and allow investors to provide funding for a business, while limiting their investment and personal risk. LPs are commonly used in businesses that require investment capital but do not require management participation by LP investors. Examples include real estate where the LP buys commercial real estate, making and funding movies or Broadway plays, and drilling oil and gas wells.

Some states have relatively recently started to allow variations on the LP structure and offer businesses the option of forming a related type of partnership entity. These limited liability partnerships are common with businesses such as law firms and accounting firms. The partners are licensed professionals, with limited liability for financial obligations related to contracts or torts, but full liability for their own personal malpractice. The primary difference between LLCs and LLPs is that LLPs must have at least one managing partner who bears liability for the partnership's actions. An LLP's legal liability is the same as that of an o wner in a simple partnership. Entities that are formed with a founding partner or partners—commonly law firms, accounting firms, and medical practices—often structure as an LLP. In this situation, junior partners typically make decisions around their personal practice but don't have a legal voice in the direction of the firm.

Managing partners may own a larger share of the partnership than junior partners.

The final type of partnership is a limited liability limited partnership (LLLP), which allows the general partner in an LP to limit their liability. In other words, an LLLP has limited liability protection for everyone, including the general partner who manages the business.

Advantages and Disadvantages of General Partnerships

The GP is a very common business structure in the US. It is created when two or more individuals or entities come together to create, own, and manage a business for profit. A GP is not technically required to have a written agreement, or to file or register with the state government. However, GPs should have their business structures described in writing, so that the entities working together have an understanding of the business and the business relationship.

When a GP is created, one partner is liable for the other partner's debts made on behalf of the partnership, and each partner has unlimited liability for the partnership's debt. This creates a problem when one partner disagrees with the source or use of funds by another partner in terms of capital outlay or expenses. Each partner in a GP has the ability to manage the partnership; if something negative happens such as an accident (called a tort) that injures people and produces liability—like a chemical spill, auto accident, or contractual breach—each of the partners is personally liable with all of their personal assets at risk. Also, the partners are liable for the taxes on the partnership, as a GP is a pass-through entity, where the partners are taxed directly, but not at the partnership level.

It should be noted that GPs may be a useful structure in certain situations because they are relatively easy and inexpensive to form. The expanding use of LPs, LLPs, and LLLPs is discussed in the preceding text, but the popularity of GPs has been on the decline. However, as long as the business does not have a high likelihood of liability-producing accidents or situations, a GP can work. An example might be two partners offering graphic design or photographic services. However, due to the different risks associated with them, GPs are often not the best choice of business entity. Other types of entities offer the protection of limited liability and are thus better choices in most circumstances.

Taxation of Partnerships

Partnerships are considered pass-through entities, whether they are GPs, LPs, or LLPs. Therefore, the partnership's profits are not taxed at the entity level, like with a C corporation, but the profits are passed through to the partners, who claim the income on their own tax returns. The partners pay income taxes on their share of distributed partnership profits (disclosed on a Schedule K-1 form from the partnership to the individual partners). Thus, there is no such thing as a partnership tax rate.

If the entity is a joint venture that is organized and run as a partnership, then it is taxed the same way, even if the partners are corporations. The profits are distributed, and each corporation pays its own taxes. If, in the alternative, the joint venture formed a separate distinct corporation, then it pays taxes as a corporation.

Joint Ventures: Business Entities Doing Business Together

A joint venture occurs when two or more individuals or businesses agree to operate a for-profit business venture for a specific purpose. A joint venture is similar to a legal partnership but different in terms of purpose and duration. Usually, joint ventures are used for a single purpose and a limited period. One example of a joint venture involved BMW and Toyota working together to research how to improve the batteries in electric cars, a single purpose, over a period of limited duration, envisioned to be ten years.

Companies enter into a joint venture often to avoid the appearance of the creation of a partnership, because partnerships tend to create long-term obligations between the partners, while a joint venture is a limited business enterprise. Typically, two business entities operate a business together on a joint project. The joint venture agreement allows the entities to pursue a specific business objective while keeping their other business operations and ventures separate.

A joint venture is not recognized as a taxable entity by the IRS. The entrepreneur can use a joint venture agreement to develop a business enterprise, and if the business enterprise is successful, a new entity can be created to take over the operations of the joint venture and move the business to the next level. For this reason, a joint venture can be a good way test a business concept. If successful, then the operations and assets can be rolled into another entity that supports investment from outside investors. The use of a joint venture also allows the parties to test drive the relationship between the entities: to develop a business venture with less risk.

Joint ventures can involve parties that are large or small, or from private or public sectors, or they can involve a combination of types of entities, most often resulting in a joint venture that is formed as a corporation or LLC. For example, the public company Google and the private entity NASA formed a joint venture to improve Google Earth. Likewise, a joint venture might be something smaller, such as an arrangement between a freelance IT engineer, a graphic designer, and a social media consultant to create a new cell phone app.

This summarizes the relationships of the business in a joint venture.

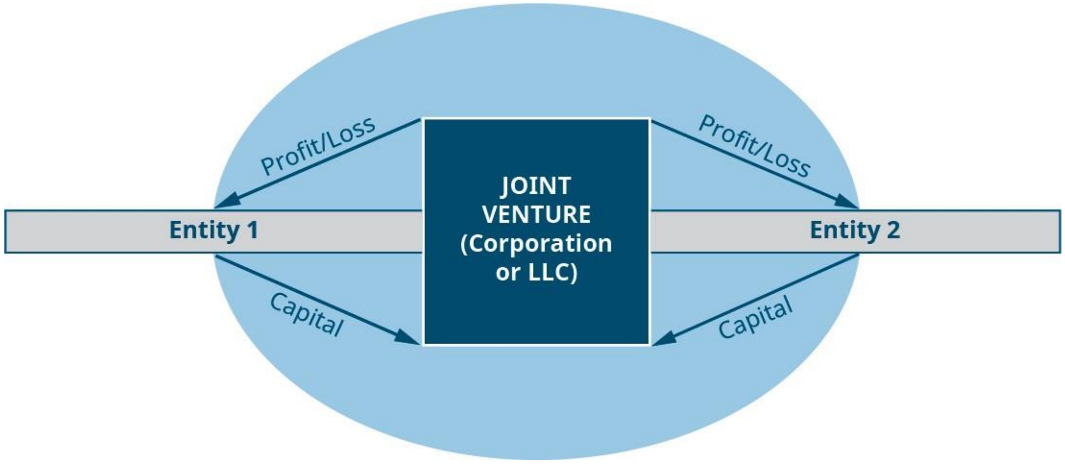

Figure 8. Joint ventures are separate business entities, most often owned and operated by two other business entities. (attribution: Copyright Rice University, OpenStax, under CC BY 4.0 license)

Limited Liability Companies

Learning Objectives

1) Describe the ownership structure of a partnership
2) Describe the ownership structure of a joint venture
3) Summarize the advantages and disadvantages of partnership and joint venture structures

A limited liability company is a hybrid of a corporation and a partnership that limits the owner's liability. The big advantage that LLCs have over GPs is in the protection of owners from personal liability. Thus, an LLC is similar to a corporation in that it offers owners limited liability.

The advantage that LLCs have when compared to corporations, especially for entrepreneurs, is that they are easier to form and less cumbersome to operate because there are fewer regulations and laws governing LLC operations. Although LLCs tend to be easier to create, they still require a filing of articles of formation with the state and the creation of an operating agreement. Owners of an LLC can be individuals and other business entities. The entrepreneur can use the flexibility of an LLC to create a business structure suitable to the operational and tax needs of the business.

In 1977, Wyoming was the first state to allow the LLC format—most states started allowing them in the early 1990s. In contrast, corporations have been around since the early nineteenth century. LLCs now significantly outnumber corporations, with some estimates indicating that four times as many LLCs are formed as corporations,[31] with the total number of LLCs nearing 20 million compared to about 2 million corporations. Each state may permit varying types of LLCs, with different types of formation agreements and operating agreements.

When evaluating the use of an LLC as the structure for your business, it is important to know that there are some constraints on the use of an LLC. In most states, a nonprofit business cannot be an LLC. Additionally, most states do not permit banks or insurance companies to operate as LLCs.

Overview of LLCs

The owners of an LLC are called members. The owner (if a single-member LLC) or owners often run the company themselves. These are called member-managed LLCs. The daily operations of the LLC can also be delegated to a professional manager, which is called a manager-managed LLC. If the original organizer of the LLC chooses, they can organize an LLC in which the owners (members) will have little or no management responsibility because it has been delegated to a professional manager. These options when drafting an LLC's operating agreement allow an LLC to operate in different ways, so that an entrepreneur can develop a business structure best suited to the needs of the business.

As long as the members (owners) do not use the LLC as an alter ego and/or commingle personal funds with LLC funds, the LLC provides the corporate shield of limited liability to the investors. If the LLC is operated to protect a sole proprietor, this might become an issue if the sole proprietor commingles funds. Commingling funds or assets gives rise to the sole proprietor or other members of a multi-owner LLC being liable for all of the debts of the LLC. Generally, the ownership of an LLC is represented by percentages or units. The term shares is not used in operating agreements because LLCs cannot sell shares of stock like a corporation can; thus, owners are not technically shareholders.

Taxation of LLCs

Entrepreneurs are able to make decisions regarding the taxation of LLCs. The government can tax the business as a corporation or as an individual. This choice may involve more than simply a tax rate decision; it might involve ownership and management issues, as well other financial considerations. However, this section will focus on the tax decision aspect of the issue.

A multi-owner LLC's default taxation is as a partnership, meaning profits pass through and are taxed on the owner's federal tax return. However, LLCs can elect to be taxed as either a partnership or a corporation. Single-member LLCs can also be taxed as a sole proprietorship or as a corporation. The fact that an LLC can select its method of taxation as either a C corporation, S corporation, or partnership allows the entrepreneur flexibility in creating the business structure of their choosing. Note, however, that tax laws change. For example, the Tax Cuts and Jobs Act of 2017 may make formation as an S corporation more attractive to some entrepreneurs than formation as an LLC, at least as far as taxation is concerned. You should seek advice from a tax accountant to ensure that you are able to make decisions based on the most current regulations.

Other Low-Risk Entry Structures in Entrepreneurship

Over the past decade, various alternatives to traditional employment have become popular, leading many to become entrepreneurs rather than employees. The US Bureau of Labor Statistics reported that, in 2019, there are 55 million people in who are “gig workers,” which is more than 35 percent of the US workforce. That percentage is expected to increase to 43 percent by 2020.[32] This offers both an opportunity and a challenge. There is a modicum of security when one is an employee of a company, which may not exist in the same way for someone who is freelancing or working as a contractor. There are many examples today of people becoming small entrepreneurs. This process goes by a variety of names, such as the sharing economy, the gig economy, the peer economy, or the collaborative economy. Maybe it means driving for a company such as Lyft, Uber, or GrubHub, or perhaps offering services through TaskRabbit, UpWork, or LivePerson.

Offering your services in this new manner is not controlling of what type of entrepreneurial enterprise you want to be. You can do most of these types of things as a sole proprietor, an LLC, or an S corporation.

According to the Tax Foundation, over the past thirty-five years, the number of C corporations has declined significantly, while the total number of pass-through businesses including LLCs, S corporations, partnerships, and sole proprietorships has tripled to over 30 million. According to estimates, there are only 1.7 million C corporations, whereas there are 7.4 million LLCs, partnerships, and S corporations, and a whopping 23 million sole proprietorships.[33] The explanation for these statistics is really quite simple. LLCs have quickly become one of the most popular business structures due to ease of formation and operation. Likewise, sole proprietorships are quick, easy, and low cost compared to corporations, which are more difficult and expensive to form and operate. The choice is open and depends on the variables discussed in this chapter.

Chapter 5: Multiple Choice

1) According to chapter 5, in this type of business owners share profits and losses.
   a) Corporation
   b) Joint Ventures
   c) Partnerships
   d) Sole proprietorship
2) According to chapter 5, this type of business involves a temporary partnership that two businesses form to gain mutual benefits.
   a) Corporation
   b) Joint Ventures
   c) Partnerships
   d) Sole proprietorship
3) According to chapter 5, this type of business have the advantage when compared to corporations is that they are easier to form and less cumbersome to operate because there are fewer regulations.
   a) General Partnership
   b) Joint Ventures
   c) Limited Liability Companies
   d) Sole proprietorship
4) According to chapter 5, this was the first state to allow the LLC format.
   a) California
   b) Oregon
   c) Washington
   d) Wyoming

Chapter 5: Short Answer

1. According to chapter 5, explain the advantages and disadvantages of general partnerships.
2. According to chapter 5, describe what is a joint venture.
3. According to chapter 5, describe what is a Limited Liability Company.

Chapter 6: Mitigating and Managing Risks

Learning Objectives

1) Explain Enterprise Risk Management and how a company uses it
2) Describe litigation and financial risks
3) Describe common insurance needs

Risk management is key to operating any business in a profitable fashion. There are many risks facing an entrepreneur when starting and operating a new business venture. The trick is to eliminate risks that will hurt the venture, while taking on risks that will provide for long-term profitability. The risks facing the entrepreneur need to be initially identified as part of developing a business plan and revisited regularly in ongoing operations. Preparation for adverse events affecting a new business venture is necessary, but being too pessimistic or allowing fear of adverse events to stop an entrepreneur from taking any risk will keep a business venture from achieving it greatest potential and profit.

It is important that an entrepreneur develop an understanding of the risks of the business environment. The risks include liability risks stemming from contracts and torts, sometimes referred to as operating risks, regulatory compliance risks, financial risks, and strategic risks, including taxation. Understanding how the business structure is used to operate the business venture allows the entrepreneur to develop a plan to manage business growth and understand business risk.

Enterprise Risk Management

Profitable ventures develop a strong enterprise risk management program, which is an integrated, cross- disciplinary approach to monitoring risk. An organization needs to look at both long-term and short-term risks at all levels of the organization, and these risks need to be evaluated from all stakeholders' perspectives and developed into an entity-wide program.

Enterprise risk management attempts to address the specific risks discussed in the preceding section by implementing a risk program that enables a business to identify and manage risk. Specifically, a business will go through a process that involves a multistage process of risk identification, risk assessment, and risk abatement. Examples of risks that businesses face include those from natural causes, economic causes, and human causes.

Natural causes of risk include disasters such as hurricanes and flooding, as well as earthquakes or other catastrophes that result in loss of life and property, as well as business interruption. For example, a business in New Orleans could be flooded by a hurricane. This results in damage to facilities and products, and threatens the lives of workers. In order to counter such causes, businesses need to plan ahead for business continuity, take out comprehensive insurance coverage, and have an evacuation/shut-down plan in place.

Economic causes of risk include global events leading to rising prices of raw materials, currency fluctuation, high interest rates, and, of course, competition from other companies in the same industry. An example of this would be unpredictable trade wars with China, leading to tariffs.

Human causes of risk refer to actions by employees, contractors, and those persons over which a company has control. These events can include torts stemming from negligence at work, labor strikes, shortages of qualified trained workers, and corporate mismanagement. An example of this type of risk would include embezzlement of money by an internal financial executive.

The use of a comprehensive approach allows a business entity to review and combine all risks into a functional perspective that allows the entrepreneur to evaluate risks and integrate new risks as different opportunities become more important to the business venture. Businesses sometimes use a risk matrix to assess or characterize the probability and impact of risk. The use of such a tool can help a business quantify risk and decide whether to undertake an activity based on its level of risk.

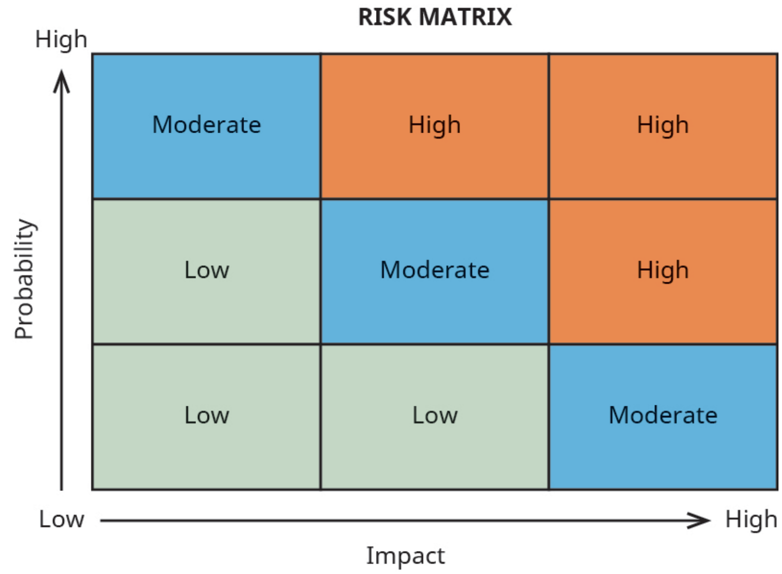

Figure 9. A risk matrix can be a useful tool to assess the likelihood and severity of risk that a venture may have. (attribution: Copyright Rice University, OpenStax, under CC BY 4.0 license)

Risk appetite is important for a business venture to consider, both when creating its business structure and during ongoing operations. The table below shows an overview of the considerations a business venture should entertain in both its creation and operation.[34]

Risk Appetite[25]

Risk Item	Consideration
Existing risk profile	Current level and distribution of risks across the business and across risk categories
Risk capacity	Amount of risk the business can support while pursuing its objectives
Risk tolerance	Amount of variation the business can tolerate while pursuing its objectives
Risk attitude	Management's attitudes toward growth, risk, and return

Table 2. COSO's Enterprise Risk Management, Understanding and Communicating Risk Appetite outlines these considerations for assessing a business's appetite for risk.

This is the basic approach to evaluating a new venture's appetite for risk. Determining and understanding the risks facing a new venture should start during the preparation of the business venture's written business plan and should continue through the operations of the venture.

Legal Risk and Protection

Business operations of any sort need to follow business regulations and laws. The failure to follow business regulations may lead to fines, lawsuits, or even criminal penalties. Legal risk stems primarily from a breach of contract and/or the commission of a tort. Common examples of this type of risk includes product liability lawsuits. These lawsuits are frequently very expensive class action lawsuits or regulatory investigations of dangerous products. There are many famous case examples including automobiles, asbestos, pharmaceutical drugs, breast implants, and airplanes.

Other lawsuits stem from contracts, including borrowing money from a bank. The business has an obligation to pay it back, or it breaches a covenant within a contract. Other common types of contracts are those used in selling services and products, leasing real estate, and other similar contractual obligations.

Due to liability risks, business owners and investors are always looking for ways to limit their personal liability. Incorporation is a standard risk protection strategy for this potential problem, as are the use of other types of limited liability structures such as LLCs. This is one of the main advantages of properly operated corporations and LLCs, which allow for limited personal liability of owners and investors. Partners in GPs and sole proprietors are personally liable for all of the debts of the business, even beyond their own investment in the business.

However, a particular challenge for small business entrepreneurs is that even when they form a corporation or LLC, many lenders, landlords, and other entities providing credit to a small business circumvent the limited liability protection by requiring owners and investors to personally guarantee the debts of the business operations. This means that the owner who personally guarantees the credit will have to pay back the obligation if the business cannot. An owner can obtain insurance or borrow money for such guarantees. LLCs and corporations do protect their owners, shareholders, and members from a number of different tort claims, such as personal injury lawsuits and claims made directly against the organization.

Financial Risk and Protection

An entrepreneur needs money to launch a business, whether that comes in the form of loans from family, their own savings, or investors. The founder will be expected to put their own money at risk, whether in the form of a loan to their own business or equity in their own business. If they do not have any “skin in the game,” then others will not be interested in loaning them money. This means that if the business fails, it will have repercussions for the owner, even if they operate as a corporation or LLC. This is the essence of financial risk: starting a new business with insufficient funds to sustain operations over an extended period of time.

Any new business owner needs to have a sound financial strategy as a part of the overall business plan. This should show income projections, the liquid assets that will be required to break even, and the expected return on investment for all investors in the first five-to-ten-year timeframe. Failure to accurately plan could mean that the entrepreneur risks business closure and bankruptcy, and investors get nothing.

Insurance Protection

Risk management and protection are enhanced with the purchase of different types of insurance, which involves spreading risk over a large number of people (policyholders). If a company is a corporation, it may need directors’ and officers’ liability insurance to indemnify the directors and officers if they get sued. Another insurance policy many companies get is called errors and omissions insurance, and this insurance coverage protects employees in negligence claims and cases if employee theft. Other types of insurance policies that most businesses carry include automobile insurance, health insurance, property insurance, and cyber/data breach insurance. Insurance coverage for a business venture needs to be specific to the business structure and its operations. Keep in mind that not all risks can be insured against—for example, a bad economy that leads to a loss of business or a bad decision by the owner to enter a market that does not work out.

Information Technology/Cybersecurity for Small Businesses

According to the SBA, the risk of hacking, ransomware, and customer privacy are equally as significant for most small businesses as for larger ones. The SBA has set guidelines related to cybersecurity for entrepreneurs.

Managing Payment Data

If you operate a small business, are you prepared to deal with hackers who break into your website and steal credit card data from consumers who bought your products online? Small businesses running an e- commerce site must comply with the Payment Card Industry Data Security Standard (https://www.pcisecuritystandards.org/). This is a regulation that could cause severe legal risk for entrepreneurs if your system is compromised, and credit card data are stolen. Consumers rightfully expect and demand a safe online experience when they visit your site. Have you paid an expert to evaluate your system and install the best security system? It may be costly, but perhaps not as expensive as the damages you could be ordered to pay by a court if credit card data are hacked.

Chapter 6: Multiple Choice

1. According to chapter 6, this kind of risk would be unpredictable
    a. trade wars with China.
    b. Economic causes
    c. Human causes
    d. Natural causes
2. According to chapter 6, within risk appetite, this considers the management's attitudes toward growth, risk, and return.
    a. Existing risk profile
    b. Risk attitude
    c. Risk capacity
    d. Risk tolerance
3. According to chapter 6, within risk appetite, this considers the amount of risk the business can support while pursuing its objectives.
   Existing risk profile
    a. Risk attitude
    b. Risk capacity
    c. Risk tolerance
4. According to chapter 6, this kind of risk and protection involves spreading risk over a large number of people.
    a. Financial
    b. Information Technology
    c. Insurance
    d. Legal

Chapter 6: Short Answer

1. According to chapter 6, describe the three (3) types of enterprise risk management.
2. According to chapter 6, describe the four (4) aspects when considering risk appetite.

Chapter 7: Entrepreneurial Finance and Accounting Strategies

Learning Objectives

1. Distinguish between financing and accounting
2. Describe common financing strategies for different stages of the company lifecycle: personal savings, personal loans, friends and family, crowdfunding, angel investors, venture capitalists, self-sustaining, private equity sales, and initial public offering
3. Explain debt and equity financing and the advantages and disadvantages of each

Once a new business plan has been developed or a potential acquisition has been identified, it is time to start thinking about financing, which is the process of raising money for an intended purpose. In this case, the purpose is to launch a new business. Typically, those who can provide financing want to be assured that they could, at least potentially, be repaid in a short period of time, which requires a way that investors and business owners can communicate how that financing would happen. This brings us to accounting, which is the system business owners use to summarize, manage, and communicate a business's financial operations and performance. The output of accounting consists of financial statements, discussed in Accounting Basics for Entrepreneurs. Accounting provides a common language that allows business owners to understand and make decisions about their venture that are based on financial data, and enables investors looking at multiple investment options to make easier comparisons and investment decisions.

Entrepreneurial Funding across the Company Lifecycle

An entrepreneur may pursue one or more different types of funding. Identifying the lifecycle stage of the business venture can help entrepreneurs decide which funding opportunities are most appropriate for their situation.

From inception through successful operations, a business's funding grows generally through three stages: seed stage, early stage, and maturity. A seed-stage company is the earliest point in its lifecycle. It is based on a founder's idea for a new product or service.

Nurtured correctly, it will eventually grow into an operational business, much as an acorn can grow into a mighty oak—hence the name "seed" stage. Typically, ventures at this stage are not yet generating revenue, and the founders haven't yet converted their idea into a saleable product. The personal savings of the founder, plus perhaps a few small investments from family members, usually constitute the initial funding of companies at the seed stage. Before an outsider will invest in a business, they will typically expect an entrepreneur to have exhausted what is referred to as F&F financing—friends and family financing—to reduce risk and instill confidence in the business's potential success.

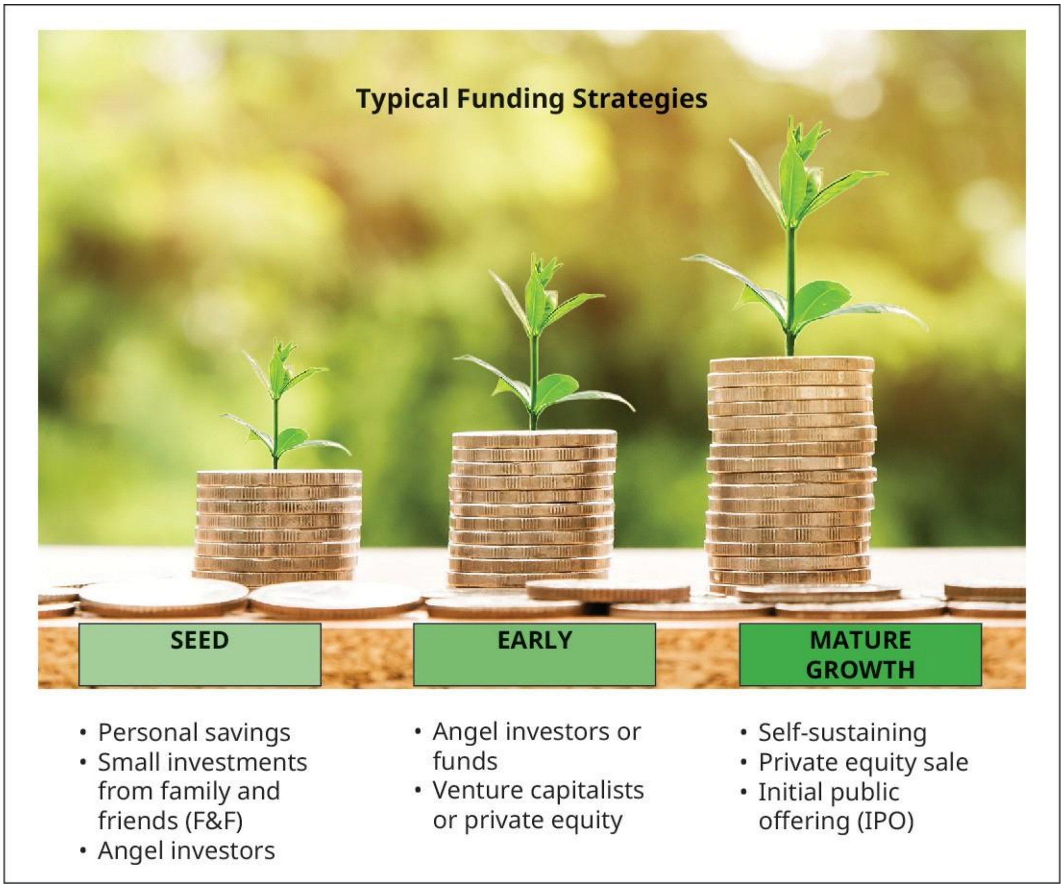

Figure 10. Funding strategies can change across different phases of the company lifecycle.

After investments from close personal sources, the business idea may begin to build traction and attract the attention of an angel investor. Angel investors are wealthy, private individuals seeking investment options with a greater potential return than is traditionally expected on publicly traded stocks, albeit with much greater risk. For that reason, they must be investors accredited by the federal Securities and Exchange Commission (SEC) and they must meet a net worth or income test. Nonaccredited investors are allowed in certain limited circumstances to invest in security-based crowdfunding for startup companies. Among the investment opportunities angel investors look at are startup and early stage companies. Angel investors and funds have grown rapidly in the past ten years, and angel groups exist in every state.

An early stage company has begun development of its product. It may be a technical proof of concept that still requires adjustments before it is customer ready. It may also be a first-generation model of the product that is securing some sales but requires modifications for large-scale production and manufacturing. At this stage, the company's investors may now include a few outsider investors, including venture capitalists.

A venture capitalist is an individual or investment firm that specializes in funding early stage companies. Venture capitalists differ from angel investors in two ways. First, a venture capital firm typically operates as a full-time active investment business, whereas an angel investor may be a retired executive or business owner with significant savings to invest. Additionally, venture capital firms operate at a higher level of sophistication, often specializing in certain industries and with the ability to leverage industry expertise to invest with more know-how. Typically, venture capitalists will invest higher amounts than angel investors, although this trend may be shifting as larger angel groups and "super angels" begin to invest in venture rounds.

Private equity investment is a rapidly growing sector and generally invests later than venture capitalists. Private equity investors either take a public company private or invest in private companies (hence the term "private equity"). The ultimate goals of private equity investors are generally taking a private company public through an initial public offering (IPO) or by adding debt or equity to the company's balance sheet, and helping it improve sales and/or profits in order to sell it to a larger company in its sector.

Companies in the mature stage have reached commercial viability. They are operating in the manner described in the business plan: providing value to customers, generating sales, and collecting customer payments in a timely manner. Companies at this stage should be self-sufficient, requiring little to no outside investment to maintain current operations. For a product company, this means manufacturing a product at scale, that is, in very large volumes. For a software company or app provider, this means generating sales of the software or subscriptions under an SaaS model (Software as a Service) and possibly securing advertising revenue from access to the user base.

Companies at the mature stage have different financing needs from those in the previous two stages, where the focus was on building the product and creating a sales/manufacturing infrastructure. Mature companies have reached a consistent level of sales but may seek to expand into new markets or regions. Typically, this requires significant investment because the proposed expansion can often mirror the present level of operations. That is to say, an expansion at this level may result in doubling the size of the business. To access this amount of capital, mature companies may consider selling a portion of the company, either to a private equity group or through an IPO.

An initial public offering (IPO) occurs the first time a company offers ownership shares for sale on a public stock exchange, such as the New York Stock Exchange. Before a company executes an IPO, it is considered to be privately held, usually by its founders and other private investors. Once the shares are available to the general public through a stock exchange, the company is considered to be publicly held. This process typically involves an investment banking firm that will guide the company. Investment bankers will solicit institutional investors, such as State Street or Goldman Sachs, which will in turn sell those shares to individual investors.

The investment banking firm typically takes a percentage of the funds raised as its fee. The benefit of an IPO is that the company gains access to a massive audience of potential investors. The downside is that the owners give up more ownership in the business and are also subject to many costly regulatory requirements. The IPO process is highly regulated by the SEC, which requires companies to provide comprehensive information up front to potential investors before completing the IPO. These publicly traded companies must also publish quarterly financial statements, which are required to be audited by an independent accounting firm. Although there are benefits to an IPO for later-stage companies, it can be very costly both at the start and on an ongoing basis. Another risk is that if the company does not meet investors' expectations, the value of the company can decline, which can hinder its future growth options.

Thus, a business's lifecycle stage greatly influences its funding strategies and so does its industry. Different types of industries have different financing needs and opportunities. For example, if you were interested in opening a pizzeria, you would need a physical location, pizza ovens, and furniture so customers could dine there. These requirements translate into monthly rent on a restaurant location and the purchase of physical assets: ovens and furniture. This type of business requires a significantly higher investment in physical equipment than would a service business, such as a website development firm. A website developer could work from home and potentially begin a business with very little investment in physical resources but with a significant investment of their own time. Essentially, the web developer's initial funding requirement would simply be several months' worth of living expenses until the business is self-sufficient.

Once we understand where a business is in its lifecycle and which industry it operates in, we can get a sense of its funding requirements. Business owners can acquire funding through different avenues, each with its own advantages and disadvantages, which we will explore in Special Funding Strategies.

Types of Financing

Although many types of individuals and organizations can provide funds to a business, these funds typically fall into two main categories: debt and equity financing. Entrepreneurs should consider the advantages and disadvantages of each type as they determine which sources to pursue in support of their venture's immediate and long-term goals.

Debt Financing

Debt financing is the process of borrowing funds from another party. Ultimately, this money must be repaid to the lender, usually with interest (the fee for borrowing someone else's money). Debt financing may be secured from many sources: banks, credit cards, or family and friends, to name a few. The maturity date of the debt (when it must be repaid in full), the payment amounts and schedule over the period from securement to maturity, and the interest rate can vary widely among loans and sources. You should weigh all of these elements when considering financing.

The advantage of debt financing is that the debtor pays back a specific amount. When repaid, the creditor releases all claims to its ownership in the business. The disadvantage is that repayment of the loan typically begins immediately or after a short grace period, so the startup is faced with a fairly quick cash outflow requirement, which can be challenging.

One source of debt financing for entrepreneurs is the Small Business Administration (SBA), a government agency founded as part of the Small Business Act of 1963, whose mission is to “aid, counsel, assist and protect, insofar as is possible, the interests of small business concerns.”[35] The SBA partners with lending institutions such as banks and credit unions to guarantee loans for small businesses. The SBA typically guarantees up to 85 percent of the amount loaned. Whereas banks are traditionally wary of lending to new businesses because they are unproven, the SBA guarantee takes on some of the risk that the bank would normally be exposed to, providing more incentive to the lending institution to finance an entrepreneurial venture.

To illustrate an SBA loan, let’s consider the 7(a) Small Loan program. Loans backed by the SBA typically fall into one of two categories: working capital and fixed assets. Working capital is simply the funds a business has available for day-to-day operations. If a business has only enough money to pay bills that are currently due, that means it has no working capital—a precarious position for a business to be in. Thus, a business in this position may want to secure a loan to help see it through leaner times. Fixed assets are major purchases—land, buildings, equipment, and so on. The amounts required for fixed assets would be significantly higher than a working capital loan, which might cover just a few months’ expenses. As we will see, loan requirements made under the 7(a) Small Loan program are based on loan amounts.

For loans over $25,000, the SBA requires lenders to demand collateral. Collateral is something of value that a business owner pledges to secure a loan, meaning that the bank has something to take if the owner cannot repay the loan. Thus, in approving a larger loan, a bank might ask you to offer your home or other investments to secure the loan. In a real estate loan, the property you are buying is the collateral. In a way, loans for larger purchases can be less risky for a bank, but this can vary widely from property to property. A loan that does not require collateral is referred to as unsecured.

To see how a business owner might use an SBA loan, let's return to the example of a pizzeria. Not all businesses own the buildings where they operate; in fact, a great many businesses simply rent their space from a landlord. In this case, a smaller loan would be needed than if the business owner were buying a building. If the prospective pizzeria owner could identify a location available for rent that had previously been a restaurant, they might need only to make superficial improvements before opening to customers. This is a case where the smaller, collateral-free type of SBA loan would make sense. Some of the funds would be allocated for improvements, such as fresh paint, furniture, and signage. The rest could be used to pay employees or rent until the pizzeria has sufficient customer sales to cover costs.

In addition to smaller loans, this SBA program also allows for loans up to $350,000. Above the $25,000 threshold, the lending bank must follow its own established collateral procedures. It can be difficult for a new business to provide collateral for a larger loan if it does not have significant assets to secure the loan. For this reason, many SBA loans include the purchase of real estate. Real estate tends to be readily accepted as collateral because it cannot be moved and holds it value from year to year. For the pizzeria, an aspiring business owner could take advantage of this higher level of lending in a situation where the business is buying the property where the pizzeria will be. In this case, the majority of loan proceeds will likely go toward the purchase price of the property. Both the high and low tiers of the SBA loan program are examples of debt financing. In Special Funding Strategies, we will look at how debt financing differs from equity financing.

Equity Financing

In terms of investment opportunities, equity investments are those that involve purchasing an ownership stake in a company, usually through shares of stock in a corporation. Unlike debts that will be repaid and thus provide closure to the investment, equity financing is financing provided in exchange for part ownership in the business. Like debt financing, equity financing can come from many different sources, including friends and family, or more sophisticated investors. You may have seen this type of financing on the TV show Shark Tank. Contestants on the series pitch a new business idea in order to raise money to start or expand their business. If the “sharks” (investors) want to invest in the idea, they will make an offer in exchange for an ownership stake. For example, they might offer to give the entrepreneur $200,000 for a return of 40 percent ownership of the business.

The advantage of equity financing is that there is no immediate cash flow requirement to repay the funds, as there is with debt financing. The drawback of equity financing is that the investor in our example is entitled to 40 percent of the profits for all future years unless the business owner repurchases the ownership interest, typically at a much higher valuation—an estimate of worth, usually described in relation to the price an investor would pay to acquire the entire company.

This is illustrated in the real-life example of the ride-sharing company Uber. One of the early investors in the company was Benchmark Capital. In the initial round of (venture capital) financing, Benchmark invested $12 million in Uber in exchange for stock. That stock, as of its IPO date in May 2019, was valued at over $6 billion, which is the price that the founders would have to pay to get Benchmark’s share back.

Some financing sources are neither debt nor equity, such as gifts from family members, funds from crowdfunding websites such as Kickstarter, and grants from governments, trusts, or individuals.

Special Funding Strategies

Learning Objectives

1. Identify funding strategies used by charitable organizations
2. Describe financing opportunities available to startups
3. Define bootstrapping
4. Describe the advantages and disadvantages of bootstrapping

It’s important to recognize that not all startups are Silicon Valley tech companies. These companies create high-profile products, such as applications and websites, which can take years to become profitable or even generate revenue. Much more common are the small businesses founded every day by entrepreneurs seeking to create value in their local communities. Moreover, not all startups are founded with a profit motive in mind.

Charitable organizations, or certain nonprofit companies, are often founded for altruistic purposes, such as advancing the arts, education, and science; protecting the natural environment; providing disaster relief; and defending human rights.

These goals supersede the profit motive that a traditional company would have. As a result, the funding strategies of these enterprises often differ quite dramatically from those of standard for-profit businesses. Without the emphasis on profit, it can be difficult to provide for the cost of ongoing operations. Thus, these organizations must develop a sustainable strategy—one that can maintain the organization’s financial stability.

In the United States, such organizations can qualify for tax-exempt status, meaning that if there is a profit from operations, it is not typically subject to taxes. Organizations seeking this exemption must apply to the Internal Revenue Service for tax-exempt status and provide information about what kind of mission the organization carries out—charitable, scientific, educational, and so on.

Consider a museum. What is its purpose? Traditional companies provide a product or service to their customers in exchange for payment, and typically fill a need their customers have. A grocery store sells food because human beings need to eat food to survive. Although viewing paintings and sculptures is not a physical requirement for life, this experience arguably enriches our lives and helps educate and shape our society. That is why museums are founded.

This is a different goal than that of most small businesses (providing a product or service in exchange for a profit) and, as a result, requires different financing strategies, such as a combination of program services, donations, and grants.

Program Services

Program services are the basic offerings that a nonprofit organization provides that result in revenue, although not typically enough to cover the overall cost of running the organization. These services most closely resemble the customer interactions of a traditional business. The organization provides a product or service in exchange for a customer's money.

In our museum example, program services could take a few different forms. First, the museum likely charges a fee for admission to view the artwork and artifacts. The individual ticket price multiplied by the number of museum visitors equals the museum's ticket revenue. An established museum will have a good sense of how many visitors it has on average and can use these data to create a budget.

Another source of program service revenue for a museum could take the form of hands-on educational activities or events with guest speakers or presenters. Often museums will host local artists, or their own employees might conduct art classes or special-topic tours. These events and activities typically have a charge (revenue) beyond the regular admission cost.

Despite these revenue-generating activities, nonprofit organizations still face many funding challenges in covering all the operating costs of a normal business, such as employee wages, facility costs, and advertising. Thus, they need many different sources of income. To illustrate, the Met's 2018 program service income only made up 2.3 percent of its total revenue for the year.[36]

Donations

One benefit to a business with a charitable mission is inherent public support, which can foster community involvement above and beyond patronage. For nonprofits, this can translate into a willingness to donate money to the organization. A donation is a financial gift with no expectation of repayment or receiving anything in return. A traditional business must provide something valuable to create a customer exchange: Their customers demand value in exchange for their hard-earned money.

The benefactors of a charitable organization want to help further the mission of the organization. This type of entity—whether it's a museum, a hospital, or the Red Cross—relies on the goodwill of community supporters. For the Met, with such a low percentage of revenue generated by program services, it's clear that donations and charitable gifts are vital to the organization's financial viability.

Grants

Another source of funding for nonprofit organizations is grants. A grant is a financial gift given for a specific purpose by a government agency or a charitable organization such as the Bill and Melinda Gates Foundation. Like a donation, a grant does not have to be repaid. Unlike with donations, both nonprofit and for-profit organizations can compete for grants. Whereas donations are typically given without restriction to offset the general operating expenses of the organization, grants often specify how the funds are to be used. Most grant-providing entities have an agenda or purpose behind their funding. For example, the National Institutes of Health (NIH) provides grants "to support the advancement of the NIH mission to enhance health, extend healthy lives, and reduce the burdens of illness and disability."[37] This federal organization invests over $32 billion annually for medical research.

Grants can be very competitive, requiring a rigorous application process. Usually, multiple organizations apply for the same grant; the organization issuing the grant reviews the many competing applications to make its selection. Grantees generally must submit audited financial statements and are required to update the grantor subsequent to the grant award to ensure proper intended use. The NIH awards almost 50,000 grants annually, most of which are competitive. Although that is an enormous number of projects to fund, only 20 percent of applications submitted to the NIH in 2018 actually were accepted.[38] In other words, the NIH rejected four out of every five applications. For entrepreneurs, this means that when you identify a grant that is specific to your organization's mission, you should weigh your chances of being awarded the grant when considering it as part of your funding strategy.

To understand grants in practice, let's further examine the NIH. The NIH Small Grant

Program provides funds for activities such as the development of new research technology. This specific grant can be awarded for up to a two-year period, with funds of up to $50,000 in direct costs per year. A grant like this could provide vital support to a nonprofit startup.

Some business ventures fall somewhere between organizations completely committed to charitable work and traditional small businesses with entrepreneurs focused on social entrepreneurship. Social entrepreneurs develop products and services as solutions to societal problems. For example, the TOMS shoe company was able to create a business model through which the company gives one pair of shoes to children in need in foreign countries for every pair of shoes that a customer purchases. This practice pioneered what they refer to as "One for One."[39]

Social entrepreneurship offers the ability to effect positive change in the world without simply relying on donations. It pairs a profitable, sustainable business model with a good cause. This combination often creates positive word of mouth. It gives potential customers a good feeling about the product beyond just its style or function.

No-Loan Finance Strategies

As you've learned, many startups come into being through the extensive use of debt. Although borrowing is a legitimate source of funding, it can be risky, especially if the entrepreneur is personally responsible for repayment. In practice, some entrepreneurs max out credit cards, take out home-equity loans against their primary residences, or secure other high-interest personal loans. If the entrepreneur fails to repay the loans, the result can be repossession of equipment, home foreclosure, and other legal action.

We now examine funding strategies attractive to many startups that do not require going into debt or exchanging ownership of the business for financial support (debt and equity financing). The financing methods described here are more creative funding strategies, including crowdfunding, bartering, and other methods.

Crowdfunding

Recall the story of iBackPack. This venture was originally funded by contributions through

Indiegogo and Kickstarter. These websites are a form of crowdfunding, which involves collecting small sums of money from a large number of people. The people who contribute money are typically referred to as backers because they are backing the project or supporting the business idea.

Browsing these crowdfunding websites, you will see many different kinds of ventures seeking financial backing—from creating new board games to opening donut cafes. Each project identifies an overall specific funding goal in terms of a dollar amount. Some crowdfunding websites, such as Kickstarter, implement an “all or nothing” model in which projects do not receive any funds unless their overall funding goal is met. The amount can be exceeded, but if it is not met, the project receives nothing. For an entrepreneur utilizing this resource, selecting an attainable funding goal must be a core part of their strategy. The funding goal must also be appropriate to the scale of the project. For example, setting a goal of $50,000 may be reasonable for launching a food truck (which could be a prototype for a full restaurant), but it is a mere fraction of the cost of constructing an entire table-service restaurant, which would come closer to $750,000. An entrepreneur seeking to enter the culinary world should consider which target would be most achievable as well as most beneficial in meeting both short- and long-term goals. Also, remember that meeting the funding goal does not ensure success of the business, as was the case with iBackPack.

Entrepreneurs vying for crowdfunding usually employ some common tactics. First, they often post an introductory video that explains the project goal and the specific value proposition. (For example, a chef might seek $75,000 to open a food truck specializing in a relatively unknown cuisine.) Second, the entrepreneur provides a more detailed written summary of the project, often including specific items that the funding will pay for, such as $50,000 for a vehicle, $10,000 for graphic design and vehicle decals, and $15,000 for kitchen equipment for the truck. Last is the reward structure, which is what entices visitors to the site to fund the project, offering a return beyond their own passion for the venture. The reward structure establishes different levels of funding and ties a specific reward to each level. For example, for a contribution of $5, the chef might thank the backer on social media; for $25, the backer would get a t-shirt and a hat featuring the food truck’s logo; for

$100, the backer would get five free meals when the food truck opens. Fees for these crowdfunding sites vary from 5 to 8 percent. Kickstarter now requires physical products or prototypes for some startups, as well as a short video to help represent and "sell" the product.

Although this financing source offers a lot of flexibility, businesses utilizing crowdfunding can run into trouble. Certain funding levels and rewards may have limits. For example, a reward structure might offer backers contributing $1,000 a trip to the grand opening of the food truck, including airfare and hotel. These top-tier rewards can generate a lot of excitement, but the expense of flying people around the country and providing accommodations could become unmanageable. One research study stated that 84 percent of Kickstarter's top projects delivered their rewards late.[40]

The advantage of crowdfunding is that the business receives cash up front to launch. The down side is that the reward requires a future payment to the backers. This payment may be in the form of branded merchandise, meals, or even events or travel, so it is important for entrepreneurs to set aside part of the investment money to fund the rewards. Depending solely on generating the reward funds out of future sales is a risk that might result in upsetting the very fans who made the business possible. Since crowdfunding is managed online, another risk is upsetting the project's vocal supporters. Crowdfunding usually provides only a "kick start" for a startup, so most seed-stage companies will need additional funding from other sources to get to their first commercial launch.

Although social media can backfire, entrepreneurs can take advantage of benefits too. Crowdfunding can allow an entrepreneur to build a community around a product before it is even sold. Like-minded fans of a product can connect with each other over the internet, in the feedback section of a website, or in shared social media posts. Additionally, backers of a project can become cheerleaders for it by sharing the idea—and their enthusiasm for it—with friends, family, and coworkers. Word-of-mouth marketing can lead to more backers or future customers after launch.

Bartering

Startup companies often don't have a lot of cash assets on hand to spend, but they often have offerings that can provide value to other businesses. Bartering is a system of exchanging goods or services for other goods or services instead of for money. Let’s consider the case of Shanti, a website designer who wants to start a business. She may want to have her business formally incorporated or may require other legal help, such as review of standard contracts. Hiring a lawyer outright for these services can be costly, but what if the lawyer needed something that a website designer could provide?

Whether the lawyer has just started his own business or has been established for several years, he may need a website created or have an old website redesigned and updated. This website overhaul could prove costly for the lawyer. But what if there were a way that both the lawyer and the web designer could get what they wanted with a resulting net cost of zero dollars? Bartering can achieve this. It should be noted that there are accounting and tax implications involved with bartering that can prevent a net zero offset of costs.

In a barter scenario, Shanti could create a website for the lawyer at the expense only of her time, which in the startup phase is often more abundant than actual cash. The lawyer could provide incorporation services or contract review in exchange, requiring no cash outlay. For many entrepreneurs, this type of exchange is appealing and enables them to meet business needs at a lower perceived cost. Although more mature firms can also use bartering, the opportunity cost is much higher. If a mature company is unable to take on a new paying client because it is doing too much free (barter) work, it may lose out on future revenue, which could potentially be a big loss. Startups, in contrast, often have excess capacity while they develop a customer base, so taking on barter work is often a low-risk, beneficial funding strategy.

Other No-Loan Funding Options

Beyond crowdfunding and bartering, startups have other options to help them get off the ground, such as funding competitions and pre-orders (Figure 9.5). Many organizations hold entrepreneurial finance contests provide financial awards to the winners. These prize funds can be used as seed money to start a new venture. For example, the New York City Public Library holds an annual business plan competition called the New York StartUP! Business Plan Competition.[41] Applicants must complete an orientation session, attend workshops that develop skills related to the creation of a business plan, and submit a complete business plan. The first- place award yields $15,000 in prize money, which can be a great start toward turning an entrepreneurial idea into a business reality.

Another way for startups to gain financial traction is to solicit pre-orders. Consider the launch of a new book or video game. Retail stores will often solicit pre-orders, which are advance purchases of the product. Customers pay for the desired item before they even have access. For example, the entrepreneur Mitchell Harper raised

$248,000 in funds before his product launched.[42] This approach is not limited to existing, well-known franchises—startups can use it as well. Although established novel and video game franchises have big fan bases and often large advertising budgets, startups can still find effective strategies in this space.

Figure 11. Entrepreneurs can explore a variety of no-loan funding options. (attribution: Copyright Rice University, OpenStax, under CC BY 4.0 license)

Companies with a prototype model of their product or a first manufacturing run can showcase the new product to potential customers, who may be interested enough to place an order. The company can use the funds received from these pre-orders to pay for the inventory. In addition to having sales staff make sales calls, new companies can attend trade shows and exhibitions to garner interest in the product. Many new products are launched in this fashion because it allows access to many potential customers in one place.

Why Bootstrapping Hurts, Then Helps

The process of self-funding a company is typically referred to as bootstrapping, based on the old adage that urges us to "pull ourselves up by our bootstraps." It describes a funding strategy that seeks to optimize use of personal funds and other creative strategies (such as bartering) to minimize cash outflows. In recent years, this strategy has been the fodder for shows like Shark Tank. These shows may make entrepreneurs think that being on TV is glamorous, or the shows may glorify the financial backing of millionaires and billionaires. We have seen that for many entrepreneurs, the reality is that there are drawbacks to bringing in outside investors to launch your venture. These drawbacks include loss of future profits and possible loss of control of the company, among others. Potential business owners must weigh the advantages and disadvantages—both short and long term—for funding their specific dream.

You've learned about financing strategies predicated on finding a willing investor or lender, but many small businesses simply don't have access to large amounts, or any amount, of capital. In these cases, aspiring business owners need lean business strategies that will yield the greatest benefit.

Bootstrapping requires entrepreneurs to shed any preconceived notions of the popular-culture image of startups. Most startups don't have trendy downtown offices, foosball tables, or personal chefs. Bootstrapping reality looks more like late nights spent clipping coupons. It involves scrutinizing potential expenses and whether each cost is really worth the investment. It can be a difficult and trying process, but without any angel investors or wealthy family backers, bootstrapping is often an entrepreneur's only option. The good news is that this approach can pay substantial dividends in the long run.

The Basics of Bootstrapping

When entrepreneurs risk their life savings, they must stretch every dollar as far as possible. Having a limited amount of capital to work with requires optimizing creative strategies to get the business launched and keep it afloat. This creativity applies to bringing customers and sales in the door as well as to managing expenses.

Understanding the ongoing costs of the business is key. In an interview on NPR's show

How I Built This, Barbara Corcoran, one of the investors on Shark Tank, shares her humble beginnings in real estate brokerage.[43] One of things she touches on is being constantly aware of how long her money would last, given her monthly expenses. If she had $10,000 in the bank and the cost of her rent and employees was $2,500 per month, she knew that the money would last her four months. Such constant information and vigilance are required when bootstrapping a business for success.

Employee costs are typically one of the largest expenses facing a business. Hiring traditional full-time employees can be costly; onboarding them too early can be fatal to a business's bottom line. Creative approaches to minimizing labor costs can be enormously helpful. One strategy for controlling these costs is utilizing independent contractors (freelancers) and other part-time employees. They do not work full time for the business and may serve other companies as well. Their compensation is generally lower than that of a full- time, salaried employee, often in part because these positions do not usually come with any benefits, such as health insurance or paid time off. Using these workers to fill resource needs can help minimize costs. Once operations have begun to stabilize, it may be possible and ideal to offer full-time employment to these individuals.

Marketing is another key area for new business investment, but billboards, web ads, TV ads, and radio spots can be expensive. TV and radio ads can also be ineffective if they are aired during low-volume times, which is typically all that startups with lower budgets can afford. Fortunately, there are many low- or no-cost marking opportunities, such as word-of-mouth marketing. Doing a good job for one customer can easily lead to referrals for more business. Some social media efforts can also provide a strong return for minimal investment, although typically it is nearly impossible to gauge an effort's potential impact or success.

A new enterprise that is bootstrapping must also carefully manage operational expenses. At the beginning of operations, an entrepreneur can often minimize unnecessary expenses—even if that means forgoing an actual business location. Working out of a home office or a co-working space (such as WeWork or Impact Hub) can lead to significant savings. Renting office space can cost hundreds or thousands of dollars a month, whereas a home office typically requires no additional investment. Depending on the location, co-working spaces can provide a single workspace and technology access for as little as $50 to $100 per month, yielding substantial savings over a dedicated office suite. In larger cities, or in locations with more amenities, the monthly costs can run between $100 and $500 per month.

The Boston Beer Company, which today produces the Samuel Adams line of beers, provides a classic example of minimizing these costs in its early days. When this company first started, it owned no office space—or even a brewery. It employed other breweries as contract brewers to manufacture its beer. Its founder, Jim Koch, invested most of his time in selling to bars and restaurants, working from his car and phone booths. (This was during the 1980s.) His lean strategy was a successful application of the bootstrapping mindset. From its humble beginnings, the Boston Beer Company has become one of the largest American-owned breweries—ranked second based on 2018 sales volume by the Brewers Association.[44] Whereas traditional thinking may dictate that a company must have an official office or headquarters, a bootstrapping mindset evaluates what the space would be used for and the trade-offs for its cost.

How Bootstrapping Hurts

The process of bootstrapping is not an easy one. It is fraught with tight budgeting and sacrifice, which can take its toll on an entrepreneur. One of the simplest bootstrapping strategies is to start a business by moonlighting, or treating your business venture as a second job. Employing this strategy, the entrepreneur continues to work at their regular job, say from 9:00–5:00, and then dedicates the rest of the evening and weekends to working on the business. Whereas this strategy has the obvious benefit of maintaining a comfortable level of income, this approach has a few drawbacks (Table 9.3). Moonlighting entrepreneurs cannot dedicate 100 percent of their time and energy to their new business. The time they can dedicate to it may be less efficient. After working all day at another job, a person may feel tired or burned out, so it can be difficult to change gears and press forward with full productivity.

In addition to the exhausting time investment, moonlighting can exact tolls on personal relationships. This strategy is easiest when an entrepreneur is in a life stage with few commitments. It may have an adverse effect on friendships, but in other life stages, this impact can be more significant. For example, it can detract from relationships with a partner/spouse or children, in both a decrease in focus/investment in these relationships and day-to-day challenges in work-life balance and household management for all affected.

Additionally, at some point, to attract serious investors, a founder will have commit to the project full time

Bootstrapping Advantages and Disadvantages

Advantages	Disadvantages
• No ownership given up • Forces creative solutions • Keeping costs low fuels growth	• Slow to start • Less glamorous • Owner must make personal sacrifices

Table 3. Bootstrapping Advantages and Disadvantages

Other bootstrapping strategies include negotiating the terms for payments on expenses. Often when businesses sell to other businesses, the vendor allows the customer to buy on credit. This means that the buyer does not have to pay at the time of purchase. Although retail customers are required to pay at the register during checkout, purchases between businesses can work on different terms, sometimes extended up to thirty, sixty, or ninety days. This extra time to pay for purchases can be a real advantage for businesses.

When a business buys inventory on credit, it has the opportunity to begin selling it before it has even paid for it. For example, a clothing retailer could sell its product in stores or online, and receive cash before it had to pay its vendors. Unfortunately, when a business's cash becomes tight, an ethical dilemma can arise. When a business has more bills to pay than money to pay them with, the owner will need to make tough decisions. It can be easy to forget about or ignore amounts due to vendors, but this problem is compounded when it occurs with more and more vendors. Ultimately, it can get to the point where vendors will no longer sell to you on credit, or even at all. When a company can no longer buy inventory to sell to customers, it won't be long until it's out of business. An ethical entrepreneur will be alert to this concern and resolve it with aboveboard business decisions.

How Bootstrapping Helps

Although bootstrapping can be painful in the early years of a business, it yields significant benefits for the business owner in the long term. One of the most valued benefits of bootstrapping a business is the fact that the founder can maintain control of the company and typically retain 100 percent ownership. Although it can be easy to give up ownership in an idea because ideas come freely and don't require financial sacrifice, entrepreneurs who accept an equity financing opportunity and give up a significant portion of ownership of the business may not realize the potential detrimental outcomes. What seems glamorous on Shark Tank may cost a business owner more control than desired. Once you give up any amount of equity in a business, it can be difficult or expensive to get it back. Once the deal is accepted, the investor is entitled to that percentage of the profit every year the company is in business, even if that person never lifts a finger to support the enterprise. Entrepreneurs usually make those financing deals because of the benefits of the money and access to the investor's contacts. It's unlikely that Mark Cuban is going to roll up his sleeves in your food truck when things get tough. If you can avoid outside financing, you will maintain complete control and full ownership of the business, and you should weigh this benefit in your financing decisions.

Another benefit of bootstrapping is avoiding taking on debt. Whether it's in the form of credit cards or personal loans, repayment of debt can take a serious toll on any business and can be especially burdensome for new businesses. Considering that some of the debt financing sources available to entrepreneurs can bear higher-than-average interest rates, digging yourself out from underneath this financial burden is no easy task. Also, delaying outside investments allows your business to grow not only in revenue and profit, but also in market value. When potential investors come along, they will consider a higher contribution for a smaller percentage in the business.

Chapter 7: Multiple Choice

1. According to chapter 7, venture capitalists are typically involved in this funding strategy.
   a) Early
   b) Mature growth
   c) Seed
2. According to chapter 7, these investors are wealthy, private individuals seeking investment options with a greater potential return than is traditionally expected.
   a) Angels
   b) Friends and family
   c) Private equity sale
   d) Venture capitalists
3. According to chapter 7, the advantage of this financing is that there is no immediate cash flow requirement to repay the funds.
   a) Angels
   b) Debt
   c) Equity
   d) Friends and family
4. According to chapter 7, this type of funding involves collecting small sums of money from a large number of people.
   a) Bootstrapping
   b) Crowdfunding
   c) Donations
   d) Grants
5. According to chapter 7, this type of funding involves risking a life savings and trying to stretch every dollar as far as possible.
   a) Bootstrapping
   b) Crowdfunding
   c) Donations
   d) Grants

Chapter 7: Short Answer

1. According to chapter 7, explain the three (3) typical funding strategies**.**

2. According to chapter 7, describe the common tactics employed when crowdfunding**.**

3. According to chapter 7, explain what is an IPO and what is involved**.**

4. According to chapter 7, explain the advantages and disadvantages of bootstrapping**.**

Chapter 8: Accounting Basics for Entrepreneurs

Learning Objectives

1) Explain the accounting equation and define its parts (assets, liabilities, and equity)
2) Define revenue, expenses, and income

Although financing and accounting complement and rely on each other, they are distinct. As we have seen, financing is the process of raising money. Accounting is the system of recording and classifying financial transactions related to a business, and summarizing and communicating those transactions in the form of financial statements. Accounting is essentially documenting what happens to money once a company receives it and thereby makes that information available for reporting to stakeholders and regulatory agencies, and informing business decisions.

At the most fundamental level, an accounting system accomplishes two goals:

5. It summarizes a business's financial performance
3) It communicates that performance to owners, managers, and outside parties

The most common approach to accounting used in the United States, and around the world, follows the basic formula: **Assets = Liabilities + Equity**.

This formula is referred to as the basic accounting equation. First, we'll define each of these terms, and then we'll look at an example of a simple transaction recorded using the equation.

Assets are items—such as equipment, cash, supplies, inventory, receivables, buildings, and vehicles—that a business owns and derives future use from. Potential investors want to know what resources a company has at its disposal. Business owners want to see where their money has gone. Let's return to the case of Shanti, the website designer who starts her business by purchasing a new laptop computer. The computer is an asset that Shanti has acquired for her business.

A liability is a debt that a company has incurred with another party, as when it borrows money from a bank or purchases materials from other suppliers. The business is required to make a future payment to satisfy that debt. For accounting purposes, we want to be able to see what the business owns (assets) compared with what it owes (liabilities). For example, if Shanti does not have sufficient cash to pay for the laptop, she may have the electronics store charge her credit card for the purchase. In that case, the credit card company pays the store, and Shanti's business now owes the credit card company for the amount of purchase (a liability).

Equity is the owner's claim on the assets of the business, that is, the difference between what they own and what they owe. Essentially, equity tells a business owner or investor how much the firm is worth after all the debt is repaid. Returning to the example of Shanti's website design business, let's compare two scenarios of startup purchases to see the effects on the accounting equation. In both cases, Shanti contributes some of her own money to the initial purchase of a laptop.

Assets	=	Liabilities	+	Equity
Cash +1,000		0		Owner's Capital +1,000

Figure 21. An initial $1,000 contribution by the owner is recorded in the accounting equation. (attribution: Copyright Rice University, OpenStax, under CC BY 4.0 license)

Each element of the accounting equation has its own account in an accounting system or software package, and all changes are tracked within its account. The accounting equation must stay in balance after every transaction with assets equaling liabilities. In this case, Cash is an assets account, and Owner's Capital is an equity account. The $1,000 cash contributed is a cash asset and becomes equity that is recorded as owner's capital. At this point, Shanti can claim 100 percent of the assets of the business, which right now consist only of the cash.

If she uses all of her cash assets to purchase the laptop, the accounting equation will record this as shown

Assets		=	Liabilities	+	Equity
Cash	Computer				Owner's Capital
+1,000			0		+1,000
−1,000	+1,000				
0	1,000		0		1,000

Figure 12. The purchase of a laptop computer using existing cash is recorded in the accounting equation.(attribution: Copyright Rice University, OpenStax, under CC BY 4.0 license)

When the cash is spent, reducing the assets column to zero, a new asset account for the computer is created to record the dollar amount paid for the laptop. Again, because Shanti doesn't owe another party at the end of the transaction (because she didn't make any additional contribution), the balance of the owner's equity account remains the same. The equation shows that Shanti still owns 100 percent of the assets.

Developing Startup Financial Statements and Projection

Learning Objectives

1. Understand the three primary financial statements: balance sheet, income statement, and statement of cash flows
2. Understand how financial projections are made and how to use the run rate and the burn rate
3. Understand how to create a break-even analysis

You have learned how an accounting system classifies transactions in terms of assets, liabilities, and equity; what those transactions mean in terms of the accounting equation; and what that information says about an entity's overall financial health. Now we'll examine how to summarize those transactions in financial statements that can be shared with stakeholders. Internally, these statements are used to make decisions about the management of the company and its operations. Externally, they provide existing and potential investors with data to inform their financial support of the venture.

The information entered into the accounting system is summarized in financial statements, which are the output of an accounting system. We will examine three basic types of financial statements: 1) The balance sheet; 2) The income statement; 3) The statement of cash flows

Each type of statement communicates specific information to its audience. Investors around the world use financial statements every day to make investment decisions

The Balance Sheet

The first financial statement is the balance sheet. The balance sheet summarizes the accounting equation and organizes the different individual accounts into logical groupings. As you previously learned, the components of the accounting equation are:

4. assets—items the company owns or will benefit from; examples include cash, inventory, and equipment
5. liabilities—debt or amounts the company must repay in the future; examples include credit card balances, loans payable, and so on
6. equity—the share of the assets due to the owners after debt is repaid

The accounting equation itself (assets = liabilities + equity) is spelled out on the balance sheet. It is shown in two portions. On one side, all of the assets are spelled out and their amounts totaled. This total is compared to the totals in the second and third portions, which show liabilities and equity. Just as the accounting equation itself must balance, so must the balance sheet.

The figure shows the 2020 balance sheet for Hometown Pizzeria. This is the same kind of financial statement that real-life investors use to learn about a business. You can see the main aspects of the accounting equation in each half of the statement, as well as many detailed individual accounts. This financial statement gives the reader a quick summary of what the company owns and what it owes. A potential investor will be interested in both items. The amount of liabilities is an indicator of how much the business needs to pay off before the investors will see a return on their investment.

Unlike the accounting equation shown in Accounting Basics for Entrepreneurs, most balance sheets display data vertically rather than horizontally. But the vertical format still presents the two sides of the equation—except that liabilities and equity are on the bottom half of the statement. Note that the two sides still must equal each other, or balance - hence the name “balance sheet.

HOMETOWN PIZZERIA Balance Sheet For the Year Ended December 31, 2020	
Assets	
Cash	3,918
Ingredient supplies	1,720
Furniture and fixtures	5,654
Restaurant equipment	15,890
Total assets	27,182
Liabilities	
Accounts payable	1,890
Credit card payable	3,759
Total liabilities	5,649
Equity	
Owner’s capital	21,533
Total liabilities and equity	27,182

Figure 33. This is Hometown Pizzeria’s balance sheet. (attribution: Copyright Rice University, OpenStax, under CC BY 4.0 license)

A review of the Hometown Pizzeria balance sheet lets us see what kind of assets the company has. We see cash, ingredients, and restaurant equipment—all things that would be necessary to make pizzas and sell them. We also see some liabilities. Accounts payable is an account that covers many different vendors that the company buys from on credit, which means the vendors let the pizzeria pay them after they have delivered their goods. These vendors could be companies that sell flour, produce, or pizza boxes. “Credit card payable” is the balance due on the credit card, which could have also been used to stock up on supplies or pay other bills.

One of the first things an investor will do is compare the total assets of a company with the total liabilities. In this case, the pizzeria reports total assets of $27,182 and total liabilities of $5,649. This means that the pizzeria owns more than it owes, which is a good sign. It actually has several times more assets than liabilities.

Although it does not have enough cash to pay off all the liabilities right now, other assets have value and could be sold to generate cash.

To recap, the balance sheet summarizes the accounting equation. It tells the business owner what the company has and how it was paid for. Investors also want to understand where the company has spent its money and where that money came from. If a company is laden with debt, any investment may be immediately spent trying to get caught up with creditors, with no real impact on helping operations. Ultimately, investors want to read these financial statements to know how their money will be used.

The Income Statement

The second basic financial statement is the income statement, which provides the results of a company's operations. At the most basic level, the income statement—also called the profit-and-loss statement—describes how much money the company earned while operating the business and what costs it incurred while generating those revenues. An investor wants to know how much money the company brought in from customers and how much it had to spend to get those customers. Revenue minus expenses results in net income, or profit if there are funds left over.

After identifying total revenue and expenses, a business can calculate its profit margin. The profit margin is the profit divided into the total revenue, described as a percent. For example, if we opened a pizzeria and generated $100,000 in sales our first year and incurred $90,000 in expenses, that would result in $10,000 of net income. If we divide that net income by our $100,000 in sales, the profit margin is 10 percent. So for every dollar of sales that was generated, ten cents remained as a profit. We could save this resulting profit for future renovations, an expansion, or payment to the owners as a distribution.

A pizzeria—or any business that sells a physical product—has costs that are specific to the product sold. For example, pizza requires flour and yeast to make the dough, tomato sauce, and cheese and other toppings. We refer to these expenses as the cost of goods sold. These costs are the primary driver that determines whether the company can be profitable. If the selling price of a pizza is $12 and our cost of ingredients is $12, the transaction nets to zero. The company wouldn't make any money on a sale and is simply recouping the money paid for the ingredients. This is not a feasible business model because there are many costs in addition to ingredients, such as rent on the building, employee wages, and other items.

The selling price of an item minus its direct costs—or cost of goods sold—is the gross profit. In a product business, this is the most important operational figure. A business needs to know how much money it makes on each sale because that gross profit pays for all other expenses. If the pizzeria sells a pizza for $12, the cost of its ingredients might be $4, so the gross profit of selling one pizza is $8. Every time the company sells another pizza, the gross profit increases. If the business sells 1,000 pizzas in a month, its sales would be $12,000, the cost of goods sold would be $4,000, and $8,000 would be left for profit.

HOMETOWN PIZZERIA Income Statement For the Year Ended December, 2020	
Revenue	
Food and beverage sales	32,593
Expenses	
Cost of goods sold	9,777
Paper products	1,201
Rent	3,000
Salaries and wages	4,809
Utilities	2,753
Total expenses	21,540
Net income	11,053

Figure 14. This is Hometown Pizzeria's income statement. (attribution: Copyright Rice University, OpenStax, under CC BY 4.0 license)

Results from Operations

As you learned earlier in this chapter, a business can create assets through debt or equity financing. After the initial investment, those assets can be employed to operate the business. For example, when Hometown Pizzeria opens, after the initial build out of the kitchen and dining area, the business can make and serve food to customers in exchange for money. This process creates new assets in the form of cash collected from customers and becomes a third way to generate assets in a business—from operations, which we call revenue. In an ideal situation, the business would require little outside investment once operations have begun.

The amount a business earns from selling a product or providing a service is referred to as revenue, or sales. The costs incurred in the normal course of operations are referred to as expenses. For the newly opened pizzeria, payments from customers for their meals are the business revenue, whereas the cost of food ingredients, beverages, dinnerware, and paper goods—such as napkins—are the operating expenses. The balance of business revenue minus operating expenses is the profit of the business, or net income.

Before moving on to visualizing operational income, let's pause here to review some of the basic distinctions between these key terms. When a company gains new assets, those assets have to come from somewhere, usually from one of three sources. We will see these options on the right side of the equation, as we move from left to right. First, if we gain a new asset, but we have not paid for it, we have created a liability—something the business owes. This was the case when Shanti paid for her computer with a credit card. In the future, she will have to pay the credit card company, but this is different process from an expense, as we will see later. For right now, we are gaining something new and must repay someone later.

The second source of new assets is owner investments. This was the first example we saw when Shanti deposited money in the business's bank account from her personal savings. In terms of the business, assets increased because she now had more cash than before, and on the right side of the accounting equation, we record the source of those assets—Shanti herself. So investments by the owner are another source of new assets.

The third way that the business gains new assets is from operations. When Shanti uses the assets of her business (a computer) to perform work for a customer (creating a website), this results in a sale, or revenue Assets of the business increase because the customer pays for the work; thus, Shanti's cash increases. Again, on the right side of the equation, we record the source of that asset: revenue. Revenue is an increase in assets from customers paying for goods and services.

Assets		=	Liabilities	+	Equity	
Cash	Computer				Owner's Capital	Revenue
+1,000	0		0		+1,000	0
−1,000	+1,000		0		0	0
+5,000	0		0		0	+5,000
5,000	1,000		0		1,000	5,000

Figure 15. This shows recording a customer sale of $5,000. (attribution: Copyright Rice University, OpenStax, under CC BY 4.0 license)

To illustrate, let's continue with Shanti's website design business. She purchased a computer with her personal savings and has been hired to create a website for a local business. This client agrees to pay $5,000 for the website, due on completion of the site. Once the work on the website is complete, Shanti records the receipt of $5,000 cash as an increase to the cash account. On the right side of the equation, this is added in an account under equity for revenue

The total company assets have grown to $6,000 with the addition of the $5,000 earned and collected from this client. On the right side of the equation, equity has increased in a new column representing revenue and expenses, where revenues are positive amounts and expenses are negative amounts.

The accounting equation describes how transactions are classified within the context of balancing what a business has (assets) with how it paid for those assets (liabilities and equity). In the next section of this chapter, we will explore how this information is summarized in financial statements and how entrepreneurs and potential investors use that information.

The Statement of Cash Flows

The third basic financial statement we will discuss is the statement of cash flows, which explains the sources of and uses of a company's cash.

You may wonder how the statement of cash flows differs from an income statement. The short answer is that the income statement captures events as they happen, not necessarily when the company gets paid. It records certain items, such as sales, when the work is completed. Let's return to Shanti, the website designer. As soon as she completes the client's website, the accounting system will record the revenue, the amount that is due from that client; this second item is referred to as accounts receivable. If Shanti's client is struggling financially or even goes out of business, she may never get paid for that work, but the income statement would show sales, and therefore possibly a profit. If the customer goes out of business, the business bank account will not have any evidence of a profit.

It is for this reason that the statement of cash flows was developed. It accounts for these differences, only showing activities that result in cash received or cash paid. To better understand the purpose and use of the statement of cash flows, let's first look at this statement again in the context of a pizzeria

Figure 16. This is Hometown Pizzeria's statement of cash flows. (attribution: Copyright Rice University, OpenStax, under CC BY 4.0 license)

HOMETOWN PIZZERIA Statements of Cash Flows For the Year Ended December 31, 2020	
Cash Flows from Operating Activities	
Cash received from customers	50,000
Cash paid for ingredients and supplies	(18,000)
Cash paid for employees	(12,500)
Cash paid for interest	(3,300)
Cash paid for taxes	(3,900)
Net provided by operating activities	12,300
Cash Flows from Investing Activities	
Purchase of equipment and furniture	(55,000)
Cash Flows from Financing Activities	
Proceeds from long-term debt	60,000
Net increase (decrease) in cash	17,300

As we can see in the statement of cash flows for Hometown Pizzeria, although the basic operations generate positive cash flow, a major purchase was required. This is common at the inception of a business. Not every location will come equipped with a commercial kitchen and dining area, so the business may need to purchase items such as a pizza oven and dining chairs and tables. Note that although the income statement approximates the cash flow from operations, it would not show the large outflow resulting from the initial purchase of equipment. That purchase would have been treated as an asset within the context of the accounting equation and would have been recorded on the balance sheet. So from that large difference alone, we can see why some people say that the statement of cash flows is the most important of the financial statements. It bridges the gap between the income statement and the balance sheet.

As you can see in the figure, the statement of cash flows is broken into three sections. The first is operating activities, the day-to-day activities of the business, including purchasing supplies, paying rent, and receiving cash from customers. This section tells a reader how effective the company's business model is at generating cash flow.

Investing activities include major purchases of equipment or facilities. For example, when Amazon develops its second headquarters, those billions of dollars spent will be recorded as investing activities. Additionally, if the company has an excess of cash, it may purchase securities such as stocks and bonds, which have a higher return on investment than a traditional bank savings account. This section tells a reader where the company spends money in terms of large acquisitions.

The third section of the statement of cash flows is financing activities. This section tells a reader where new infusions of cash come from. The owners of Hometown Pizzeria need to find a way to pay for the kitchen equipment and furniture. If they have such an amount in their personal savings, then they can simple contribute it to the company themselves. If they don’t have the money already, they will need to seek other sources, such as loans or the types of investors discussed in Overview of Entrepreneurial Finance and Accounting Strategies. Generally, any financing activity is also booked in the balance sheet as well. This section of the statement explains which sources the owners used to generate outside funds coming into the business. It always indicates future requirements as well. For example, if a bank loaned the pizzeria the money, then we know it will have to be repaid in the future. So the business will need to ensure it is setting aside money to make monthly repayments. If new investors contribute money, what manner of return on investment will they be seeking? If they decide to seek regular distributions of profit, they will have to factor that in.

Projections

Among the most powerful tools business owners can use are projections. A projection is a forecast of the future operations of the business. It is a landscape for the business: What do the next few months look like? What about the next year? A projection would outline what level of payments are expected to come in and the timing of costs incurred. This lets the business owner understand what potential financing needs to be secured.

Two key concepts related to projections are the run rate and burn rate. The run rate helps extrapolate into the future. For example, if the pizzeria is generating sales of $10,000 per month, that translates into an annual run rate of $120,000 per year. Multiplying the monthly amount by twelve tells us the annual amount; if we wanted quarterly projections, we would multiply the monthly amount by three. This is useful for explaining to investors what the company will look like now that it has achieved traction in generating sales.

The burn rate is the rate at which cash outflow exceeds cash inflow, or essentially how much money the company is expending overall each month. Before generating revenue, or generating enough to just break even, startup companies will incur losses. Understanding the pace at which the expenses exceed revenue helps business owners plan accordingly. For example, if it takes six months to renovate the pizzeria and the monthly rent is $2,000, then the burn rate is $2,000 per month and forecasts that the business will need an additional $12,000 ($2,000 × six months) available in financing on top of the cost of renovations. The location's rent must be paid, even if the pizzeria isn't yet open for business

During the seed stage of a company, projections can also be used to show potential investors how quickly the company will make money and hopefully inspire them to invest in the venture. Just as on Shark Tank, projections are used during the "pitch." Investors and lenders want to see exactly how they can expect the business to perform and how quickly the company generates positive financial results.

Break-Even Analysis

Variable costs fluctuate with the level of revenue. Returning to Hometown Pizzeria, we see that the cost of ingredients would be a variable cost. In a previous section, we also referred to these as the cost of goods sold. Variable costs are based on the number of pizzas sold, with the goal being to buy just enough ingredients that the business doesn't run out of supplies or incur spoilage. In this example, the cost of making a pizza is $4, so the total variable costs in any given month equal $4 times the number of pizzas made. This differs from a fixed cost such as rent, which remains the same every month regardless of whether the pizzeria sells any pizzas or not.

HOMETOWN PIZZERIA	
Selling price of a pizza	$12
Cost of ingredients	(4)
Contribution margin	$ 8

Figure 17. This is Hometown Pizzeria's contribution margin. (attribution: Copyright Rice University, OpenStax, under CC BY 4.0 license)

The first step in understanding the break-even point is to calculate the contribution margin of each item sold. The contribution margin is the gross profit from a single item sold. Therefore, selling price minus variable costs is the contribution margin. Hometown Pizzeria’s selling price of a pizza is $12. The variable cost is $4, which results in a contribution margin of $8 per pizza. This $8 will go toward paying other expenses; when those are covered, the remainder will be added to the profit. Once we understand how much each item sold contributes to other expenses, we understand how those other costs behave. The other main category of costs is fixed costs. Fixed costs are a set amount and do not change, regardless of the amount of sales. Previously, we referred to rent as such a cost, but most of the business’s other costs operate in this manner as well. Although some costs vary from month to month, costs are described as variable only if they will increase if the company sells even one more item. Costs such as insurance, wages, and office supplies are typically considered fixed costs.

The other main category of costs is fixed costs. Fixed costs are a set amount and do not change, regardless of the amount of sales. Previously, we referred to rent as such a cost, but most of the business’s other costs operate in this manner as well. Although some costs vary from month to month, costs are described as variable only if they will increase if the company sells even one more item. Costs such as insurance, wages, and office supplies are typically considered fixed costs.

Once variable and fixed costs are determined, this information can be used to produce a break-even analysis. Calculating the break-even point is simply a matter of dividing the total fixed costs by the contribution margin. To illustrate, let’s assume that Hometown Pizzeria still sells pizzas with a contribution margin of $8 each. Let’s also assume that the only fixed cost is the rent of $2,000 per month. If we wanted to know how many pizzas the owner needs to sell each month to pay the rent, we divide $2,000 by $8. This results in a break-even point of 250 pizzas. Now we know that if the pizzeria sells 250 pizzas a month, its rent is completely paid. Any additional pizzas sold add to the company’s profit. If the business sells fewer than 250 pizzas, it will not generate enough income to cover the rent and will incur a loss. Whenever a business incurs a loss, the owners will need to contribute more of their own personal savings or potentially go into debt.

HOMETOWN PIZZERIA	
Total fixed costs	$2,000
Contribution margin of a pizza	÷8
Break-even point (in number of pizzas)	250

Figure 18. This is Hometown Pizzeria's break-even point. (attribution: Copyright Rice University, OpenStax, under CC BY 4.0 license)

Understanding the break-even point for a business provides a great deal of insight. At the most basic level, it demonstrates how many units of a product must be sold to cover the expenses of the business and not incur a loss. It may also help business owners understand when costs are too high and decide how many units need to be sold to break even. Realizing this up front can help entrepreneurs avoid starting a business that will result only in losses.

Chapter 8: Multiple Choice

1. According to chapter 8, in accounting supplies are a(n) _____.
   a) Asset
   b) Equity
   c) Liability
2. According to chapter 8, expenses are found on the _____.
   a) The balance sheet
   b) The income statement
   c) The statement of cash flows
3. According to chapter 8, cash paid for employees are found under cash flows from _____.
   a) Financing activities
   b) Investing activities
   c) Operating activities

Chapter 8: Short Answer

1. According to chapter 8, what is the basic accounting formula and explain the two goals of an accounting system**.**

2. According to chapter 8, describe three (3) sources a company to gain a new asset**.**
3. According to chapter 8, explain what is a break-even analysis and how to do it**.**

Chapter 9: Types of Resources

Learning Objectives

1) Distinguish between tangible and intangible resources
7. Determine the venture’s tangible and intangible resource needs and how to attain them
8. Describe the various funding resources available to entrepreneurs and discuss the pros and cons of each

You have learned about many opportunities for entrepreneurs to explore and the processes that ensure their success. This discussion focuses on the various resources that entrepreneurs need to start, maintain, and grow an enterprise, and, in general, how to procure those assets. Many entrepreneurs make the mistake of moving forward in their business endeavor without taking enough time to research their industry and determine what resources are required to help their business not only get off to a positive start but also the resources needed for its continued operation. Before we delve into allocation, let us examine the general categories of resources needed in just about every new venture: tangible, intangible, and financial.

Tangible Resources

As you can imagine, resources needed for the enterprise are varied and can have different attributes. These assets are essential in the operation of the business enterprise. They can be tangible or intangible. Tangible resources are assets that have a physical form. They can be seen, touched, and felt. Tangible resources differ between product-based and service-based businesses. A product- based business uses tangible resources in the production of goods sold to customers, such as raw materials, land, facilities, buildings, machinery, computers, supplies, and vehicles.

Tangible resources for a service-based business include buildings such as a doctor’s office, bank, movie theater, amusement park, retail store, or restaurant, which are enterprises that include both products and services. Facilities and resources that the business needs to provide its services and run operations may include computers, office equipment, furniture, and technological resources. The equipment and décor need to be taken into consideration because they becomes part of the product offerings, even if the core product is a service.

Place of Operation

Your facility needs will depend on the type of product or service you are offering and vary in scope from office space to a food truck to a manufacturing facility to a storefront for sales. Knowing the limit of your budget (discussed in the next section) should help you focus on locations that you can afford. Experts recommend that you allocate only a certain percentage of your sales to your lease or purchase; some businesses use industry averages as guidelines. Factors to assess are location, visibility, foot traffic (how many potential customers walk by), how well the building has been maintained, the maintenance it will need in the future, how long you would want to stay in that location, and the insurance, property tax, and renovation costs, or the cost to build a new building. One approach is to make an assessment of your sales per square foot and compare those to sales of similar companies in the same industry or market. These data can be found through local commercial realtor offices, city or county government offices, and local associations.

Machinery/Equipment

Machinery and equipment are critical assets to helping launch a business. For service businesses, such as restaurants, dry cleaners, print shops, etc., the equipment can be expensive. In recent years, however, a larger reseller market has emerged for many types of equipment that are still serviceable. It is important for tax purposes to report the current asset value of used equipment and have an accountant confirm its useful life for your income statement and tax returns.

For companies that manufacture products, you may have to order customized tooling and assembly equipment. Again, if you must acquire new equipment, you will need to understand what its useful life is and determine whether you must procure or acquire the equipment from a supplier who charges a “piece price” on top of each component or finished product they supply to you. If you choose this second approach, your supplier may insist on a long-term manufacturing agreement to manage their risk.

Vehicles

For some businesses, vehicles are necessary equipment to run day-to-day operations. You can use your own, which can be cost effective, or you can purchase or lease one. If purchasing a used vehicle, it is best to check the Kelley Blue Book (www.kbb.com), a reference guide that lists market prices, before purchasing it from a dealership; make sure that there are no defects or negotiate a lower price if you find them; and make sure to secure documentation on warranties. Other reliable valuation sources are carfax.com, nada.com, and edumunds.com.

Many small business owners are undecided as to whether buying or leasing a business vehicle nets better benefits. Let’s assume for the purposes of this discussion that the vehicle is primarily a business vehicle and is not used a majority of the time for personal use. Relevant considerations include both tax and cost-related issues.

One difference between the purchase and lease of the vehicle relates to the tax deduction for depreciation. When you own a business vehicle, you can deduct a depreciation value over the life of the vehicle. Generally, you are not eligible to deduct depreciation on a leased vehicle. However, there is a corresponding difference with regard to the deductibility of monthly payments. With a leased vehicle, the monthly lease payments ar e tax deductible, whereas if the vehicle is purchased with a car loan, only the interest on the car loan is deductible as a business expense. Ultimately, the decision to lease or buy is one that an entrepreneur should make in concert with a tax advisor.

Technology

No matter what business you are in, you must invest in technology to support your day-to-day operations. This typically includes computers and software, as well as Internet service and intranet/network functionality. The following list includes most of the basic investments you will need to make for your business:

Computers: Laptops, desktops, and tablets are an obvious necessity for day-to-day tasks, communication, and even production of products or services. Think about the performance and attributes needed to operate the business for insight about what brand and quality to buy. A good operating system that can process calculations and requests faster can make your business operations smoother and more efficient.

Internet: Every business must have strong and reliable Internet service to ensure connectivity of computers, routers, and peripherals. Communication in today's environment cannot happen without this technology, and there are many providers that have good packages for businesses to get the bandwidth necessary to operate a business and/or to provide connectivity to customers.

Router: If you are using multiple computers, laptops, and printers that need to be connected to each other, you will need a wireless router. A wireless router will help you keep documents and printers accessible from anywhere in your office, even if it's a small home office. You can also have a hard-wired router, which blocks outside signal interference.

Printer: Most businesses need a good quality printer for printing documents, marketing materials, and forms. Most printers now use color ink and come with the ability to scan and copy documents. They also vary in quality, so you will need to consider your printing needs and the costs of toner/ink to determine the level of quality you need.

Server: If you need to store and retrieve data—such as customer profiles, emails, and sales information—you will likely need a server. The server is a hardware system with software that performs various functions that cannot be done from one computer.

Cloud computing: Cloud services have emerged as a cost-effective way to process, store, and use data for company operations. Rather than host your data and systems on your own hardware services, many large companies like Amazon, Verizon, and Microsoft offer web services hosted on a network of computers. This option provides ongoing data integrity and security, while lowering the cost of IT services and equipment.

Software: There are many software applications and tools that are essential for business operations. These tools support day-to-day tasks. Common software needs include accounting and billing software like QuickBooks, customer relationship management tools such as Salesforce or Marketo, word processing and spreadsheet software like Microsoft Word and Microsoft Excel, presentation software such as Microsoft PowerPoint, diagram tools like Draw.io, email marketing tools like Constant Contact or Mail Chimp, file management systems like Dropbox, online phone/meeting apps like Skype and Zoom, social media management systems such as Hootsuite, project management tools like Bootcamp, and more. Some of these tools are free. Others carry a cost but may have free trial periods if you need to test them before investing. Most offer easy subscription payment schedules that can be set up monthly or yearly, and include ongoing software updates.

Supplies

There are many other supplies needed to operate the business, mostly basic items that you might take for granted but that need to be expensed: paper, toner, files, staplers, writing utensils, cleaners, and so on. You will likely need basic office furniture too. You may also want to invest in certain amenities that create a working environment and set the stage for your envisioned company culture—whether that's a coffeemaker, a dartboard in a break area, or whiteboards for meetings and brainstorming.

Licenses and Permits

What types of licenses might be required to operate your business? You may need a basic business license or permit provided by the government for the business to be valid, such as registering as an LLC, partnership, or company. These licenses let the government know what kind of activities the business performs and ensure taxes are collected properly. They also make your business a legal entity and prove that it exists in case you need funding or permits. Some businesses require a sales tax license for products and services, whether they are tangible or digital.

Other considerations include professional certifications that pertain to the industry you are working in, such as certifications in accounting (CPA), financial advising, cosmetic services, or healthcare. Many industries require licenses before you can begin to operate; such industries include healthcare, financial services, construction, real estate, insurance, transportation, and engineering. If you will be receiving customers in your home office or storefront, you may be required to undergo a home inspection, especially from the health department if you are in a foodservice industry. Signage outside your business location may also require a permit or compliance with local regulations.

Other permits that may be required for a building include a certificate of occupancy, fire, electrical, HVAC, plumbing, and hazardous materials such as gasoline, diesel, oil, or compressed gas cylinders. Check the laws and regulations of your local and state governments to ensure your business meets the legal requirements for licensing and permits. You can do this by contacting the secretary of state in your state and also by contacting your local chamber of commerce. Importantly, these licenses and permits often carry a cost and should be part of your startup costs with renewals included in your operational budget.

Intangible Resources

Intangible resources are assets that cannot be seen, touched, or felt. Intellectual property—which includes creative imaginings such as formulas, designs, brands, and inventions—is an intangible resource, and so are the patents, trademarks, and copyrights that protect the intellectual property. For example, if you are a small business owner, you might want to protect your logo, company name, website, slogan, new product prototype, or maybe a newly developed manufacturing process that allows you to shorten production time.

In our current technological era, intellectual property has become more important than ever. Entrepreneurs must protect their ideas for as long as possible to sustain a competitive advantage. A competitive advantage for a business could be a formula for a product, like the recipes Kentucky Fried Chicken or Coca-Cola use for their food and beverage products. They protect their formulas so other companies do not replicate them and profit from them. Smaller companies can also invent new products, methods, and branding that will need to be protected. Patents, trademarks, and copyrights are three protections for this type of intangible resource.[45]

Patents

A patent grants the owner the right to claim the ability to exclude others from making, selling, using, and importing a product or process to the United States for a period of time. This time is usually twenty years from the date the application was first submitted to the US Patent and Trademark Office (USPTO). This allows the inventor to recuperate the costs of researching and developing the novelty before competitors can copy it. Types of patents include utility, business process, design, and plant patents.

A utility patent is granted to an individual who invents or discovers something novel and purposeful such as a machine, a process, a product, an improvement to any of these, or even a composition of matter. Most patents awarded to inventors are utility or plant patents. The USPTO receives more than half a million applications each year.[46]

The application and approval process can take several years and can involve a substantial investment that can range from a couple thousand dollars to over $15,000, depending on the complexity and type of patent, as well as the fee for a patent lawyer. Lawyers can help with conducting a patent search and ensuring that the invention doesn't yet exist, while providing guidance on the application process. Patent attorneys are often expensive, charging between $200 and $800 an hour, but they can make the process easier.

Usually, the first application an inventor files is for provisional twelve-month patent protection, which covers the invention for the first year while the inventor waits for the approval of a final, nonprovisional patent. A patent examiner processes the application and determines whether to award the protection or not. Having the help of a patent lawyer is not necessary, but it usually makes the process easier and increases the odds of receiving the patent. Not having a lawyer can delay the process or prevent the inventor from getting the patent, especially if the inventor is not familiar with the process, or if the invention is complex. Choosing a lawyer carefully is important, as experience and knowledge of the process matters. If the patent is awarded, the final patent goes into effect retroactively to the filing date of the provisional patent, and the inventor has twenty years of protection against other companies copying the design

A business process patent is a type of utility patent granted to someone who develops a new business method, and just like a tangible product, the method must be new and nonobvious, and it must employ an equipment or type of technology to be valid. Non-obviousness is a legal requirement for a patent acquired under federal law (35 U.S.C. § 103), and generally means something that is not readily apparent. A proposed invention is obvious if someone of ordinary skill in a relevant field could easily make the invention based on prior art and thus would not be patentable, whereas a nonobvious invention is capable of being patented. The application must include a description of how the method works with the technology or equipment, and it must have a real-world application and not just be an idea. An example is Amazon's 1-Click shopping cart that enables people to store credit card and shipping information to enable speedy purchases. A design patent is granted to an individual who creates something original and novel as an ornamental design. A design patent involves the actual design of an invention.

Trademarks

A trademark provides the owner the ability to use a name, symbol, jingle, or character in conjunction with a specific good. A service mark is, according to the USPTO, a word, phrase, symbol, or graphic that identifies the origin or source of a service.[47] Both marks prevent others from using those same assets to sell their products. A trademark can be the most valuable asset a company owns. Customers will often pay more for a product or service if it comes from a specific brand with a good reputation. Customers view brands as a promise of the experience they will have: Brands promote confidence in the product and the benefits that the consumer may enjoy. Successful businesses create brand loyalty through these efforts, creating a relationship with customers. When users see themselves in the brand, they will choose that brand to create their own identities.

Protecting the name of the company and its products, jingles, logos, and even social media is therefore necessary to gain and protect a competitive advantage, because among competitors, the trademark is often the only way to distinguish among products. Can you think of a brand you are loyal to—perhaps your Apple iPhone, your Starbucks coffee, or your local entertainment spot? Consider what that company has done to earn your loyalty.

Usually, once the business begins to use its name, logo, character, and other assets, they are informally protected by trademark law and can use the ™ symbol. However, if a business wants extended protection, they should file for legal trademark protection.

Trademarks can be registered at the state or federal level. As the names imply, state trademark registration protects the business's mark within its own state, and federal trademark registration protects the business's mark across the United States. Once the registration has been filed and accepted at the federal level, the business can use the ® symbol after the protected item. Examples of trademarks include the Apple name and logo, the McDonald's logo, the talking GEICO lizard, and Nike's "Just Do It" slogan.

If you are opening your own candle and soap company, for example, you might want to register your company name and logo initially to prevent others from using it and benefiting from your reputation. If you decide to create a jingle, a slogan, a character, or another branding asset, you can do it while you develop and grow your business, as it can become cumbersome and expensive if it's done all at once. Getting a trademark itself is not as difficult as getting a patent, but just as with a patent, getting a lawyer's help can prove beneficial. Trademarks are not as costly—it may cost a few hundred dollars to file the application—but attorney fees can vary, depending on the type of project and the length of time it takes to process the application. This can range from a few hundred to thousands of dollars. This type of intellectual property can provide an opportunity for your company to be sustainable for years to come and avoid other businesses copying or using your ideas to promote themselves.

Copyrights

A copyright is provided to an author of an original work, including artistic, dramatic, architectural, musical, literary, and software works. Copyrights are granted by the Copyright Office, which is a part of the Library of Congress.[48]

Intellectual Property Protection	Protected Items	Office Providing Protection
Patent	Machine, process, improvement, plant, design, and matter composition	US Patent and Trademark Office
Trademark	Name, symbol, jingle, character, and logo	US Patent and Trademark Office
Copyright	Artistic, dramatic, architectural, musical, literary, and software	US Copyright Office

Table 4. Summarizes the types of US intellectual property protection The US Copyright Office's website offers a variety of publications that further explain what works are or are not eligible for copyright: https://www.copyright.gov/help/faq/faq-protect.html.

While filing with the Copyright Office is not required for copyright (the rights exist when the work is created), the process provides more formal legal documentation to protect your business interests. Registration requires a fee (basic registrations are under $100), and other services or specialty requests may add additional expenses.[49]

Trade secrets are oddly similar yet completely different from traditional intellectual property (patents, copyrights, and trademarks.) Trade secrets derive their legal protection from their inherently secret nature, not from a grant of exclusivity by the government. In fact, patents and copyrights are required to be made public, whereas trade secrets are not.

Examples of trade secrets range from the formula for Coca-Cola to the Google search algorithm. An inventor has a choice: patent the invention or keep it as a trade secret. Some advantages of trade secrets include the fact that a trade secret is not limited in duration/time (patents generally only last for twenty years). A trade secret may therefore continue indefinitely as long as the secret is not revealed to the public. However, a trade secret is more difficult to enforce than a patent because the level of protection granted to trade secrets is generally considered weaker when compared with the protection granted by a patent. Additionally, a trade secret may be patented by someone else who developed the relevant information by legitimate means.

Determining Your Resource Needs and How to Attain Them

As you begin your entrepreneurial plan, start by developing a list of the basic tangible and intangible resources you will need and determine their availability. For example, let's say you are starting a solar panel manufacturing company called Helios Panels. Your new manufacturing plant will require you to have a 10,000 square foot factory, where you will need two or three specialized machines to build your solar panels.

Unfortunately, the area of town that you like does not have buildings available. You will probably need to look for another location where there's a facility that fits your needs that is easily accessible for transport vehicles. If you don't make your list first, then you run the risk of ending up in a facility that is not suitable. The following tables provide starting points for thinking through the tangible and intangible resources needs for your venture.

Tangible Resource Needs

Resource	**Considerations**
Location/ facility	• Will there be customer interaction, and if so, does the location meet the needs of the target market? • How much square space is needed? • How well will the location meet the needs of employees? • Does inventory need to be stored?
Machinery/ equipment	• What equipment is needed to create the product or provide the service? • What quantity of equipment is needed to meet customer demand? • Are there any special requirements for machinery, such as level ground, vibration or sound protection, or water and electricity supplies?
Technology	• What hardware is needed (computers, tablets, printers, or routers)? • What software is required? • What type of Internet service is needed? • What other technology architecture might be required (server, network, or cloud computing)?
Vehicles	• Are vehicles needed, and if so, for what function (transporting goods or meeting clients)?
Miscellaneous supplies	• What basic supplies may be needed (desks, chairs, wastebaskets, or whiteboards)? • What office supplies are needed for operations?
Licenses/ permits	• Is the business licensed as a legal business entity if needed? • Does the location/facility require any licenses or permits to operate? • Do all parties involved in providing products/services have necessary licenses or certification to be in compliance with industry and government standards?

Table 5. This table can help you determine your tangible resource needs.

Intangible Resource Needs

Resource	Considerations
Patents	• Does the venture merit patent applications (utility, design, or plant)?
Trademarks	• Do the immediate plans or long-term vision include elements that should be trademarked (name, symbol, logo, jingle, or character)?
Copyrights	• Do the company's offerings include intellectual property such as artistic, literary, architectural, or software works that need to be protected?

Table 6. This table can help you determine your intangible resource needs.

Chapter 9: Multiple Choice

1) According to chapter 9, this tangible resource often relates to the tax deduction for depreciation.
   a) Machinery / Equipment
   b) Supplies
   c) Technology
   d) Vehicles
2) According to chapter 9, this tangible resource might include things like basic office furniture, coffeemaker, and/or whiteboards.
   a) Machinery / Equipment
   b) Supplies
   c) Technology
   d) Vehicles
3) According to chapter 9, this intangible resource is granted by an office, which is a part of the Library of Congress.
   a) Copyright
   b) Patent
   c) Trademark

Chapter 9: Short Answer

1. According to chapter 9, explain the seven (7) basic investments in technology**.**

2. According to chapter 9, describe the three (3) intangible resources**.**

Endnotes

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