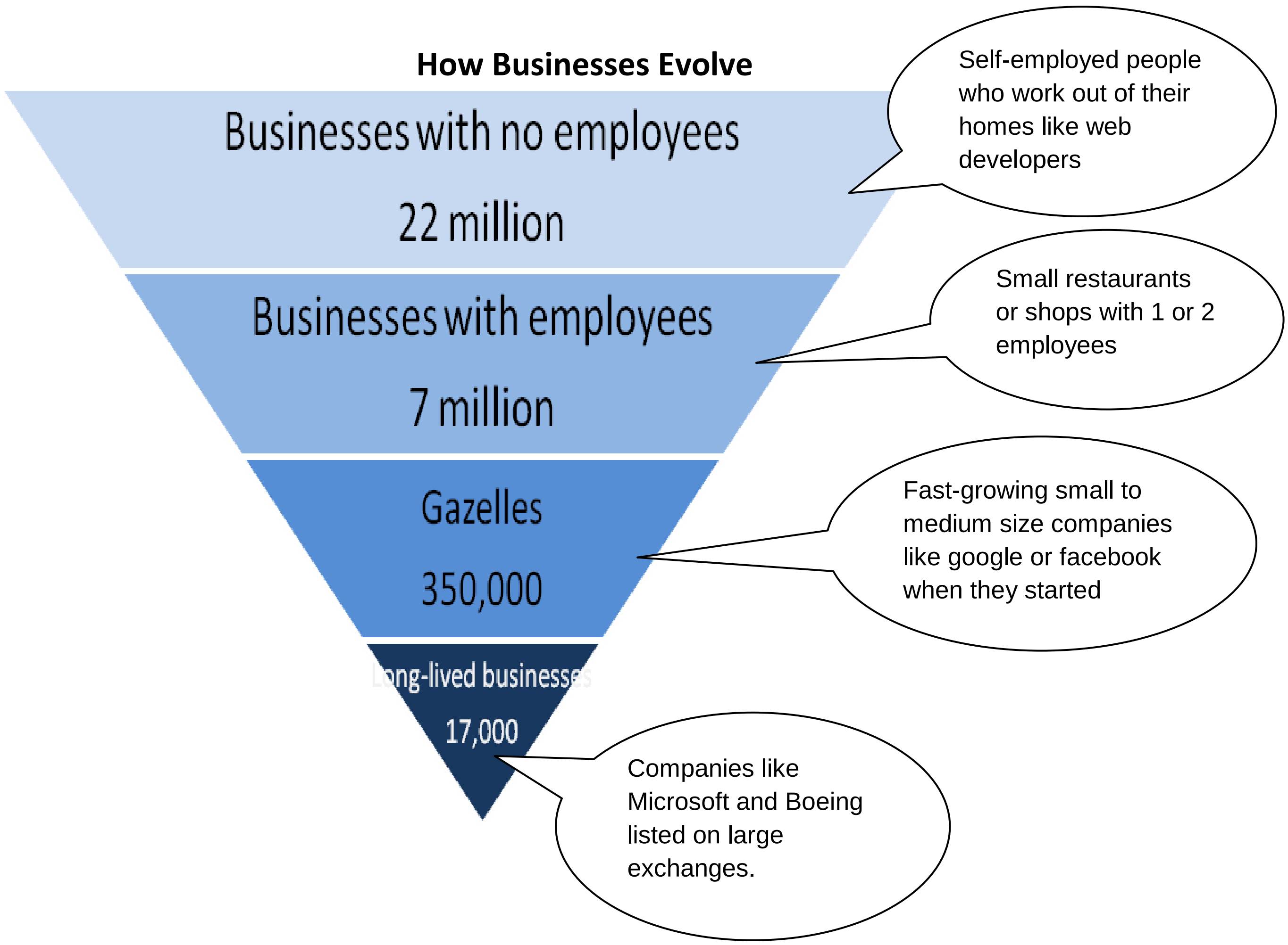
Module 2 - Entrepreneurship and Legal Forms of Business

Module 2 Goals:

- **Describe the legal forms of businesses (Sole proprietorships, partnerships, corporations, LLCs, Sub S), entrepreneurship, business models, components of business plans, breakeven analysis.**
- **Identify the pros and cons of the legal forms of business.**
- **Use tax rates to calculate the after-tax profit of various forms of business.**
- **Use breakeven analysis to determine when a business will be profitable.**
- **Analyze the appropriateness of various legal forms for various business situations.**
- **Create a business plan for a small business including breakeven analysis**

Businesses and Entrepreneurship

Of all businesses, most involve self-employment with no employees account for $992 million in revenues in 2007. Firms with employees which have people on their payrolls numbered about 7 million in 2007 and had $29 billion in receipts. Of the employer firms, according to David Birch, who coined the term, there are about 350,000 "gazelles." Gazelles represent the holy grail of business in that they grow very quickly (over 20% per year) and generate employment as a result of their growth. They typify the best in entrepreneurship in America. Only recently have efforts been made to isolate factors that cause businesses to break away from the pack to become gazelles. The businesses that command the most attention are the largest 17,000 firms. Of these about 7,000 are listed on the public stock exchanges.



Characteristics of Types of Businesses

	Self-Employed	Employer Firms	Gazelles	Long-lived Firms
Definition	Firms with one owner/employee	Firms that have employees	Coined by David Birch, fast-growing businesses that typify the best in US entrepreneurship.	Established large enterprises characterized by publicly-listed companies.
Number	21 million	7 million	350,000	17,000
Characteristics	Most self-employed start businesses to accommodate lifestyle choice	Most are small marginal businesses and continue to be small.	Growth rates of over 20% per year.	S&P 500 growth rates.
Capital	Low capital requirements: 75% start with less than $5000. Over 90% start with less than $25,000.	Low capital requirements: About 75% start with less than $25,000. Over 50% required less than $5000.	Don’t differ much from employer firms. Two thirds use less than $50,000 to start their businesses. More capital seems to accelerate process, though it does not increase profitability. Key is that the entrepreneur knows how to bootstrap. Only 4% use venture capital.	Large banks and financial markets.
Industries	Professional and other services, retail, and construction.	Most are low capital and low barrier industries.	“Fuzzy” market opportunities not completely defined. No major competitors.	See S&P 500 classifications.
Owner characteristics	Wants to be own boss, control over number of hours worked, and family reasons.	Risk-aversive.	Strong tolerance for ambiguity. Strong self confidence. Sales skills. Problem solving in a fuzzy environment. Open to learning from mistakes. Previous experience in industry. 80% have college degrees.	Leadership. Audacious goals. Strategic outlook. Coherence of goals.
Business characteristics	Marginal businesses with low-risk incremental opportunities.	Most popular are restaurants, beauty salons, and construction.	Few substitutes for products/services. Not an original idea.	Portfolio of businesses.
Revenue generation	Most generate less than $50,000 and one third operate at loss.	Most do not grow. Bulk have less than $100,000 in sales.	High revenue growth of over 20% a year.	Averages to GDP growth rate.

	Self-Employed	Employer Firms	Gazelles	Long-lived Firms
Job generation	None.	Only 24% of employer firms tracked over 10 years show any growth in employment	Estimated that these generate 60% of the new jobs.	Generate one-third of net jobs.
Cycle	Self-employment increases during economic downturns.	Growing at 1% to 2% a year. Follows business cycle with more starts during expansions and more deaths during downturns.		Business cycle specific to industry.
Survival	One study showed 51% survive five years as compared to 82% of businesses with employees.	About 500,000 started every year and about 500,000 terminated. Only 30,000 are bankruptcies. One SBA study shows lack of capital is a major source of business dissolution.	Survival may be subject to industry life cycle.	Survival rate is very high.
What causes it to move to the next phase.	If self-employment becomes primary source of income then move to become employer firm. 41% contribute less than 10% of family income.	Choosing a market without major competitors. Information about the market is imperfect and evolving. Previous experience in that industry. Strong sales skills. Bootstrapping and making do with little at the fledgling stages.	Ability of management to transition from entrepreneur to manager. Vision to set audacious goals. Moving from single business to portfolio of businesses. Ability to motivate teamwork. Coherence of vision.	

Source: Bhide, Amar, The Origin and Evolution of New Businesses, Oxford University Press, 2000
SBA Study of Employer Businesses, 1987-1992
SBA Self Employment Study

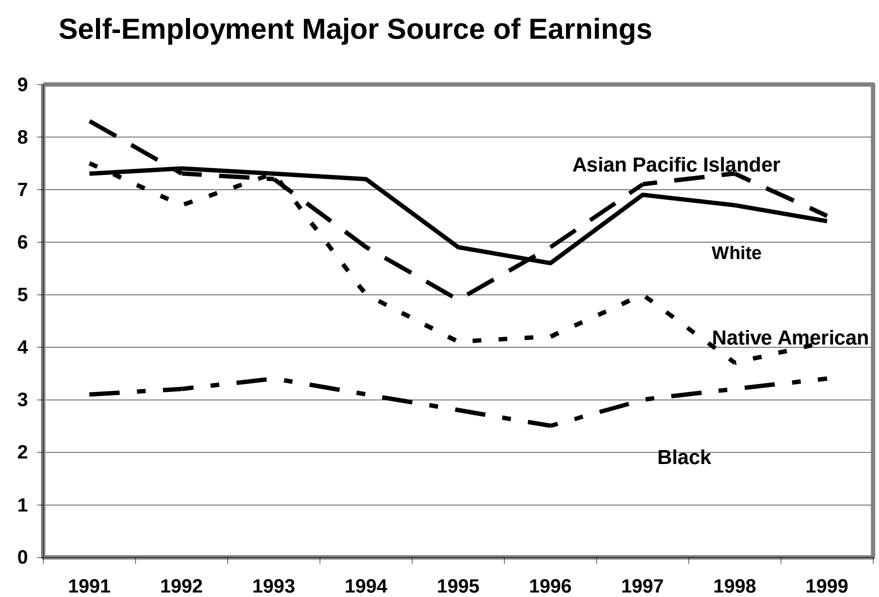
Firms with No Employees

Studies of the self-employed show that these individuals often start businesses to accommodate a lifestyle choice. Their reasons include control over the number of hours they work, family reasons, health reasons, or being their own boss. The self-employed tend to be concentrated in industries that have low capital requirements. Most of these businesses start with less than $25,000 in initial capital and about 75% start with less than $5000 in initial capital. Construction, retail, real estate, and other services dominate. The ranks of the self-employed include a broad spectrum of occupations from construction workers to doctors and lawyers. Most of these individuals have no desire to grow their businesses past self-employment.

Although, a small percent of these businesses can generate significant revenues and profit, most of these businesses generate less than $50,000 in revenues and about one-third operate at a loss. Some evidence suggests that the low revenue generation may be a result of the number of hours put into the business. The survival rate for the self-employed is worse than for businesses with employees. About 51% of self-employed survive five years compared to 82% of those with employees. Businesses state that lack of cash as the main reason for closing the business. Most business owners consider the business still viable at closing. These same factors handicap minority self-employed in moving from marginal business to promising business.

A key factor in reaching escape velocity out of self-employment is lifestyle choice. 41% of these businesses provide less than 10% of family income for their owners. Only 18% of these businesses rely on business income for the owners' primary income. When self-employed rely on the business for primary income, the business owner is more likely put in more time to move the business to become larger.

Comparative Self-employment as Major Source of Earnings



Source: Minorities in Business, 2001, SBA

Employer Firms

Employer firms currently number about 7 million and have been growing at a rate of 1% to 2% a year. About half a million businesses are started every year and about the same number are terminated. Business termination is not always because the business failed. Only about 30,000 business bankruptcies are filed every year. Both business births and deaths seem to pay some heed to the economic cycle in that there appears to be fewer births and more deaths during down or slow cycles such as 1991 and 2001.

The bulk of these enterprises do not grow. Only 24% of employer firms tracked over ten years report any increase in employment. Amar Bhide has theorized that these firms stay small because typically the business owners select marginal businesses that have dim prospects of high growth. Contrary to the popular entrepreneurial myth, most business owners are risk aversive when selecting their businesses. They choose businesses with low capital requirements and, as such, low barriers to entry.

Most Popular Small Businesses

Most Popular Small Businesses	Total Number of Firms
Trade contractors	1.8 million
Administrative and support services	1.4 million
Personal and laundry services	1.1 million
Nonstore retailers	1 million
Professional and Consulting services	1 million
Artists and entertainers	0.9 million
Real estate	0.7 million
Child care	0.6 million
Store retailers	0.4 million
Repair services	0.4 million

Source: 1997 Survey of Business Owners

From the table above, it can be seen that the most popular businesses include restaurants, beauty salons, and construction. These require relatively little in terms of human capital. The business owner need not have a college education nor long-term training to start one of these businesses. With such low barriers, there are many entrants and returns are correspondingly low. Additionally these business owners don't engage in radical adaptation or innovation. They run the businesses at status quo. As such the probability of high profits are minimal. Even the best practitioners will find it difficult to reach escape velocity to become a gazelle.

Gazelles

Although gazelles number only about 350,000, according to David Birch, they account for 60% of job growth in the US. These enterprises typify what most people believe entrepreneurship to be. They log growth rates in excess of 20% per year. They generate the bulk of job growth. Even among gazelles, there are the elite who generate growth rates well in excess of 20% annually. These are often referred to as the super gazelles.

Amar Bhide studied businesses on the ***Inc*** 500 (a list of the fastest growing private businesses) as a means of determining what set these businesses apart from general population of firms. According to his research, gazelles don't differ significantly from other employer firms or even sole proprietorships in the amount of capital used to start the business. Most gazelles started with a median of $10,000. Even the most recent ***Inc*** survey (2002) of owners showed that only one third used more than $50,000 to start their businesses. The amount of capital used had no bearing on how soon the business reached profitability but it may have an effect on the growth rate of the firm. It is believed that the low amount of capital to start a firm may contribute to business success. First, the entrepreneur must bootstrap to survive. He or she learns to adapt and allocate scarce resources. Second, the small amount of capital makes innovation less risky. If the venture does not succeed, then the cost of failure is small. The entrepreneur can start another venture and try again.

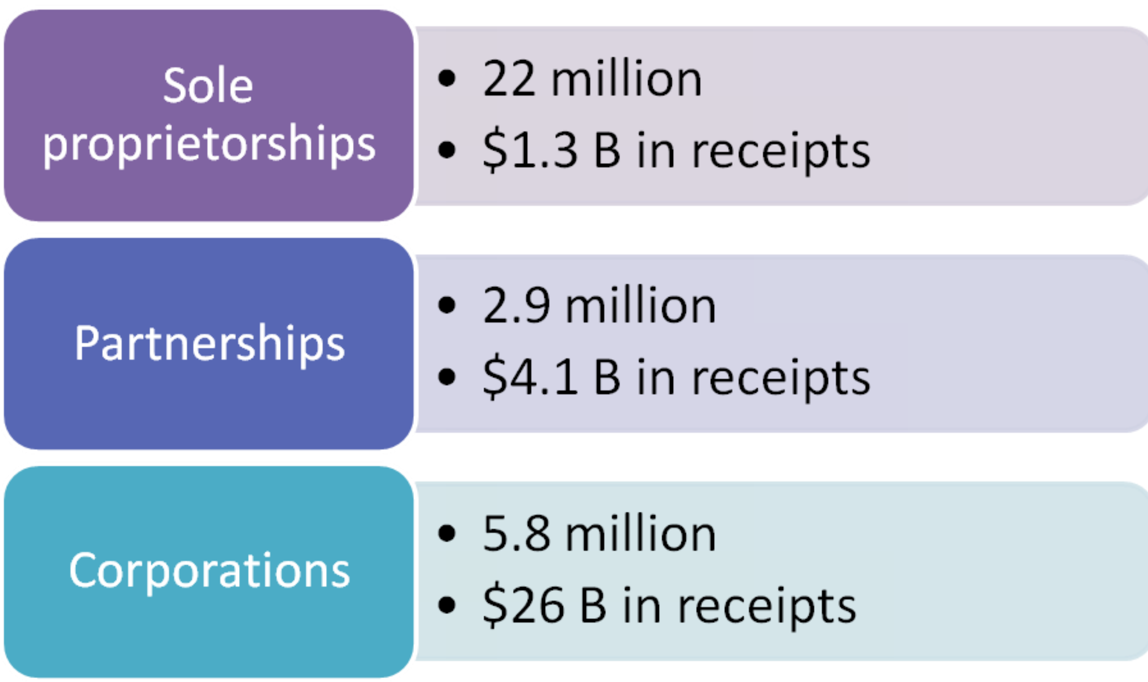
Long-lived Businesses

Long-lived enterprises are those who survive over a long period of time and become major firms. They are epitomized by the companies listed on the public exchanges and ultimately part of the Standard and Poors 500 index. Only a handful of company founders are able to stay at the helm during the transition from fledgling enterprise to long-lived company. Individuals such as Bill Gates, Michael Dell, and Sam Walton become the stuff of legends. Some business thinkers speculate that few entrepreneurs make it to the ranks of Fortune 500 CEOs because the skill sets necessary to transition to a long-lived company are significantly different from those needed to get a fledgling business into growth mode.

For the fledgling entrepreneur, long-term planning serves little use in uncertain or undefined markets where information is imperfect. Their business models are being refined by a series of adaptations. The entrepreneur plays a key role in being the firm's chief salesperson. Planning plays a relatively small role in these businesses. Most founders of gazelles say they didn't have a strategic plan and a study done by the National Federation of Independent Businesses shows that detailed study and planning makes no difference in the early success of a business.Once a business moves past its fledgling stage, a strategic outlook becomes more important. The bulk of businesses don't expand past certain limits because the founders fail to see the possibilities.

The Small Business Administration (SBA) provides some excellent resources for starting a business and legal forms. SBA material on business legal forms and business plans follows.

Forms of Ownership



Retrieved 7/11/10 from http://www.sba.gov/smallbusinessplanner/start/chooseastructure/index.html

Sole Proprietorships

The vast majority of small businesses start out as sole proprietorships. These firms are owned by one person, usually the individual who has day-to-day responsibilities for running the business. Sole proprietors own all the assets of the business and the profits generated by it. They also assume complete responsibility for any of its liabilities or debts. In the eyes of the law and the public, you are one in the same with the business.

Advantages of a Sole Proprietorship

- Easiest and least expensive form of ownership to organize.

- Sole proprietors are in complete control, and within the parameters of the law, may make decisions as they see fit.
- Sole proprietors receive all income generated by the business to keep or reinvest.
- Profits from the business flow directly to the owner's personal tax return.
- The business is easy to dissolve, if desired.

Disadvantages of a Sole Proprietorship

- Sole proprietors have unlimited liability and are legally responsible for all debts against the business. Their business and personal assets are at risk.
- May be at a disadvantage in raising funds and are often limited to using funds from personal savings or consumer loans.
- May have a hard time attracting high-caliber employees or those that are motivated by the opportunity to own a part of the business.
- Some employee benefits such as owner's medical insurance premiums are not directly deductible from business income (only partially deductible as an adjustment to income).

Partnerships

In a Partnership, two or more people share ownership of a single business. Like proprietorships, the law does not distinguish between the business and its owners. The partners should have a legal agreement that sets forth how decisions will be made, profits will be shared, disputes will be resolved, how future partners will be admitted to the partnership, how partners can be bought out, and what steps will be taken to dissolve the partnership when needed. Yes, it's hard to think about a breakup when the business is just getting started, but many partnerships split up at crisis times, and unless there is a defined process, there will be even greater problems. They also must decide up-front how much time and capital each will contribute, etc.

Advantages of a Partnership

- Partnerships are relatively easy to establish; however time should be invested in developing the partnership agreement.
- With more than one owner, the ability to raise funds may be increased.
- The profits from the business flow directly through to the partners' personal tax returns.
- Prospective employees may be attracted to the business if given the incentive to become a partner.
- The business usually will benefit from partners who have complementary skills.

Disadvantages of a Partnership

- Partners are jointly and individually liable for the actions of the other partners.
- Profits must be shared with others.
- Since decisions are shared, disagreements can occur.
- Some employee benefits are not deductible from business income on tax returns.
- The partnership may have a limited life; it may end upon the withdrawal or death of a partner.

Types of Partnerships that should be considered:

1. General Partnership
   Partners divide responsibility for management and liability as well as the shares of profit or loss according to their internal agreement. Equal shares are assumed unless there is a written agreement that states differently.
2. Limited Partnership and Partnership with limited liability
   Limited means that most of the partners have limited liability (to the extent of their investment) as well as limited input regarding management decisions, which generally encourages investors for short-term projects or for investing in capital assets. This form of ownership is not often used for operating retail or service businesses. Forming a limited partnership is more complex and formal than that of a general partnership.

3. Joint Venture
   Acts like a general partnership, but is clearly for a limited period of time or a single project. If the partners in a joint venture repeat the activity, they will be recognized as an ongoing partnership and will have to file as such as well as distribute accumulated partnership assets upon dissolution of the entity.

Corporations

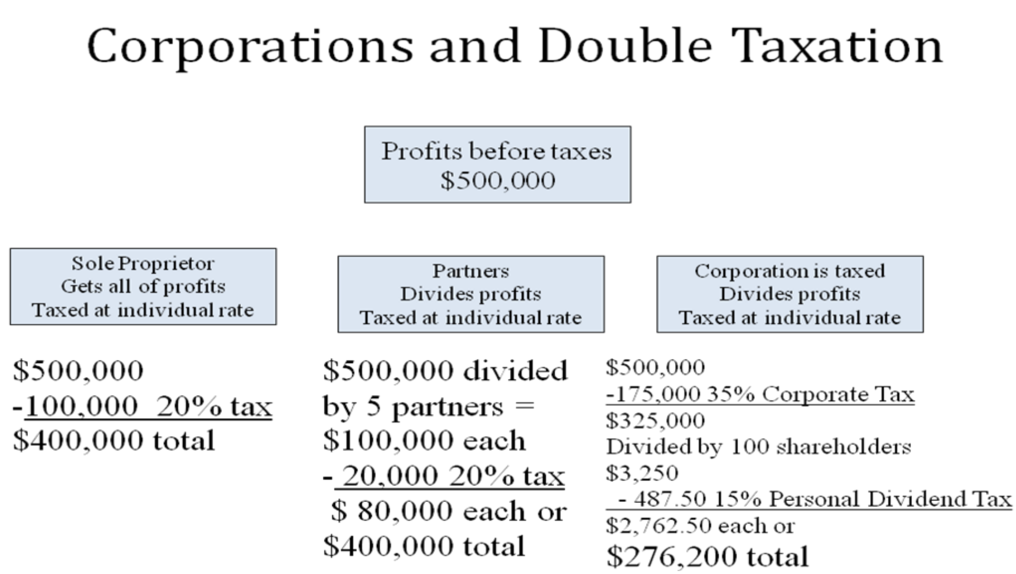
A corporation chartered by the state in which it is headquartered is considered by law to be a unique entity, separate and apart from those who own it. A corporation can be taxed, it can be sued, and it can enter into contractual agreements. The owners of a corporation are its shareholders. The shareholders elect a board of directors to oversee the major policies and decisions. The corporation has a life of its own and does not dissolve when ownership changes.

Advantages of a Corporation

- Shareholders have limited liability for the corporation's debts or judgments against the corporations.
- Generally, shareholders can only be held accountable for their investment in stock of the company. (Note however, that officers can be held personally liable for their actions, such as the failure to withhold and pay employment taxes.)
- Corporations can raise additional funds through the sale of stock.
- A corporation may deduct the cost of benefits it provides to officers and employees.
- Can elect S corporation status if certain requirements are met. This election enables company to be taxed similar to a partnership.

Disadvantages of a Corporation

- The process of incorporation requires more time and money than other forms of organization.
- Corporations are monitored by federal, state and some local agencies, and as a result may have more paperwork to comply with regulations.
- Incorporating may result in higher overall taxes. Dividends paid to shareholders are not deductible from business income; thus it can be taxed twice. Although some argue that double taxation may not be an issue (only 25% of corporations pay any taxes), it may be a factor in smaller businesses which cannot afford the tax advice that would eliminate taxes. The following is an example of after-tax calculations of profits for the three main legal forms.



Subchapter S Corporations

A tax election only; this election enables the shareholder to treat the earnings and profits as distributions and have them pass through directly to their personal tax return. The catch here is that the shareholder, if working for the company, and if there is a profit, must pay him/herself wages, and must meet standards of "reasonable compensation". This can vary by geographical region as well as occupation, but the basic rule is to pay yourself what you would have to pay someone to do your job, as long as there is enough profit. If you do not do this, the IRS can reclassify all of the earnings and profit as wages, and you will be liable for all of the payroll taxes on the total amount.

Limited Liability Company (LLC)

The LLC is a relatively new type of hybrid business structure that is now permissible in most states. It is designed to provide the limited liability features of a corporation and the tax efficiencies and operational flexibility of a partnership. Formation is more complex and formal than that of a general partnership.

The owners are members, and the duration of the LLC is usually determined when the organization papers are filed. The time limit can be continued, if desired, by a vote of the members at the time of expiration. LLCs must not have more than two of the four characteristics that define corporations: Limited liability to the extent of assets, continuity of life, centralization of management, and free transferability of ownership interests.

Choosing the Business Structure

Downloaded 7/11/10 from http://www.toolkit.com/small_business_guide/sbg.aspx?nid=P10_2160

Although we discuss the main advantages and disadvantages of different organizational forms, no formula exists for making the determination of which entity is best for your business, and this module's focus on how to obtain financing for your business does not fully address important considerations relating to taxes, personnel, marketing and business strategies, and a variety of other factors that influence your choice of entity.

However, certain general principles can be identified to help guide your selection of an organizational form for your small business. For example, many startup businesses follow a progression of organizational forms, evolving from a sole proprietorship into some form of corporate entity as the business's financing needs and options become more complicated. The sole proprietorship is popular for startups because it requires virtually no formalities and no cost to create and maintain, and tax treatment is favorable and simple.

On the other hand, if your business will have employees (creating potential personal tort liability for owners), poses relatively high risks, and/or needs to attract equity financing, the business may benefit from beginning as a corporation. The LLC entity may also be worth considering for a startup business if you want the pass-through tax benefits of a partnership but also want to limit your personal liability. Among the more specific principles to consider are:

Use of equity financing. The degree to which you need to sell ownership interests to raise money for your business will influence your choice of organizational forms. The number and type of equity investors in several of the entity forms are limited. The C corporation allows the greatest flexibility in terms of manipulating ownership interests through the type and number of ownership shares that you sell. However, S corporations and close corporations limit the number and type of shareholders. A sole proprietorship obviously precludes equity financing from anyone other than yourself. Likewise, a general partnership may have problems raising equity capital because adding a new partner requires the unanimous consent of all existing partners. In addition, having numerous partners in a general partnership can create cumbersome management decision-making. LLCs and LLPs are similar to partnerships in this constraint.

Of course, most small businesses do not begin with a large number of owners (e.g., more than ten); consequently, you can usually convert a more simple organizational form, such as a partnership, into a corporation if and when the need for greater equity financing arises.

Risk. If the business has employees, or if several owners will participate actively in the business, the potential personal liability from the conduct of these persons can influence your choice of organizational form. A high-risk business, such as construction contracting, may favor an entity that limits the personal liability of the owners, such as a corporation, limited liability company, limited liability partnership, or limited partnership. In contrast, a sole proprietor and a partner in a general partnership have unlimited personal liability for the conduct of associates and employees.

Taxes. Startup businesses typically experience an initial period of tax losses. A sole proprietorship, a general or limited partnership, an S corporation, and an LLC or LLP will usually allow you to "pass-through" a greater amount of these losses to your individual tax return (unless your interest in the partnership or S corporation is considered a passive activity and your loss deductions are consequently limited). A C corporation would limit the amount of loss you could deduct in any one year to the amount of corporate income for that year (plus any carry-over losses from prior years). In addition, the owners of a C corporation pay a second tax on earnings when corporate revenues are distributed to shareholders.

Image. To some investors, a more formal organizational entity may add to the intangible appeal of your business. A corporate name may create an image of credibility and business sophistication for some investors.

Control. Any entity that has more than one owner involves compromising your exclusive control over the business. Your willingness to dilute your ownership control, and the need to obtain outside equity financing, will govern this factor.

Transferability and marketability. All organizational forms, other than sole proprietorships and C corporations, usually have restrictions on the transfer of ownership interests. Although these restrictions allow the owners a greater degree of ownership control, the constraints are also likely to limit the marketability and liquidity of the equity interests.

Starting a Business – The Business Plan

Retrieved from http://www.sba.gov/smallbusinessplanner/plan/writeabusinessplan/SERV_ESSENTIAL.html

A business plan should be a work-in-progress. Even successful, growing businesses should maintain a current business plan. As any good salesperson knows, you have to know everything you can about your products or services in order to persuade someone to buy them. In this discussion, you are the salesperson and your products represent your business. Your customers are potential investors and employees. Since you want your customers to believe in you, you must be able to convince them that you know what you are talking about when it comes to your business.

To become an expert (or to fine-tune your knowledge if you already believe you are one), you must be willing to roll up your sleeves and begin digging through information. Since not all information that you gather will be relevant to the development of your business plan, it will help you to know what you are looking for before you get started. In order to help you with this process, we have developed an outline of the essential elements a good business plan.

Every successful business plan should include something about each of the following areas, since these are what make up the essentials of a good business plan:

Part 1: The Executive Summary

The executive summary is the most important section of your business plan. It provides a concise overview of the entire plan along with a history of your company. This section tells your reader where your company is and where you want to take it. It's the first thing your readers see; therefore it is the thing that will either grab their interest and make them want to keep reading or make them want to put it down and forget about it. More than anything else, this section is important because it tells the reader why you think your business idea will be successful.

The executive summary should be the last section you write. After you've worked out all the details of your plan, you'll be in a better position to summarize it - and it should be a summary (i.e., no more than 4 pages).

Contents of the Executive Summary

- The Mission Statement - The mission statement briefly explains the thrust of your business. It could be two words, two sentences, a paragraph, or even a single image. It should be as direct and focused as possible, and it should leave the reader with a clear picture of what your business is all about.
- Date business began
- Names of founders and the functions they perform
- Number of employees
- Location of business and any branches or subsidiaries
- Description of plant or facilities
- Products manufactured/services rendered
- Banking relationships and information regarding current investors
- Summary of company growth including financial or market highlights (e.g. your company doubled its worth in 12-month period; you became the first company in your industry to provide a certain service)
- Summary of management's future plans - With the exception of the mission statement, all of the information in the Executive Summary should be highlighted in a brief, even bulleted, fashion. Remember, these facts are laid out in-depth further along in the plan.

If you're just starting a business, you won't have a lot of information to plug into the areas mentioned above. Instead, focus on your experience and background as well as the decisions that led you to start this particular enterprise. Include information about the problems your target market has and what solutions you provide. Show how the expertise you have will allow you to make significant inroads into the market.Tell your reader what you're going to do differently or better. Convince the reader that there is a need for your service or product, then go ahead and address your (the company's) future plans.

To assist the reader in locating specific sections in your business plan, include a table of contents directly following the executive summary. Make sure that the content titles are very broad; in other words, avoid detailed descriptions in your table of contents.

Part 2: Market Analysis

The market analysis section should illustrate your knowledge about the particular industry your business is in. It should also present general highlights and conclusions of any marketing research data you have collected; however, the specific details of your marketing research studies should be moved to the appendix section of your business plan.

This section should include: an industry description and outlook, target market information, market test results, lead times, and an evaluation of your competition.

Industry Description and Outlook

This overview section should include: a description of your primary industry, the current size of the industry as well as its historic growth rate, trends and characteristics related to the industry as a whole (i.e., What life cycle stage is the industry in? What is its projected growth rate?), and the major customer groups within the industry (i.e., businesses, governments, consumers, etc).

Identifying Your Target Market

Your target market is simply the market (or group of customers) that you want to target (or focus on and sell to). When you are defining your target market, it is important to narrow it to a manageable size; many businesses make the mistake of trying to be everything to everybody. Often times, this philosophy leads to failure.

In this section, you should gather information which identifies the:

- Distinguishing characteristics of the major/primary market you are targeting. This section might include information about the critical needs of your potential customers, the degree to which those needs are (or are not) currently being met, and the demographics of the group. It would also include the geographic location of your target market, the identification of the major decision-makers, and any seasonal or cyclical trends which may impact the industry or your business.
- Size of the primary target market. Here, you would need to know the number of potential customers in your primary market, the number of annual purchases they make in products or services similar to your own, the geographic area they reside in, and the forecasted market growth for this group.
- The extent to which you feel you will be able to gain market share and the reasons why. In this research, you would determine the market share percentage and number of customers you expect to obtain in a defined geographic area. You would also outline the logic you used to develop these estimates.
- Your pricing and gross margin targets. Here, you would define the levels of your pricing, your gross margin levels, and any discount structures that you plan to set up for your business, such as volume/bulk discounts or prompt payment discounts.
- Resources for finding information related to your target market. These resources might include directories, trade association publications, and government documents.
- Media you will use to reach your target audience. These might include publications, radio or television broadcasts, or any other type of credible source that may have influence with your target market.
- Purchasing cycle of your potential customers. Here, you will need to identify the needs of your target market, do research to find the solutions to their needs, evaluate the solutions you come up with, and finally, identify who actually has the authority to choose the final solution.
- Trends and potential changes which may impact your primary target market. Key characteristics of your secondary markets. Just like with your primary target market, here you would again want to identify the needs, demographics, and the significant trends which will influence your secondary markets in the future.

Market Tests

When you are including information about any of the market tests you have completed for your business plan, be sure to focus only on the results of these tests. Any specific details should be included in the appendix. Market test results might include: the potential customers who were contacted, any information or demonstrations that were given to prospective customers, how important it is to satisfy the target market's needs, and the target market's desire to purchase your business' products or services at varying prices.

Lead Times

Lead time is the amount of time between when a customer places an order and when the product or service is actually delivered. When you are researching this information, determine what your lead time will be for the initial order, reorders, and volume purchases.

Competitive Analysis

When you are doing a competitive analysis, you need to identify your competition by product line or service as well as by market segment; assess their strengths and weaknesses, determine how important your target market is to your competitors, and identify any barriers which may hinder you as you are entering the market.
Be sure to identify all of your key competitors for each of your products or services. For each key competitor, determine what their market share is, then try to estimate how long it will take before new competitors will enter into the marketplace. In other words, what is your window of opportunity? Finally, identify any indirect or secondary competitors which may have an impact on your business' success.

The strengths of your competitors are also competitive advantages which you, too, can provide. The strengths of your competitors may take many forms, but the most common include:

- An ability to satisfy customer needs
- A large share of the market and the consumer awareness that comes with it
- A good track record and reputation
- Solid financial resources and the subsequent staying power which that provides
- Key personnel

Weaknesses are simply the flip side of strengths. In other words, analyze the same areas as you did before to determine what your competitors' weaknesses are. Are they unable to satisfy their customers' needs? Do they have poor market penetration? Is their track record or reputation not up to par? Do they have limited financial resources? Can they not retain good people? All of these can be red flags for any business. If you find weak areas in your competition, be sure to find out why they are having problems. This way, you can avoid the same mistakes they have made.

If your target market is not important to your competition, then you will most likely have an open field to run in if your idea is a good one - at least for a while. However, if the competition is keen for your target market, be prepared to overcome some barriers. Barriers to any market might include:

- A high investment cost
- The time it takes to set up your business
- Changing technology
- The lack of quality personnel
- Customer resistance (i.e., long-standing relationships, brand loyalty)
- Existing patents and trademarks that you can not infringe upon

Regulatory Restrictions

The final area that you should look at as you're researching this section is regulatory restrictions. This includes information related to current customer or governmental regulatory requirements as well as any changes that may be upcoming. Specific details that you need to find out include: the methods for meeting any of the requirements which will effect your business, the timing involved (i.e., How long do you have to comply? When do the requirements go into effect?), and the costs involved.

Part 3: Company Description

Without going into detail, this section should include a high level look at how all of the different elements of your business fit together. The company description section should include information about the nature of your business as well as list the primary factors that you believe will make your business a success.

When defining the nature of your business (or why you're in business), be sure to list the marketplace needs that you are trying to satisfy; include the ways in which you plan to satisfy these needs using your products or services. Finally, list the specific individuals and/or organizations that you have identified as having these needs.

Primary success factors might include a superior ability to satisfy your customers' needs, highly efficient methods of delivering your product or service, outstanding personnel, or a key location. Each of these would give your business a competitive advantage.

Every business needs a viable business model. A business model is an articulation of how the business makes a profit—both over and above investment and on an ongoing basis. It should outline how the business can survive in a competitive environment where there are many businesses that provide the same products or services. Or, it may describe how it serves a new market and how it will sustain its position if other competitors decide to enter the market.

Part 4: Organization & Management

This section should include: your company's organizational structure, details about the ownership of your company, profiles of your management team, and the qualifications of your board of directors.

Who does what in your business? What is their background and why are you bringing them into the business as board members or employees? What are they responsible for? These may seem like unnecessary questions to answer in a one- or two-person organization, but the people reading your business plan want to know who's in charge, so tell them. Give a detailed description of each division or department and its function.

This section should include who's on the board (if you have an advisory board) and how you intend to keep them there. What kind of salary and benefits package do you have for your people? What incentives are you offering? How about promotions? Reassure your reader that the people you have on staff are more than just names on a letterhead.

Organizational Structure

A simple but effective way to lay out the structure of your company is to create an organizational chart with a narrative description. This will prove that you're leaving nothing to chance, you've thought out exactly who is doing what, and there is someone in charge of every function of your company. Nothing will fall through the cracks, and nothing will be done three or four times over. To a potential investor or employee, that is very important.

Ownership Information

This section should also include the legal structure of your business along with the subsequent ownership information it relates to. Have you incorporated your business? If so, is it a C or S corporation? Or perhaps you have formed a partnership with someone. If so, is it a general or limited partnership? Or maybe you are a sole proprietor.

Important ownership information that should be incorporated into your business plan includes:

- Names of owners
- Percentage ownership
- Extent of involvement with the company
- Forms of ownership (i.e., common stock, preferred stock, general partner, limited partner)
- Outstanding equity equivalents (i.e., options, warrants, convertible debt)
- Common stock (i.e., authorized or issued)

Management Profiles

Experts agree that one of the strongest factors for success in any growth company is the ability and track record of its owner/management, so let your reader know about the key people in your company and their backgrounds. Provide resumes that include the following information:

- Name
- Position (include brief position description along with primary duties)
- Primary responsibilities and authority
- Education
- Unique experience and skills
- Prior employment
- Special skills
- Past track record
- Industry recognition
- Community involvement
- Number of years with company
- Compensation basis and levels (make sure these are reasonable - not too high or too low)

Be sure you quantify achievements (e.g. "Managed a sales force of ten people," "Managed a department of fifteen people," "Increased revenue by 15% in the first six months," "Expanded the retail outlets at the rate of two each year," "Improved the customer service as rated by our customers from a 60% to a 90% rating").

Also highlight how the people surrounding you complement your own skills. If you're just starting out, show how each person's unique experience will contribute to the success of your venture.

Board of Directors' Qualifications

The major benefit of an unpaid advisory board is that it can provide expertise that your company cannot otherwise afford. A list of well-known, successful business owners/managers can go a long way toward enhancing your company's credibility and perception of management expertise.

If you have a board of directors, be sure to gather the following information when developing the outline for your business plan:

- Names
- Positions on the board
- Extent of involvement with company
- Background
- Historical and future contribution to the company's success

Part 5: Marketing and Sales Strategies

Marketing is the process of creating customers, and customers are the lifeblood of your business. In this section, the first thing you want to do is define your marketing strategy. There is no single way to approach a marketing strategy; your strategy should be part of an ongoing self-evaluation process and unique to your company. However, there are steps you can follow which will help you think through the strategy you would like to use.

An Overall Marketing Strategy would include a:

- Market penetration strategy
- Strategy for growing your business. This growth strategy might include: an internal strategy such as how to increase your human resources, an acquisition strategy such as buying another business, a franchise strategy for branching out, a horizontal strategy where you would provide the same type of products to different users, or a vertical strategy where you would continue providing the same products but would offer them at different levels of the distribution chain.
- Channels of distribution strategy. Choices for distribution channels could include: original equipment manufacturers (OEMs), an internal sales force, distributors, or retailers.
- Communication strategy. How are you going to reach your customers? Usually some combination of the following works the best: promotions, advertising, public relations, personal selling, and printed materials such as brochures, catalogs, flyers, etc.
  Once you have defined your marketing strategy, you can then define your sales strategy. How do you plan to actually sell your product?

Your Overall Sales Strategy should include:

- A sales force strategy. If you are going to have a sales force, do you plan to use internal or independent representatives? How many salespeople will you recruit for your sales force? What type of recruitment strategies will you use? How will you train your sales force? What about compensation for your sales force?
- Your sales activities. When you are defining your sales strategy, it is important that you break it down into activities. For instance, you need to identify your prospects. Once you have made a list of your prospects, you need to prioritize it. Next, identify the number of sales calls you will make over a certain period of time. From there, you need to determine the average number of sales calls you will need to make per sale, the average dollar size per sale, and the average dollar size per vendor.

Part 6: Service or Product Line

What are you selling? In this section, describe your service or product, emphasizing the benefits to potential and current customers. For example, don't tell your readers which 89 foods you carry in your "Gourmet to Go" shop. Tell them why busy, two-career couples will prefer shopping in a service-oriented store that records clients' food preferences and caters even the smallest parties on short notice.

Focus on the areas where you have a distinct advantage. Identify the problem in your target market for which your service or product provides a solution.

Give the reader hard evidence that people are, or will be, willing to pay for your solution. List your company's services and products and attach any marketing/promotional materials. Provide details regarding suppliers, availability of products/services, and service or product costs. Also include information addressing new services or products which will soon be added to the company's line.

Overall, this section should include:

- A detailed description of your product or service (from your customers' perspective). Here, you would need to include information about the specific benefits of your product or service. You would also want to talk about your product/service's ability to meet consumer needs, any advantages your product has over that of the competition, and the present development stage your product is in (i.e., idea, prototype, etc.).
- Information related to your product's life cycle. Be sure to include information about where your product or service is in its life cycle, as well as any factors that may influence its cycle in the future.
- Any copyright, patent, and trade secret information that may be relevant. Here, you need to include information related to existing, pending, or anticipated copyright and patent filings along with any key characteristics of your products/services that you cannot obtain a copyright or patent for. This is where you should also incorporate key aspects of your products/services that may be

classified as trade secrets. Last, but not least, be sure to add any information pertaining to existing legal agreements, such as nondisclosure or noncompete agreements.

- Research and development activities you are involved in or are planning to be involved in. R&D activities would include any in-process or future activities related to the development of new products/services. This section would also include information about what you expect the results of future R&D activities to be. Be sure to analyze the R&D efforts of not only your own business, but also that of others in your industry.

Part 7: Funding Request

In this section, you will request the amount of funding you will need to start or expand your business. If necessary, you can include different funding scenarios, such as a best and worst case scenarios, but remember that later, in the financial section, you must be able to back up these requests and scenarios with corresponding financial statements.

You will want to include the following in this section: your current funding requirement, your future funding requirements over the next five years, how you will use the funds you receive, and any long-range financial strategies that you are planning that would have any type of impact on your funding request.

When you are outlining your current and future funding requirements, be sure to include the amount you want now and the amount you want in the future, the time period that each request will cover, the type of funding you would like to have (i.e., equity, debt), and the terms that you would like to have applied.

How you will use your funds is very important to a creditor. Is the funding request for capital expenditures? Working capital? Debt retirement? Acquisitions? Whatever it is, be sure to list it in this section.

Last of all, make sure that you include any strategic information related to your business that may have an impact on your financial situation in the future, such as: going public with your company, having a leveraged buyout, being acquired by another company, the method with which you will service your debt, or whether or not you plan to sell your business in the future. Each of these are extremely important to a future creditor, since they will directly impact your ability to repay your loan(s).

Part 8: Financials

The financials should be developed after you've analyzed the market and set clear objectives. That's when you can allocate resources efficiently. The following is a list of the critical financial statements to include in your business plan packet.

Historical Financial Data

If you own an established business, you will be requested to supply historical data related to your company's performance. Most creditors request data for the last three to five years, depending on the length of time you have been in business.

The historical financial data you would want to include would be your company's income statements, balance sheets, and cash flow statements for each year you have been in business (usually for up to 3 to 5 years). Often creditors are also interested in any collateral that you may have that could be used to ensure your loan, regardless of the stage of your business.

Prospective Financial Data

All businesses, whether startup or growing, will be required to supply prospective financial data. Most of the time, creditors will want to see what you expect your company to be able to do within the next five years. Each year's documents should include forecasted income statements, balance sheets, cash flow statements, and capital expenditure budgets. For the first year, you should supply monthly or quarterly projections. After that, you can stretch it to quarterly and/or yearly projections for years 2 through 5.

Make sure that your projections match your funding requests; creditors will be on the lookout for inconsistencies. It's much better if you catch mistakes before they do. If you have made assumptions in your projections, be sure to summarize what you have assumed. This way, the reader will not be left guessing.

Finally, include a short analysis of your financial information. Include a ratio and trend analysis for all of your financial statements (both historical and prospective). Since pictures speak louder than words, you may want to add graphs of your trend analysis (especially if they are positive).

Part 9: The Appendix

The appendix section should be provided to readers on an as-needed basis. In other words, it should not be included with the main body of your business plan. Your plan is your communication tool; as such, it will be seen by a lot of people. Some of the information in the business section you will not want everyone to see, but, specific individuals (such as creditors) may want access to this information in order to make lending decisions. Therefore, it is important to have the appendix within easy reach.
The appendix would include:

- Credit history (personal & business)
- Resumes of key managers
- Product pictures
- Letters of reference
- Details of market studies
- Relevant magazine articles or book references
- Licenses, permits, or patents
- Legal documents
- Copies of leases
- Building permits
- Contracts
- List of business consultants, including attorney and accountant

Any copies of your business plan should be controlled; keep a distribution record. This will allow you to update and maintain your business plan on an as-needed basis. Remember, too, that you should include a private placement disclaimer with your business plan if you plan to use it to raise capital.

Breakeven Analysis

In evaluating the investment, the concept of breakeven is important. Breakeven is defined as the time and amount of money it takes to recoup the investment. The concept is the same for starting a restaurant or developing a new technology. In achieving breakeven, it is important to control the initial investment as well as get to the point of generating profits as soon as possible.

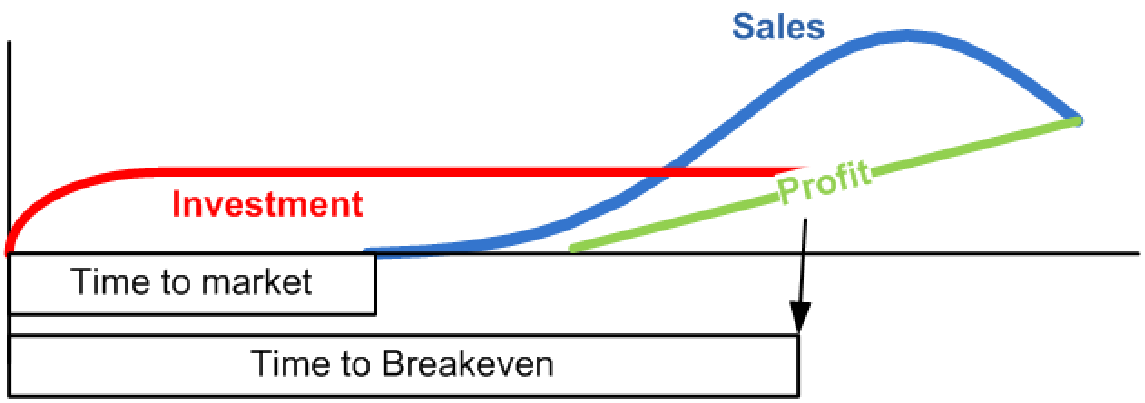
Investment: Most businesses require a lump sum of money to started. This money could be used for renovating a store, legal costs, or buying products to be sold. This is different from the regular expenses that are incurred day to day.

Revenues: Revenue is the money the business takes in from selling its products or services.

Expenses: Expenses are the costs of running the business. This could include paying employees, rent, utilities, etc. Expenses are often broken up into fixed (those that must be paid every month such as rent) and variable (those that can be reduced or increased based on the amount of sales you have such as employees, supplies, etc.)

Profit: Revenues less expenses is the profit.

Every business should look to breakeven as soon as it can. The breakeven is noted as the time when:



Source: House and Price, "The Return Map: Tracking Product Teams," Harvard Business Review 1991

Take the case of a small business considering a website in the table below. When focusing on costs, first divide the costs between the up-front investment (often the fixed costs) and ongoing costs. The more experience the business owner has in e-commerce, the more accurate and, usually, the lower these costs will be. In this instance, $10,000 is budgeted to develop the site and mount the catalog and an additional $5,000 is budgeted in one-time marketing costs.

Next the cost of goods sold is examined. Although the business may have a storefront, the cost of goods sold may be different on the commerce site. There may be additional costs in packaging and handling. Shipping will be an added expense. It's important to get an accurate accounting of what these might be. Experienced e-commerce businesses know that fulfillment costs are often higher than originally projected.

Selling on the internet involves a new way of getting to the customer. There are affiliate programs, new promotional programs, and advertisements that have to be developed. Additionally, there are site maintenance and hosting costs. A small business will find the lowest price services and try to be innovative about squeezing the most out of the dollars spent.

Once the costs have been figured out for the first year, projections have to be made into the future. For some costs, like hosting costs, the business might just add 10% every year. For others like personnel, costs behave in step function—they take a jump (additional person needed) when they hit a certain level of sales. The time needs to be taken to get into the detail of each cost.

Payback Period

This is the simplest measure of return on investment and calculates the time to breakeven. With the investment of $15,000 in the example above, take the profit for each year and determine what year the investment is recouped. In this case, the payback period happens in the second year. The 2004 profit of $8500 + 2005 profit of $17100 = $25,600 which covers the original $15,000 invested.

The faster the payback period, the better the investment. Some enterprises require 18-month payback period for certain levels of investment. While large enterprises don't put much credence on payback, small businesses with scarce money resources and tight cash flow find the payback period, simple as it is, is the main criterion for go-or-no-go decision on an investment.

Year	0	1	2	3
Marketing	5000			
Site Development	10000			
Revenues		50000	75000	100000
Cost of Goods (50%)		25000	37500	50000
Gross Margin		25000	37500	50000
Expenses				
Hosting		3000	3300	3630
Advertising		2500	5000	7500
Ongoing maintenance		1000	1100	1210
Personnel		10000	11000	20000
Profit		8500	17100	17660
Cumulative Profit		8500	**25600**	43260
			PAYBACK	

Team Name: ___________________

Team Assignment – Forms of Business

Choosing the legal form of a business is a very important decision and requires that you determine which of the criteria discussed in the reading is most important to you:

1. Need for equity financing
2. Risk
3. Taxes
4. Image
5. Control
6. Transferability and marketability

Each of the following six scenarios relates to at least one of the criteria above. Specify which criteria applies (make sure that you get all of them) in each case. Determine what would happen with each of the three major forms of business below. Although all teams must consider all scenarios, only one team will report on each.

The business is a spa and salon called Beautiful Dreamer.

What would happen if the business was each of the following:

- Sole proprietorship
- Partnership with one other person
- Corporation

Scenario 1: The company profits are $100,000
Individual tax rate is 20%. Corporate tax rate is 35%. Dividend tax is 15%
As a sole proprietor how much do you take home after paying the taxman?
As a partnership of two, how much do you take home?
As a corporation with 10 shareholders, how much do you take home?

1. Need for equity financing
2. Risk
3. Taxes
4. Image
5. Control
6. Transferability and marketability

Scenario 2: You want to start a pet spa so that pet owners can bring their pets to the spa but nobody else in the company thinks it will work.

1. Need for equity financing
2. Risk
3. Taxes
4. Image
5. Control
6. Transferability and marketability

Scenario 3: Someone sues you for $1 million because your product turned their skin green. The company is worth $500,000.

1. Need for equity financing
2. Risk
3. Taxes
4. Image
5. Control
6. Transferability and marketability

Scenario 4: You want to expand your company by acquiring another spa. The other spa will cost $2 million.

1. Need for equity financing
2. Risk
3. Taxes
4. Image
5. Control
6. Transferability and marketability

Scenario 5: A large corporate entity is looking for an innovative spa concept. What happens if you want to be taken over? What happens if you don't want to be taken over.

1. Need for equity financing
2. Risk
3. Taxes
4. Image
5. Control
6. Transferability and marketability

Scenario 6: You want to retire to California.

1. Need for equity financing
2. Risk
3. Taxes
4. Image
5. Control
6. Transferability and marketability

Team Assignment – Entrepreneurship and Business Plan

The business plan reading is a good overview of just about everything we cover in this course. In this team assignment, you will play the entrepreneur and come up with a business plan that you will pitch to hypothetical angel investors.

Students have been very creative in coming up with some excellent ideas that meet real needs in the marketplace. Have fun with this assignment. The team will have one session to come up with the idea and do research. The second session will be used for team presentations. The better the presentation, usually the more likely the business will be funded. We will debrief at the end of the assignment as to why certain businesses are selected and why others are not.

At the end of the two sessions, the class will vote whether to fund or not to fund the business. <u>You cannot vote for your own business</u>. You cannot trade votes. You are a very rich angel investor have an unlimited amount of money so you can allocate money (full or partial) to any and all teams you choose.

Although you will not be able to cover each section of the business plan in detail, each team is required to come up with elements of the following:

- Market Analysis – What is your target market? Who are your competitors?
- Company Description – Come up with your company name, mission and logo. What is your business model? How will you make money?
- Organization & Management –Describe which legal form you will take and why. Give key positions to each of your team members.
- Marketing & Sales Management – How will you break into the market and grow?
- Service or Product Line – Describe your product. How much do you expect to sell when your business is up and running?
- Funding Request – How much money are you asking for?
- Financials – What will your sales and expenses be for the next five years? Optional: When will you break even? (Use the breakeven analysis form to develop your breakeven analysis.)

Tally your results.

Team	***Business***	***Amount Given***	***Reason***

Team Assignment Optional - Breakeven analysis of your business plan

For extra credit on the business plan assignment, use the following template to create a breakeven analysis for a business. Be sure to note fixed costs and variable costs. Plot your breakeven on a graph.

Breakeven Analysis

Year	20XX	20XX	20XX	20XX	20XX
Investment					
Revenues					
Cost of Goods (XX%)					
Gross Margin					
Expenses (list)					
Profit					

Module 2 Questions for Timed Write

(Note only 15 minutes allowed for each question.)

A business generates $300,000 in total profits. Calculate the profits after paying all taxes if you were part of the following business structures. (Answer with numbers no sentences necessary)
Individual Tax Rates: 30%
Dividend Tax Rate: 15%
Corporate Tax Rates: 25%
What is the after-tax profit for a sole proprietor?
What is the after-tax profit for a partnership of 4 people? Give the after-tax profit for each partner.
What is the after-tax profit for a corporation (not S or LLC) with 20 shareholders? Give the after-tax profit for each shareholder.

Evaluate a sole proprietorship as compared to a partnership on

1. Need for equity financing
2. Risk
3. Taxes
4. Image
5. Control
6. Transferability and marketability

Evaluate a corporation as compared to a partnership on

1. Need for equity financing
2. Risk
3. Taxes
4. Image
5. Control
6. Transferability and marketability

Evaluate a corporation as compared to a sole proprietorship on

1. Need for equity financing
2. Risk
3. Taxes
4. Image
5. Control
6. Transferability and marketability

What is the difference between a long-lived firm and a gazelle? Give an example of each

How are the self-employed different from employer firms? Give an example of each.

What is a market analysis in a business plan? What elements should be covered?

Create an example of a breakeven analysis.

Give an example of a business model. What elements are necessary? Why is it important to a business plan?

When would a business owner choose a LLC over a corporation?