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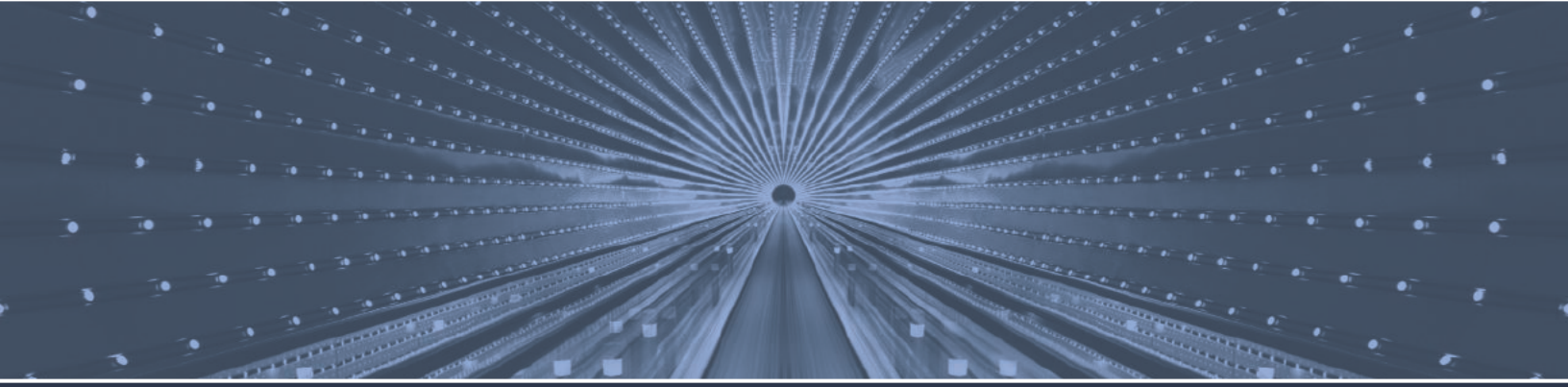
Twelfth Edition

Entrepreneurship

Theory, Process, Practice



Donald F. Kuratko



12th Edition

Entrepreneurship

Theory, Process, Practice

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Preface

Entrepreneurship is the most powerful economic force known to humankind! The Entrepreneurial Revolution that captured our imagination during the last three decades has now permeated every aspect of business thinking and planning. As exemplified by the dynasty builders of the previous decades, such as Sam Walton of Walmart, Fred Smith of FedEx, Bill Gates of Microsoft, Herb Kelleher of Southwest Airlines, Steve Jobs of Apple, Andy Grove of Intel, Larry Page and Sergey Brin of Google, Mark Zuckerberg of Facebook, Peter Thiel of PayPal, and Elon Musk of Tesla and SpaceX, the applications of creativity, risk taking, innovation, and passion led the way to economic development far greater than anyone could imagine. Today, we witness the immense impact of entrepreneurial companies such as Google, Amazon, Facebook, Twitter, Instagram, Snapchat, LinkedIn, Uber, and Airbnb, which have produced technological breakthrough after breakthrough. In this third decade of the twenty-first century, we continue to encounter newer and sometimes more complex challenges and pressures than ever before in the form of green technologies, social entrepreneurship, sustainability, health care, and disruptive technological change. The entrepreneurial drive and determination of yet-to-be-discovered dynasty builders will be our greatest solution to all of these challenges.

The process of transforming creative ideas into commercially viable businesses continues to be a major force in today's global economy. Successful entrepreneurship requires more than merely luck and money. It is a cohesive process of creativity, risk taking, and planning. Students today need courses and programs that set forth a basic framework for understanding the process of entrepreneurship. I wrote this textbook to structure and illustrate the discipline of entrepreneurship in a manner that is as unique and creative as entrepreneurship itself. The text and online materials included in *Entrepreneurship: Theory, Process, Practice*, 12th edition, to bring together in one place the most significant resources for exploring the development of new and emerging ventures and to present them in an exciting, organized, and challenging manner.

Organization

The chapter sequence in *Entrepreneurship: Theory, Process, Practice*, 12th edition, is systematically organized around the initiation, planning, growth, and development of new and emerging ventures. Each major part of the text contains chapters that specifically address these pertinent concepts of entrepreneurship.

Part 1 (Chapters 1–4) introduces the entrepreneurial mindset and examines the Entrepreneurial Revolution that has taken root across the globe. In it, we address the individual characteristics that shape entrepreneurs and their thinking, the "dark side" of entrepreneurship, and the ethical perspective that impels entrepreneurs in the development of morally conscious approaches to business. From an organizational perspective, we introduce the concept of corporate entrepreneurship as a strategy to foster innovation within larger domains. Finally, and perhaps increasing in significance, we focus on social entrepreneurship and the global environment.

Part 2 (Chapters 5–8) examines the initiation of entrepreneurial ventures. We begin with the pursuit of ideas, opportunity recognition, creativity, and innovation. We then examine the methods for assessing new ventures and business opportunities (including the Lean Startup methodology and design thinking) and the pathways to ventures, whether starting a brand-new venture, acquiring an existing firm, or purchasing a franchise. This part concludes with a thorough examination of the sources of capital formation available to entrepreneurs.

Part 3 (Chapters 9–12) focuses on the development of entrepreneurial plans. We begin with the legal perspective, the critical legal issues (proprietary protections, patents, copyrights, trademarks, and bankruptcy laws), and the structures of organizations (sole proprietorships, partnerships, and corporations). We then discuss the marketing issues that affect the preparing, planning, and operating of entrepreneurial start-ups (including social media marketing and mobile marketing) as well as the financial tools that entrepreneurs need. Finally, the development of a clear and comprehensive business plan is examined. A complete sample business plan appears in the appendix following Chapter 12.

Part 4 (Chapters 13–15) focuses on the growth, valuation, and harvesting of entrepreneurial ventures. The need for strategic planning, the challenge of managing entrepreneurial growth, and understanding the transition from the entrepreneurial to managerial are all discussed in this part. We then present the valuation process for an entrepreneurial venture as well as effective methods for valuation that need to be considered. Finally, we look at harvesting strategies available to entrepreneurial firms.

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Distinguishing Features

Entrepreneurship: Theory, Process, Practice presents an organized, systematic study of entrepreneurship. Certain distinguishing features enhance its usefulness for both students and professors. Each chapter contains these specific learning items:

- **Opening Quotations.** Thought-provoking quotes titled "Entrepreneurial Thought" at the beginning of each chapter capture students' interest about the basic idea for the chapter.
- **Learning Objectives.** A clear set of learning objectives provides a preview of the chapter material and can be used by students to check whether they have understood and retained important points.
- **Figures and Tables.** Numerous charts and tables illustrate specific text material, expand chapter ideas, or refer to outside source material.
- **Summary and Discussion Questions.** Each chapter closes with a summary of key points to be retained. The discussion questions are a complementary learning tool that will enable students to check their understanding of key issues, think beyond basic concepts, and determine areas that require further study. The summary and discussion questions help students discriminate between main and supporting points and provide mechanisms for self-teaching.
- **Key Terms.** The most important terms appearing in each chapter are shown in boldface where they first appear. A list of the key terms appears at the end of each chapter, and a complete glossary appears at the end of the book.

Innovative Content in the 12th Edition

Producing a new edition is always an ambitious undertaking, but we always welcome the opportunity to refocus and, if necessary, redefine content that makes entrepreneurship clear and engaging for learners and future entrepreneurs.

- **Diversity and Entrepreneurship.** A new addition to the 12th edition is the special boxes containing stories pertaining to diversity and its relation to entrepreneurship. Topics include gender, age, race, trust, disabilities, thought, and practice.
- **The Entrepreneurial Process.** Short vignettes about the entrepreneurial process are included throughout the text to show how practicing entrepreneurs handle specific challenges and opportunities. Newer and updated process boxes reflect some of the more interesting stories on the various roads traveled by entrepreneurs, including entrepreneurial passion and entrepreneurial fear in Chapter 2, corporate innovation initiatives in top tech companies in Chapter 3, new legal forms for social enterprises in Chapter 4, the metaverse in Chapter 5, the franchise disclosure document in Chapter 7, MBA search funds in Chapter 8, omnichannel and multichannel marketing in Chapter 10, blitzscaling in Chapter 13, and valuing a venture in Chapter 14.
- **New Topics, Models, and Processes.** This edition contains the most recent topics, models, and processes developed by scholars in the entrepreneurship field. Some examples include a typology of entrepreneurial ventures (Chapter 1); cognition, metacognition, and grief recovery with failure, entrepreneurial hustle and entrepreneurial coachability, and ethical challenges for entrepreneurs (Chapter 2); new illustrations and a training program for corporate entrepreneurship (Chapter 3); sustainable entrepreneurship, shared value and triple bottom line thinking, benefit corporations, global poverty, global entrepreneurs, and diaspora networks (Chapter 4); building an effective entrepreneurial team (Chapter 6); a "Newness Framework" (Chapter 7); franchise disclosure documents (Chapter 7); incubators, accelerators, and entrepreneurial ecosystems (Chapter 7); bootstrapping and crowdfunding as sources of capital (Chapter 8); parody, issues with mobile devices, and other new legal concepts (Chapter 9); social media marketing, mobile marketing, and pricing in the social media age (Chapter 10); new tips on business plans and effective "pitches" (Chapter 12); strategic entrepreneurship (Chapter 13); and harvesting issues (Chapter 15).
- **New References and Citations.** In an effort to make *Entrepreneurship: Theory, Process, Practice* the most comprehensive text available, every chapter contains a wealth of endnotes located at the end of each chapter. These references have been carefully selected to provide professors and students with a thorough background of the latest research that relates to the entrepreneurship material being presented. The focus here is on the "theoretical" component of entrepreneurship.
- **New Concept of Entrepreneurial Hustle.** This concept is defined as an entrepreneur's urgent, unorthodox actions that are intended to be useful in addressing immediate challenges and opportunities under conditions of uncertainty.
- **Online Ethical Dilemmas in E-Commerce.** Questions concerning the ethical challenges that now confront entrepreneurs in the social media age strike at the potential venture success, which is at stake in the hands of the social media reputation management sites. How should entrepreneurs proceed?

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- **Incubators, Accelerators, and Entrepreneurial Ecosystems.** When examining the pathways to entrepreneurial ventures, it is important to understand the rise of incubators, accelerators, and entrepreneurial ecosystems because they may be an important pathway for an entrepreneur to pursue.
- **New Venture Legitimation.** New venture legitimacy is a major challenge for every entrepreneurial start-up. Legitimacy is a resource that enables new ventures to overcome the "liability of newness," thereby allowing for the acquisition of other resources such as financial capital, human resources, and strategic relationships.
- **Social Impact Investing.** This type of investing has started to bring opportunities to harness entrepreneurial ideas and capital markets to finance social initiatives. Increasing the funding capability of social entrepreneurship will increase the likelihood of more efficient, sustainable, and effective social initiatives.
- **The Contemporary Methodologies for Venture Evaluation.** With newer movements taking shape in the ever-changing entrepreneurial world, we provide sections that highlight some of the more contemporary methodologies being utilized for concept assessment and new-venture evaluation.
  - **Design Methodology.** Design is now a hot topic in the business world. The demand is becoming so great that universities are now building programs that take a general approach to design rather than concentrating it in just technical schools like architecture and engineering. We present sections on the following:
    - **Design and Learn.** Design is a learning process that shapes and converts ideas into form, whether that is a plan of action, experience, or physical thing. Learning from qualitative research, learning from prototyping, and learning from feedback are all presented in this edition of the text.
    - **Design Development.** Design development is taking an initial concept idea and developing a proof of concept that elicits feedback from relevant stakeholders. To accomplish this, several criteria must be met, including concept feasibility, concept desirability, and concept viability.
    - **Design-Centered Entrepreneurship.** Researchers Michael G. Goldsby, Donald F. Kuratko, Matthew R. Marvel, and Thomas Nelson have introduced the concept of design-centered entrepreneurship with a conceptual model.
  - **The Lean Startup Methodology.** Similar to design methodology, the Lean Startup methodology provides a scientific approach to creating early venture concepts and delivers a desired product to customers' hands faster. The Lean Startup methodology was first developed in 2011 by Eric Ries, founder of IMVU Inc., as a way to prevent waste in start-ups and ensure that the business plan remains a living document. We include key Lean Startup terminology in this section.
- **Peer-to-Peer (P2P) Lending.** Peer-to-peer lenders are Internet-based sites that pool money from investors willing to lend capital at agreed-on rates.
- **Equity Crowdfunding.** This practice seeks equity funding for a venture by raising money from a large number of people via the Internet. In the United States, legislation is mentioned in the 2012 JOBS Act, which allowed for a wider pool of small investors with fewer restrictions following the implementation of the act. SEC exemptions were enacted into law in 2015, and investments began in May 2016.
- **The Rise of Special Purpose Acquisition Companies.** A special purpose acquisition company (SPAC) is a company that has no commercial operations and is formed strictly to raise capital through an initial public offering (IPO) for the purpose of acquiring or merging with an existing company.
- **Updated Information on IPOs, Venture Capitalists, Angel Investors, B Corporations, and LC3s.**
- **Blitzscaling.** Blitzscaling tries to push the growth faster by prioritizing speed over efficiency in an environment of uncertainty. For most technology start-ups, the general appeal of blitzscaling is that it leads to rapid growth on a global scale.
- **Business Model Canvas.** The essential elements of the Business Model Canvas are presented and discussed in Chapter 12.

Updated and Enhanced Digital and Supplementary Materials

Additional resources, such as MindTap, and ancillaries are available online for *Entrepreneurship: Theory, Process, Practice*, 12th edition. Instructor assets include an Instructor's Manual, a test bank powered by Cognero®, PowerPoint® slides, and Educator's Guide. Sign up or sign in at www.cengage.com to search for and access this product and its online resources.

- **MindTap.** Through paths of dynamic assignments and applications that you can personalize, real-time course analytics, and an accessible reader, MindTap helps you turn cookie cutter into cutting edge, apathy into engagement, and memorizers into higher-level thinkers. Students learn firsthand what it's like to be an entrepreneur as they complete challenges that develop their creative and critical thinking skills. Give

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your students a powerful learning experience while saving time planning lessons and course structure using our exclusive interface designed to improve your workflow. Learn more about MindTap here: https://www.cengage.com/mindtap/

- **Self-Assessments** engage students by helping them make personal connections to the content presented in the chapter.
- **Learn It Quizzes:** Learn It multiple choice question sets are designed to reinforce the content in the text and simultaneously offer low-stakes assessment and feedback.
- **Apply It: Chapter Assignment:** These multiple choice assignments assess students' comprehension of the reading material and go further in asking learners to apply and analyze the content within varying contexts.
- **Apply It: Case Activity:** These case activities pair case content from the text with a series of questions to assess learner's ability to think critically about real world dynamics and decisions facing entrepreneurs.
- **Study It:** Flashcards: Digital flashcards help learners familiarize themselves with essential terminology in the course and within the entrepreneurship field overall.
- **Video Case Activities** engage students by presenting everyday businesses facing managerial challenges, placing concepts in real-world contexts, and making for great points of discussion.

- **Instructor's Manual.** The Instructor's Manual contains chapter outlines, lecture notes, answers to review and case questions, teaching notes for the comprehensive part cases, and similar content.
- **Test bank powered by Cognero®.** This program is easy-to-use test-creation software. Instructors can add or edit questions, instructions, and answers and select questions by previewing them on the screen, selecting them randomly, or selecting them by number. Instructors can also create and administer quizzes online.
- **LivePlan Business Software.** Students can create robust, polished business plans worthy of the most distinguished investor using the LivePlan business software.
- **PowerPoint® Slides.** PowerPoint presentations for instructors and students are colorful and varied, designed to hold students' interest and reinforce all of each chapter's main points.

Acknowledgments

Many individuals played an important role in helping to write, develop, and refine the text, and they deserve special recognition. First, my wife, Debbie, and daughters, Christina Diane and Kellie Margaret, always deserve my deepest love and appreciation over the years. My appreciation is extended to the staff at Cengage Learning, in particular Michael Worls and Sheila Moran, and Manoj Kumar of Lumina Datamatics Ltd. The professionals who reviewed the manuscript and offered copious suggestions for improvement played a decisive role in the final result. I would first like to acknowledge the reviewers whose comments and suggestions have helped to shape this and all previous editions of *Entrepreneurship*. Solochidi Ahiarah, SUNY College at Buffalo; Mary Allender, University of Portland; James Almeida, Fairleigh Dickinson University; Jeffrey Alves, Wilkes University; Joseph S. Anderson, Northern Arizona University; Lawrence Aronhime, Johns Hopkins University; Kenneth M. Becker, University of Vermont; Ted Berzinski, Mars Hill College; Thomas M. Box, Pittsburg State University; Stephen Braun, Concordia University; Martin Bressler, Houston Baptist University; Debbi Brock, Berea College; John Callister, Cornell University; Don Cassidy, Inver Hills Community College; A. A. Farhad Chowdhury, Mississippi Valley State University; James J. Chrisman, Mississippi State University; John E. Clarkin, College of Charleston; Teresa A. Daniel, Marshall University; Judy Dietert, Texas State University–San Marcos; Barbara Frazier, Western Michigan University; Barry Gilmore, University of Memphis; Michael Giuliano, University of Maryland University, College Asia; James V. Green, University of Maryland, College Park; Judith Grenkowicz, Kirtland Community College; Stephanie Haaland, Linfield College; Peter Hackbert, Sierra Nevada College; David M. Hall, Saginaw Valley State University; Barton Hamilton, Olin School of Business, Washington University; Brenda Harper, Athens State University; Tim Hatten, Mesa State College; Daniel R. Hogan Jr., Loyola University; Kathie K. Holland, University of Central Florida; Frank Hoy, University of Texas–El Paso; Rusty Juban, Southeastern Louisiana University; Ronald Kath, Life University; James T. Kilinski, Purdue University Calumet; Michael Krajsa, DeSales University; Stewart D. Langdon, Spring Hill College; Karl LaPan, Indiana University-Purdue University Fort Wayne; Hector Lopez, Hostos Community College/CUNY; Louis Marino, University of Alabama; Charles H. Matthews, University of Cincinnati; Todd Mick, Missouri Western State College;

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Dr. Donald F. Kuratko
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About the Author



Courtesy of KMK Photography

Dr. Donald F. Kuratko (known as "Dr. K") is the Jack M. Gill Distinguished Chair of Entrepreneurship, Professor of Entrepreneurship, and Executive and Academic Director of the Johnson Center for Entrepreneurship and Innovation and the Institute for Entrepreneurship and Competitive Enterprise at the Kelley School of Business, Indiana University–Bloomington. Dr. Kuratko is considered a prominent scholar and national leader in the field of entrepreneurship. He has published over 200 articles on aspects of entrepreneurship, corporate entrepreneurship, and new-venture development. His work has been published in journals such as the *Strategic Management Journal*, *Journal of Business Venturing*, *Journal of Management Studies, Entrepreneurship Theory and Practice*, *Small Business Economics*, *Journal of Operations Management*, *Academy of Management Executive*, *Journal of Product Innovation Management*, *Journal of Small Business Management*, *Family Business Review*, *Business Horizons*, and *Journal of Business Ethics*. He has received numerous awards for his published articles, including the Academy of Management 2017 Entrepreneurship Practice Award for the Best Journal Article Advancing Entrepreneurship Practice, the inaugural Journal of Operations Management Ambassador Award for Best Interdisciplinary Journal Article published between 2011 and 2016 and based on citation count (awarded in 2016 at Academy of Management), and the *Journal of Business Venturing*'s Best Journal Article of the Year for 2017 (awarded in 2018). According to recent journal articles, Dr. Kuratko is the #1 Most Productive Author in Corporate Entrepreneurship (*International Entrepreneurship and Management Journal*, 2021) and 3rd Most Prolific Author in Corporate Entrepreneurship and 4th Most Cited Author in Corporate Entrepreneurship (*Small Business Economics*, 2022). Professor Kuratko has authored or coauthored 40 books, including one of the leading entrepreneurship books in universities today, *Entrepreneurship: Theory, Process, Practice*, 12th edition (Cengage Learning, 2024), as well as *Corporate Entrepreneurship and Innovation*, 3rd edition (Cengage Learning, 2011); *Corporate Innovation* (Routledge, 2019); *New Venture Management*, 3rd edition (Routledge, 2021); and *What Do Entrepreneurs Create? Understanding Different Venture Types* (Edward Elgar, 2020). In addition, Dr. Kuratko has been consultant on corporate innovation and entrepreneurial strategies to a number of major corporations, such as Anthem Blue Cross/Blue Shield, AT&T, United Technologies, Ameritech, Walgreens, McKesson, Union Carbide Corporation, ServiceMaster, SPX Corp., Molex Corp., Ceva Biomune, Toyota, and TruServ. Dr. Kuratko was cofounder of the Global Consortium of Entrepreneurship Centers (GCEC), an organization comprising over 350 top university entrepreneurship centers throughout the world. He served as the inaugural executive director for 20 years.

Under Professor Kuratko's leadership and with one of the most prolific entrepreneurship faculties in the world, Indiana University's Entrepreneurship Program has consistently been ranked as the #1 university for entrepreneurship research in the world by a major 10-year research study in the *Journal of Small Business Management*, the #1 University Entrepreneurship Program in the United States (public universities) by *Fortune*, the #1 Graduate Business School (Public Institutions) for Entrepreneurship, and the #1 Undergraduate Business School for Entrepreneurship (Public Institutions) by *U.S. News & World Report*. In addition, Indiana University was awarded the National Model MBA Program in Entrepreneurship for the MBA Program in Entrepreneurship and Innovation developed by Dr. Kuratko. Before coming to Indiana University, he was the Stoops Distinguished Professor of Entrepreneurship and Founding Director of the Entrepreneurship Program at Ball State University. In addition, he was Executive Director of the Midwest Entrepreneurial Education Center. Dr. Kuratko was the first professor ever to be named a Distinguished Professor for the College of Business at Ball State University and held that position for 15 years. The Entrepreneurship Program that Dr. Kuratko developed at Ball State University continually earned national rankings, including Top 20 in *Business Week* and *Success* magazines, Top 10 business schools for entrepreneurship research by the *Journal*

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of Management, Top 4 in *U.S. News & World Report* (including the #1 public university for entrepreneurship), and the #1 Regional Entrepreneurship Program by *Entrepreneur*.

Dr. Kuratko's honors include earning Entrepreneur of the Year for the state of Indiana (sponsored by Ernst & Young and *Inc.* magazine) and being inducted into the Institute of American Entrepreneurs Hall of Fame. He has been honored with the George Washington Medal of Honor, the Leavey Foundation Award for Excellence in Private Enterprise, the NFIB Entrepreneurship Excellence Award, and the National Model Innovative Pedagogy Award for Entrepreneurship. In addition, he was named the National Outstanding Entrepreneurship Educator by the U.S. Association for Small Business and Entrepreneurship, and he was selected one of the Top Entrepreneurship Professors in the United States by *Fortune*. He has been honored with the Thomas W. Binford Memorial Award for Outstanding Contribution to Entrepreneurial Development by the Indiana Health Industry Forum, and he was named a 21st Century Entrepreneurship Research Fellow by the Global Consortium of Entrepreneurship Centers. In his years at Ball State University, he earned the College of Business Teaching Award for 15 consecutive years and was the only professor in the history of the university to achieve all four of the university's major lifetime awards, which included the Outstanding Young Faculty Award, Outstanding Teaching Award, Outstanding Faculty Award, and Outstanding Researcher Award. Dr. Kuratko was honored by his peers in *Entrepreneur* magazine as one of the top entrepreneurship program directors in the nation for three consecutive years, including the #1 Entrepreneurship Program Director in the nation. The U.S. Association for Small Business and Entrepreneurship honored him with the John E. Hughes Entrepreneurial Advocacy Award for his career achievements in entrepreneurship and corporate innovation, and the National Academy of Management honored Dr. Kuratko with the Entrepreneurship Advocate Award for his career contributions to the development and advancement of the discipline of entrepreneurship. Professor Kuratko has been named one of the top 10 entrepreneurship scholars in the world and was the recipient of the Riata Distinguished Entrepreneurship Scholar Award. He was the inaugural recipient of the Karl Vesper Entrepreneurship Pioneer Award for his career dedication to developing the field of entrepreneurship. The U.S. Association for Small Business and Entrepreneurship honored him with the Max S. Wortman, Jr./USASBE Lifetime Achievement Award for Entrepreneurship for his career research and accomplishments in the field of entrepreneurship. Finally, he was honored by the National Academy of Management with the Entrepreneurship Mentor Award for his exemplary mentorship to the next generation of entrepreneurship scholars and professors.

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In Remembrance

Dr. Richard M. Hodgetts (1942–2001)

On November 17, 2001, Dr. Richard M. Hodgetts passed away after a three-and-a-half-year battle with bone marrow cancer. The field of management lost one of its most significant scholars and teachers.

Dr. Hodgetts earned a PhD from the University of Oklahoma, an MBA from Indiana University, and a BS from New York University. A prolific scholar and author, Professor Hodgetts published more than 125 articles on a variety of topics ranging from entrepreneurship to strategic management to total quality management. His articles appeared in a host of leading journals, including *Academy of Management Journal*, *Academy of Management Executive*, *Organizational Dynamics*, *Business Horizons*, *Personnel*, *Personnel Journal*, and *Journal of Small Business Management*. He was also the editor of the *Journal of Leadership Studies* and served on a number of editorial boards. He was the author or coauthor of 49 books. Some of the more recent included *Management*, *International Business*, *International Management*, *Modern Human Relations at Work*, *Measures of Quality and High Performance*, and *Entrepreneurship: A Contemporary Approach*, which he wrote with Dr. Kuratko.

Dr. Hodgetts was an active Academy of Management member his whole career, serving as program chair in 1991, chair of the Management History Division, editor of the New Time special issue of *Academy of Management Executive*, and member of the Board of Governors from 1993 to 1996. For all of his dedicated service, he was inducted into the prestigious *Academy of Management Fellows*.

Besides his tremendous contributions to the knowledge base of management, Dr. Hodgetts was a truly outstanding teacher. He won every distinguished teaching award offered at both his first job of 10 years at the University of Nebraska and his home school for 25 years at Florida International University (FIU), including Faculty Member of the Year by the Executive MBA students in the year of his passing. Some of his more notable honors included the Outstanding Educator Award from the National Academy of Management in 1999, the John F. Mee Management Contribution Award from the Management History Division of the Academy of Management in 1998, the Professor Excellence Program Award from FIU in 1997, a Teaching Improvement Program Award from FIU in 1996, and an Excellence in Teaching Award from FIU in 1995.

Dr. Hodgetts consulted for a number of Fortune 500 firms and provided training for a wide variety of companies, including AT&T, Delco Electronics, Eastman Kodak, GE, IBM, Motorola, Texas Instruments, and Walmart. He has also lectured in Mexico, Venezuela, Peru, Chile, Jamaica, Trinidad, Denmark, and Kuwait and at a host of U.S. colleges and universities.

He developed literally thousands of students at all levels—undergraduate, MBA, executive development, and doctoral—and millions across the world were influenced by his texts and innovative distance education materials and courses. Simply put, he was the ultimate scholar and educator.

Dr. Hodgett's distinguished career as a scholar and educator was exemplified in his humor, dedication to research, genuine interest in his students, compassion, and true courage. Millions of students and practicing leaders have been—and will continue to be—influenced by his teaching and publications. Dr. Hodgetts forever shaped my career as my epiphany to academia, my doctoral adviser, my mentor, my coauthor, and my friend. His legacy will live forever.

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Introduction

Theory, Process, and Practice

I have subtitled this book on entrepreneurship as *Theory, Process, Practice* for two specific reasons, one of which is emotional and the other logical. First, I wanted to honor my former mentor, coauthor, and dear friend, Dr. Richard M. Hodgetts, in selecting a subtitle that he developed for one of his most successful management books decades ago. The sad loss of Dr. Hodgetts to cancer in 2001 will always leave a void for all of us who knew him and recognized his powerful influence on the entire field of management in business schools. (See my remembrance of Dr. Hodgetts located just after the preface.) The second reason I selected this subtitle is its representation of the book's focus. I believe that students studying entrepreneurship must be exposed to the theory development of the field, the processes by which we now teach and study entrepreneurship, and the actual practice of entrepreneurship by those individuals and organizations that have been successful. Thus, in order to completely understand and appreciate this emerging discipline we call entrepreneurship, students must learn from theory, process, and practice. The subtitle represents the complete foundation of a discipline. Let's begin by briefly examining each facet.

The Theory of Entrepreneurship

A few decades ago, the field of entrepreneurship was considered little more than an applied trade as opposed to an academic area of study. There was no "research" to be accomplished because it was thought that those who could not attend college would simply "practice" the concept of new business start-up. Yet our economy was actually based on entrepreneurship, and history has proven that with each downturn in the economy, it is entrepreneurial drive and persistence that bring us back. Thus, individual scholars began to examine entrepreneurship from a research perspective, and in doing so, they initiated an academic field of scholarly pursuit. So we look back at some of the "believers" among the academic community, such as Arnold C. Cooper (Purdue University), Karl A. Vesper (University of Washington), Donald L. Sexton (Ohio State University), Robert C. Ronstadt (Babson College), Max S. Wortman (University of Iowa), Justin G. Longenecker (Baylor University), and Howard H. Stevenson (Harvard University), who are all examples of the "pioneering" researchers in the embryonic days of entrepreneurship. Their wisdom, scholarship, and persistence guided the field of entrepreneurship from what was once considered a disrespected academic area to a field that has now gained unimaginable respect and admiration among business schools in the twenty-first century. Their willingness to delve into the research issues important to this developing discipline provided motivation for the next generation of scholars to pursue the entrepreneurship field with greater vigor.

Today, we celebrate the immense growth in entrepreneurship research as evidenced by the number of academic journals devoted to entrepreneurship (44), the number of endowed professorships and chairs in entrepreneurship (more than 400), the development of the 21st Century Entrepreneurship Research Fellows by the Global Consortium of Entrepreneurship Centers, and the increasing number of top scholars devoting much of their valuable research time and efforts to publishing on aspects of entrepreneurship in the top academic journals. It is indeed gratifying to see the *Academy of Management Journal*, *Academy of Management Review*, *Strategic Management Journal*, *Journal of Operations Management*, and *Journal of Management Studies* publishing more entrepreneurship research; this increase is in direct proportion to the change in the journals' editorial review boards to include more scholars in the entrepreneurship field. Finally, many universities are now including certain entrepreneurship journals in their lists of top journals for the faculty to publish in. Many of the top business schools in the United States have accepted the fact that certain entrepreneurship journals have impact factors that exceed most of the traditional management journals already mentioned above. In fact, the *Journal of Business Venturing and Entrepreneurship Theory and Practice are two that top the list of the best journals today*. In addition, journals such as *Small Business Economics*, *Strategic Entrepreneurship Journal*, and *Journal of Small Business Management* have gained worldwide acceptance as excellent research outlets. Additionally, a number of major academic institutions have developed programs in entrepreneurial research, and every year Babson College conducts a symposium titled "Frontiers in Entrepreneurship Research." Since 1981, the conference has provided an outlet for the latest developments in entrepreneurship.

In 1998, the National Consortium of Entrepreneurship Centers (NCEC) was founded for the purpose of continued collaboration among the established entrepreneurship centers, as well as the newer emerging centers,

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to work together to share information, develop special projects, and assist one another in advancing and improving their centers' impact. Today, that organization has changed its name to the Global Consortium of Entrepreneurship Centers (GCEC) to better reflect the international growth of entrepreneurship centers. As mentioned earlier, this consortium also established the 21st Century Entrepreneurship Research Fellows, a growing collection of scholars in the field of entrepreneurship who have developed a mission to identify leading-edge research issues and domains and develop high-profile research initiatives that demonstrate the highest level of scholarship to entrepreneurship centers and the academic community at large. There is no question that research drives business schools and universities in general. Today, we see research in entrepreneurship as an accepted and respected part of this drive.

The Process of Entrepreneurship

Beginning with the "early adopters" of the discipline of entrepreneurship, such as the University of Southern California, Babson College, Harvard University, and Indiana University, the number of schools teaching and researching entrepreneurship has exploded to more than 4,000 schools with majors in entrepreneurship, an additional 1,000 with concentrations in entrepreneurship, and at least one course in entrepreneurship now taught at over 5,000 universities worldwide! Some of the more prestigious research universities in the United States, such as Indiana University, Syracuse University, Oklahoma State University, Iowa State University, the University of Tennessee, the University of Louisville, the University of Oklahoma, and the University of Washington, have developed PhD programs in entrepreneurship in order to prepare the next generation of scholars and researchers. The academic field of entrepreneurship has evolved dramatically over the last 45 years! In the midst of this huge expansion of courses remains the challenge of teaching entrepreneurship more effectively.

It has become clear that entrepreneurship, or certain facets of it, *can* be taught. Business educators and professionals have evolved beyond the myth that entrepreneurs are born, not made. Peter Drucker, recognized as one of the leading management thinkers of the twentieth century, said, "The entrepreneurial mystique? It's not magic, it's not mysterious, and it has nothing to do with the genes. It's a discipline. And, like any discipline, it can be learned."[1] Additional support for this view comes from a 10-year literature review of enterprise, entrepreneurship, and small-business management education that reported, "Most of the empirical studies surveyed indicated that entrepreneurship can be taught, or at least encouraged, by entrepreneurship education."[2]

Given the widely accepted notion that entrepreneurial ventures are the key to innovation, productivity, and effective competition, the question of whether entrepreneurship can be taught is obsolete. Robert C. Ronstadt posed the more relevant question regarding entrepreneurial education: What should be taught, and how should it be taught? He proposed that entrepreneurial programs should be designed so that potential entrepreneurs are aware of barriers to initiating their entrepreneurial careers and can devise ways to overcome them. He contended that an effective program must show students how to behave entrepreneurially and should also introduce them to people who might be able to facilitate their success.[3]

Four years later, researchers Robinson and Hayes conducted a survey of universities with enrollments of at least 10,000 students to determine the extent of the growth in entrepreneurship education.[4] While significant growth was cited, two specific challenges were pointed out: developing existing programs and personnel, thus improving the quality of the field. There are several obstacles that need to be overcome to facilitate the development of quality in the field. At the heart may be the lack of solid theoretical bases on which to build pedagogical models and methods and the lack of formal academic programs, representing a lack of commitment on the part of institutions. Professors Robinson and Hayes believed that entrepreneurship education had come a long way in 20 years, yet there were several weak points in the field that were identified through their research. Of primary concern is the lack of depth in most of the programs that were then started. Further growth would depend on how new programs were integrated with and nurtured by the established entrepreneurship education system. In the years that followed, we experienced a greater depth in the academic programs as well as newer initiatives to integrate entrepreneurship throughout the campuses.

In more recent times, researchers Solomon, Duffy, and Tarabishy conducted one of the most comprehensive empirical analyses on entrepreneurship education. In their review of entrepreneurship pedagogy, they stated, "A core objective of entrepreneurship education is that it differentiates from typical business education. Business entry is fundamentally a different activity than managing a business."[5] They concluded that pedagogy is changing based on a broadening market interest in entrepreneurial education. New interdisciplinary programs use faculty teams to develop programs for the nonbusiness student, and there is a growing trend in courses specifically designed for art, engineering, and science students. In addition to courses focused on preparing the future

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entrepreneur, instructional methodologies are being developed for those who manage entrepreneurs in organizations, potential resource people (accountants, lawyers, and consultants) used by entrepreneurs, and top managers who provide vision and leadership for corporations, which must innovate in order to survive. Today's entrepreneurship educators are challenged with designing effective learning opportunities for entrepreneurship students.

The current trend in most universities is to develop or expand entrepreneurship programs and design unique and challenging curricula specifically designed for entrepreneurship students. One shining example of this expansionary trend is Dr. Michael H. Morris at the University of Notre Dame, who developed one of the most powerful educational programs for faculty to learn how to teach entrepreneurship. Titled "The Entrepreneurship Experiential Classroom," this uniquely designed entrepreneurship program has touched the lives of over 1,000 faculty members who have experienced the latest curriculum techniques and methods to enhance their own classrooms across the world. Another significant example is the national recognition now being given to the top entrepreneurial schools through awards such as the United States Association for Small Business and Entrepreneurship (USASBE) National Model Programs and the national rankings, such as those done by *U.S. News & World Report* and the Global Entrepreneurship Research Productivity ranking from Texas Christian University. This kind of experience is offered to students in innovative entrepreneurship programs recognized by the USASBE. Highlights of these programs can be found at **www.usasbe.org**. These awarded model programs include undergraduate majors and concentrations, graduate-level programs, innovative pedagogy, and specialized programs. All of these universities have produced entrepreneurship education that has had real impact on students and a lasting impact on the entrepreneurship field.

The Practice of Entrepreneurship

The final aspect of entrepreneurship is its application in practice. We have seen this exhibited by the thousands of successful entrepreneurs throughout the last 45 years. They and their new ventures have changed our world—forever! However, it is important to understand the differences between mere opportunistic moneymaking and the real practice of entrepreneurship. For example, in the late 1990s, we experienced the dot-com frenzy in which everyone thought they were entrepreneurs simply because they put a business title on the Internet. As I have pointed out many times, in the 1940s, it cost $20 billion to invent the atomic bomb. It took another $20 billion to put man on the moon 20 years later. In 1999, the dot-coms burned right through $20 billion to achieve, well, nothing really. The dot-com bust hurt more than the cash-burning Internet start-ups and the venture capitalists that funded them. This plague spread like wildfire, collapsing the true entrepreneurial spirit of building a dream into an enduring entity. Our classrooms became infatuated with the drive for investment and liquidity, fast cash, quick exits, and no real commitment. We pursued an "investment mentality" rather than facilitating the search for an "enduring enterprise." We have survived that time, but it did leave us a legacy to *learn* from. We must again focus on the real goals of entrepreneurs and the motivation that permeates them. We must educate our next generation of entrepreneurs to learn from the dot-com evaporation and return to the roots of business formation and development. Exit strategies are fine, but they should not dominate the pursuit of entrepreneurial opportunity. One author referred to the dot-com individuals as "opportuneurs" rather than entrepreneurs because they uncoupled wealth from contribution, replaced risk taking with risk faking, and exploited external opportunity rather than pursuing inner vision.[6]

It should be the mission of all entrepreneurship educators to teach the students of today about the *true* entrepreneur. It is the mission of this book to provide an integration of entrepreneurs and their entrepreneurial pursuits into the text material. I want to be sure that today's practicing entrepreneurs and their interesting stories are presented in order to illustrate the real problems and issues involved with their ventures. Students need the exposure to those entrepreneurs who have paid the price, faced the challenges, and endured the failures. I want the lessons learned from our experienced entrepreneurs to "make a difference." It is only by reading about and studying their practices that we can truly learn the real application of the entrepreneurial theories and processes.

Final Thoughts before Venturing into the Text

After reviewing the major facets of theory, process, and practice that are so integral to the study of entrepreneurship, the question remains: So how do I approach this subject? The answer is neither complex nor profound. The answer is really an appreciation for your abilities and recognizing that each one of us can make a difference if we try. Remember, the journey of 10,000 miles always starts with the first step! Let this book and your entrepreneurial course be your first step.

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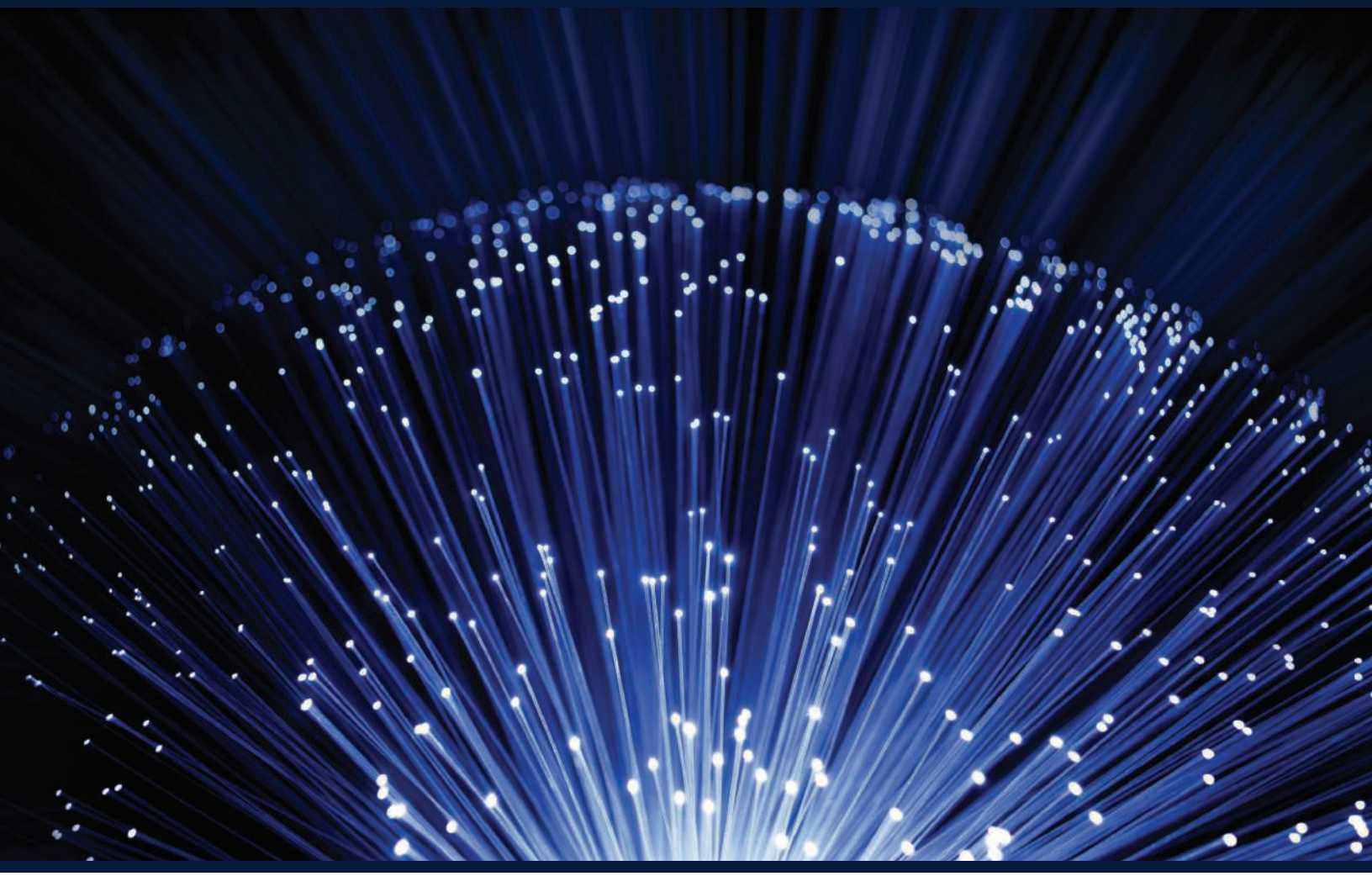
Entrepreneurship is the new revolution, and it's about disruptive innovation and creativity. It is the future of our world economy. Today, the words used to describe the new innovation regime of the twenty-first century are *dream*, *create*, *explore*, *invent*, *pioneer*, and *imagine*! I believe we are at a point in time when the gap between what can be imagined and what can be accomplished has never been smaller. This is the challenge for all of today's entrepreneurship students. To paraphrase the late Robert F. Kennedy in a speech made more than 50 years ago: You are living in one of the rarest moments in education history—a time when all around us the old order of things is crumbling, and a new world society is painfully struggling to take shape. If you shrink from this struggle and the many difficulties it entails, you will betray the trust that your own position forces on you. You possess one of the most privileged positions, for you have been given the opportunity to educate and to lead. You can use your enormous privilege and opportunity to seek purely your tenure and security. But entrepreneurial history will judge you, and as the years pass, you will ultimately judge yourself on the extent to which you have used your abilities to pioneer and lead into new horizons. In your hands is the future of your entrepreneurial world and the fulfillment of the best qualities of your own spirit.[7]

Notes

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3. R. Ronstadt, "The Educated Entrepreneurs: A New Era of Entrepreneurial Education Is Beginning," *American Journal of Small Business* 11, no. 4 (1987): 37–53.
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Part 1 | Understanding the Impact of the Entrepreneurial Mindset



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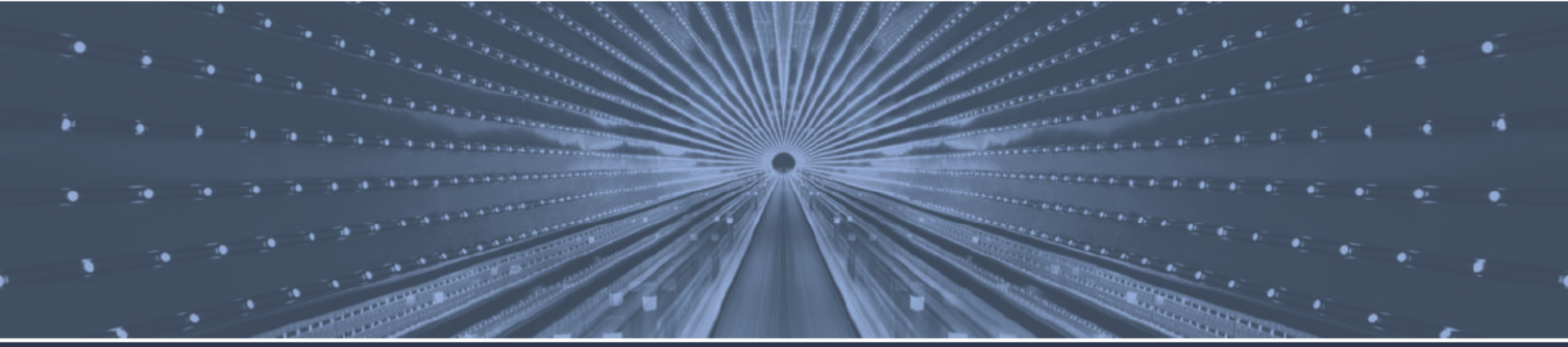
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Chapter 1

Entrepreneurship: Evolutionary Development—Revolutionary Impact

Learning Objectives

1.1. Identify the major types of entrepreneurial ventures
1.2. Examine the historical development of entrepreneurship
1.3. Summarize the myths of entrepreneurship
1.4. Define the major schools of entrepreneurial thought
1.5. Explain the process and framework approaches to the study of entrepreneurship
1.6. Paraphrase a comprehensive definition of entrepreneurship
1.7. Examine the entrepreneurial revolution taking place today
1.8. Illustrate today's entrepreneurial environment
1.9. Outline the trends in entrepreneurship research
1.10. Examine the future trajectory of entrepreneurship
1.11. Define the key concepts in entrepreneurship

Entrepreneurial Thought

Most of what you hear about entrepreneurship is all wrong. It's not magic; it's not mysterious; and it has nothing to do with genes. It's a discipline and, like any discipline, it can be learned.

—Peter F. Drucker, *Innovation and Entrepreneurship*

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1-1 Entrepreneurs—Breakthrough Innovators

Entrepreneurs are individuals who recognize opportunities where others see chaos, contradiction, and confusion. They are aggressive catalysts for change within the marketplace. They have been compared to Olympic athletes challenging themselves to break new barriers, to long-distance runners dealing with the agony of the miles, to symphony orchestra conductors balancing different skills and sounds into a cohesive whole, and to top-gun pilots continually pushing the envelope of speed and daring. Whatever their passion, entrepreneurs are the heroes of today's marketplace. They start companies and create jobs at a breathtaking pace. The global economy has been revitalized because of their efforts, and the world now embraces free enterprise as the most significant force for economic development. The passion and drive of entrepreneurs moves the world of business forward. They challenge the unknown and continuously create breakthroughs for the future.

One anonymous quote sums up the realities for entrepreneurs: "Anyone [can be an entrepreneur] who wants to experience the deep, dark canyons of uncertainty and ambiguity; and who wants to walk the breathtaking highlands of success. But I caution, do not plan to walk the latter, until you have experienced the former."[1]

1-2 Entrepreneurs: A Typology of Distinctive Journeys

LO1.1 Identify the major types of entrepreneurial ventures

The terms *entrepreneur* and *small-business owner* sometimes are used interchangeably. Although some situations encompass both terms, it is important to note the differences in the titles. Small businesses are independently owned and operated, are not dominant in their fields, and usually do not engage in many new or innovative practices. They may never grow large, and the owners may prefer a more stable and less aggressive approach to running these businesses; in other words, they manage their businesses by expecting stable sales, profits, and growth. Because small firms include those purchased as already established businesses as well as franchises, these entrepreneurs can have very different goals for their venture.

On the other hand, entrepreneurial ventures are those for which the entrepreneur's principal objectives are innovation, profitability, and growth. Thus, the business is characterized by innovative strategic practices and sustainable growth. Entrepreneurs and their financial backers are usually seeking rapid growth and immediate profits. They may even seek the sale of their businesses if there is potential for large capital gains. These entrepreneurs may be viewed as having a different perspective from small-business owners on the development of their firms.

It is clear that entrepreneurs create a wide variety of ventures. These include everything from giants like Uber and Amazon to a small local artisan brewery. As mentioned above, entrepreneurs vary in numerous ways, including how they confront risks, expand in the market, produce innovations, seek outside capital, involve family members, and incorporate new technologies. Each entrepreneur will experience the entrepreneurial journey in a different and unique way. In fact, there is so much diversity in what gets created that it becomes difficult to provide one set definition of an entrepreneurial firm. For example, we see diversity in the terms applied to different entrepreneurs, such as the following:

- ***Nascent entrepreneurs.*** Someone thinking about starting a business.
- ***Artisan entrepreneurs.*** Individuals who emphasize independence over conglomeration, local community over scale, and value creation over profit maximization.
- ***Home-based entrepreneurs.*** Entrepreneurs who locate their ventures at their place of residence.
- ***Niche entrepreneurs.*** Entrepreneurs who have family-owned firms and are owner managed.[2]

All this diversity substantiates the need for creating a typology of entrepreneurial firms so that there is an appreciation for the various forms that a venture can take as well as the unique journey experienced by the entrepreneur. Researchers Michael H. Morris and Donald F. Kuratko[3] created a typology consisting of four major types of ventures. They include the following:

- ***Survival ventures.*** Provide basic subsistence for the entrepreneur and their family. As the business exists to provide for basic personal financial needs, once costs are covered, there is generally no capacity to reinvest into the venture. Launch of the business is often necessity driven. (examples: handyman, roadside fruit stand, small-craft maker, personal trainer, Uber driver, dog walker)
- ***Lifestyle ventures.*** Provide a relatively stable income stream for owners based on a workable business model and a maintenance approach to management. Relatively modest reinvestments are made to maintain competitiveness in a local market where the firm is embedded but does not seek meaningful expansion or growth. The number of employees remains relatively constant. (examples: local bar or restaurant, hair salon, hardware store, auto repair shop, toy store, small accounting firm, owner of a single franchise)

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- *Managed growth ventures.* A workable business model that seeks stable growth over time with occasional launches of new products and a steady expansion of facilities to establish a strong local or regional brand. Controlled growth guide ongoing business development. (examples: custom boat manufacturer, third-party logistics company, multilocation walk-in medical clinics, real estate company, marketing agency, auto dealership)
- *Aggressive growth ventures.* Referred to as gazelles (fast growing), unicorns (market value at $1 billion), or decacorns (market value at $10 billion), these are often technology-based ventures with strong innovation capabilities that seek exponential growth and are funded by equity capital. The venture seeks to transform industries and create new markets. The focus is typically national or international, and the firms often become candidates for initial public offerings or acquisition. (examples: Amazon, Baidu, Eventbrite, Fitbit, Facebook, LinkedIn, SpaceX, Under Armour)

This typology allows for an inclusive approach to entrepreneurship. While all ventures represent change, they do not necessarily have to be disruptive, highly innovative, or scalable. As such, this typology eliminates the need to pursue debates concerning the difference between small businesses and entrepreneurial firms, as all start-ups are to some degree entrepreneurial.

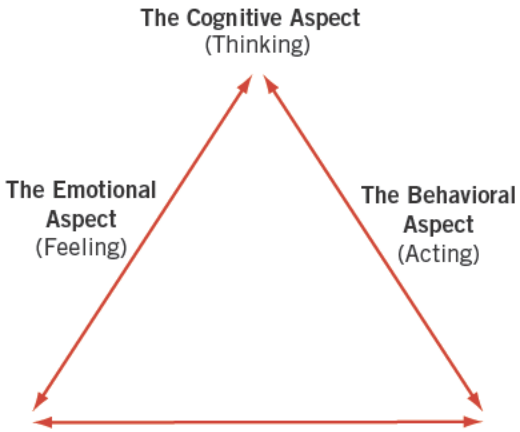
In this book, we concentrate on all entrepreneurs and the effective development of entrepreneurship, including the entrepreneurial mindset in established organizations and social entrepreneurship. Some of the particular points in this book may apply to all of the different entrepreneurs; however, keep in mind that our focus is on the aspects of innovation and growth associated with entrepreneurs.

1-3 Entrepreneurship: A Mindset

Entrepreneurship is more than the mere creation of business. Although that is certainly an important facet, it's not the complete picture. The characteristics of seeking opportunities, taking risks beyond security, and having the tenacity to push an idea through to reality combine into a special perspective that permeates entrepreneurs. As we will illustrate in Chapter 2, an entrepreneurial mindset can be developed in individuals. Entrepreneurial mindset represents the cognition and commitment to view the world with an innovative perspective. This mindset represents a way of thinking, acting, and feeling.

Researchers Donald F. Kuratko, Greg Fisher, and David B. Audretsch developed a threefold model of the entrepreneurial mindset (see Figure 1.1).[4] It includes the entrepreneurial cognitive aspect (how entrepreneurs use mental models to think), the entrepreneurial behavioral aspect (how entrepreneurs engage or act for opportunities), and the entrepreneurial emotional aspects (what entrepreneurs feel in entrepreneurship).

Figure 1.1 The Triad of the Entrepreneurial Mindset



Source: D. F. Kuratko, G. Fisher, and D. B. Audretsch, "Unraveling the Entrepreneurial Mindset," *Small Business Economics* 57, no. 3 (2022).

This composes the entrepreneurial potential in every individual. This mindset can be exhibited inside or outside an organization, in for-profit or not-for-profit enterprises, and in business or nonbusiness activities for the purpose of bringing forth creative ideas. Thus, entrepreneurship is an integrated concept that permeates an individual's business in an innovative manner. It is this mindset that has revolutionized the way business is conducted at every level and in every country. It is clear that the world has embraced entrepreneurship and innovation, and the way we view business will never be the same. So it is. The entrepreneurial revolution has taken hold in an economic sense, and the entrepreneurial mindset is the dominant force.

1-4 The Evolution of Entrepreneurship

LO1.6 Paraphrase a comprehensive definition of entrepreneurship

The word entrepreneur is derived from the French *entreprendre,* meaning "to undertake." The entrepreneur is one who undertakes to organize, manage, and assume the risks of a business. In recent years, entrepreneurs have been doing so many things that it is now necessary to broaden this definition. Today, an entrepreneur is an innovator or developer who recognizes and

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The Entrepreneurial Process

Employee vs. Entrepreneur Mindset

Becoming an entrepreneur is less about the money, the commitment, or the support and more about the mindset. Becoming an entrepreneur revolves around shifting from an employee mindset to an entrepreneur mindset. Here are some interesting perspectives to compare:

Employee Perspective	vs.	Entrepreneur Perspective
Out of fear for my job, I must conform		*Fear fuels me*
Mistakes must be avoided		*Mistakes help me learn*
Avoiding risks is security		*Calculated risks are my security*
I must know everything about my job		*Continuous learning is my approach*
Try and be smartest one on my team		*Seek a team of people smarter han me*
How I look externally is key		*How I appear internally is more important*
Promotion is my goal		*The entrepreneurial journey is my goal*

Entrepreneurship is more than just creating a business; it is an actual spiritual and emotional transformation that takes you from an established way of thinking to a new, groundbreaking mentality. An entrepreneur must get comfortable with being uncomfortable and be able to deal with fear. Entrepreneurship, in whatever capacity or form it shows itself in, is risky and fear inducing. It does not matter if you are selling lemonade in your backyard as a kid, writing your first book, or hustling to market your brand after hours. The more a person can change their mindset from employee to entrepreneur, the more they will be able to find satisfaction in entrepreneurship.

Source: Adapted from E. Network, "How to Switch from an Employee to an Entrepreneur Mindset," September 11, 2017, https://www.huffingtonpost.com/entry/how-to-switch-from-an-employee-to-an-entrepreneur-mindset_us_59b69e29e4b0d364c97f53fb, accessed January 16, 2018.

seizes opportunities; converts those opportunities into workable/marketable ideas; adds value through time, effort, money, or skills; assumes the risks of the competitive marketplace to implement these ideas; and realizes the rewards from these efforts.[5]

The entrepreneur is the aggressive catalyst for change in the world of business. They are independent thinkers who dare to be different amid a background of common events. The literature of entrepreneurial research reveals some similarities as well as a great many differences in the characteristics of entrepreneurs. Chief among these characteristics are personal initiative, the ability to consolidate resources, management skills, a desire for autonomy, and risk taking. Other characteristics include aggressiveness, competitiveness, goal-oriented behavior, confidence, opportunistic behavior, intuitiveness, reality-based actions, the ability to learn from mistakes, and the ability to employ human relations skills.[6]

Although no single definition of *entrepreneur* exists and no one profile can represent today's entrepreneur, research is beginning to provide an increasingly sharper focus on the subject. A brief review of the history of entrepreneurship illustrates this.

The world currently is in the midst of a new wave of business and economic development, and entrepreneurship is its catalyst. Yet the social and economic forces of entrepreneurial activity existed long before the new millennium. In fact, the entrepreneurial spirit has driven many of humanity's achievements.

Humanity's progress—from caves to campuses—has been explained in numerous ways. But central to virtually all of these theories has been the role of the "agent of change," the force that initiates and implements material progress. Today we recognize that the agent of change in human history has been and most likely will continue to be the entrepreneur.[7]

LO1.2 Examine the historical development of entrepreneurship

The recognition of entrepreneurs dates back to eighteenth-century France, when economist Richard Cantillon associated the "risk-bearing" activity in the economy with the entrepreneur. The Industrial Revolution was evolving in England during the same period, with the entrepreneur playing a visible role in risk taking and the transformation of resources.[8]

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The association of entrepreneurship and economics has long been the accepted norm. In fact, until the 1950s, the majority of definitions and references to entrepreneurship had come from economists. For example, the aforementioned Cantillon (1725), the French economist Jean Baptiste Say (1803), and twentieth-century economist Joseph Schumpeter (1934) all wrote about entrepreneurship and its impact on economic development.[9] Since that time, researchers have continued to try to describe or define what entrepreneurship is all about. Following are some examples:

> Entrepreneurship . . . consists in doing things that are not generally done in the ordinary course of business routine; it is essentially a phenomenon that comes under the wider aspect of leadership.[10]
>
> Entrepreneurship, at least in all nonauthoritarian societies, constitutes a bridge between society as a whole, especially the noneconomic aspects of that society, and the profit-oriented institutions established to take advantage of its economic endowments and to satisfy, as best they can, its economic desires.[11]
>
> In . . . entrepreneurship, there is agreement that we are talking about a kind of behavior that includes: (1) initiative taking, (2) the organizing or reorganizing of social economic mechanisms to turn resources and situations to practical account, and (3) the acceptance of risk of failure.[12]

After reviewing the evolution of entrepreneurship and examining its varying definitions, Robert C. Ronstadt put together a summary description:

> Entrepreneurship is the dynamic process of creating incremental wealth. This wealth is created by individuals who assume the major risks in terms of equity, time, and/or career commitment of providing value for some product or service. The product or service itself may or may not be new or unique but value must somehow be infused by the entrepreneur by securing and allocating the necessary skills and resources.[13]

Entrepreneurship as a topic for discussion and analysis was introduced by the economists of the eighteenth century, and it continued to attract the interest of economists in the nineteenth century. In the twentieth century, the word *entrepreneurship* became synonymous—or at least closely linked—with free enterprise and capitalism. Also, it was generally recognized that entrepreneurs serve as agents of change; provide creative, innovative ideas for business enterprises, and help businesses grow and become profitable.

Whatever the specific activity they engage in, entrepreneurs in the twenty-first century are considered the heroes of free enterprise. Many of them have used innovation and creativity to build multi-million-dollar enterprises from fledgling businesses—some in less than a decade! These individuals have created new products and services and have assumed the risks associated with these ventures. Many people now regard entrepreneurship as "pioneership" on the frontier of business.

In recognizing the importance of the evolution of entrepreneurship in the twenty-first century, we have developed an integrated definition that acknowledges the critical factors needed for this phenomenon.

> *Entrepreneurship is a dynamic process of vision, change, and creation. It requires an application of energy and passion toward the creation and implementation of innovative ideas and creative solutions. Essential ingredients include the willingness to take calculated risks—in terms of time, equity, or career; the ability to formulate an effective venture team; the creative skill to marshal needed resources; the fundamental skill of building a solid business plan; and, finally, the vision to recognize opportunity where others see chaos, contradiction, and confusion.*

1-5 Avoiding Folklore: The Myths of Entrepreneurship

LO1.3 Summarize the myths of entrepreneurship

Throughout the years, many myths have arisen about entrepreneurship—primarily because of a lack of research on the subject. As many researchers in the field have noted, the study of entrepreneurship is still emerging, and thus "folklore" tends to prevail until it is dispelled with contemporary research findings. Twelve of the most notable myths (and an explanation to dispel each myth) are as follows.

1-5a Myth 1: Entrepreneurs Are Doers, Not Thinkers

Although it is true that entrepreneurs tend toward action, they are also thinkers. Indeed, they are often very methodical people who plan their moves carefully. The emphasis today on the creation of clear and complete business plans (see Chapter 12) is an indication that "thinking" entrepreneurs are as important as "doing" entrepreneurs.

1-5b Myth 2: Entrepreneurs Are Born, Not Made

The idea that the characteristics of entrepreneurs cannot be taught or learned—that they are innate traits one must be born with—has long been prevalent. These traits include aggressiveness, initiative, drive, a willingness to take risks, analytical ability, and skill in human

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relations. Today, however, the recognition of entrepreneurship as a discipline is helping to dispel this myth. Like all disciplines, entrepreneurship has models, processes, and case studies that allow the topic to be studied and the knowledge to be acquired.

1-5c Myth 3: Entrepreneurs Are Always in Tech Ventures

The idea that entrepreneurs are involved only in the tech industry is a result of misunderstanding and tunnel vision. Although many entrepreneurs have arisen in the exploding tech world, numerous entrepreneurs encompass all sorts of innovative activity.[14] For example, Ray Kroc worked on a fast-food franchise, and his innovative ideas made McDonald's the largest fast-food enterprise in the world. A contemporary understanding of entrepreneurship covers more than just tech innovation; it requires a complete understanding of innovative behavior in all its forms.

1-5d Myth 4: Entrepreneurs Are Academic and Social Misfits

The belief that entrepreneurs are academically and socially ineffective is a result of some business owners having started successful enterprises after dropping out of school or quitting a job. In many cases, such an event has been blown out of proportion in an attempt to "profile" the typical entrepreneur. Historically, in fact, educational and social organizations did not recognize the entrepreneur. Entrepreneurs were abandoned or deemed misfits in a world of corporate giants. Business education, for example, was aimed primarily at the study of corporate activity. Today the entrepreneur is considered a hero—socially, economically, and academically. No longer a misfit, the entrepreneur is now viewed as a professional role model.

1-5e Myth 5: Entrepreneurs Must Fit the Profile

Many books and articles have presented checklists of characteristics of the successful entrepreneur. These lists were neither validated nor complete; they were based on case studies and on research findings among achievement-oriented people. Today we realize that a standard entrepreneurial profile is hard to compile. The environment, the venture, and the entrepreneur have interactive effects, which result in many different types of profiles. Contemporary studies conducted at universities across the world will, in the future, provide more accurate insights into the various profiles of successful entrepreneurs. As we will show in Chapter 2, an "entrepreneurial mindset" within individuals is more understandable and realistic than a particular profile.

1-5f Myth 6: All Entrepreneurs Need Is Money

It is true that a venture needs capital to survive; it is also true that a large number of business failures occur because of a lack of adequate financing. However, money is not the only bulwark against failure. Failure due to a lack of proper financing often is an indicator of other problems: managerial incompetence, lack of financial understanding, poor investments, poor planning, and the like. Many successful entrepreneurs have overcome a lack of money while establishing their ventures. To those entrepreneurs, money is a resource but never an end in itself.

1-5g Myth 7: All Entrepreneurs Need Is an Idea

As we will see in Chapter 5, ideas and the ideation process are very important for entrepreneurs. However, it is shortsighted to think that it is simply the idea that makes the entrepreneur a success. It is actually the entire process of entrepreneurship that needs to be understood and executed on to succeed. Learning the processes of entrepreneurship simply makes entrepreneurs better prepared to deal with situations and turn them into successes. What appears to be only an idea is actually a combination of preparation, determination, desire, knowledge, and innovativeness.

1-5h Myth 8: Entrepreneurship Is Unstructured and Chaotic

There is a tendency to think of entrepreneurs as people who shoot from the hip and ask questions later. They are assumed by some to be disorganized and unstructured, leaving it to others to keep things on track. The reality is that entrepreneurs are heavily involved in all facets of their ventures, and they usually have a number of balls in the air at the same time. As a result, they are typically well-organized individuals. They tend to have a system—perhaps elaborate, perhaps not—that is personally designed to keep things straight and maintain priorities. In fact, their system may seem strange to the casual observer, but it works.

1-5i Myth 9: Most Entrepreneurial Initiatives Fail

The common mythical statement is that 9 out of 10 new ventures fail. The facts do not support such a contention. The statistics of entrepreneurial failure rates have been misleading over the years. In fact, the *Kauffman Indicators of Entrepreneurship*, a leading report on entrepreneurship activity in the United States, has reported that the "high failure rate" most commonly accepted might be misleading.

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The Entrepreneurial Process

The E-Myth

Michael E. Gerber has written a book titled *The E-Myth: Why Most Businesses Don't Work and What to Do about It*, in which he clearly delineates the differences among the types of people involved with contemporary small businesses:

- The *entrepreneur* invents a business that works without him or her. This person is a visionary who makes a business unique by imbuing it with a special and exciting sense of purpose and direction. The entrepreneur's far-reaching perspective enables him or her to anticipate changes and needs in the marketplace and to initiate activities to capitalize on them.
- The *manager* produces results through employees by developing and implementing effective systems and, by interacting with employees, enhances their self-esteem and ability to produce good results. The manager can actualize the entrepreneur's vision through planning, implementation, and analysis.
- The *technician* performs specific tasks according to systems and standards management developed. The technician, in the best of businesses, not only gets the work done but also provides input to supervisors for improvement of those systems and standards.

Understanding these definitions is important because Gerber contends that most small businesses *don't work*—their owners do. In other words, he believes that today's small-business owner works too hard at a job that they have created for themselves rather than working to create a business. Thus, most small businesses fail because the owner is more of a technician than an entrepreneur. Working only as a technician, the small-business owner realizes too little reward for so much effort, and eventually, according to Gerber, the business fails.

The e-myth is that today's business owners are not true entrepreneurs who create businesses but merely technicians who have created a job for themselves. The solution to this myth lies in the owner's willingness to begin thinking and acting like a true entrepreneur: to imagine how the business would work without them. In other words, the owner must begin working *on* the business in addition to working *in* it. They must leverage the company's capacity through systems development and implementation. The key is for a person to develop an "entrepreneurial perspective."

Source: Adapted from Michael E. Gerber, *The E-Myth Revisited: Why Most Businesses Don't Work and What to Do about It* (New York: HarperCollins, 1995, 2001), and personal interview.

In 2021, the Kauffman report showed that 78.1 percent of start-up firms had survived one year after their founding.[15] More recent studies have supported the fact that new ventures do not fail at such an alarming rate.[16]

While many entrepreneurs do suffer a number of failures before they are successful, they follow the adage "If at first you don't succeed, try, try, again." In fact, failure can teach many lessons to those willing to learn, and often it leads to future successes. This is clearly shown by the corridor principle, which states that, with every venture launched, new and unintended opportunities often arise.

1-5j Myth 10: Entrepreneurs Are Extreme Risk Takers

As we will show in Chapter 2, the concept of risk is a major element in the entrepreneurial process. However, the public's perception of the risk most entrepreneurs assume is distorted. Although it may appear that an entrepreneur is "gambling" on a wild chance, the entrepreneur is usually working on a moderate or "calculated" risk. Most successful entrepreneurs work hard—through planning and preparation—to minimize the risk involved and better control the destiny of their vision.

These 10 myths have been presented to provide a background for today's current thinking on entrepreneurship. By sidestepping the folklore, we can build a foundation for critically researching the contemporary theories and processes of entrepreneurship.

1-5k Myth 11: The Unicorn Fallacy

As mentioned earlier, the term ***unicorn*** was introduced as a label for aggressive growth ventures with a market value at $1 billion. There appears to be groups of unicorns on the rise. As of 2023, there were more than 1,143 ventures that have been valued at $1 billion or more by venture capitalists, and there seems to be a continued trend in more arising. As they continue to grow, many start-ups are surpassing the $1 billion level and achieving the $10 billion level. These firms, such as Facebook, Uber, and Airbnb, are now referred to as decacorns.[17] Despite the infatuation with these high growth ventures, compared to the millions of start-up ventures each year, those that rise to the level of a unicorn are still quite small in number. Thus, the truth is that most entrepreneurial ventures will not rise to that level.

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1-5l Myth 12: Entrepreneurship Education Is Not Needed

Contrary to the popular belief that entrepreneurship cannot be taught and that entrepreneurs should simply go out and "do it," it has become clear that entrepreneurship education is in fact hugely important. Students who study the discipline of entrepreneurship enhance their own skills for a start-up as well as grasp a greater understanding of what constitutes the entrepreneurial mindset.[18]

1-6 Approaches to Entrepreneurship

To understand the nature of entrepreneurship and better recognize its emerging importance, it is important to consider some of its theory development. The research on entrepreneurship has grown dramatically over the years. As the field has developed, research methodology has progressed from empirical surveys of entrepreneurs to more contextual- and process-oriented research. Theory development is what drives a field of study. Entrepreneurship theory has been developing for the past 40 years, and it is apparent that the field is growing. We need to understand some of that development to better appreciate the discipline of entrepreneurship. The study of the basic theories in entrepreneurship also helps to form a foundation on which a student can build an understanding of the process and practice of entrepreneurship.

A *theory of entrepreneurship* is a verifiable and logically coherent formulation of relationships, or underlying principles, that either explain entrepreneurship, predict entrepreneurial activity (e.g., by characterizing conditions that are likely to lead to new profit opportunities or to the formation of new enterprises), or provide normative guidance (i.e., prescribe the right action in particular circumstances).[19] It has become increasingly apparent in the new millennium that we need to have some cohesive theories or classifications to better understand this emerging field.

In the study of contemporary entrepreneurship, one concept recurs: Entrepreneurship is interdisciplinary. We outline, in the following sections, various approaches that can increase our understanding of the field.[20]

1-6a Schools-of-Thought Approaches to Entrepreneurship

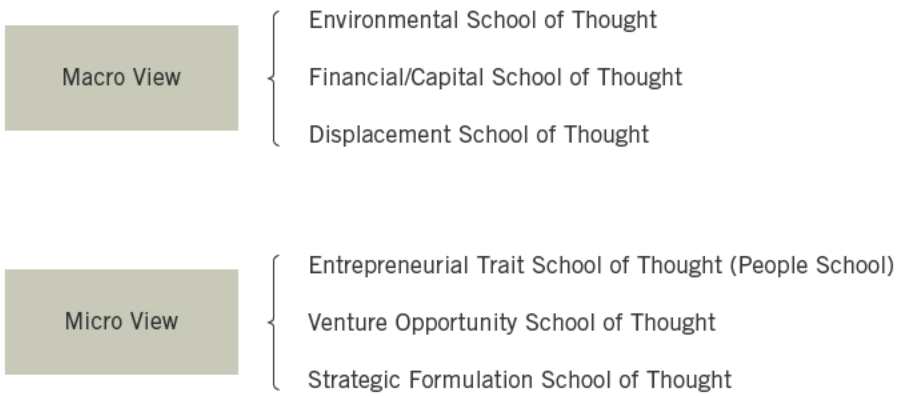
LO1.4 Define the major schools of entrepreneurial thought

A schools-of-thought approach divides entrepreneurship into specific activities, either macro or micro in viewpoint, but both address the conceptual nature of entrepreneurship. We further break down each of these two major views into six distinct schools of thought, three of which apply to the micro and three to the macro view (see Figure 1.2). Although this presentation does not purport to be all-inclusive, neither does it claim to limit the schools to these six, for a movement may develop for unification or expansion. Whatever the future holds, however, it is important to become familiar with these conceptual ideas on entrepreneurship to avoid the semantic warfare that has plagued general management thought for so many years.[21]

The Macro View

The macro view of entrepreneurship presents a broad array of factors that relate to success or failure in contemporary entrepreneurial ventures. This array includes external processes that are sometimes beyond the control of the individual entrepreneur, for they exhibit a strong external locus of control point of view.

Figure 1.2 Entrepreneurial Schools-of-Thought Approach



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Three schools of entrepreneurial thought represent a breakdown of the macro view: (1) the **environmental school of thought**, (2) the **financial/capital school of thought**, and (3) the **displacement school of thought**. The first of these is the broadest and most pervasive school.

The Environmental School of Thought The environmental school of thought deals with the external factors that affect a potential entrepreneur's lifestyle. These can be either positive or negative forces in the molding of entrepreneurial desires. The focus is on institutions, values, and mores that—grouped together—form a sociopolitical environmental framework that strongly influences the development of entrepreneurs.[22] For example, if a middle manager experiences the freedom and support to develop ideas, initiate contracts, or create and institute new methods, the work environment will serve to promote that person's desire to pursue an entrepreneurial career. Another environmental factor that often affects the potential development of entrepreneurs is their social group. The atmosphere of friends and relatives can influence the desire to become an entrepreneur.

The Financial/Capital School of Thought The financial/capital school of thought is based on the capital-seeking process—the search for seed and growth capital is the entire focus of this entrepreneurial emphasis. Certain literature is devoted specifically to this process, whereas other sources tend to treat it as but one segment of the entrepreneurial venture.[23] In any case, the venture capital process is vital to an entrepreneur's development. Business-planning guides and texts for entrepreneurs emphasize this phase, and development seminars that focus on the funds application process are offered throughout the country on a continuous basis. This school of thought views the entire entrepreneurial venture from a financial management standpoint. As is apparent from Table 1.1, decisions involving finances occur at every major point in the venture process.

Table 1.1 Financial Analysis Emphasis

Venture Stage	Financial Consideration	Decision
Start-up or acquisition	Seed capital Venture capital sources	Proceed or abandon
Ongoing	Cash management Investments Financial analysis and evaluation	Maintain, increase, or reduce size
Decline or succession	Profit question Corporate buyout Succession question	Sell, retire, or dissolve operations

The Displacement School of Thought The displacement school of thought focuses on the negative side of group phenomena, in which someone feels out of place—or is literally "displaced"—from the group. It holds that the group hinders a person from advancing or eliminates certain critical factors needed for that person to advance. As a result, the frustrated individual will be projected into an entrepreneurial pursuit out of their own motivations to succeed. As researchers have noted, individuals fight adversity and tend to pursue a venture when they are prevented or displaced from doing other activities.[24] Three major types of displacement illustrate this school of thought:

1. *Political displacement*. Caused by factors ranging from an entire political regime that rejects free enterprise (international environment) to governmental regulations and policies that limit or redirect certain industries.
2. *Cultural displacement*. Deals with social groups precluded from professional fields. Ethnic background, religion, race, and sex are examples of factors that figure in the underrepresented experience. Increasingly, this experience turns various individuals away from standard business professions and toward entrepreneurial ventures. In the United States, members of myriad racial and ethnic underrepresented groups have made significant strides during the past 20 years.[25]
3. *Economic displacement*. Concerned with the economic variations of recession and depression. Job loss, capital shrinkage, or simply "bad times" can create the foundation for entrepreneurial pursuits, just as it can affect venture development and reduction.[26]

These examples of displacement illustrate the external forces that can influence the development of entrepreneurship. Cultural awareness, knowledge of political and public policy, and economic indoctrination will aid and improve entrepreneurial understanding under the displacement school of thought. The broader the educational base in economics and political science, the stronger the entrepreneurial understanding.

The Micro View

The **micro view of entrepreneurship** examines the factors that are specific to entrepreneurship and are part of the **internal locus of control**. The potential entrepreneur has the ability, or control, to direct or adjust the outcome of each major influence in this view. Although some researchers have developed this approach into various definitions and segments, our approach presents the *entrepreneurial trait* theory (sometimes

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referred to as the "people school of thought"), the *venture opportunity* theory, and the *strategic formulation* theory. Unlike the macro approach, which focuses on events from the outside looking in, the micro approach concentrates on specifics from the inside looking out. The first of these schools of thought is the most widely recognized.

The Entrepreneurial Trait School of Thought Many researchers and writers have been interested in identifying traits common to successful entrepreneurs.[27] This approach of the **entrepreneurial trait school of thought** is grounded in the study of successful people who tend to exhibit similar characteristics that, if copied, would increase success opportunities for the emulators. For example, achievement, creativity, determination, and technical knowledge are four factors that *usually* are exhibited by successful entrepreneurs. Family development and educational incubation are also examined. Certain researchers have argued against educational development of entrepreneurs because they believe it inhibits the creative and challenging nature of entrepreneurship.[28] Other authors, however, contend that new programs and educational developments are on the increase because they have been found to aid in entrepreneurial development.[29] The family development idea focuses on the nurturing and support that exist within the home atmosphere of an entrepreneurial family. This reasoning promotes the belief that certain traits established and supported early in life will lead eventually to entrepreneurial success. (In Chapter 2, the concepts of entrepreneurial cognition and metacognition, which are beginning to take hold in the research on entrepreneurs, are discussed.)

The Venture Opportunity School of Thought The **venture opportunity school of thought** focuses on the opportunity aspect of venture development. The search for idea sources, the development of concepts, and the implementation of venture opportunities are the important interest areas for this school. Creativity and market awareness are viewed as essential. Additionally, according to this school of thought, developing the right idea at the right time for the right market niche is the key to entrepreneurial success.[30]

Another development from this school of thought is the previously described *corridor principle*: New pathways or opportunities will arise that lead entrepreneurs in different directions. The ability to recognize these opportunities when they arise and to implement the necessary steps for action are key factors. The maxim that preparation meeting opportunity equals "luck" underlies this corridor principle. Proponents of this school of thought believe that proper preparation in the interdisciplinary business segments will enhance an entrepreneur's ability to recognize venture opportunities.

The Strategic Formulation School of Thought George Steiner once stated that "strategic planning is inextricably interwoven into the entire fabric of management; it is not something separate and distinct from the process of management."[31] The **strategic formulation school of thought** approach to entrepreneurial theory emphasizes the planning process in successful venture development.[32]

One way to view strategic formulation is as a leveraging of unique elements.[33] Unique markets, unique people, unique products, or unique resources are identified, used, or constructed into effective venture formations. The interdisciplinary aspects of strategic adaptation are apparent in the following characteristic elements (and their corresponding strategies):

- ***Unique markets.*** Mountain versus **mountain gap strategies**, which refer to identifying major market segments as well as interstice (in-between) markets that arise from larger markets.
- ***Unique people.*** **Great chef strategies**, which refer to the skills or special talents of one or more individuals around whom the venture is built.
- ***Unique products.*** **Better widget strategies**, which refer to innovations that encompass new or existing markets.
- ***Unique resources.*** **Water well strategies**, which refer to the ability to gather or harness special resources (land, labor, capital, and raw materials) over the long term.

Without question, the strategic formulation school encompasses a breadth of managerial capability that requires an interdisciplinary approach.[34]

Schools of Entrepreneurial Thought: A Summary

Although the knowledge and research available in entrepreneurship are in an emerging stage, it is still possible to piece together and describe current schools of thought in the field. We can begin to develop an appreciation for the schools and view them as a foundation for entrepreneurial theory. However, just as the field of management has used a "jungle" of theories as a basis for understanding the field and its capabilities, so too must the field of entrepreneurship use a number of theories in its growth and development.

1-6b Process Approaches to Entrepreneurship

LO1.5 Explain the process and framework approaches to the study of entrepreneurship

Another way to examine the activities involved in entrepreneurship is through a *process approach*. Although numerous methods and models attempt to

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structure the entrepreneurial process and its various factors, we shall examine two of the more traditional process approaches here.[35]

First, we discuss the *integrative* approach, as described by Michael H. Morris, Pamela S. Lewis, and Donald L. Sexton.[36] Their model incorporates theoretical and practical concepts as they affect entrepreneurship activity. Then we explore the *dynamic states* approach based on a complex systems perspective developed by researchers Jonathan Levie and Benyamin B. Lichtenstein. Both of these methods attempt to describe the entrepreneurial process as a consolidation of diverse factors, which is the thrust of this book.

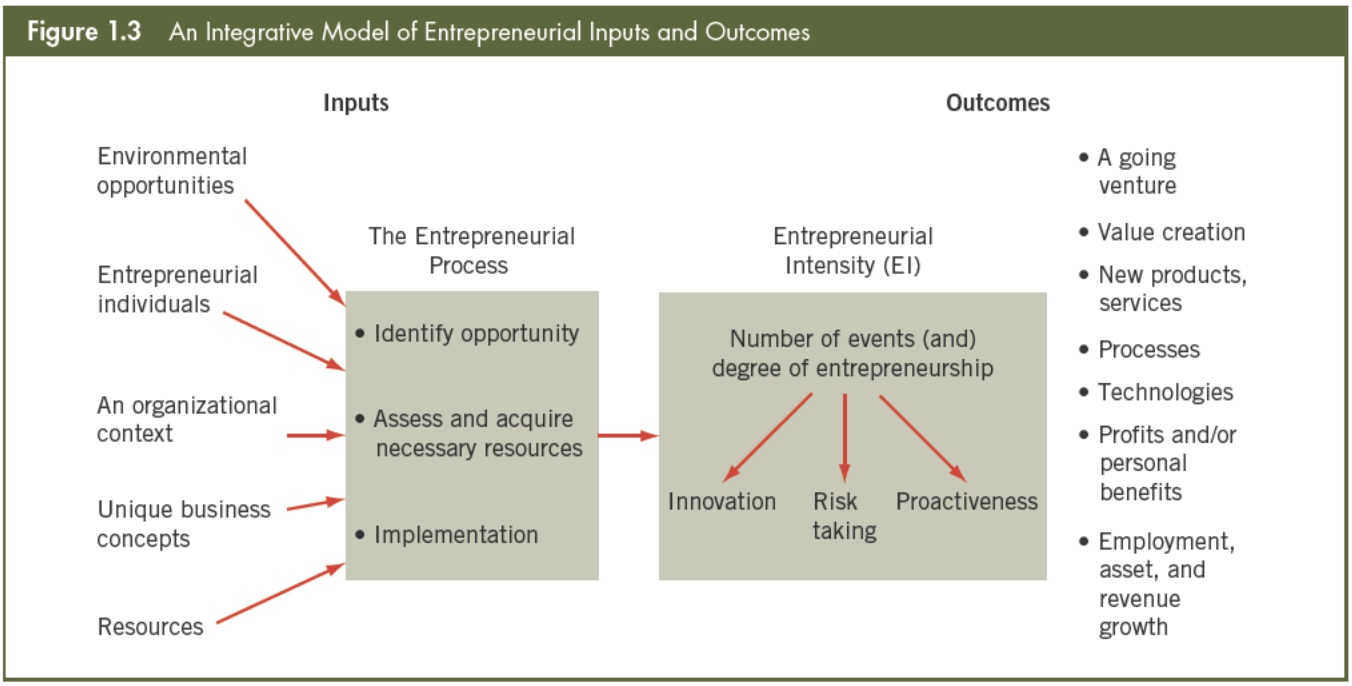
An Integrative Approach

A more integrative picture of the entrepreneurial process is provided by Morris, Lewis, and Sexton.[37] Presented in Figure 1.3, this model is built around the concepts of input to the entrepreneurial process and outcomes from the entrepreneurial process. The input component of Figure 1.3 focuses on the entrepreneurial process itself and identifies five key elements that contribute to the process. The first element is environmental opportunities, such as a demographic change, the development of a new technology, or a modification to current regulations. Next is the individual entrepreneur, the person who assumes personal responsibility for conceptualizing and implementing a new venture. The entrepreneur develops some type of business concept to capitalize on the opportunity (e.g., a creative approach to solving a particular customer need). Implementing this business concept typically requires some type of organizational context, which could range from a sole proprietorship run out of the entrepreneur's home or a franchise of some national chain to an autonomous business unit within a large corporation. Finally, a wide variety of financial and nonfinancial resources are required on an ongoing basis. These key elements then are combined throughout the stages of the entrepreneurial process. Stated differently, the process provides a logical framework for organizing entrepreneurial inputs.

The outcome component of Figure 1.3 first includes the level of entrepreneurship being achieved. As we shall discuss in more detail in the next chapter, entrepreneurship is a variable. Thus, the process can result in any number of entrepreneurial events and can produce events that vary considerably in terms of how entrepreneurial they are. Based on this level of "entrepreneurial intensity," final outcomes can include one or more going ventures, value creation, new products and processes, new technologies, profit, jobs, and economic growth. Moreover, the outcome can certainly be failure and thereby include the corresponding economic, psychic, and social costs.

This model not only provides a fairly comprehensive picture regarding the nature of entrepreneurship but also can be applied at different levels. For example, the model describes the phenomenon of entrepreneurship in both the independent start-up company and within a department, division, or strategic business unit of a large corporation.

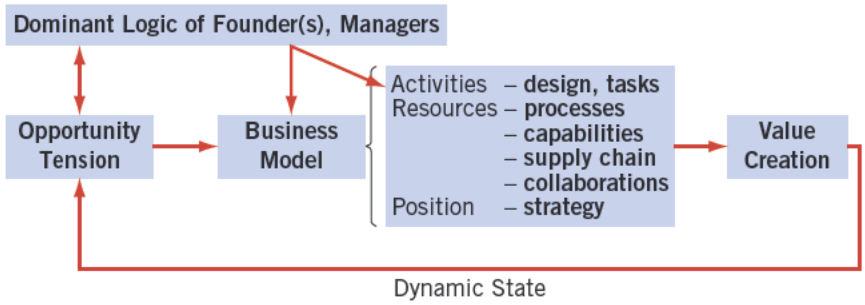
Figure 1.3 An Integrative Model of Entrepreneurial Inputs and Outcomes



Source: Michael H. Morris, Pamela S. Lewis, and Donald L. Sexton, "Reconceptualizing Entrepreneurship: An Input-Output Perspective," reprinted with permission from *SAM Advanced Management Journal* 59, no. 1 (Winter 1994): 21–31.

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Figure 1.4 Dynamic States Approach



Source: Jonathan Levie and Benjamin B. Lichtenstein, "A Terminal Assessment of Stages Theory: Introducing a Dynamic States Approach to Entrepreneurship," *Entrepreneurship Theory and Practice* 34, no. 2 (2010): 332. Reproduced with permission of John Wiley & Sons Ltd.

Dynamic States Approach

Researchers Jonathan Levie and Benyamin B. Lichtenstein developed a dynamic states model that depicts ventures being dependent on their environment for survival. A dynamic state is a network of relationships and systems that convert opportunity tension into value for a venture's customers, generating new resources that maintain the dynamic state. This model is a more process-oriented view that incorporates an array of individual, organizational, and environmental elements. The strategy for value creation chosen by the firm is enacted by its business model, which itself is derived from the emerging dominant logic of the firm. These elements of a dynamic states model are pictured in Figure 1.4. The dynamic states model is more optimistic for entrepreneurs, suggesting that smaller and newer firms have more flexibility in making ongoing changes. Thus, it may be easier for new ventures to create a high degree of interdependence between themselves and their environment, enabling entrepreneurs to organize for the current and anticipated demands of their market.[38]

A Framework-of-Frameworks Approach

Researchers Donald F. Kuratko, Michael H. Morris, and Minet Schindehutte contend that theories or frameworks based on combinations offer a more dynamic view of the phenomenon of entrepreneurship. Much like the "multiple lens" approach that characterizes general management, the theories based on combinations can delve into some of the particular aspects of entrepreneurship with greater granularity.[39] As one researcher noted in regard to entrepreneurial decision making, "There are numerous opportunities for multilevel research to make a substantial contribution to the field of entrepreneurship" (p. 419).[40]

The schools-of-thought and the process approaches that exist in the field of entrepreneurship are based on a phenomenon that incorporates many diverse and heterogeneous dimensions that only a comprehensive framework approach might afford researchers the capacity to explore and expand the knowledge base. A sizable body of research has developed that supports the individual frameworks through the schools-of-thought or through process models, but the integration of previously disparate aspects of entrepreneurship may be particularly valuable to advancing the field of entrepreneurship. As such, greater knowledge could be gained from the extrapolation of particular insights from each of the frameworks presented in this approach. Thus, a framework of frameworks that allows for the profession to move forward, identifying the static and dynamic elements of new theories, typologies, or frameworks, could be an important and distinguishing approach to grow the knowledge base of the field. Figure 1.5 depicts the framework-of-frameworks approach for entrepreneurship as the nexus of the major strands of entrepreneurship frameworks currently employed.

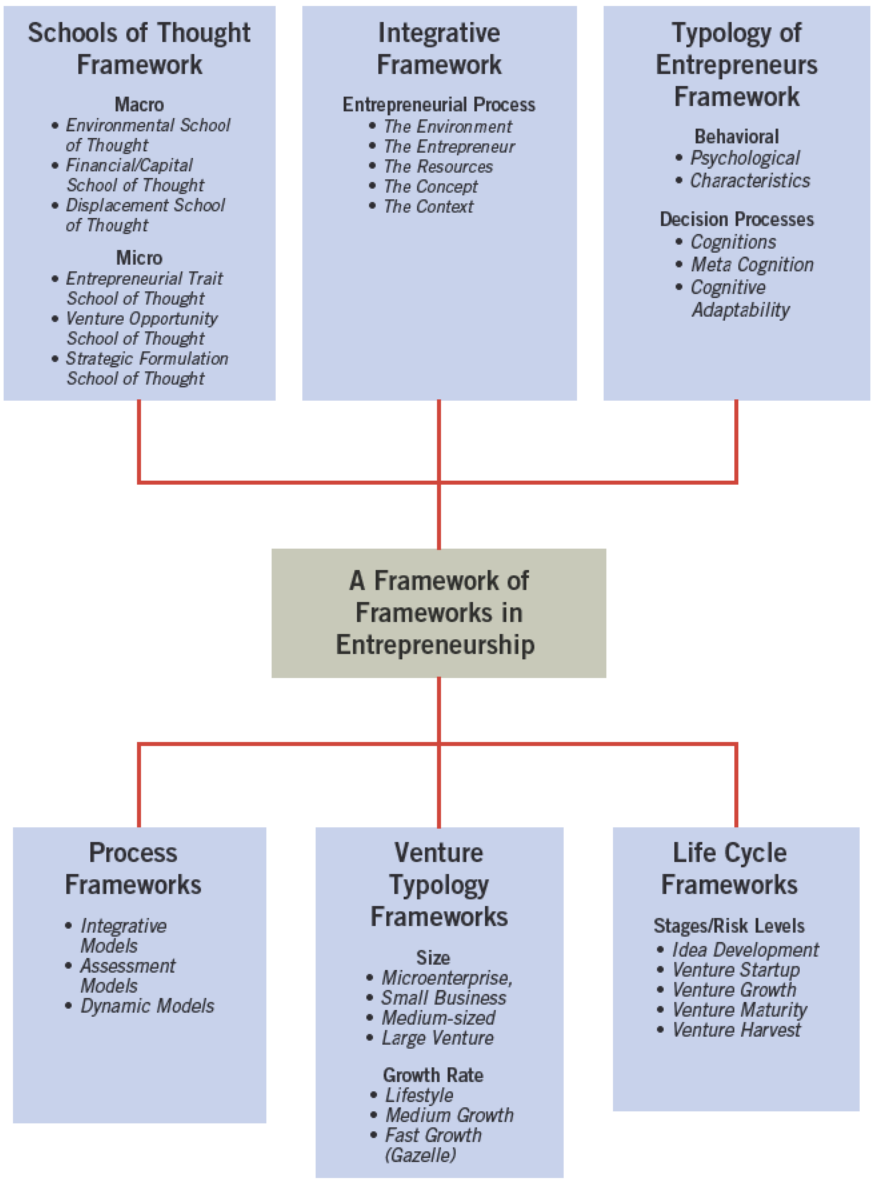
1-7 The Entrepreneurial Revolution: A Global Phenomenon

LO1.7 Examine the entrepreneurial revolution taking place today

Entrepreneurship is the symbol of business tenacity and achievement. Entrepreneurs were the pioneers of today's business successes. Their sense of opportunity, their drive to innovate, and their capacity for accomplishment have become the standard by which free enterprise is now measured. This standard has taken hold throughout the entire world.

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Figure 1.5 A Framework-of-Frameworks Approach



Source: Donald F. Kuratko, Michael H. Morris, and Minet Schindehutte, "Understanding the Dynamics of Entrepreneurship through Framework Approaches," *Small Business Economics* 45, no. 1 (2015): 9.

For example, starting with just 10 developed countries in 1999, the Global Entrepreneurship Monitor (GEM) has now grown to include over 120 economies representing 3.2 million adults. In 2021, 140,000 people were surveyed in 46 economies, which was the first careful assessment and measurement of the impact of the COVID-19 pandemic on levels of entrepreneurial activity, attitudes, and perceptions across the globe. The report reflected the very beginning of a long road of economic and entrepreneurial recovery.

The GEM data have shown that 582 million people were involved in early-stage entrepreneurial activity. Out of these individuals, an estimated 63 million people expected to hire at least five employees over the next five years, and 27 million of these individuals anticipated hiring 20 or more employees in five years. The latest GEM analyses show that growth expectations and aspirations of early-stage entrepreneurs represent a key dimension of potential entrepreneurial impact and may be linked directly to many first-priority policy objectives around

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the world: to create more jobs. All of this illustrates the contribution of entrepreneurship and the entrepreneurial mindset to job growth across the globe.[41]

Some of the latest global reports identify specific types of entrepreneurs across the world. The BNP Paribas Entrepreneur Report, conducted among 2,700 entrepreneurs based in 18 countries in Asia, Europe, and the United States, revealed the emergence of a new generation of entrepreneur types. The first are referred to as "millennipreneurs." They are under the age of 35 and define their professional success in terms of the positive social or environmental impact generated by their business. Other types include "ultrapreneurs," focusing on environmental and social concerns; "serialpreneurs," who have established four or more operating companies; and "boomerpreneurs," who are 55 years or older and even more convinced than younger generations that their business has generated a positive social impact since its inception.[42]

Whatever the category, it is clear that we have experienced an **Entrepreneurial Revolution** across the world. This revolution will continue to be as important (if not more!) to the twenty-first century as the Industrial Revolution was to the twentieth century.

In the post-pandemic world, entrepreneurs will continue to be critical contributors to economic growth through their leadership, management, innovation, research and development effectiveness, job creation, competitiveness, productivity, and formation of new industry.

To understand the nature of entrepreneurship, it is important to consider from two perspectives the environment in which entrepreneurial firms operate. The first perspective is statistical, providing actual aggregate numbers to emphasize the importance of small firms in the U.S. economy. The second perspective examines some of the trends in entrepreneurial research and education to reflect the emerging importance of entrepreneurship in academic developments.

1-7a The Impact of Entrepreneurial Ventures in the United States

The past 20 years have witnessed the powerful emergence of entrepreneurial activity in the United States. Many statistics illustrate this fact. For example, the U.S. Small Business Administration reported that, during the past 10 years, new business start-ups numbered over 600,000 *per year*. Although many of these incorporations may have previously been sole proprietorships or partnerships, the trend still demonstrates the popularity of venture activity, whether through start-ups, expansions, or development. More specifically, in the second decade of the new millennium, we have witnessed the number of businesses in the United States soar to more than 31 million, and that number is still growing at a rate of 2 percent annually. Let us examine some of the historical numbers supporting this phenomenon.

The United States consistently exhibits one of the highest entrepreneurship rates in the developed world. Entrepreneurship provides job options for those who see opportunities and those who need a *source* of income. They affect the U.S. economy as both current and future employers. Entrepreneurs additionally play key roles as suppliers, customers, and service providers for other businesses, creating value and employment beyond their specific organizations.

The COVID-19 pandemic hit smaller firms especially hard. The number of active business owners in the United States fell by 3.3 million—or 22 percent—from February to April 2020, the National Bureau of Economic Research reported. That was the largest decline on record, and it affected nearly all industries. Even though hundreds of thousands of businesses struggled amid the COVID-19 pandemic, many entrepreneurs persisted in record numbers. In 2021, entrepreneurs applying for new business applications was at the fastest rate since 2007, according to the U.S. Census Bureau. Additionally, according to a Gallup poll, Americans' confidence in small businesses has reached record highs, even exceeding confidence in the military, the medical system, public schools, the U.S. Supreme Court, and many other major American institutions. Some interesting statistics about U.S. entrepreneurial activity include the following:

- There are more than 31 million entrepreneurs.
- Fifty-five percent of adults have started at least one business in their lifetime.
- Twenty-six percent of adults have started two or more businesses in their lifetime.
- The average entrepreneur starts their business when they are 42, but that age varies by industry.
- Among high-performing start-ups (in the top 0.1 percent of growth in the first five years), the average entrepreneur starts their company when they are 45.
- There were nearly 13 million women-owned businesses in the as of 2021.
- There was a 21 percent increase in the number of women-owned businesses compared with a 9 percent increase in the number of all businesses.
- Thirty-five percent of Black business owners are women, compared with 27 percent for all business owners. Black women own 2.7 million businesses.
- Latina or Hispanic women own 2.3 million businesses.
- There are about 6.4 million businesses owned by women of color.
- Women of color run 50 percent of all women-owned businesses.

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- The number of Latino business owners grew 34 percent, outpacing the 1 percent growth among all business owners and the 6 percent decline among White business owners.
- Asian entrepreneurs run 10 percent of all businesses, and 92 percent of Asian entrepreneurs started new businesses out of opportunity rather than necessity in 2018.
- Eighty-six percent of White entrepreneurs started new businesses out of opportunity rather than necessity in 2018; 85 percent of Latino entrepreneurs started new businesses out of opportunity rather than necessity in 2018; and 81 percent of Black entrepreneurs started new businesses out of opportunity rather than necessity.[43]

The United States has the highest rate of entrepreneurship among 55- to 64-year-olds in the 25 developed economies studied, as they are more confident in their abilities to start businesses than those 18 to 44 years of age.[44] Compared to the older population in the United States, those in the younger age-groups are more likely to see opportunities, but they are less likely to believe that they have the needed capabilities for entrepreneurship, and their fear of failure is high. The older age-groups, in contrast, don't see as many opportunities, but they express more confidence in their capabilities and are less afraid of failing.[45]

According to the *Kauffman Index of Entrepreneurial Activity, 2021*,[46] a leading indicator of new business creation in the United States, 0.38 percent of American adults created a business in 2020, representing a slight decrease in the level of entrepreneurship over the past two decades due to the COVID-19 pandemic.

The U.S. Small Business Administration reports that smaller firms reached a record total of 31.7 million by 2021. Of these, approximately 6 million were employing firms, and they accounted for 48 percent of U.S. private-sector jobs. Small firms made up 99.9 percent of U.S. employing firms. Further, women- and minority-owned businesses increased. Minority-owned businesses numbered 5.8 million, a 45.6 percent increase over the past five years; women-owned businesses experienced a 20.1 percent increase over the five-year span.[47]

Entrepreneurs will continue to be the answer to any economic downturn, and they will continue to lead economic growth in several different ways. Entrepreneurs enter and expand existing markets, thereby increasing competition and economic efficiency. Entrepreneurs also create entirely new markets by offering innovative products. These new markets present profit opportunities to others, further spurring economic growth. Some of the reasons cited for the exceptional entrepreneurial activity in the United States include the following:

- The United States is a culture that supports risk-taking and risk-seeking opportunities.
- Americans are relatively alert to unexploited economic opportunity and have a relatively low fear of failure.
- The United States is a leader in entrepreneurship education at both undergraduate and graduate levels.
- The United States is home to a high percentage of individuals with professional, technological, or business degrees, a group that registers at the highest entrepreneurial activity rate.

Overall, every study continues to demonstrate that entrepreneurs' ability to expand existing markets and create new markets makes entrepreneurship important for individuals, firms, and entire nations.[48]

1-7b The Growth of Gazelles, Unicorns, and Decacorns

LO1.8 Illustrate today's entrepreneurial environment

New and smaller firms create the most jobs in the U.S. economy (and across the globe, for that matter). The facts speak for themselves: The vast majority of these job-creating companies are fast-growing businesses. David Birch of Cognetics, Inc., named these firms *gazelles*.[49] A **gazelle**, by Birch's definition, is a business establishment with at least 20 percent sales growth every year (for five years), starting with a base of at least $100,000.

The "gazelle factor" may be the most important finding in economic growth. Consider that despite the continual downsizing in major corporations over the past two decades, gazelles have produced millions of jobs and brought net employment growth to the economy. In some years, gazelles have generated practically as many jobs as the entire U.S. economy during that period.

Recent global studies are demonstrating consistent results about gazelles. The 2021 Deloitte *Tech Fast 500* rankings showed that the companies in the ranking achieved revenue growth ranging from 175 to 106,508 percent over the three-year time frame, with a median growth rate of 450 percent. In the Inc. 5000 sample of the fastest-growing U.S. companies, these firms accounted for $248 billion in revenue, produced 2,563,000 jobs, and demonstrated a median growth rate of 167 percent. The United Kingdom sample in *Fast Track 100* was similar, with the top 1 percent responsible for 20.8 percent and the top 10 percent accounting for 55.2 percent.[50]

In another study focused on the United States, titled *High-Growth Firms and the Future of the American Economy*, it was found that in any given year, the top-performing 1 percent of companies account for some 40 percent of jobs. Within that category, fast-growing gazelle companies (three to five years old) make up less

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than 1 percent of all businesses yet account for approximately 10 percent of net new jobs in any given year. The "average" company in the top 1 percent generates an astounding 88 net new jobs annually compared to the two to three net new jobs generated by the average firm in the economy as a whole.[51] Overall, the extraordinary performance and contribution of these gazelles warrants further recognition as a powerful factor in the economy.[52] (See Table 1.2 for myths associated with gazelles.)

Unicorns and Decacorns

In the early 2000s, the idea of a pre–initial public offering tech start-up with a $1 billion market value was a fantasy. For example, Google and Amazon (or any other original dot-com venture) were never worth $1 billion as private companies. However, today, disruptive technologies are driving the creation of numerous billion-dollar start-ups. The term *unicorn* was introduced as a label for such corporate ventures. Smartphones, inexpensive sensors, and cloud computing are examples of new technologies that have enabled new Internet-connected services to be introduced into traditionally non-tech industries. For example, Uber has disrupted the taxi industry, while Airbnb is busy disrupting the hotel industry.

As of 2023, there were more than 1,191 start-ups worldwide that have been valued at $1 billion or more by venture capitalists, and there seems to be a continued trend in more arising. Just a decade ago, the term *unicorn* represented mythical creatures, but today there appears to be groups of unicorns (sometimes referred to as a "blessing"). As they continue to grow, many start-ups are surpassing the $1 billion level and achieving the $10 billion level. These firms, such as Facebook, Uber, and Airbnb, are now referred to as decacorns. If they achieve a valuation of more than $100 billion they are then referred to as hectacorns.

Why the sudden increase in valuations of these ventures? The answer may be the acquisition of many new ventures by established corporations. Facebook paid $19 billion for instant-messaging start-up WhatsApp and then purchased Oculus VR (virtual headset reality company) for $2 billion. Other examples include Google paying $3.2 billion for smart thermostat maker Nest, Apple acquiring headphone maker Beats for $3 billion, Microsoft spending $2.5 billion for the Swedish gaming start-up responsible for *Minecraft*, and Genentech acquiring Seragon Pharmaceuticals for $1.7 billion. The acquisition trend appears to be continuing as a viable strategy for larger firms to gain access to new innovations and for new innovative start-ups to find a valuable exit strategy (more on exit strategies in Chapter 15).

Thus, the terms *unicorn*, *decacorn,* and *hectacorn* have now become part of the innovation lexicon for the 2020s and beyond. Start-up entrepreneurs creating disruptive innovations in any industry will find a viable market of potential soaring market valuations that will enhance their standing for their future opportunities.[53]

Table 1.2 Mythology Associated with Gazelles

Gazelles are the goal of all entrepreneurs. Creating a gazelle can be rewarding not only financially but also professionally; however, not all entrepreneurs are suited to the high-stress environment that running a gazelle induces. The more successful a firm becomes, the more society scrutinizes the actions of the management. Once the world is watching, keeping a gazelle growing takes not only tenacity but also composure under extreme pressure.
Gazelles receive venture capital. Although venture capital (VC) firms prefer to invest in gazelles, many gazelles have never received VC funding. With gazelles numbering close to 400,000, less than 2 percent of these companies have received funding, even in boom times.
Gazelles were never mice. By definition, gazelles are companies created with the intent of high growth and wealth creation, whereas *mice* are companies created with the goal of merely generating income and no intention of growth. Companies can be gazelles at birth; however, many businesses become gazelles later in life. As many as 20 percent of gazelles have been in operation for more than 30 years.
Gazelles are high tech. To be classified as a gazelle, a company must have grown sales by 20 percent for at least a five-year period, starting with a base of at least $100,000—which can include firms in any industry. This myth most likely stems from the high margins enjoyed by most technology-based companies; however, gazelles are commonly found in low-tech sectors. Two prevalent examples are Best Buy and Starbucks.
Gazelles are global. The scope of a business has no role in its distinction as a gazelle, so even though some gazelles are operating on a global scale, it is not a necessary characteristic. Making the decision to expand overseas prematurely can just as quickly lead to the death of a business as it can lead to its success. Beyond the risks, international trade accounts for more than $800 billion annually in economic activity—but without careful planning, going global could lead to going out of business.

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1-7c Legacy of Entrepreneurial Firms

Fostering and promoting entrepreneurial activity has been and will continue to be an economic solution for recessions, downturns, and challenges. It is the most powerful economic force ever discovered on our planet, and its success has at least three entrepreneurial components.

First, large existing firms in mature industries that adapted, downsized, restructured, and reinvented themselves in the first two decades of the twenty-first century are now thriving, having learned to become more entrepreneurial. As large firms have become leaner, their sales and profits have increased sharply. For example, in many cases, by returning to the firm's "core competencies," developing innovations inside the organization, and by contracting out certain functions formerly done in-house to small firms, firms are becoming more agile.

Second, while large existing companies have been transforming themselves, new entrepreneurial companies have been blossoming. Newer entrepreneurial companies—some of which did not exist 25 years ago—have collectively created millions of new jobs during the past decade. Among many notable examples, consider Facebook, Twitter, Google, LinkedIn, and YouTube.

Third, thousands of entrepreneurial firms have been founded, including many established by women, members of myriad racial and ethnic underrepresented groups, and immigrants. These new companies have footholds in every sector of the economy and can be found in every part of the country. Together they make a formidable contribution to the economy, as many, by hiring on one or two employees, have created most of the net new jobs in the past few years.

In summary, entrepreneurial firms make two indispensable contributions to the U.S. economy. First, they are an integral part of the renewal process that pervades and defines market economies. They also play a crucial role in championing innovations that lead to technological change and productivity growth. In short, they are about change and competition because they change market structure. The U.S. economy is a dynamic, organic entity, always in the process of "becoming" rather than having already arrived. It is about prospects for the future, not the inheritance of the past.

Second, entrepreneurial firms are the essential mechanism by which millions enter the economic and social mainstream of American society. Small businesses enable millions of people—including immigrants and people of varying racial, ethnic, and gender backgrounds—to access the American dream. The greatest source of U.S. strength has always been the dream of economic growth, equal opportunity, and upward mobility. In this evolutionary process, entrepreneurship plays the crucial and indispensable role of providing the "social glue" that binds together both high-tech and "Main Street" activities. As researchers Donald F. Kuratko and David B. Audretsch explain, the future of entrepreneurship belongs to the many, not just the few.[54]

New-business formation is the critical foundation for any net increase in global employment. All of our detailed information provides insight into why the global economic future may well lie in the development of our entrepreneurial abilities.

1-8 Twenty-First-Century Trends in Entrepreneurship Research

LO1.9 Outline the trends in entrepreneurship research

As we continue our study of entrepreneurship, it is important to note the research and educational developments that have occurred in this century. The major themes that characterize recent research about entrepreneurs and new-venture creation can be summarized as follows:

1. *Venture financing*, including venture capital, angel capital, and crowdfunding financing as well as other innovative financing techniques, emerged in the twenty-first century with unprecedented strength, fueling entrepreneurship throughout the world.[55]
2. *Corporate entrepreneurship* (corporate innovation within large organizations) and the need for the entrepreneurial mindset among employees have gained greater acceptance during the past few decades.[56]
3. *Social entrepreneurship* has emerged with unprecedented popularity among the new generation of entrepreneurs seeking innovative solutions to world problems.[57]
4. *Entrepreneurial cognition* (examining the ways that entrepreneurs think and act) is a wave of research on the psychological aspects of the entrepreneurial process.[58]
5. *Women and minority entrepreneurs* have emerged in greater numbers over the past two decades. They appear to face obstacles and difficulties different from those that other entrepreneurs face.[59]
6. The *global entrepreneurial movement* is increasing, judging by the enormous growth of interest in entrepreneurship around the world in the past few years.[60]
7. *Family businesses* have become a stronger focus of research. The economic and social contributions of entrepreneurs with family businesses have been shown to make immensely disproportionate contributions to job creation, innovation, and economic renewal.[61]
8. *Entrepreneurial education* has become one of the hottest topics in business and engineering schools

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The Entrepreneurial Process

The Best Business Schools for Entrepreneurship

In examining the various rankings of entrepreneurship programs over the past five years, the following universities have consistently been noted as among the very best in the world.

The Best Graduate Programs in Entrepreneurship

Indiana University, Bloomington**
Stanford University
Harvard University
Massachusetts Institute of Technology
University of California, Berkeley**
Babson College

The Best Undergraduate Programs in Entrepreneurship

Indiana University, Bloomington**
University of Pennsylvania
University of Southern California
University of California, Berkeley**
Babson College

**denotes public university

Source: Adapted from "Best Colleges for Aspiring Entrepreneurs," *Fortune Small Business* (2007); "Venture Education," *Fortune Magazine* (2010); and "Best Business School Rankings" *U.S. News & World Report* (2007 through 2023).

throughout the world. It has even expanded across campuses to include almost every major discipline. The number of schools teaching entrepreneurship courses has grown from as few as a dozen 40 years ago to more than 4,000 schools offering majors or minors in entrepreneurship at this time.[62]

1-9 The Future Trajectory of Entrepreneurship: The Entrepreneurial Mindset

LO1.10 Examine the future trajectory of entrepreneurship

As mentioned in the beginning of this chapter, the entrepreneurial imperative involves encouraging a mindset that centers on seeking opportunities, taking risks beyond security, tolerating failure, bootstrapping, creatively leveraging resources, and having the tenacity to overcome obstacles and push an idea to implementation. It is about creating new opportunities and executing new concepts in uncertain and unknowable environments. This mindset includes a behavioral aspect, an emotional aspect, and a cognitive aspect. As a mindset, entrepreneurship has assumed a unique position globally because of its empowering and transformational potential. Thus, it is permeating a wide range of demographic, ethnic, organizational, institutional, socioeconomic, geographic, cultural, and political boundaries.

So what will be the future progress of entrepreneurship? As researchers Donald F. Kuratko and Michael H. Morris[63] explain, there must be a continuation of a unique identity for the field of entrepreneurship such that it is not simply subsumed by other disciplines. At the same time, there must be an avoidance of the tendencies to apply entrepreneurship in virtually any context no matter how far removed it is from the act of recognizing and capitalizing on opportunity for the purposes of economic or social gain or to label literally any phenomenon as being "entrepreneurial" simply because it is different from the status quo. The way forward requires a reassessment of some of the most basic issues surrounding, perhaps being the very essence of, entrepreneurship education. Toward this end, the authors presented six trajectories:

Trajectory 1: Why Teach Entrepreneurship: A Clear Purpose

Building on a shared conceptualization can establish a clear purpose for the effort, enhance communication and collaboration across disciplines, and reduce any confusion experienced by different stakeholders.

Trajectory 2: What Is Taught in Entrepreneurship: The Content

In the content of modern entrepreneurship program, it would seem the emphasis might take three forms (or some combination of these forms): (1) business basics in a new venture management context, (2) core entrepreneurial content, and (3) the entrepreneurial mindset.

Trajectory 3: How Entrepreneurship Is Taught: The Delivery Mechanism

For their part, students will increasingly be expected to build experience portfolios as they progress through

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their studies in entrepreneurship. Hence, on completion of a minor, major, certificate, or other program in entrepreneurship, the student might submit a portfolio summary that includes their work on idea diaries, elevator pitches, business models, small-business consulting reports, interviews with entrepreneurs, entrepreneurial audits, study abroad experiences, and so on.

Trajectory 4: Organizing Entrepreneurship: The Structure

As researchers Michael H. Morris, Donald F. Kuratko, and Jeffrey Cornwall explain, "While structure covers a wide range of organizational issues, the most fundamental include determining where the entrepreneurship program should be housed, how it will be led, to whom it will report, how it is staffed, and how it operates from a budgetary standpoint."[64] So, whether more centralized or decentralized and whether based in the business school or elsewhere, the program needs a structural base with consistent leadership and authority.

Trajectory 5: Outcomes of Teaching Entrepreneurship: The Metrics

If programs are attempting to prepare students for a life of entrepreneurship and seeking to instill an entrepreneurial mindset, the future will find more emphasis on competency mastery. As more priority is placed on cross-campus entrepreneurship, basic metrics might be extended to include numbers of students involved with elements of the university-wide effort within each college or discipline, interdisciplinary collaborations that result in publications, new courses and course modules being developed, and measures of student and faculty innovations that are traceable to involvement in the program.

Trajectory 6: Leadership of Entrepreneurship Programs: Academic Entrepreneurs

How educators view themselves may be critical to the development of a champion. For entrepreneurship programs to realize their full potential, those who lead them must define themselves as *academic entrepreneurs* so that the entrepreneurial mindset that one is trying to convey to students becomes ingrained in how faculty and staff approach the academic environment. As an academic entrepreneur, the faculty member becomes an agent of social and economic change, leveraging the university context to empower students and facilitate disruptive approaches to problem solving.[65]

Effective entrepreneurship programs of the future will empower students to create their own jobs, create their own futures, create their own wealth, create their own sense of pride and self-worth, create their own identity, create their own facilities and operations, create jobs for others, create their own contribution to the world, and create their own ability to give back. They will also empower students to transform markets, business practices, industries, individuals, families, communities, and economies. In whatever manner the transformations occur, entrepreneurship represents the potential for individuals to change the world. This reveals the intense power of the entrepreneurial mindset that university education can foster in tomorrow's younger generation.

1-10 Key Entrepreneurship Concepts

LO1.11 Define the key concepts in entrepreneurship

Before concluding our discussion of the nature of entrepreneurship, we need to put into perspective three key concepts: entrepreneurship, entrepreneur, and entrepreneurial management.

1-10a Entrepreneurship

Entrepreneurship is a dynamic process of vision, change, and creation that requires an application of energy and passion toward the creation and implementation of new ideas and creative solutions. This process of innovation and new-venture creation is accomplished through four major dimensions—individual, organizational, environmental, and process—and is aided by collaborative networks in government, education, and institutions. All of the macro and micro positions of entrepreneurial thought must be considered while recognizing and seizing opportunities that can be converted into marketable ideas capable of competing for implementation in today's economy.

1-10b Entrepreneur

As we demonstrated earlier in the chapter, the *entrepreneur* is an innovator or developer who recognizes and seizes opportunities; converts those opportunities into workable/marketable ideas; adds value through time, effort, money, or skills; and assumes the risks of the competitive marketplace to implement these ideas. The entrepreneur is a catalyst for economic change who uses purposeful searching, careful planning, and sound judgment when carrying out the entrepreneurial process. The entrepreneur—uniquely optimistic and committed—works creatively to establish new resources or endow old ones with a new capacity, all for the purpose of creating wealth.

1-10c Entrepreneurial Discipline

The underlying theme of this book is the **entrepreneurial discipline**, a concept that has been delineated as follows:

Entrepreneurship is based upon the same principles, whether the entrepreneur is at an existing large institution or an individual starting his or her new

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venture singlehanded. It makes little or no difference whether the entrepreneur is a business or a nonbusiness public-service organization, nor even whether the entrepreneur is a governmental or nongovernmental institution. The rules are pretty much the same, the things that work and those that don't are pretty much the same, and so are the kinds of innovation and where to look for them. In every case, there is a discipline *and* the techniques and principles of this emerging discipline will continue to drive the entrepreneurial economy in the twenty-first century.[66]

1-10d Entrepreneurial Leadership

Entrepreneurship represents the ultimate source of economic dynamism and empowerment and is transformative at the societal, organizational, and individual levels. Researchers Donald F. Kuratko and Michael H. Morris use the metaphor of "fire in a bottle." From a leadership perspective, entrepreneurship has become the symbol of business tenacity and achievement. Entrepreneurs' sense of opportunity, their drive to innovate, and their capacity for accomplishment have become the standard by which true leadership is now measured.

Diversity in Entrepreneurship

Entrepreneurship as a Vehicle for Diversity

Entrepreneurship has long been attracting individuals with a desire to be their own boss and work in their own time. Even before the pandemic, entrepreneurship started to gain momentum as a way to work anywhere around the globe with a laptop and an Internet connection. The pandemic accelerated the idea of remote work and rapidly increased the degree of connectedness between different businesses and locations. While the reality may be far from the idealistic image of a person working on a beach while sipping a martini, there is another key reason as to why some individuals in particular are deciding to take their chances with the entrepreneurial path. As U.S. businesses fail to make a visible progress with their diversity, equity, and inclusion (DEI) initiatives, some individuals have decided to take the matter into their own hands by starting their own ventures.

One such group are Black entrepreneurs, who are choosing to live, work, and build their businesses in locations where they feel welcomed. They are taking advantage of the globally connected world by creating online-only business with third-party fulfillment services. One such entrepreneur, Hervé Da Costa, was born in France but went to college in the United States. He has an impressive résumé: he obtained a master's degree from the University of California, Berkeley; worked for major corporations in Silicon Valley; helped to launch two start-ups (one successfully sold and the other listed on NASDAQ); and participated in the creation of the Internet at the prestigious organizations, including HP Labs and the Xerox Palo Alto Research Center. Even with his outstanding experience, Da Costa eventually decided to move back to France, tired of the challenges he faced on a daily basis because of his skin color. "It felt like my skin color was seen before I was given an opportunity to show what I had to offer," he said. For him and many other Black entrepreneurs, location independence means taking away a few of those challenges.

The United States has long been battling with racism, creating generational roadblocks. Black entrepreneurs often limit their opportunities to the ones given to their parents and grandparents. But there is an increasing desire to break this cycle of generational trauma. Entrepreneurship provides Black entrepreneurs with location independence, enabling them to experience the world outside the one lived by previous generations. Embracing remote entrepreneurship for them means choosing to build a new life in locations that make them feel welcomed and setting an example for future generations to come.

Another group that has been largely disappointed with the support and treatment from the broader economy are working mothers. To them, entrepreneurship means the necessary flexibility and autonomy that they need to combine a career path with their family responsibilities. The pandemic exposed the incredible lack of support for working women, as many were forced to sacrifice their careers to take on child care and household responsibilities. As people became unemployed due to the pandemic, women aged 25 to 44 were almost three times as likely as men to leave a job due to child care demands. Since the broader economy has been unable to support working mothers, they have turned to entrepreneurship as a way to regain control over their personal and financial future.

While entrepreneurship is a compelling path for many, it can also be a challenging and daunting path and one that not everyone wants to take. For many, going down this path is an exciting choice, but for some, entrepreneurship might be the only way to escape prejudice, stereotypes, discrimination, or other types of inequity in the economy. Businesses need to do more to improve their DEI initiatives: to give minorities a choice rather than force them to go down an entrepreneurial path out of a desire to find an environment where their needs can be met and where they can feel accepted.

Source: Adapted from Kimanzi Konstable, "Remote Work Is Helping Black Entrepreneurs Break with Generational Trauma," *Fortune*, April 2022, and Deborah Sweeney, "Why Working Moms Make Great Entrepreneurs," *Forbes*, May 2021.

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If leadership is the capacity to lead and entrepreneurial relates to the pursuit of innovation, then combining the two capacities—the capacity to lead and the capacity to risk pursuing innovative opportunities—results in entrepreneurial leadership. It is leadership in discovering new possibilities, opening up new horizons, promulgating a new vision, combining resources in new ways, and inspiring others while implementing new-venture concepts. And it is leadership in dealing with the externalities and ethical dilemmas that surround entrepreneurial action. *Entrepreneurial leadership* may be one of the most significant phrases in the twenty-first century, and it serves as the ultimate vision for this book.[67]

Summary

This chapter examined the evolution of entrepreneurship, providing a foundation for further study of this dynamic and developing discipline. By exploring the early economic definitions as well as select contemporary ones, the chapter presented a historical picture of how entrepreneurship has been viewed. In this chapter, a typology of four specific venture types is presented: survival, lifestyle, managed growth, and aggressive growth (gazelles, unicorns, and hectacorns). The chapter then discusses the elements of an entrepreneurial mindset. In addition, the 12 major myths of entrepreneurship were discussed to permit a better understanding of the folklore that surrounds this newly developing field of study. Contemporary research is broadening the horizon for studying entrepreneurship and is providing a better focus on the what, how, and why behind this discipline.

The approaches to entrepreneurship were examined from three different perspectives: schools of thought, process, and frameworks. Six selected schools of thought were presented, two approaches for understanding contemporary entrepreneurship as a process were discussed, and a framework of frameworks was proposed for future development of the field.

This chapter then attempted to provide a broad perspective on the Entrepreneurial Revolution that is occurring throughout the United States and the world. The chapter discussed important statistics that support our entrepreneurial economy. A description of gazelles, unicorns, decacorns, and hectacorns and their impact on the economy was presented: Gazelles are business establishments with at least 20 percent sales growth every year for at least five years, starting from a base of $100,000. A unicorn is a firm that achieves a valuation of over $1 billion. If it grows the valuation to over $10 billion it is referred to as a decacorn. A firm achieving a valuation of over $100 billion is then referred to as a hectacorn.

The chapter concluded with definitions of three key concepts: entrepreneurship, entrepreneur, and entrepreneurial leadership.

Key Terms

better widget strategies
corridor principle
decacorn
displacement school of thought
dynamic states model
entrepreneur
entrepreneurial discipline
entrepreneurial leadership
entrepreneurial mindset
Entrepreneurial Revolution
entrepreneurial trait school of thought
entrepreneurship
environmental school of thought
external locus of control
financial/capital school of thought
framework of frameworks
gazelle
great chef strategies
hectacorn
internal locus of control
macro view of entrepreneurship
managed growth ventures
micro view of entrepreneurship
mountain gap strategies
strategic formulation school of thought
unicorn
venture opportunity school of thought
water well strategies
survival ventures

Review and Discussion Questions

1. Briefly describe the evolution of the term *entrepreneurship*.
2. Explain the typology of entrepreneurs distinctive journeys.
3. What are the elements of the *entrepreneurial mindset*?
4. What are the 12 myths associated with entrepreneurship? Debunk each.
5. What is the macro view of entrepreneurship?
6. What are the schools of thought that use the macro view of entrepreneurship?
7. What is the micro view of entrepreneurship?
8. What are the schools of thought that use the micro view of entrepreneurship?
9. What are the three specific types of displacement?

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10. In the strategic formulation school of thought, what are the four types of strategies involved with unique elements? Give an illustration of each.
11. What is the process approach to entrepreneurship? In your answer, describe the dynamic states approach.
12. Describe the framework-of-frameworks approach to entrepreneurship.
13. Explain the predominance of new ventures in the economy.
14. Define the terms *gazelle, unicorn, decacorn, and hectacorn* and discuss their importance.
15. Identify three of the future trajectories of the entrepreneurial mindset and discuss their implications.

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Chapter 2

The Entrepreneurial Mindset in Individuals: Cognition, the Dark Side, and Ethics

Learning Objectives

2.1. Describe the entrepreneurial mindset and entrepreneurial cognition
2.2. Identify and discuss the most commonly cited characteristics found in successful entrepreneurs
2.3. Describe the skills of entrepreneurial hustle and coachability
2.4. Identify how entrepreneurs deal with failure
2.5. Describe the entrepreneurial experience
2.6. Discuss the "dark side" of entrepreneurship
2.7. Identify and describe the different types of risk entrepreneurs face
2.8. Describe the major causes of stress for these individuals and the ways they can handle stress
2.9. Discuss the ethical dilemmas confronting entrepreneurs within a dynamic environment
2.10. Present strategies for establishing ethical responsibility and leadership
2.11. Examine entrepreneurial motivation

Entrepreneurial Thought

For all we know about balance sheets, income statements, and cash flow accounting; for all of our understanding about marketing strategies, tactics, and techniques; and for everything we have learned about management principles and practices, there remains something essential, yet mysterious, at the core of entrepreneurship. It is so mysterious that we cannot see it or touch it; yet we feel it and know it exists. It cannot be mined, manufactured, or bought; yet it can be discovered. Its source is invisible; yet its results are tangible and measurable. This mysterious core is so powerful that it can make the remarkable appear ordinary, so contagious that it can spread like wildfire from one to another and so persuasive that it can transform doubt and uncertainty into conviction. This mysterious core is PASSION!

—Ray Smilor, PhD, *Daring Visionaries*

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2-1 The Entrepreneurial Mindset

LO2.1 Describe the entrepreneurial mindset and entrepreneurial cognition

If past generations dreamed of the prestige and perks that come with the executive suite of a major corporation, the dreams of the millennial generation (Generation Y) and postmillennial generation (Generation Z) appear quite different. They believe that career success will require them to be more nimble, independent, and entrepreneurial than past generations. In one study only 13 percent of millennials said their career goal involves climbing the corporate ladder to become a CEO or president. By contrast, almost two-thirds (67 percent) said their goal involves starting their own business. In another recent survey of Generation Z members, 53 percent hope to run their own business within the next 10 years. That proportion increases to 65 percent for those who have already entered the workforce. This generation yearns for careers that enable original thought and ideas, and entrepreneurship delivers on this promise of creative control. Millions of individuals younger than age 35 are actively trying to start businesses, one-third of new entrepreneurs are younger than 30, and large numbers of 18- to 30-year-olds study entrepreneurship in business schools. Major universities are devoting more resources to entrepreneurship, and the success stories of young entrepreneurs are increasing.[1]

Every person has the potential and free choice to pursue a career as an entrepreneur, but exactly what motivates people to make this choice is not fully understood. As we demonstrated in Chapter 1, researchers are attempting better to understand the driving forces within entrepreneurs but have not yet identified one single event, characteristic, or trait that pushes an individual into the domain.[2]

The chapters in this book focus on learning the discipline of entrepreneurship. This chapter, however, is devoted to a more psychological look at entrepreneurs: It describes entrepreneurial cognition, the most common characteristics associated with successful entrepreneurs, the elements associated with the "dark side" of entrepreneurship, as well as the ethical challenges that entrepreneurs confront. In this manner, we can gain a more complete perspective on the **entrepreneurial behavior** that a person with an **entrepreneurial mindset** exhibits. Although it certainly is not an exact science, examining this mindset provides interesting insights into the entrepreneurial potential within every individual.[3] Let's examine the cognition of entrepreneurs as a doorway to understanding the entrepreneurial mindset.

2-1a Entrepreneurial Cognition

In science, **cognition** refers to mental processes. These processes include attention, remembering, producing and understanding language, solving problems, and making decisions. The term comes from the Latin *cognoscere*, which means "to know," "to conceptualize," or "to recognize," and refers to a faculty for the processing of information, applying knowledge, and changing preferences. Cognition is used to refer to the mental functions, mental processes (thoughts), and mental states of intelligent humans. **Social cognition theory** introduces the idea of knowledge structures—mental models (cognitions) that are ordered in such a way as to optimize personal effectiveness within given situations—to the study of entrepreneurship. Concepts from cognitive psychology are increasingly being found to be useful tools to help probe entrepreneurial-related phenomena, and, increasingly, the applicability of the cognitive sciences to the **entrepreneurial experience** is cited in the research literature.

Researchers Ronald K. Mitchell, Lowell Busenitz, Theresa Lant, Patricia P. McDougall, Eric A. Morse, and J. Brock Smith define **entrepreneurial cognition** as *the knowledge structures that people use to make assessments, judgments, or decisions involving opportunity evaluation, venture creation, and growth*.[4] In other words, entrepreneurial cognition is about understanding how entrepreneurs use simplifying mental models to piece together previously unconnected information that helps them to identify and invent new products or services and to assemble the necessary resources to start and grow businesses. Specifically, then, the entrepreneurial cognitions view offers an understanding as to how entrepreneurs think and "why" they do some of the things they do.

2-1b Metacognitive Perspective

While the research has focused on entrepreneurial cognitions, a new stream of thinking links the foundation of the entrepreneurial mindset to **cognitive adaptability**, which can be defined as the ability to be dynamic, flexible, and self-regulating in one's cognitions given dynamic and uncertain task environments. Adaptable cognitions are important in achieving desirable outcomes from entrepreneurial actions.

In this light, a team of researchers developed a situated, **metacognitive model** of the entrepreneurial mindset that integrates the combined effects of **entrepreneurial motivation** and context toward the development of metacognitive strategies applied to information processing within an entrepreneurial environment.[5]

Consider an entrepreneur faced with the entrepreneurial task of developing a sound explanation for a new venture in preparation for an important meeting with a venture capitalist. Before the entrepreneur is prepared

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to evaluate alternative strategies, the entrepreneur must first formulate a strategy to frame how they will "think" about this task. This process is metacognitive. The process responsible for ultimately selecting a response (i.e., a particular venture strategy) is cognitive—the process responsible for ultimately selecting how the entrepreneur will frame the entrepreneurial task is metacognitive. Thus, metacognition is not to study why the entrepreneur selected a particular strategy for a set of alternative strategies (cognition) but instead to study the higher-order cognitive process that resulted in the entrepreneur framing the task effectually and thus why and how the particular strategy was included in a set of alternative responses to the decision task (metacognition).

Although it has become a significant area of study, entrepreneurial cognitive research presents future conceptual challenges that will have to be examined in order to be an effective contribution to the entrepreneurial world. For example, many works are built on the premise that founders and entrepreneurs "think" differently than other individuals or business executives. But it is far less clear whether this "cognitive difference" originates from idiosyncratic factors and events that *predate* entrepreneurs' efforts and actions or from the very experience of entrepreneurship by these individuals. Similarly, it is not clear whether the "cognitive difference" of entrepreneurs results from tasks and environmental conditions that "reward" individuals with particular "thinking" or from conditions that encourage the expression and/or development of such thinking. Those questions introduce the notion of the entrepreneurial experience, which we examine next.[6]

2-2 Who Are Entrepreneurs?

Frank Carney, one of the founders of Pizza Hut, Inc., once described entrepreneurs as the cornerstone of the American enterprise system and the self-renewing agents for our economic environment. Entrepreneurs—normally defined as "risk takers" in new-venture creations—are uniquely optimistic, hard-driving, committed individuals who derive great satisfaction from being independent. Starting a new business requires more than just an idea; it requires a special person, an entrepreneur, who combines sound judgment and planning with risk taking to ensure the success of their own business.

Entrepreneurs, driven by an intense commitment and determined perseverance, work very hard. They are optimists who see the cup as half full rather than half empty. They strive for integrity. They burn with the competitive desire to excel. They use **failure** as a tool for learning. They have enough confidence in themselves to believe that they personally can make a major difference in the final outcome of their ventures.

The substantial failure rate of new ventures attests to the difficulty of entrepreneurship. Inexperience and incompetent management are the main reasons for failure. But what are the factors for success? Do they apply to all components of entrepreneurship? These are some of the issues we shall explore in this chapter.

2-2a Characteristics and Skills Associated with the Entrepreneurial Mindset

LO2.2 Identify and discuss the most commonly cited characteristics found in successful entrepreneurs

A review of the literature related to entrepreneurial characteristics reveals the existence of a large number of factors that can be consolidated into a much smaller set of profile dimensions.

Howard H. Stevenson and David E. Gumpert have presented an outline of the entrepreneurial organization that reveals such characteristics as imagination, flexibility, and willingness to accept risks.[7] William B. Gartner examined the literature and found a diversity of reported characteristics.[8] John Hornaday examined various research sources and formulated a list of 42 characteristics often attributed to entrepreneurs (see Table 2.1).

In the simplest of theoretical forms for studying entrepreneurship, entrepreneurs cause entrepreneurship. $E = f(e)$; that is, entrepreneurship is a function of the entrepreneur. Thus, the continuous examination of entrepreneurial characteristics aids the evolving understanding of the entrepreneurial mindset. One author provides the following description:

> Would-be entrepreneurs live in a sea of dreams. Their destinations are private islands—places to build, create, and transform their particular dreams into reality. Being an entrepreneur entails envisioning your island, and even more important, it means getting in the boat and rowing to your island. All dreamers may one day be entrepreneurs if they can marshal the resources—external and internal—needed to transform their dreams into reality.[9]

Entrepreneurs also have been characterized as the interaction of the following skills: inner control, planning and goal setting, risk taking, innovation, reality perception, use of feedback, decision making, human relations, and independence. In addition, many people believe that successful entrepreneurs are individuals who are not afraid to fail.

As we showed earlier in the chapter, research continues to expand our understanding of the cognitions of entrepreneurs.[10] New characteristics are continually being added to this ever-growing list. At this point,

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Table 2.1 Characteristics Often Attributed to Entrepreneurs	
1. Confidence	22. Responsibility
2. Perseverance, determination	23. Foresight
3. Energy, diligence	24. Accuracy, thoroughness
4. Resourcefulness	25. Cooperativeness
5. Ability to take calculated risks	26. Profit orientation
6. Dynamism, leadership	27. Ability to learn from mistakes
7. Optimism	28. Sense of power
8. Need to achieve	29. Pleasant personality
9. Versatility; knowledge of product, market, machinery, technology	30. Egotism
10. Creativity	31. Courage
11. Ability to influence others	32. Imagination
12. Ability to get along well with people	33. Perceptiveness
13. Initiative	34. Toleration for ambiguity
14. Flexibility	35. Aggressiveness
15. Intelligence	36. Capacity for enjoyment
16. Orientation to clear goals	37. Efficacy
17. Positive response to challenges	38. Commitment
18. Independence	39. Ability to trust workers
19. Responsiveness to suggestions and criticism	40. Sensitivity to others
20. Time competence, efficiency	41. Honesty, integrity
21. Ability to make decisions quickly	42. Maturity, balance

Source: John A. Hornaday, "Research about Living Entrepreneurs," in *Encyclopedia of Entrepreneurship*, ed. Calvin Kent, Donald Sexton, and Karl Vesper (Englewood Cliffs, NJ: Prentice Hall, 1982), 26–27. Adapted by permission of Prentice Hall, Englewood Cliffs, NJ.

however, let us examine some of the most often cited entrepreneurial characteristics. Although this list admittedly is incomplete, it does provide important insights into the entrepreneurial mindset.

Determination and Perseverance

More than any other factor, total dedication to success as an entrepreneur can overcome obstacles and setbacks. Sheer determination and an unwavering commitment to succeed often win out against odds that many people would consider insurmountable. They also can compensate for personal shortcomings. Often, entrepreneurs with a high-potential venture and a plan that includes venture capital financing can expect investors to measure their commitment in several ways. Examples include a willingness to mortgage a home, take a cut in pay, sacrifice family time, and reduce standards of living.

Drive to Achieve

Entrepreneurs are self-starters who appear to others to be internally driven by a strong desire to compete, to excel against self-imposed standards, and to pursue and attain challenging goals. This drive to achieve is well documented in the entrepreneurial literature, beginning with David McClelland's pioneering work on motivation in the 1950s and 1960s.[11] High achievers tend to be moderate risk takers. They examine a situation, determine how to increase the odds of winning, and then push ahead. As a result, high-risk decisions for the average businessperson often are moderate risks for the well-prepared high achiever.

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Opportunity Orientation

One clear pattern among successful, growth-minded entrepreneurs is their focus on opportunity rather than on resources, structure, or strategy. Opportunity orientation is the constant awareness of opportunities that exist in everyday life. Successful entrepreneurs start with the opportunity and let their understanding of it guide other important decisions. They are goal oriented in their pursuit of opportunities. Setting high but attainable goals enables them to focus their energies, to selectively sort out opportunities, and to know when to say "no." Their goal orientation also helps them to define priorities and provides them with measures of how well they are performing.

Persistent Problem Solving

Entrepreneurs are not intimidated by difficult situations. In fact, their self-confidence and general optimism seem to translate into a view that the impossible just takes a little longer. Yet they are neither aimless nor foolhardy in their relentless attack on a problem or an obstacle that is impeding business operations. If the task is extremely easy or perceived to be unsolvable, entrepreneurs often will give up sooner than others—simple problems bore them; unsolvable ones do not warrant their time. Moreover, although entrepreneurs are extremely persistent, they are realistic in recognizing what they can and cannot do and where they can get help to solve difficult but unavoidable tasks.

Seeking Feedback

Effective entrepreneurs often are described as quick learners. Unlike many people, however, they also have a strong desire to know how well they are doing and how they might improve their performance. In attempting to make these determinations, they actively seek out and use feedback. Feedback is also central to their learning from mistakes and setbacks.

Internal Locus of Control

Successful entrepreneurs believe in themselves. They do not believe that the success or failure of their venture will be governed by fate, luck, or similar forces. They believe that their accomplishments and setbacks are within their own control and influence, and that they can affect the outcome of their actions. This attribute is consistent with a high-achievement motivational drive, the desire to take personal responsibility, and self-confidence.

Tolerance for Ambiguity

Start-up entrepreneurs face uncertainty compounded by constant changes that introduce ambiguity and stress into every aspect of the enterprise. Setbacks and surprises are inevitable; lack of organization, structure, and order is a way of life. A tolerance for ambiguity exists when the entrepreneur can deal with the various setbacks and changes that constantly confront them. Successful entrepreneurs thrive on the fluidity and excitement of such an ambiguous existence. Job security and retirement generally are of no concern to them.

Calculated Risk Taking

Successful entrepreneurs are not gamblers—they are *calculated risk takers*. When they decide to participate in a venture, they do so in a very calculated, carefully thought-out manner. They do everything possible to get the odds in their favor, and they often avoid taking unnecessary risks. These strategies include getting others to share inherent financial and business risks with them—for example, by persuading partners and investors to put up money, creditors to offer special terms, and suppliers to advance merchandise.

High Energy Level

The extraordinary workloads and stressful demands placed on entrepreneurs put a premium on their energy. Many entrepreneurs fine-tune their energy levels by carefully monitoring what they eat and drink, establishing exercise routines, and knowing when to get away for relaxation.

Creativity and Innovativeness

Creativity was once regarded as an exclusively inherited trait. Judging by the level of creativity and innovation in the United States compared with that of equally sophisticated but less creative and innovative cultures, it appears unlikely that this trait is solely genetic. An expanding school of thought believes that creativity can be learned (Chapter 5 provides a comprehensive examination of this critical characteristic). New ventures often possess a collective creativity that emerges from the joint efforts of the founders and personnel and produces unique goods and services.

Vision

Entrepreneurs know where they want to go. They have a vision or concept of what their firms can be. For example, Steve Jobs of Apple Computer fame wanted his firm to provide microcomputers that could be used by everyone, from schoolchildren to businesspeople. The computer would be more than a machine. It would be an integral part of the person's life in terms of learning and communicating. This vision helped make Apple a major competitor in the microcomputer industry. Not all entrepreneurs have predetermined visions for their firms, however. In many cases, this vision develops over time as the individual begins to realize what the firm is and what it can become.

Passion

Entrepreneurial passion is a fundamental emotional experience for entrepreneurs. Researcher Melissa S. Cardon has devoted much of her efforts on examining this element of the entrepreneurial mindset.[12] She has found that entrepreneurial passion is an expression constructed by the

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The Entrepreneurial Process

Global Breakthrough Innovators

Over the past few decades, we have witnessed the emergence of breakthrough innovators who, driven by goals beyond personal achievement and venture success, have changed the world with their ideas. Here are a few of the most notable breakthrough innovators.

Steve Jobs, of Apple

He was cofounder, chairman, and chief executive officer of Apple, Inc. An entrepreneur who is widely recognized as a charismatic pioneer of the personal computer revolution started his company in a garage in 1976. By 2011, Apple had over 50,000 employees worldwide with annual sales exceeding $65 billion. It was the largest publicly traded company in the world by market capitalization and the largest technology company in the world by revenue and profit. Steve Jobs passed away in 2011 at the age of 56.

Bill Gates, of Microsoft

One of the best-known entrepreneurs of the personal computer revolution, Gates was the chief software architect of Microsoft Corporation, the worldwide leader in software, services, and solutions. Microsoft would also come to dominate the office suite market with Microsoft Office. In 2011, Microsoft Corporation acquired Skype Communications for $8.5 billion. Microsoft revenues exceed $36 billion, employing more than 55,000 people in 85 countries and regions.

Larry Page and Sergey Brin, of Google

Together they founded Google, Inc., in 1998. Today, Google is one of the most financially successful and most innovative companies in the world, expanding its reach into many industries from Google maps to Google cell phones. With revenue at $30 billion, Google has been estimated to run over 1 million servers in data centers around the world and to process over 1 billion search requests and about 24 petabytes of user-generated data every day.

Oprah Winfrey, of Harpo, Inc.

Oprah Winfrey is the first woman in history to own and produce her own talk show. Winfrey is best known for her award-winning talk show (nationally syndicated from 1986 to 2011), which became the highest-rated program of its kind in history. She has been ranked the richest African American of the twentieth century and the greatest black philanthropist in American history. According to some experts, she is one of the most influential women ever.

Sam Walton, of Walmart

He is best known for starting Walmart in 1962. His philosophy was to help bring a large variety of products and low prices to his consumers throughout his career. Today, Walmart is the world's eighteenth-largest public corporation with over $400 billion in revenue and over 600,000 employees. Walmart has 8,500 stores in 15 countries under 55 different names. As a result of his accomplishments, Sam Walton reached the ranks of the richest man in the United States from 1985 until 1988.

Gordon Moore, of Intel

Moore cofounded Intel in 1968, the world's largest semiconductor chip maker. In 2011, Intel's market capitalization was $122.41 billion. Moore is widely known for "Moore's Law," in which, in 1965, he predicted that the number of transistors the industry would be able to place on a computer chip would double once every two years. It has become the guiding principle for the industry.

Paul Orfalea, of Kinko's

Paul Orfalea founded Kinko's as a copy center. The name comes from how other kids joked about his "kinky" hair. In February 2004, Kinko's was bought by FedEx for $2.4 billion and then became known as FedEx Kinko's Office and Print Centers. Today, Kinko's is a worldwide printing center offering a variety of services and bringing in m llions of dollars per year in revenue.

entrepreneur to provide a coherent understanding to an emotional experience of intense arousal and energy mobilization involving an entrepreneur and their venture. Moreover, entrepreneurial passion is characterized by a discrete emotion that is quite intense being described as an underlying force that fuels our strongest emotions, the intensity felt when engaging in activities that are of deep interest, or the energy that enables entrepreneurs to achieve peak performance. Thus, entrepreneurial passion is recognized as a fundamental component of the entrepreneurial mindset.

Team Building

The desire for independence and autonomy does not preclude the entrepreneur's desire to build a strong entrepreneurial team. Most successful entrepreneurs have highly qualified, well-motivated teams that help handle the venture's growth and development. In fact, although the entrepreneur may have the clearest vision of where the firm is (or should be) headed, the personnel often are more qualified to handle the day-to-day implementation challenges.[13]

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The Entrepreneurial Process

Persistence Pays Off for Entrepreneurs

"If at first you don't succeed, try and try again." "If you fall off the horse, you have to get back on." "What doesn't kill you only makes you stronger." Whatever adage you choose, it seems they really do apply to entrepreneurs. Perhaps it is the constant optimism of entrepreneurs that forms this perception. Always keeping an eye open for opportunity and positive change is the earmark of successful entrepreneurs. Persistently asking why deviations occur and how they can be prevented or exploited may be a key element for successful entrepreneurs.

There are certain principles that seasoned entrepreneurs understand more than first-time entrepreneurs. For example, experienced entrepreneurs devour information within their industries. They keep abreast of new and prevailing trends and technologies in their current and related industries. Experienced entrepreneurs also see problems as opportunities for improvements and potential new ventures. So these entrepreneurs are able to study and recognize patterns. More significantly, they have certain targets in mind as they grow their ventures, but their goals are always moving forward. Thus, it may be that experience and persistence teach lessons to entrepreneurs that are used to vault them into future successes.

One study from the Harvard Business School demonstrated that experienced entrepreneurs with some history of success are much more likely to succeed in new ventures than first-timers or those who failed previously. While this may not be shocking news, this is one of the first studies to establish that performance persistence does benefit the entrepreneur quite significantly. In the study, experienced entrepreneurs were 34 percent more likely to succeed in their next venture-backed firm compared with 23 percent for those who previously failed and 22 percent for first-timers. Essentially, the study showed that entrepreneurs who start successful venture-backed ventures were far more likely to be successful in their next venture-backed firm.

It should also be recognized that some component of performance persistence could stem from "success breeding success." In other words, entrepreneurs whose first venture succeeded at least in part due to good timing seem to also do well in subsequent ventures. Timing, such as the Internet boom of the late 1990s or the popularity of apps on iPhones in 2012, could cause greater successes for those entrepreneurs who work within those domains. However, they gain certain success, and it is still an experience factor that benefits their next entrepreneurial effort.

One consideration that emerges from this study is for inexperienced entrepreneurs to find an experienced and previously successful partner. During stagnant economic times, investors will be hesitant to place money on a huge risk. Therefore, they will always consider the experience factor of the founding team. Persistence in entrepreneurship may be today's best asset!

Source: Adapted from Lesson #1: "Persistence Is the Single Most Important Thing for Success," Evan Carmichael Blog on Famous Entrepreneurs; http://www.evancarmichael.com/Famous-Entrepreneurs/4955/Lesson-1-Persistence-is-thesingle-most-important-thing-for-success.html; Sarah Jane Gilbert, "The Success of Persistent Entrepreneurs," *HBS Newsletter*, February 2009, http://hbswk.hbs.edu/item/5941.html; and "Persistence: The Only Way for the Entrepreneurs," Future StartUp, April 14, 2012, http://futurestartup.com/2012/04/14/persistence-the-only-way-for-the-entrepreneurs (accessed June 6, 2012).

2-3 The Skills of Hustle and Coachability

2-3a Entrepreneurial Hustle

LO2.3 Describe the skills of entrepreneurial hustle and coachability

Entrepreneurs need to act under conditions of uncertainty and resource constraints to bring new, often-unrecognizable products or services to market and convince an unknown set of stakeholders to support their endeavors. By taking action, entrepreneurs can learn how their ideas relate to the environment and assess whether stakeholders perceive their efforts as legitimate, attractive, and worthy of support. However, the type of action entrepreneurs need to take in navigating uncertain entrepreneurial contexts is unique and something that researchers Greg Fisher, Regan Stevenson, Devin Burnell, Emily Neubert, and Donald F. Kuratko examined. They analyzed interviews with entrepreneurs (conducted for the National Public Radio podcast titled *How I Built This*) to inductively identify an action-oriented construct that they labeled as entrepreneurial hustle. This concept is defined as an entrepreneur's urgent, unorthodox actions that are intended to be useful in addressing immediate challenges and opportunities under conditions of uncertainty.[14]

In a follow-up study, the researchers use an experimental approach to assess the impact of an entrepreneur's hustle on venture stakeholders. Since entrepreneurial hustle is composed of urgency, unorthodoxy, and intended usefulness in addressing challenges and opportunities, the study found that entrepreneurial hustle positively influenced stakeholder perceptions of the entrepreneur's leadership effectiveness and a venture's legitimacy.[15] Thus, they demonstrated that entrepreneurial hustle is a fundamental behavior that enables entrepreneurs to enroll

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new venture stakeholders and lead their entrepreneurial efforts. It is a critical skill that every entrepreneur should embrace as obstacles present themselves in the course of launching a new venture.

2-3b Entrepreneurial Coachability

Mentorship/coaching from other experienced individuals has become essential to entrepreneurs and their fledgling ventures, particularly in today's accelerators because it improves an entrepreneur's likelihood of success. Therefore, **entrepreneurial coachability** becomes another critical skill that needs to be developed. Founder coachability is defined as the degree to which an entrepreneur seeks, considers, and integrates feedback.

Researchers Donald F. Kuratko, Emily Neubert, and Matthew R. Marvel undertook an examination of mentors and founders across entrepreneurial incubator and accelerator organizations to investigate the factors that influence an entrepreneur's coachability, how coachability translates to venture outcomes, and whether the mentor–mentee relationship met the entrepreneur's expectations. This study showed that entrepreneurs who are more coachable are ultimately more successful during their time in these programs and more satisfied with their mentorship experience.[16]

In a related study, researchers Matthew R. Marvel, Marcus T. Wolfe, and Donald F. Kuratko examined entrepreneurs and their coaches within incubators and accelerators in order to see whether coachability could be used as a learning mechanism beneficial for exploring new knowledge, while also alleviating the constraining effects of prior knowledge, to create innovative offerings.[17] The study showed that coachability is helpful for accumulating missing information, engaging in experiments (e.g., testing different prototypes), or adapting, shaping, and refining the venture.[18] Coachability also translates to an entrepreneur's motivation to improve specific skills, their openness to learning and adapting, and their willingness to trust in the skills and capabilities of those who coach them.[19] Another significant result of the study showed that coachability positively impacts product innovativeness.[20] All of the current studies have demonstrated the importance of an entrepreneur's coachability in achieving greater chances for success.

2-4 Dealing with Failure

LO2.4 Identify how entrepreneurs deal with failure

Entrepreneurs use failure as a learning experience; hence, they have a *tolerance for failure*. The iterative, trial-and-error nature of becoming a successful entrepreneur makes serious setbacks and disappointments an integral part of the learning process. Keep in mind that entrepreneurial ventures that are created to pursue new and unique opportunities often fail due to the uncertain environment within which they develop. Although failure can be an important source of information for learning, this learning is not automatic or instantaneous. The emotions generated by failure (i.e., grief) can interfere with the learning process. While we espouse the importance of failure and the learning that must take place once failure has occurred, seldom do we recognize the importance of grief in the failure experience. Grief is a negative emotional response to the loss of something important, triggering behavioral, psychological, and physiological symptoms.

2-4a The Grief Recovery Process

The traditional process of recovering from grief involves focusing on the particular loss to construct an account that explains why the loss occurred. As a plausible account for the failure is constructed, the individual is able to begin to break the emotional bonds to the project lost. However, empirical research has found that this *loss orientation* toward **grief recovery** can sometimes exacerbate the negative emotional reaction. By focusing on the failure, the entrepreneur's thoughts can shift from the events leading up to the failure to the emotions surrounding the failure event. That is, by continually focusing on the failure, negative thoughts and memories become more salient and can lead to ruminations that escalate grief.[21]

A *restoration orientation* is an alternate approach and is based on both distracting oneself from thinking about the failure event and being proactive toward secondary causes of stress. Distraction takes the individual's thoughts away from the source of their negative emotions, and addressing secondary causes of stress (brought on by the failure) can diminish the primary stressor—the entrepreneurial failure. However, avoiding negative emotions is unlikely to be successful in the long run—suppressing emotions leads to physical and psychological problems, and these suppressed emotions are likely to reemerge and do so at an inopportune time.[22]

Researcher Dean A. Shepherd[23] proposed a dual process model of recovering from the grief over entrepreneurial failure. Based on this dual process model, an entrepreneur recovers more quickly from a failure if they oscillate between a loss and a restoration orientation. This oscillation means that the entrepreneur can gain the benefits of both orientations while minimizing the costs of maintaining either for an extended period. By oscillating (switching back and forth) between these orientations, entrepreneurs can learn more from their failure experiences.

The most effective entrepreneurs are realistic enough to expect difficulties and failures. If they can deal effectively with any grief that emanates from the failure, then they will not become disappointed, discouraged, or depressed by a setback or failure. In adverse and difficult times, they will continue to look for opportunity. In this way, entrepreneurs will believe that they learn more from their early failures to form the foundation of later successes.

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2-5 The Entrepreneurial Experience

LO2.5 Describe the entrepreneurial experience

As we discussed in Chapter 1, the prevalent view in the literature is that entrepreneurs create ventures. Although that is a true statement, its narrow framing neglects the complete process of entrepreneurship and much of the reality regarding how ventures and entrepreneurs come into being. Researchers Michael H. Morris, Donald F. Kuratko, and Minet Schindehutte point out that—similar to a painting that emerges based on the individual interacting with, feeling, and agonizing over their creation—a venture is not simply produced by an entrepreneur. Entrepreneurs do not preexist; they emerge as a function of the novel, idiosyncratic, and experiential nature of the venture creation process. Venture creation is a lived experience that, as it unfolds, forms the entrepreneur. In fact, the creation of a sustainable enterprise involves three parallel, interactive phenomena: emergence of the opportunity, emergence of the venture, and emergence of the entrepreneur. None are predetermined or fixed—they define and are defined by one another.[24] Thus, this perspective on the entrepreneur has gained new momentum in the entrepreneurship research of the twenty-first century.

This experiential view of the entrepreneur captures the emergent and temporal nature of entrepreneurship. It moves us past a more static "snapshot" approach and encourages consideration of a dynamic, socially situated process that involves numerous actors and events. It allows for the fact that the many activities addressed as a venture unfolds are experienced by different actors in different ways.[25] Moreover, it acknowledges that venture creation transcends rational thought processes to include emotions, impulses, and physiological responses as individuals react to a diverse, multifaceted, and imposing array of activities, events, and developments. This perspective is consistent with recent research interest in a situated view of entrepreneurial action.[26] However, we must be aware that this psychological aspect of entrepreneurship presents a dark side as well.

2-6 The Dark Side of Entrepreneurship

LO2.6 Discuss the "dark side" of entrepreneurship

A great deal of literature is devoted to extolling the rewards, successes, and achievements of entrepreneurs. However, a **dark side of entrepreneurship** also exists, and its destructive source can be found within the energetic drive of successful entrepreneurs. In examining this dual-edged approach to the entrepreneurial personality, researcher Manfred F. R. Kets de Vries has acknowledged the existence of certain negative factors that may envelop entrepreneurs and dominate their behavior.[27] Although each of these factors has a positive aspect, it is important for entrepreneurs to understand their potential destructive side as well.

2-6a The Entrepreneur's Confrontation with Risk

LO2.7 Identify and describe the different types of risk that entrepreneurs face

Starting or buying a new business involves **risk**. The higher the rewards, the greater the risks entrepreneurs usually face. This is why entrepreneurs tend to evaluate risk very carefully.

In an attempt to describe the risk-taking activity of entrepreneurs, researchers developed a typology of entrepreneurial styles.[28] Figure 2.1 illustrates these classifications in terms of the financial risk endured when a new venture is undertaken. In this model, the financial risk is measured against the level of *profit motive* (the desire for monetary gain or return from the venture), coupled with the type of activity. Profit-seeking activity is associated with the strong desire to maximize profit, and activity seeking refers to other activities associated with entrepreneurship, such as independence or the work of the venture itself. The thrust of this theory argues that entrepreneurs vary with regard to the relationship between risk and financial return. This typology

Figure 2.1 Typology of Entrepreneurial Styles

Level of Profit Motive	Level of Personal Financial Risk: Low	Level of Personal Financial Risk: High
Low	Risk avoiding Activity seeking	Risk accepting Activity seeking
High	Risk avoiding Profit seeking	Risk accepting Profit seeking

Source: Thomas Monroy and Robert Folger, "A Typology of Entrepreneurial Styles: Beyond Economic Rationality," *Journal of Private Enterprise* 9, no. 2 (1993): 71.

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highlights the need to explore within economic theory the styles or entrepreneurial motivations that deviate from the styles most characteristic of the rational person.

"If different entrepreneurial styles exist, then not every person who founds a new business enterprise does so by seeking to minimize financial risk and maximize financial return. Models of organization formation would thus have to be adjusted for differences among those who form organizations."[29] Thus, not all entrepreneurs are driven solely by monetary gain, and the level of financial risk cannot be completely explained by profit opportunity. Entrepreneurial risk is a complex issue that requires far more than a simple economic risk-versus-return explanation.

It should be noted that "people who successfully innovate and start businesses come in all shapes and sizes. But they do have a few things others do not. In the deepest sense, they are willing to accept risk for what they believe in. They have the ability to cope with a professional life riddled by ambiguity, a consistent lack of clarity. Most have a drive to put their imprint on whatever they are creating. And while unbridled ego can be a destructive thing, try to find an entrepreneur whose ego isn't wrapped up in the enterprise."[30]

Entrepreneurs face a number of different types of risk. These can be grouped into four basic areas: (1) financial risk, (2) career risk, (3) family and social risk, and (4) psychic risk.[31]

Financial Risk

In most new ventures, the individual puts a significant portion of their savings or other resources at stake, which creates a serious **financial risk**. This money or these resources will, in all likelihood, be lost if the venture fails. The entrepreneur also may be required to sign personally on company obligations that far exceed their personal net worth. The entrepreneur is thus exposed to personal bankruptcy. Many people are unwilling to risk their savings, house, property, and salary to start a new business.

Career Risk

A question frequently raised by would-be entrepreneurs is whether they will be able to find a job or go back to their old job should their venture fail. This **career risk** is a major concern to managers who have a secure organizational job with a high salary and a good benefit package.

Family and Social Risk

Starting a new venture requires much of the entrepreneur's energy and time, which can in turn create a **family and social risk**. Consequently, their other commitments may suffer. Entrepreneurs who are married, especially those with children, expose their families to the risks of an incomplete family experience and the possibility of permanent emotional scars. In addition, old friends may vanish eventually because of missed get-togethers.

Psychic Risk

The **psychic risk** may be the greatest risk to the well-being of the entrepreneur. Money can be replaced; a new house can be built; and spouses, children, and friends usually can adapt. But some entrepreneurs who have suffered financial catastrophes have been unable to bounce back, at least not immediately. The psychological impact has proven to be too severe for them.

2-6b Stress and the Entrepreneur

LO2.8 Describe the major causes of stress for these individuals and the ways they can handle stress

Some of the most common entrepreneurial goals are independence, wealth, and work satisfaction. Research studies of entrepreneurs show that those who achieve these goals often pay a high price.[32] A majority of entrepreneurs surveyed had back problems, indigestion, insomnia, or headaches. To achieve their goals, however, these entrepreneurs were willing to tolerate these effects of stress. The rewards justified the costs.

What Is Entrepreneurial Stress?

In general, **stress** can be viewed as a function of discrepancies between a person's expectations and ability to meet demands as well as discrepancies between the individual's expectations and personality. If a person is unable to fulfill role demands, stress occurs. When entrepreneurs' work demands and expectations exceed their abilities to perform as venture initiators, they are likely to experience stress. One researcher has pointed out how entrepreneurial roles and operating environments can lead to stress. Initiating and managing a business requires taking significant risk. As previously mentioned, these risks may be described as financial, career, family, social, or psychic. Entrepreneurs also must engage in constant communication activities—interacting with relevant external constituencies such as customers, suppliers, regulators, lawyers, and accountants—which can be stressful.

Lacking the depth of resources, entrepreneurs must bear the cost of their mistakes while playing a multitude of roles, such as salesperson, recruiter, spokesperson, and negotiator. These simultaneous demands can lead to role overload. Owning and operating a business requires a large commitment of time and energy, as noted previously, often at the expense of family and social activities. Finally, entrepreneurs often work alone or with a small number of employees and therefore lack the support from colleagues that may be available to managers in a large corporation.[33]

In addition to the roles and environment experienced by entrepreneurs, stress can result from a basic

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personality structure. Referred to as *type A* behavior, this personality structure describes people who are impatient, demanding, and overstrung. These individuals gravitate toward heavy workloads and find themselves completely immersed in their business demands. Some of the distinguishing characteristics associated with type A personalities are as follows:

- ***Chronic and severe sense of time urgency***. For example, type A people become particularly frustrated in traffic jams.
- ***Constant involvement in multiple projects subject to deadlines***. Type A people take delight in the feeling of being swamped with work.
- ***Neglect of all aspects of life except work***. These workaholics live to work rather than work to live.
- ***A tendency to take on excessive responsibility***. Often combined with the feeling that "only I am capable of taking care of this matter."
- ***Explosiveness of speech and a tendency to speak faster than most people***. Type A people are prone to ranting and swearing when upset.

A widespread belief in the stress literature is that type A behavior is related to coronary heart disease and that stress is a contributor to heart disease.[34]

Thus, to better understand stress, entrepreneurs need to be aware of their particular personality as well as the roles and operating environments that differentiate their business pursuits.[35]

Sources of Stress

Researchers David P. Boyd and David E. Gumpert have identified four causes of entrepreneurial stress: (1) loneliness, (2) immersion in business, (3) people problems, and (4) the need to achieve.[36]

Loneliness Although entrepreneurs usually are surrounded by others—employees, customers, accountants, and lawyers—they often are isolated from people in whom they can confide. Long hours at work prevent them from seeking the comfort and counsel of friends and family members. Moreover, they tend not to participate in social activities unless they provide a business benefit. A sense of *loneliness* can set in because of the inner feelings of isolation.

Immersion in Business One of the ironies of entrepreneurship is that successful entrepreneurs make enough money to partake of a variety of leisure activities, but they cannot take that exotic cruise, fishing trip, or skiing vacation because their business will not allow their absence. Most entrepreneurs are married to their business—*immersion in business* can mean they work long hours and have little time for civic organizations, recreation, or further education.

People Problems Entrepreneurs must depend on and work with partners, employees, customers, bankers, and professionals. Many experience frustration, disappointment, and aggravation in their experiences with these people. Successful entrepreneurs are to some extent perfectionists and know how they want things done; often they spend a lot of time trying to get lackadaisical employees to meet their strict performance standards. Frequently, because of irreconcilable conflict, partnerships are dissolved.

Need to Achieve Achievement brings satisfaction. During the Boyd and Gumpert study, however, it became clear that a fine line exists between attempting to achieve too much and failing to achieve enough. More often than not, the entrepreneur was trying to accomplish too much. Many are never satisfied with their work, no matter how well it is done. They seem to recognize the dangers (e.g., to their health) of unbridled ambition, but they have a difficult time tempering their achievement need. They appear to believe that if they stop or slow down, some competitor is going to come from behind and destroy everything they have worked so hard to build.

Dealing with Stress

It is important to point out that not all stress is bad. Certainly, if stress becomes overbearing and unrelenting in a person's life, it wears down the body's physical abilities. However, if stress can be kept within constructive bounds, it can increase a person's efficiency and improve performance.

Researchers Boyd and Gumpert made a significant contribution to defining the causes of entrepreneurial stress, but what makes their study particularly noteworthy is the presentation of stress-reduction techniques—ways entrepreneurs can improve the quality of their business and personal lives.[37] Although classic stress-reduction techniques such as meditation, biofeedback, muscle relaxation, and regular exercise help reduce stress, they suggest that another important step entrepreneurs can take is to clarify the causes of their stress. Having identified these causes, entrepreneurs then can combat excessive stress by (1) acknowledging its existence, (2) developing healthy coping mechanisms, and (3) probing unacknowledged personal needs.

Following are six specific ways entrepreneurs can cope with stress.

Networking One way to relieve the loneliness of running a business is to share experiences by *networking* with other business owners. The objectivity gained from hearing about the triumphs and errors of others is itself therapeutic.

Getting Away from It All The best antidote to immersion in business, report many entrepreneurs, is a holiday. If vacation days or weeks are limited by valid business constraints, short breaks still may be possible. Such interludes allow a measure of self-renewal.

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Communicating with Employees Entrepreneurs are in close contact with employees and can readily assess the concerns of their staffs. The personal touches often unavailable in large corporations—such as company-wide outings, flexible hours, and small loans to tide workers over until payday—are possible here. In such settings, employees often are more productive than their counterparts in large organizations and may experience less stress due to the personal touches that are applied.

Finding Satisfaction Outside the Company Countering the obsessive need to achieve can be difficult because the entrepreneur's personality is inextricably woven into the company fabric. Entrepreneurs need to get away from the business occasionally and become more passionate about life itself; they need to gain some new perspectives.

Delegating Implementation of coping mechanisms requires implementation time. To gain this time, the entrepreneur has to *delegate* tasks. Entrepreneurs find delegation difficult because they think they have to be at the business all of the time and be involved in every aspect of the operation. But if time is to be used for alleviation of stress, appropriate delegatees must be found and trained.

Exercising Rigorously Researchers Michael G. Goldsby, Donald F. Kuratko, and James W. Bishop examined the relationship between exercise and the attainment of personal and professional goals for entrepreneurs.[38] The study addressed the issue by examining the exercise regimens of 366 entrepreneurs and the relationship of exercise frequency with both the company's sales and the entrepreneur's personal goals. Specifically, the study examined the relationship that two types of exercise—running and weightlifting—had with sales volume, extrinsic rewards, and intrinsic rewards. The results indicated that running is positively related to all three outcome variables and that weightlifting is positively related to extrinsic and intrinsic rewards. This study demonstrates the value of exercise regimens on relieving the stress associated with entrepreneurs.

Therapy with a Professional If you feel that stress is starting to interfere with your daily activities, it's time to reach out for help. The American Psychological Association is a good place to start your online search. You can also ask your family doctor for recommendations. Trained psychologists or a psychotherapists are generally the best type of mental health professionals for stress-related therapies.

2-6c Entrepreneurial Stress and Sleep

Recent research has focused on the issue of entrepreneurial stress and insomnia. One study showed that both novice and experienced entrepreneurs suffer from insomnia when encountering entrepreneurial stressors.[39] However, using three different studies, including a self-comparison study over time and a randomized sleep deprivation experiment, researchers J. Jeffrey Gish, David T. Wagner, Denis Gregoire, and Christopher M. Barnes showed that a good night of sleep positively influenced entrepreneurs' abilities to perform cognitive tasks in their entrepreneurial pursuits, whereas short-changing sleep decreased performance.[40] In yet another study of 121 entrepreneurs, researchers Amanda J. Williamson, Martina Battisti, Michael Leatherbee, and J. Jeffrey Gish found that sleep quality was a precursor to an entrepreneur's subsequent innovative behavior. In addition, sleep quality was positively related to high positive moods, such as enthusiastic and inspired, and negatively related to negative moods, such as tension or anxiety.[41] In an effort to find solutions for the exhaustion experienced by entrepreneurs in the course of launching and growing ventures, researchers Charles Y. Murnieks, Jonathan D. Arthurs, Melissa S. Cardoon, Nusrat Farah, Jason Stornelli, and J. Michael Haynie found that both sleep and mindfulness exercises provide avenues for entrepreneurs to combat exhaustion. More interestingly, they found that these two factors compensate for one another, which has implications for reducing exhaustion and improving cognitive functioning and motivational energy among entrepreneurs.[42]

All of the recent studies point to the simple fact that sleep quality is extremely important for entrepreneurs in combating the stress and exhaustion associated with venture activities. More significantly, the research has demonstrated that a good night of sleep will impact the actual performance of entrepreneurs such that they are more innovative, more enthusiastic, and more inspired.

2-6d The Entrepreneurial Ego

In addition to the challenges of risk and stress, the entrepreneur also may experience the negative effects of an inflated ego. In other words, certain characteristics that usually propel entrepreneurs into success also can be exhibited to their extreme. We examine four of these characteristics that may hold destructive implications for entrepreneurs.[43]

Overbearing Need for Control and Power

Entrepreneurs are driven by a strong *need to control* and sometimes a *need for power* both in their venture and in their lives. This internal focus of control spills over into a preoccupation with controlling everything. An obsession with autonomy and control may cause entrepreneurs to work in structured situations *only* when they have created the structure on *their* terms. This, of course, has serious implications for networking in an entrepreneurial team because entrepreneurs can visualize

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external control by others as a threat of subjection or infringement on their will. Worse yet, the strong desire for power can be a corruptive force that could lead to negative consequences.[44] Thus, the same characteristic that entrepreneurs need for successful venture creation also contains a destructive side.

Sense of Distrust

To remain alert to competition, customers, and government regulations, entrepreneurs must continually scan the environment. They try to anticipate and act on developments that others might recognize too late. This distrustful state can result in their focusing on trivial things and cause them to lose sight of reality, distort reasoning and logic, and take destructive actions. Again, distrust is a dual-edged characteristic.

Overriding Desire for Success

The entrepreneur's ego is involved in the desire for success. Although many of today's entrepreneurs believe they are living on the edge of existence, constantly stirring within them is a strong desire to succeed in spite of the odds. Thus, the entrepreneur rises up as a defiant person who creatively acts to deny any feelings of insignificance. The individual is driven to succeed and takes pride in demonstrating that success. Therein lie the seeds of possible destructiveness. If the entrepreneur seeks to demonstrate achievement through the erection of a monument—such as a huge office building, an imposing factory, or a plush office—the danger exists that the individual will become more important than the venture itself. A loss of perspective like this can, of course, be the destructive side of the desire to succeed.

The Entrepreneurial Process

Entrepreneurial Fear 101

The fear an entrepreneur experiences has its own taste, its own smell, and its own gut-wrenching pain—and it does not go away as long as the person remains an entrepreneur. It becomes an education: Entrepreneurial Fear 101. Although the course is very exclusive, admission is automatic; permission is neither needed nor sought, and tenure is indefinite. The fear that entrepreneurs experience cannot be anticipated, cannot be escaped, and cannot be prepared for. Because most entrepreneurs do not admit that they have experienced this entrepreneurial fear, it remains a deep, dark secret. Because it is not talked about, most entrepreneurs believe that they are the only ones who have ever experienced it.

According to Wilson Harrell, an entrepreneur from Jacksonville, Florida, entrepreneurial fear is much different from simple fear. Fear is usually accidental, unexpected, and short lived—such as the sudden rush of adrenaline experienced when you almost get hit by a bus, he explains. Entrepreneurial fear, on the other hand, is self-inflicted. It is a private world in which no sleep occurs, where nightmares filled with monsters constantly try to destroy every morsel of the entrepreneur's being.

What causes this fear? It is not the money—any entrepreneur will explain that money is simply a bonus of the accomplishment and that losing money is one of the risks taken. Fear of failure has a lot to do with it. Entrepreneurs do not want to become just another businessperson and pass into oblivion without leaving their mark. What induces this complex fear has yet to be determined.

For Harrell, the fear came when he started his own food brokerage business to sell products on military bases in Europe. Harrell was appointed a representative of Kraft Food Company and did so well increasing its sales that he sold himself out of a job. Because he had made his job look so easy, it was suggested to Kraft's management team that its own salespeople could do the work better and cheaper. So what did Harrell do? Because losing the Kraft account would put him out of business, he placed everything on the line and proposed that if Kraft kept brokering through his company and not take over the brokering in Germany, Harrell would help it take over the food industry everywhere. While Harrell experienced 30 days of immeasurable terror, Kraft made the decision to trust Harrell and to continue brokering through his company.

What is the secret to entrepreneurship given such fear? Reward. No matter what pain is experienced because of the fear, the elation of success surmounts it. That high, along with fear, is an emotion reserved for entrepreneurs and becomes food for the spirit. It is like a roller-coaster ride: In the beginning, imagine pulling yourself up the incline very slowly, making any tough decisions with a growing sense of excitement and foreboding. Then, when you hit the top, for a brief moment, it is frightening, and the anticipation accelerates before you lose all feelings of control. As you go screaming into the unknown, fear takes over. At first, all you feel is fear; then, suddenly, the ride is over, and the fear is gone, but the exhilaration remains. What is next for the entrepreneur? They buy another ticket.

So what is the key ingredient for entrepreneurial success? According to Wilson Harrell, it is the ability to handle fear. He believes that the lonely entrepreneur, living with their personal fear, breathes life and excitement into an otherwise dull and mundane world.

Source: Adapted from Wilson Harrell, "Entrepreneurial Terror," *Inc.*, February 1987, 74–76.

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Unrealistic Optimism

The ceaseless optimism that emanates from entrepreneurs (even through the bleak times) is a key factor in the drive toward success. Entrepreneurs maintain a high enthusiasm level that becomes an *external optimism*—which allows others to believe in them during rough periods. However, when taken to its extreme, this optimistic attitude can lead to a fantasy approach to the business. A self-deceptive state may arise in which entrepreneurs ignore trends, facts, and reports and delude themselves into thinking that everything will turn out fine. This type of behavior can lead to an inability to handle the reality of the business world.

These examples do not imply that *all* entrepreneurs fall prey to these scenarios or that each of the characteristics presented always gives way to the "destructive" side. Nevertheless, all potential entrepreneurs need to know that the dark side of entrepreneurship exists.

2-7 Entrepreneurial Ethics

Ethical issues in business are of great importance today and with good reason. The prevalence of scandals, fraud, and various forms of executive misconduct in corporations has spurred the watchful eye of the public.[45]

Ethics is not a new topic, however. It has figured prominently in philosophical thought since the time of Socrates, Plato, and Aristotle. Derived from the Greek word *ethos*, meaning "custom or mode of conduct," ethics has challenged philosophers for centuries to determine what exactly represents right or wrong conduct. For example, business executive Vernon R. Loucks Jr. notes that "it was about 560 b.c. . . . when the Greek thinker Chilon registered the opinion that a merchant does better to take a loss than to make a dishonest profit. His reasoning was that a loss may be painful for a while, but dishonesty hurts forever—and it's still timely."[46]

Today's entrepreneurs are faced with many ethical decisions, especially during the early stages of their new ventures. And, as Sir Adrian Cadbury observed, "There is no simple universal formula for solving ethical problems. We have to choose from our own codes of conduct whichever rules are appropriate to the case in hand; the outcome of these choices makes us who we are."[47]

In the following sections, we examine some of the ethical dilemmas confronting entrepreneurs. It is our hope that aspiring entrepreneurs will realize the powerful impact that integrity and ethical conduct have on creating a successful venture.

2-8 Ethical Dilemmas

LO2.9 Discuss the ethical dilemmas confronting entrepreneurs within a dynamic environment

In the broadest sense, **ethics** provides the basic rules or parameters for conducting any activity in an "acceptable" manner. More specifically, ethics represents a set of principles prescribing a behavioral code that explains what is good and right or bad and wrong; ethics may, in addition, outline moral duty and obligations.[48] The problem with most definitions of the term is not the description itself but its implications for implementation. The definition is a static description implying that society agrees on certain universal principles. Because society operates in a dynamic and ever-changing environment, however, such a consensus does not exist.[49] In fact, continual conflict over the ethical nature of decisions is quite prevalent.

This conflict arises for a number of reasons. First, business enterprises are confronted by many interests both inside and outside the organization—for example, stockholders, customers, managers, the community, the government, employees, private interest groups, unions, peers, and so on. Second, society is undergoing dramatic change. Values, mores, and societal norms have gone through a drastic evolution in the past few decades. A definition of ethics in such a rapidly changing environment must be based more on a process than on a static code. Figure 2.2 illustrates a conceptual framework for viewing this process. As one ethicist states, "Deciding what is good or right or bad and wrong in such a dynamic environment is necessarily 'situational.' Therefore, instead of relying on a set of fixed ethical principles, we must now develop an ethical process."[50]

The quadrants depicted in Figure 2.2 demonstrate the age-old dilemma between law and ethics. Moving from the ideal ethical and legal position (Quadrant I) to an unethical and illegal position (Quadrant IV), one can see the continuum of activities within an ethical process. Yet legality provides societal standards but not definitive answers to ethical questions.

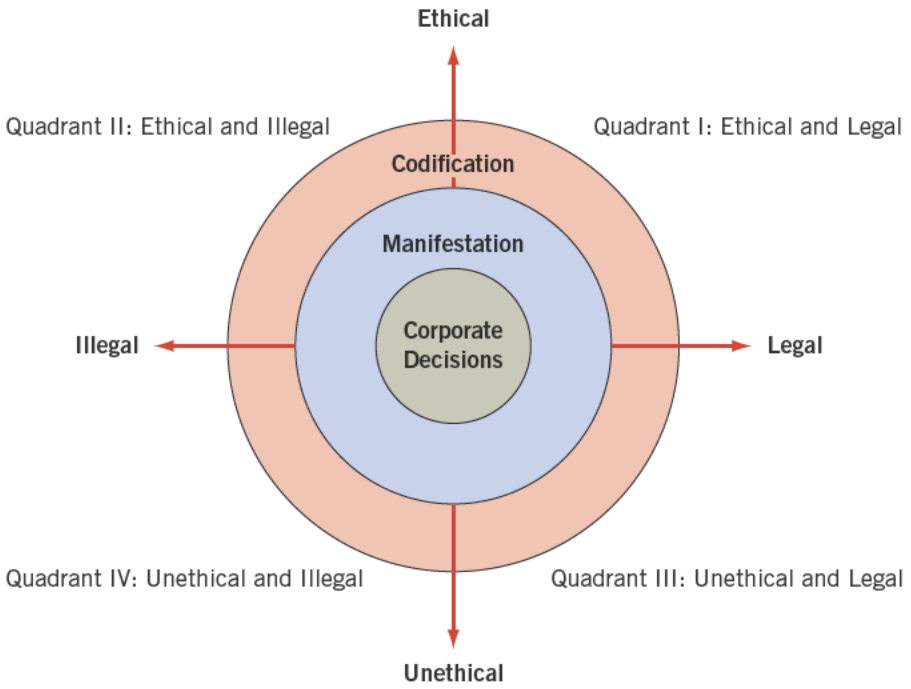
For the entrepreneur, the legal-versus-ethical dilemma is a vital one. Just how far can an entrepreneur go to establish their venture? Survival of the venture is a strong motivation for entrepreneurs, and although the law provides the boundaries for what is illegal (even though the laws are subject to constant interpretation), it does not supply answers for ethical considerations.

2-8a Ethical Rationalizations

One researcher suggests that legal behavior represents one of four **rationalizations** managers use to justify questionable conduct. The four rationalizations are believing

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Figure 2.2 Classifying Decisions Using a Conceptual Framework



Source: Verne E. Henderson, "The Ethical Side of Enterprise," *Sloan Management Review* (Spring 1982): 42.

(1) that the activity is not "really" illegal or immoral, (2) that it is in the individual's or the corporation's best interest, (3) that it will never be found out, and (4) that, because it helps the company, the company will condone it.[51]

These rationalizations appear realistic given the behavior of many business enterprises today. However, the legal aspect can be the most dubious. This is because the business world (and society) relies heavily on the law to qualify the actions of various situations. The law interprets the situations within the prescribed framework. Unfortunately, this framework does not always include ethical or moral behavior. This is left up to the individual, which is the precise reason for the dilemma.

In any examination of the realm of managerial rationalizations, the idea of morally questionable acts becomes a major concern for understanding ethical conduct. One research study developed a typology of morally questionable acts (Table 2.2 summarizes the distinctions made in this typology).[52] Morally questionable acts are either "against the firm" or "on behalf of the firm." In addition, the managerial role differs for various acts. Nonrole acts are those the person takes outside of their role as manager, yet they go against the firm; examples include expense account cheating and embezzlement. Role failure acts also go against the firm, but they involve a person failing to perform their managerial role, including superficial performance appraisals (not totally honest) and not confronting someone who is cheating

Table 2.2 Types of Morally Questionable Acts

Type	Direct Effect	Examples
Nonrole	Against the firm	Expense account cheating Embezzlement Stealing supplies
Role failure	Against the firm	Superficial performance appraisal Not confronting expense account cheating Palming off a poor performer with inflated praise
Role distortion	For the firm	Bribery Price fixing Manipulating suppliers
Role assertion	For the firm	Investing in unethically governed countries Using nuclear technology for energy generation Not withdrawing product line in face of initial allegations of inadequate safety

Source: James A. Waters and Frederick Bird, "Attending to Ethics in Management," *Journal of Business Ethics 5* (1989): 494.

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on expense accounts. Role distortion acts and role assertion acts are rationalized as being "for the firm." These acts involve managers/entrepreneurs who rationalize that the long-run interests of the firm are foremost. Examples include bribery, price fixing, manipulating suppliers, and failing to withdraw a potentially dangerous product from the market. Role distortion is the behavior of individuals who think they are acting in the best interests of the firm, so their roles are "distorted." Role assertion is the behavior of individuals who assert their roles beyond what they should be, thinking (falsely) that they are helping the firm.

All four of the roles involved in the morally questionable acts—whether "for" or "against" the firm—illustrate the types of rationalizations that can occur. In addition, this typology presents an interesting insight into the distinctions involved with managerial rationalization.

2-8b The Matter of Morality

Ethical conduct may reach beyond the limits of the law.[53] As one group of noted legal writers has pointed out, morals and law are not synonymous but may be viewed as two circles partially superimposed on each other (see Figure 2.3). The area covered by both the moral standards circle and the legal requirements circle represents the body of ideas that is both moral and legal. Yet the largest expanse of area is outside this overlapping portion, indicating the vast difference that sometimes exists between morality (ethics) and law.[54]

Ethics researcher LaRue T. Hosmer has reached three conclusions regarding the relationship between legal requirements and moral judgment. First, as noted earlier, the requirements of law may overlap at times but do not duplicate the moral standards of society. Some laws have no moral content whatsoever (e.g., driving on the right side of the road), some laws are morally unjust (e.g., racial segregation laws, which were in effect in the United States into the 1960s and 1970s), and some moral standards have no legal basis (e.g., telling a lie). Second, legal requirements tend to be negative (forbidding acts), whereas morality tends to be positive (encouraging acts). Third, legal requirements usually lag behind the acceptable moral standards of society.[55]

In addition, even if the argument were made that laws are supposed to be the collective moral judgment of society, inherent problems arise when people believe that laws represent morality. Whether it is because of a lack of information on issues, a misrepresentation of values or laws, or an imprecise judicial system, the legal environment has difficulty encompassing all ethical and moral expectations. Thus, the issue of law and ethics will continue to be a dilemma for entrepreneurs.

But it is clear that unethical behavior does take place in business. Why? A few possible explanations include (1) greed, (2) distinctions between activities at work and activities at home, (3) a lack of a foundation in ethics, (4) survival (bottom-line thinking), and (5) a reliance on other social institutions to convey and reinforce ethics. Whatever the reasons, ethical decision making is a challenge that confronts every entrepreneur.[56]

2-8c Complexity of Decisions

Entrepreneurs are challenged by the need to make business decisions each day. Many of these decisions are complex and raise ethical considerations. The business decisions of entrepreneurs are highly complex for five reasons. First, ethical decisions have extended consequences. They often have a ripple effect in that the consequences are felt by others outside the venture. For example, the decision to use inexpensive but unsafe products in operations will affect both workers and consumers of the final good.

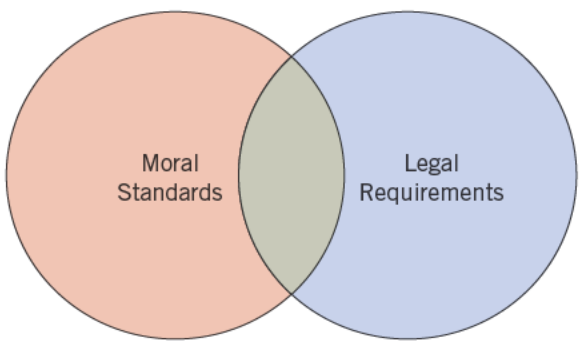
Second, business decisions that involve ethical questions have multiple alternatives—the choices are not always "do" or "don't do." Many decisions have a wide range of alternatives that may involve several less important decisions. With regard to the first example about the use of unsafe products, the entrepreneur may have the alternative of using still less expensive but nevertheless safe products.

Third, ethical business decisions often have mixed outcomes. Social benefits as well as costs are involved with every major business decision, as are financial revenues and expenses.

Fourth, most business decisions have uncertain ethical consequences. It is never absolutely certain what actual consequence(s) a decision will have, even when it appears logical; in other words, a decision is never without ethical risk.

Finally, most ethical business decisions have personal implications. It is difficult for an entrepreneur to divorce themselves from a decision and its potential outcome. Venture success, financial opportunity, and new-product development are all areas that may be affected by decisions with ethical consequences.

Figure 2.3 Overlap between Moral Standards and Legal Requirements



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The entrepreneur often will find it impossible to make a purely impersonal decision.[57]

These five statements about business decisions need to be considered when an entrepreneur is developing a new venture. They indicate the need to grasp as much information as possible about each major decision. One ethicist who believes that this implies understanding the characteristic features of a venture's activities (which in turn allows for a stronger sensitivity to the outcomes) has noted that "someone in business needs to know its general tendencies—the special tracks it leaves—to anticipate points of crisis, and of special concern to us, to increase the possibility of intelligent moral actions."[58]

2-8d Online Ethical Dilemmas in E-Commerce

It is clear that e-commerce and online purchases have grown in popularity possibly redefining the social norms inherent in commerce. With the slow demise of face-to-face interactions, the question of how entrepreneurs can establish trust becomes a priority. Contributing to consumers' concerns is the fact that unethical behavior is more likely to take place through online transactions than through offline ones due to the ease with which businesses can deceive consumers online. So we see consumers now relying on the opinions of fellow consumers posted through online consumer reviews to inform their own purchasing decisions.[59] These online consumer reviews are posted to *reputation management systems,* which now play an integral role in e-commerce, as they are commonly used on popular sites such as Amazon and Yelp.[60] However, a new ethical concern has arisen in regard to the use and sometimes abuse of these new systems.

Even though researchers have documented the importance of consumer trust in e-commerce,[61] the pressures faced by businesses to protect their online reputation has resulted in some businesses resorting to tactics that betray that trust, specifically posting online consumer reviews in order to strategically manipulate the reputation management systems.[62] One study revealed how young professionals have been conditioned by the anonymity of web-based interactions and the degree to which they rationalize the misrepresentation of information by business professionals for the purpose of manipulating consumers' purchasing decisions in order to drive sales.[63]

These questions concerning the ethical challenges that now confront entrepreneurs in the social media age strike at the potential venture success that is at stake in the hands of the social media reputation management sites. How should entrepreneurs proceed? Rather than using the *rationalizations* already discussed to justify questionable conduct, it would be far greater in the long run to exhibit strong ethical responsibility in their actions. In the next section, we examine how to establish an ethical strategy.

2-9 Establishing a Strategy for an Ethical Venture

LO2.10 Present strategies for establishing ethical responsibility and leadership

Because the free enterprise system in which the entrepreneur flourishes is fraught with myriad conflicts, entrepreneurs need to commit to an established strategy for an ethical venture.

2-9a Ethical Codes of Conduct

A **code of conduct** is a statement of ethical practices or guidelines to which an enterprise adheres. Many such codes exist—some related to industry at large and others related directly to corporate conduct. These codes cover a multitude of subjects, ranging from misuse of corporate assets, conflict of interest, and use of inside information to equal employment practices, falsification of books or records, and antitrust violations. Based on the results of recent research, two important conclusions can be reached. First, codes of conduct are becoming more prevalent in industry. Management is not just giving lip service to ethics and moral behavior; it is putting its ideas into writing and distributing these guidelines for everyone in the organization to read and follow. Second, in contrast to earlier codes, the more recent ones are proving to be more meaningful in terms of external legal and social development, more comprehensive in terms of their coverage, and easier to implement in terms of the administrative procedures used to enforce them.[64]

Of course, the most important question remains to be answered: Will management really adhere to a high moral code? Many managers would respond to this question by answering "yes." Why? The main reason is that it is good business. One top executive put the idea this way: "Singly or in combination, unethical practices have a corrosive effect on free markets and free trade, which are fundamental to the survival of the free enterprise system. They subvert the laws of supply and demand, and they short-circuit competition based on classical ideas of product quality, service, and price. Free markets become replaced by contrived markets. The need for constant improvement in products or services is thus removed."[65]

A second, related reason is that by improving the moral climate of the enterprise, the corporation can eventually win back the public's confidence. This would mark a turnaround because many people today question the moral and ethical integrity of companies and believe that businesspeople try to get away with everything they can. Only time will tell whether codes of conduct will improve business practices. Current trends indicate,

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however, that the business community is working hard to achieve this objective.[66]

Mark Twain once said, "Always do the right thing. This will surprise some people and astonish the rest." It will also motivate them to do the right thing. Indeed, without a good example from the top, ethical problems (and all the costs that go with them) are probably inevitable within your organization.

2-9b Ethical Responsibility

Establishing a strategy for ethical responsibility is not an easy task for entrepreneurs. No single, ideal approach to organizational ethics exists. Entrepreneurs need to analyze the ethical consciousness of their organization, the process and structure devised to enhance ethical activity, and, finally, their own commitment to institutionalize ethical objectives within the company.[67] Keeping these points in mind, entrepreneurs eventually can begin to establish a strategy for ethical responsibility. This strategy should encompass three major elements: ethical consciousness, ethical process and structure, and institutionalization:

- ***Ethical Consciousness*** The development of ethical consciousness is the responsibility of the entrepreneur because their vision created the venture. The key figure to set the tone for ethical decision making and behavior is the entrepreneur. An open exchange of issues and processes within the venture, established codes of ethics for the company, and the setting of examples by the entrepreneur are all illustrations of how this is done. For example, when the CEO of a large corporation discovered bookkeeping discrepancies in one of the departments, he directed the 20 implicated employees to make retribution by donating $8,500 to charity.[68] This action commanded positive ethical action and set the tone for ethical expectations.
- ***Ethical Process and Structure*** Ethical process and structure refer to the procedures, position statements (codes), and announced ethical goals designed to avoid ambiguity. Having all key personnel read the venture's specific ethical goals and sign affidavits affirming their willingness to follow those policies is a good practice for ventures.
- ***Institutionalization*** Institutionalization is a deliberate step to incorporate the entrepreneur's ethical objectives with the economic objectives of the venture. At times, an entrepreneur may have to modify policies or operations that become too intense and infringe on the ethics of the situation. This is where

The Entrepreneurial Process

Shaping an Ethical Strategy

The development of an organizational climate for responsible and ethically sound behavior requires continuing effort and investment of time and resources. A code of conduct, ethics officers, training programs, and annual ethics audits do not necessarily add up to a responsible, ethical organization. A formal ethics program can serve as a catalyst and a support system, but organizational integrity depends on the integration of the company's values into its driving systems.

Following are a few key elements that entrepreneurs should keep in mind when developing an ethical strategy.

- *The entrepreneur's guiding values and commitments must make sense and be clearly communicated.* They should reflect important organizational obligations and widely shared aspirations that appeal to the organization's members. Employees at all levels must take them seriously, feel comfortable discussing them, and have a concrete understanding of their practical importance.
- *Entrepreneurs must be personally committed, credible, and willing to take action on the values they espouse.* They are not mere mouthpieces.
- *Entrepreneurs must be willing to scrutinize their own decisions.* Consistency on the part of leadership is key. Entrepreneurs must assume responsibility for making tough calls when ethical obligations conflict.
- *The espoused values must be integrated into the normal channels of the organization's critical activities.* This includes planning innovation, resource allocation, information communication, and personnel promotion and advancement.
- *The venture's systems and structures must support and reinforce its values.* Information systems, for example, must be designed to provide timely and accurate information. Reporting relationships must be structured to build in checks and balances to promote objective judgment.
- *Employees throughout the company must have the decision-making skills, knowledge, and competencies needed to make ethically sound decisions every day.* Ethical thinking and awareness must be part of every employee's skills.

Source: Adapted from Lynn Sharp Paine, "Managing for Organizational Integrity," *Harvard Business Review* (March/April 1994): 106–17.

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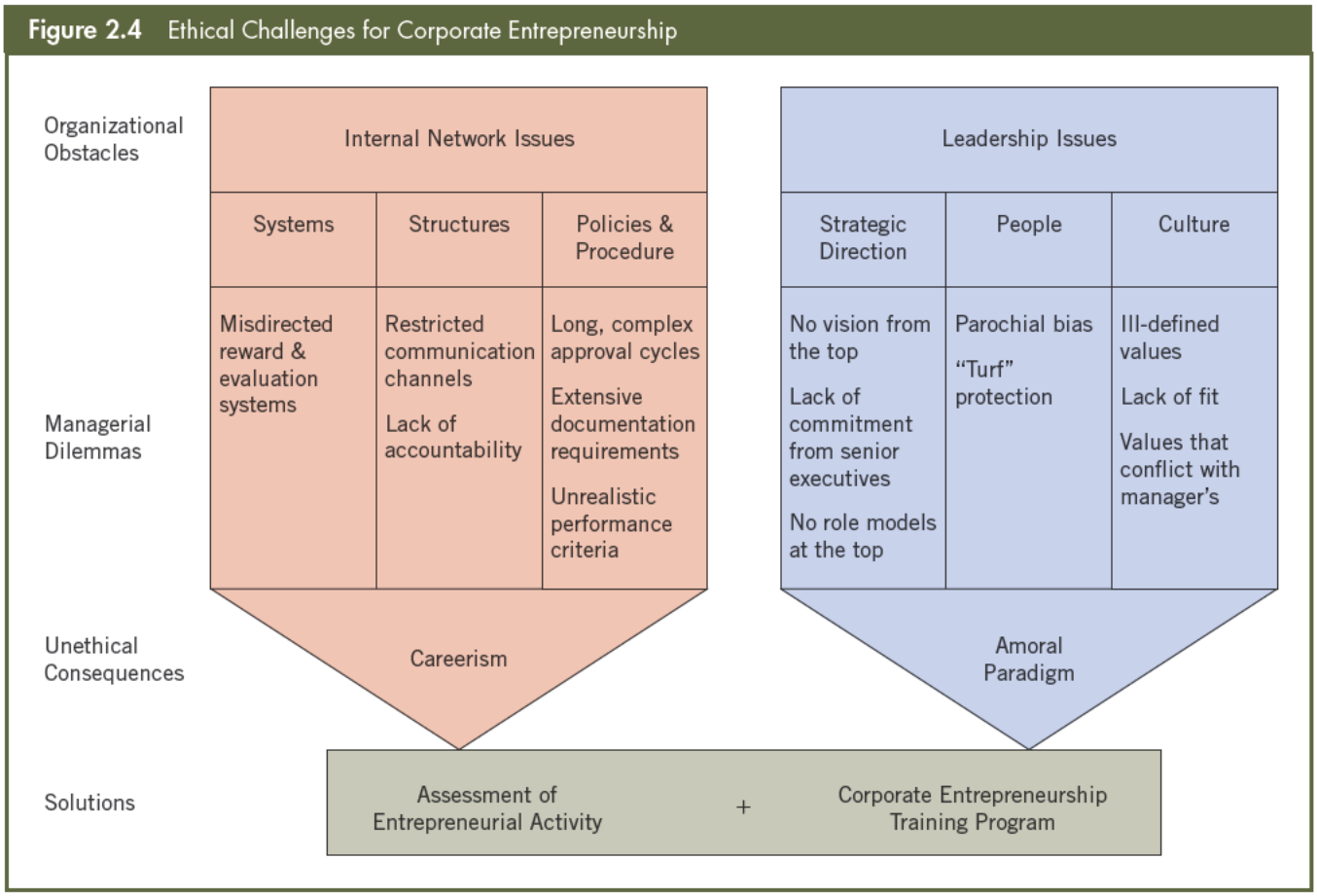
the entrepreneur's commitment to ethics and values is tested. Constant review of procedures and feedback in operations are vital to institutionalizing ethical responsibility.[69]

2-10 Ethical Considerations of Corporate Entrepreneurs

Corporate entrepreneurs—described in the academic literature as those managers or employees who do not follow the status quo of their coworkers—are depicted as visionaries who dream of taking the company in new directions. As a result, in overcoming internal obstacles to reaching their professional goals, they often walk a fine line between clever resourcefulness and outright rule breaking. Researchers Donald F. Kuratko and Michael G. Goldsby developed a framework as a guideline for managers and organizations seeking to impede unethical behaviors in the pursuit of entrepreneurial activity (see Figure 2.4).[70] They examined the barriers that middle managers face in trying to be entrepreneurial in less supportive environments, the unethical consequences that can result, and a suggested assessment and training program to avert such dilemmas.

The barriers include organizational obstacles in two major categories: internal network issues and leadership issues. The specific barriers to innovative actions include systems, structures, policies and procedures, culture, strategic direction, and people. Based on these barriers and the managerial dilemmas that can be caused, the researchers advise companies that embrace corporate entrepreneurship to (1) establish the needed flexibility, innovation, and support of employee initiative and risk taking; (2) remove the barriers that the entrepreneurial middle manager may face to more closely align personal and organizational initiatives and reduce the need to behave unethically; and (3) include an ethical component to corporate training that will provide guidelines for instituting compliance and values components into state-of-the-art corporate entrepreneurship programs. However, even if corporate entrepreneurship is supported, some managers still may pose ethical risks to the company. Rarely will everyone in an organization do the right thing. For this reason, it would be wise to include an ethical component in corporate training programs to

Figure 2.4 Ethical Challenges for Corporate Entrepreneurship



Source: Donald F. Kuratko and Michael G. Goldsby, "Corporate Entrepreneurs or Rogue Middle Managers? A Framework for Ethical Corporate Entrepreneurship," *Journal of Business Ethics* 55 (2004): 18.

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ensure that everyone is aware of the expectations and vision of senior management. A more complete training program and approach to corporate entrepreneurship should make for a better future—for both the organization and its members—and prevent future ethical crises.

2-11 Ethical Leadership by Entrepreneurs

Although ethics present complex challenges for entrepreneurs, the value system of an owner/entrepreneur is the key to establishing an ethical organization.[71] An owner has the unique opportunity to display honesty, integrity, and ethics in all key decisions. The owner's actions serve as a model for all other employees to follow.

In smaller ventures, the ethical influence of the owner is more powerful than in larger corporations because their leadership is not diffused through layers of management. Owners are easily identified, and employees usually can observe them on a regular basis in a small business. Therefore, entrepreneurs possess a strong potential to establish high ethical standards in all business decisions.

One research study found that an owner's value system was a critical component of the ethical considerations that surround a business decision. This study also had implications for entrepreneurs who are seeking to establish an ethical environment within which employees and other constituents can work. For example, it was shown that the preparation of a specific policy statement on ethics (code of ethics) by the owner and their other employees may provide the clear understanding needed for administrative decision making. Small-business owners also may need to specifically address administrative decision-making processes. In addition, they may need to spend some time developing benchmarks or guidelines concerning ethical behaviors of employees. Although these guidelines cannot be expected to cover every possible scenario, they nevertheless will help address the business development/profit motive dimension. Finally, if entrepreneurs can carefully establish explicit rewards and punishments based on ethical behaviors (and these are enforced), the concerns of crime and theft can begin to be addressed.[72]

The huge increase in social media usage has now presented new ethical challenges for entrepreneurs in the area of consumer reviews. According to online research, 95 percent of people read consumer reviews before making a purchase. These sites are known as reputation management systems, and they play an integral role in e-commerce with popular sites such as Amazon and Yelp, yet an ethical concern has arisen due to the strategic manipulation of these systems in order to improve consumers' perceptions of products or services. In 2015, over 1,000 individuals were sued by Amazon for allegedly posting fake product reviews on the site, claiming that individuals wrote phony positive five-star reviews for $5 each. Consumer complaints of fraudulent reviews are increasing. It has been reported that fake online reviews cost $152 billion per year.[73] Amazon strictly prohibits incentivized or fake reviews and uses a combination of machine learning technology and skilled investigators to detect, prevent, and remove them. In 2020, Amazon stopped more than 200 million suspected fake reviews before they were ever seen by a customer.

For entrepreneurs trying to promote their new ventures through such sites, a new ethical dilemma has arisen. Researchers Donald F. Kuratko, Travis J. Brown, and Keith A. Radzik provided a study to examine the ethicality of online consumer reviews. Using a survey of 107 young upcoming professionals, they demonstrated that the strategic manipulation of reputation management systems is deemed unethical yet professionally acceptable. If this is the case, it presents another dilemma that entrepreneurs must confront.[74]

An interesting perspective has begun to take shape. As a result of the growing number of female entrepreneurs, companies are now examining the ethics of caring. Caring is a traditionally feminine alternative to the more traditional and masculine ethics based on rules and regulations.[75] The focus of feminist philosophies is the fostering of positive relationships in all areas of life, or, as Milton Mayeroff states, "To care for another person, in the most significant sense, is to help him grow and actualize himself."[76] By considering the interests of others and maintaining healthy relationships, caring can lead to more genuinely moral climates.

It is clear that entrepreneurial ethics will always be extremely difficult to define, codify, and implement because of the personal values and morality issues it surfaces. Yet the importance of ethics when initiating new enterprises must be stressed. As one writer has noted, "The singular importance of enterprises to our daily lives and our collective future demands our careful attention and finest efforts."[77]

Overall, entrepreneurs must realize that their personal integrity and ethical example will be the key to their employees' ethical performance. Their values can permeate and characterize the organization. This unique advantage creates a position of ethical leadership for entrepreneurs.[78]

2-12 Entrepreneurial Motivation

LO2.11 Examine entrepreneurial motivation

Examining why people start businesses and how they differ from those who do not (or from those who start unsuccessful businesses) may help explain how the

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motivation that entrepreneurs exhibit during start-up is linked to the sustaining behavior exhibited later. Lanny Herron and Harry J. Sapienza have stated, "Because motivation plays an important part in the creation of new organizations, theories of organization creation that fail to address this notion are incomplete."[79] One researcher—in his review of achievement motivation and the entrepreneur—said, "It remains worthwhile to carefully study the role of the individual, including their psychological profile. Individuals are, after all, the energizers of the entrepreneurial process."[80]

Thus, although research on the psychological characteristics of entrepreneurs has not provided an agreed-on "profile" of an entrepreneur, it is still important to recognize the contribution of psychological factors to the entrepreneurial process.[81] In fact, the quest for new-venture creation as well as the willingness to *sustain* that venture is directly related to an *entrepreneur's motivation.*[82]

One research study examined the importance of satisfaction to an entrepreneur's willingness to remain with the venture. Particular goals, attitudes, and backgrounds

Diversity in Entrepreneurship

Age: An Overlooked Source of Diversity and Innovation

For the first time, five generations are working together in the US, adding yet another dimension to the workplace dynamic. Like ethnic, gender, or racial differences, age differences are often a source of tension. While older workers are postponing their retirement due to better health and longevity, younger workers, anxious for change and upward mobility, are impatient for them to move on. With the so-called Great Resignation due to the pandemic, older and younger workers have started competing for similar roles, with younger workers often preferred due to their digital skills. Even as the online world becomes more and more integrated with every generation, older people tend to scroll Facebook, while younger ones choose TikTok, which further exacerbates the generational differences. These differences can limit trust, collaboration, spark conflicts, and lead to a greater employee turnover.

Nevertheless, considering generational differences simply as "differences" is a missed opportunity. Age-diverse teams bring together workers with complementary skills, abilities, information, and networks. These generational differences can actually be a powerful combination of seasoned experience and fresh ideas. A great example of this is the Open Sustainability Technology Lab at Michigan Technological University that developed the first low-cost open-source metal 3D printer. A multigenerational team willing to learn from each other was the key to their success. They combined the technical skills of Gen X faculty, the software wizardry of Millennial graduate students, and the experienced resourcefulness of Boomer researchers. Instead of a younger worker ordering a mechanical part from Amazon, for instance, an older worker built it from spare parts quicker than Amazon could have delivered it. This combination of abilities enabled them to create a 3D printer with the ability to print aluminum and steel at a much lower cost than had been possible before.

Unfortunately, organizations do not often take steps to reap the benefits of generational differences. In fact, only 8% of organizations include age as a part of their diversity, equity, and inclusion (DEI) strategy. With DEI becoming a hot topic, it is surprising that such a profound source of diversity is being overlooked. If managed effectively, team members can share and learn from each other's differences, which leads to better decision-making, more-productive collaboration, and improved overall performance.

With these challenges, it is not surprising that, as the pandemic hit the world, many older adults turned to entrepreneurship, instead of facing a job hunt with the fear of rejection, especially those adults that have not looked for a job in ages. Still, rather than being the main reason, studies show that older adults who go into entrepreneurship after being laid off form only a small percentage of the whole older entrepreneur population. In fact, studies show that entrepreneurs over 50 are 2.8 times more likely to have a successful business than a 25-year-old person. Many famous companies, such as Geico, KFC, McDonalds, Home Depot, and The Huffington Post, were all started by individuals over 50 years old. With years of experience and accumulated capital, older adults are often in the best spot to overcome some of the most common reasons for venture failure.

Generational differences should therefore not be considered as an issue to be managed, but as an opportunity to be seized. We should not be too eager for younger generations to replace older generations. Whether in the corporate or entrepreneurial world, older people can provide a valuable source of insights, experience, and skills. As the longevity market continues to expand, people over 50 are outpacing the rate of spending by consumers younger than 50. This age group is projected to expand 45% by 2050, compared with only 13% for the younger group. The ever-expanding longevity market is an enormous opportunity where older entrepreneurs and older workers alike can bring invaluable perspective and directly contribute to the company's bottom line.

Source: Adapted from: Megan W. Gerhardt, Josephine Nachemson-Ekwall, and Brandon Fogel, "Harnessing the Power of Age Diversity" *Harvard Business Review*, Mar 2022; and Susan B. Garland "As They Aged, They Started Businesses for People Like Them," *The New York Times*, Oct 2020.

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were all important determinants of an entrepreneur's eventual satisfaction.[83] In that vein, another research approach examined the motivational process an entrepreneur experiences, concluding that the decision to behave entrepreneurially is the result of the interaction of several factors.[84] One set of factors includes the individual's personal characteristics, the individual's personal environment, the relevant business environment, the individual's personal goal set, and the existence of a viable business idea.[85] In addition, the individual compares their perception of the probable outcomes with the personal expectations they have in mind. Next, an individual looks at the relationship between the entrepreneurial behavior they would implement and the expected outcomes.

According to this approach, the entrepreneur's expectations finally are compared with the actual or perceived firm outcomes. Future entrepreneurial behavior is based on the results of all of these comparisons. When outcomes meet or exceed expectations, the entrepreneurial behavior is positively reinforced, and the individual is motivated to continue to behave entrepreneurially—either within the current venture or possibly through the initiation of additional ventures, depending on the existing entrepreneurial goal. When outcomes fail to meet expectations, the entrepreneur's motivation will be lower and will have a corresponding impact on the decision to continue to act entrepreneurially. These perceptions also affect succeeding strategies, strategy implementation, and management of the firm.[86]

Another line of research examined the specific motivations as to how and why entrepreneurs persist with a venture, defining **entrepreneurial persistence** as an entrepreneur's choice to continue with an entrepreneurial opportunity regardless of counterinfluences or other enticing alternatives.[87] Researchers Daniel V. Holland and Dean A. Shepherd found that the decision to persist was influenced by personal characteristics as well as by feedback from the environment relative to certain thresholds of adversity. Their findings demonstrate that the decision policies of entrepreneurs regarding persistence differed based on their level of experience with adversity and individual values held.

Summary

In attempting to explain the entrepreneurial mindset within individuals, this chapter presented the concepts of entrepreneurial cognition and metacognition in examining the ways in which entrepreneurs view opportunities and make decisions. Several studies have been conducted to determine the personal qualities and traits of successful entrepreneurs. Some of these characteristics were examined in the chapter: determination and perseverance, drive to achieve, opportunity orientation, internal locus of control, tolerance for ambiguity, calculated risk taking, high energy level, creativity and innovativeness, vision, and passion. This chapter also presented the importance of entrepreneurial hustle and entrepreneurial coachability as skills for entrepreneurs to develop.

An examination of failure and the grief recovery process was then introduced, and the idea of the entrepreneurial experience was discussed to explore the links between entrepreneur, venture, and process. The next part of the chapter focused on the dark side of entrepreneurship, including the confrontation with risk, the problems of stress, and the particular traits that may permeate the entrepreneurial ego. Entrepreneurs have unique opportunities to exert personal influence on their ventures, thereby creating unique challenges of ethical leadership for all entrepreneurs.

The chapter then examined ethics as a set of principles prescribing a behavioral code that explains right and wrong; ethics also may outline moral duty and obligations. Because it is so difficult to define the term *ethics*, it is helpful to look at ethics more as a process than as a static code. Entrepreneurs face many ethical decisions, especially during the early stages of their new ventures.

When entrepreneurs make decisions that border on the unethical, they commonly rationalize their choices. These rationalizations may be based on morally questionable acts committed "against the firm" or "on behalf of the firm" by the managers involved. Within this framework are four distinct types of managerial roles: nonrole, role failure, role distortion, and role assertion. To establish ethical strategies, some entrepreneurs create codes of conduct. A code of conduct is a statement of ethical practices or guidelines to which an enterprise adheres. Codes are becoming more prevalent in organizations today, and they are proving to be more meaningful in their implementation. Despite the ever-present lack of clarity and direction in ethics, however, ethics will continue to be a major issue for entrepreneurs during the new century.

The chapter concluded with a discussion of entrepreneurial motivation. A research framework that recognizes the contribution of psychological factors to the process of entrepreneurship and that demonstrates the importance of entrepreneurs' perceived expectations and actual outcomes in the motivation to start and sustain a venture was considered. Finally, some of the latest research on "entrepreneurial persistence" was introduced in order to acknowledge the growing interest in this concept.

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Key Terms

career risk
code of conduct
cognition
cognitive adaptability
dark side of entrepreneurship
entrepreneurial behavior
entrepreneurial coachability
entrepreneurial cognition
entrepreneurial experience
entrepreneurial hustle
entrepreneurial mindset
entrepreneurial motivation
entrepreneurial persistence
ethics
failure
family and social risk
financial risk
grief recovery
metacognitive model
psychic risk
rationalizations
risk
role assertion
role distortion
role failure
social cognition theory
stress

Review and Discussion Questions

1. What is "entrepreneurial cognition," and how does it impact the mindset of entrepreneurs? How does "metacognition" come into play here?
2. Entrepreneurs have a tolerance for ambiguity, are calculated risk takers, and exude passion. What do these characteristics mean for any potential entrepreneur?
3. Explain the importance of entrepreneurial hustle and entrepreneurial coachability.
4. How should failure be dealt with by entrepreneurs? How does "grief" play a role in this process?
5. Entrepreneurship has a "dark side." What is meant by this statement? Be complete in your answer.
6. What are the four specific areas of risk that entrepreneurs face? Describe each.
7. What are four causes of stress among entrepreneurs? How can an entrepreneur deal with each of them?
8. Describe factors associated with the entrepreneurial ego.
9. *Ethics must be based more on a process than on a static code*. What does this statement mean? Do you agree? Why or why not?
10. A small pharmaceutical firm has just received permission from the Food and Drug Administration (FDA) to market its new anti COVID-19 drug. Although the product has been tested for two years, management believes that serious side effects may still result from its use, and a warning to this effect is being printed on the label. If the company markets this FDA-approved drug, how would you describe its actions from an ethical and legal standpoint? Use Figure 2.2 to help you.
11. Explain the four distinct roles that managers may take in rationalizing morally questionable acts "against the firm" or "on behalf of the firm." Be complete in your answer.
12. Why do complex decisions often raise ethical considerations for the entrepreneur?
13. Cal Whiting believes that entrepreneurs need to address the importance of ethics in their organizations. However, he is unsure of where to begin in his own company because the entire area is unclear to him. What would you suggest? Where can he begin? What should he do? Be as practical as you can in your suggestions.
14. What is the concept of entrepreneurial motivation, and how has it been depicted?
15. Explain the concept of entrepreneurial persistence and how it is being examined.

Notes

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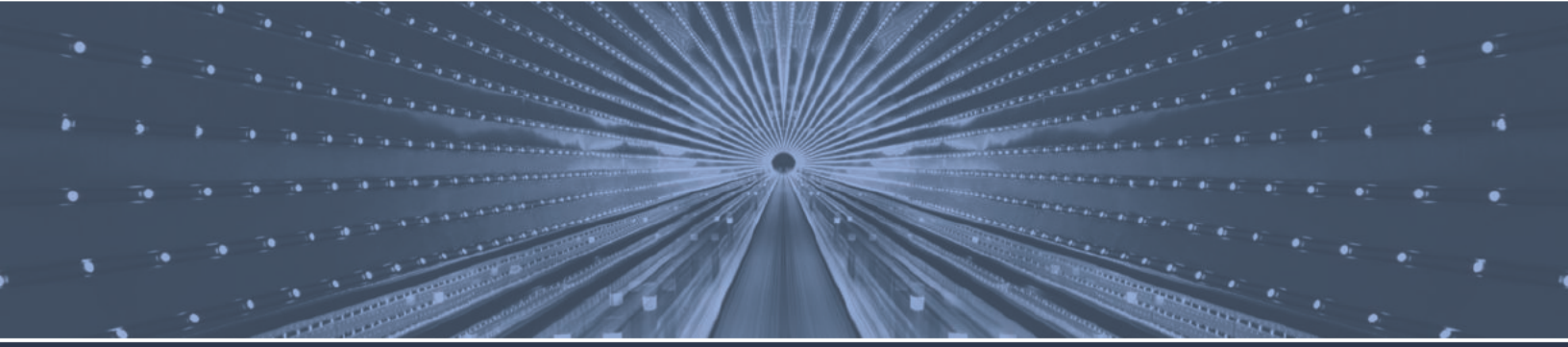
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Chapter 3

The Entrepreneurial Mindset in Organizations: Corporate Entrepreneurship

Learning Objectives

3.1. Describe the entrepreneurial mindset within the context of a broader organization
3.2. Illustrate the need for entrepreneurial thinking in organizations
3.3. Define the term *corporate entrepreneurship*
3.4. Describe obstacles that prevent innovation within corporations
3.5. Summarize the considerations involved in reengineering corporate thinking
3.6. Describe the specific elements of a corporate entrepreneurial strategy
3.7. Explain the methods of developing managers for corporate entrepreneurship
3.8. Illustrate the interactive process of corporate entrepreneurship

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Entrepreneurial Thought

There is nothing more difficult to take in hand, more perilous to conduct, than to take a lead in the introduction of a new order of things, because the innovation has for enemies all those who have done well under the old conditions and lukewarm defenders in those who may do well under the new.

—Machiavelli, ***The Prince***

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3-1 The Entrepreneurial Mindset in Organizations

LO3.1 Describe the entrepreneurial mindset within the context of a broader organization

The global economy is profoundly and substantively changing organizations and industries throughout the world, making it necessary for businesses to reexamine their purposes and to select and follow strategies that have high probabilities of satisfying multiple stakeholders. In response to rapid, discontinuous, and significant changes in their external and internal environments, many companies have restructured their operations in fundamental and meaningful ways. In fact, after years of such restructuring, some companies bear little resemblance to their ancestors in scope, culture, or competitive approach.[1]

LO3.2 Illustrate the need for entrepreneurial thinking in organizations

The contemporary thrust of entrepreneurship as the major force in global business has led to a desire for this type of activity *inside* enterprises. Although some earlier researchers concluded that entrepreneurship and bureaucracies were mutually exclusive and could not coexist,[2] today we find many researchers examining entrepreneurial ventures within the enterprise framework.[3] Successful corporate venturing is present in many different companies, including Google, 3M, Amazon, Tesla, Procter & Gamble, and Abbott.[4] A wealth of popular business literature describes a new "corporate revolution" taking place thanks to the infusion of entrepreneurial thinking into large bureaucratic structures.[5] This infusion is referred to as **corporate entrepreneurship**,[6] corporate innovation,[7] or **intrapreneurship**.[8] Why has corporate entrepreneurship become so popular? One reason is that it allows corporations to tap the innovative talents of their own workers and managers. Steven Brandt puts it this way:

> The challenge is relatively straightforward. The United States must upgrade its innovative prowess. To do so, U.S. companies must tap into the creative power of their members. Ideas come from people. Innovation is a capability of the many. That capability is utilized when people give commitment to the mission and life of the enterprise and have the power to do something with their capabilities.[9]

Corporate entrepreneurship has evolved over the past 40 years to become a strategy that can facilitate firms' efforts to create innovation and cope effectively with the competitive realities in today's world markets. All organizations are facing a new global reality requiring innovation, courage, risk taking, and entrepreneurial leadership. As researcher Donald F. Kuratko pointed out, organizations must realize "the entrepreneurial imperative of the 21st Century" is now at hand.[10] Firms that exhibit corporate entrepreneurship are typically viewed as dynamic, flexible entities prepared to take advantage of new business opportunities when they arise. An "entrepreneurial orientation" of innovation, risk taking, and proactiveness is needed for today's organizations to implement the needed strategies for corporate entrepreneurship to develop.[11]

Continuous innovation (in terms of products, processes, and administrative routines and structures) and an ability to compete effectively in global markets are among the skills that are increasingly expected to influence corporate performance in the twenty-first century. Today's executives agree that innovation is the most important pathway for companies to accelerate their pace of change in the global environment. Corporate entrepreneurship is a process that can facilitate efforts to innovate and can help firms cope with the competitive realities of world markets. Leading strategic thinkers are moving beyond traditional product and service innovations and are pioneering innovation in processes, value chains, business models, and all functions of management. The entrepreneurial mindset does exist in corporations despite the litany of barriers and challenges. An entrepreneurial mindset is central to the successful execution of corporate entrepreneurship, and it seems clear that it is necessary for firms of all sizes to prosper and flourish in competitive environments.[12]

3-2 Corporate Innovation Philosophy

Despite the fact that entrepreneurship and innovation are highly touted as a most viable strategy for successful results in today's corporations, the fact remains that successful implementation of corporate innovation has been quite elusive for most companies.[13] Corporate innovation succeeds in organizations that provide employees with the freedom and encouragement to develop their ideas, but top managers, if they do not believe that entrepreneurial ideas can be nurtured, have been known to hamper innovation. They may find it difficult, for example, to implement policies that endorse unstructured activity. If innovative people are to reach their potential, however, new types of thinking must overcome managerial hesitations. Five important practices for establishing innovation-driven organizations follow:

1. Set *explicit innovation goals*. These goals need to be mutually agreed on by the employee and management so that specific steps can be achieved.

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2. Create a system of *feedback* and *positive reinforcement*. This is necessary for potential innovators or creators of ideas to realize that acceptance and reward exist.
3. Emphasize *individual responsibility*. Confidence, trust, and accountability are key features in the success of any innovative program.
4. Provide *rewards* for innovative ideas. Reward systems should enhance and encourage others to risk and to achieve.
5. *Do not punish failures*. Real learning takes place when failed projects are examined closely for what can be learned by individuals. In addition, individuals must feel free to experiment without fear of punishment.

Although each enterprise must develop its own philosophy of corporate innovation, the answers to these questions can inform the process:

- *Does our company encourage entrepreneurial thinking?* Will individuals receive the corporation's blessing for their self-appointed idea creations? Some corporations foolishly try to appoint people to carry out an innovation when, in fact, the ideas must surface on their own.
- *Does our company provide ways for innovators to stay with their ideas?* When the innovation process involves switching the people working on an idea—that is, handing off a developing business or product from a committed innovator to whoever is next in line—that person often is not as committed as the originator of the project.
- *Are people in our company permitted to do the job in their own way, or are they constantly stopping to explain their actions and ask for permission?* Some organizations push decisions up through a multilevel approval process so that the doers and the deciders never even meet.
- *Has our company evolved quick and informal ways to access the resources to try new ideas?* Innovators usually need discretionary resources to explore and develop new ideas. Some companies give employees the freedom to use a percentage of their time on projects of their own choosing and set aside funds to explore new ideas when they occur. Others control resources so tightly that nothing is available for the new and unexpected—the result is nothing new.
- *Has our company developed ways to manage many small and experimental innovations?* Today's corporate cultures favor a few well-studied, well-planned attempts to hit a home run. In fact, nobody bats a thousand; it is better to make more frequent attempts, with less careful and expensive preparation for each.
- *Is our system set up to encourage risk taking and to tolerate mistakes?* Innovation cannot be achieved without risk and mistakes. Even successful innovation generally begins with blunders and false starts.
- *Are people in our company more concerned with new ideas or with defending their turf?* Because new ideas almost always cross the boundaries of existing patterns of organization, a jealous tendency toward "turf protection" blocks innovation.
- *How easy is it to form functionally complete, autonomous teams in our corporate environment?* Small teams with full responsibility for developing an innovation solve many of the basic problems, yet some companies resist their formation.[14]

Another way to create an innovative corporate atmosphere is to apply rules for innovation. The rules in Table 3.1 can provide hands-on guidelines for developing the necessary innovative philosophy.

When these rules are followed, they create an environment conducive to and supportive of potential entrepreneurial thinking. The result is a corporate philosophy that supports innovative behavior.

What can a corporation do to reengineer its thinking to foster the entrepreneurial process? The organization needs to examine and revise its management philosophy. Many enterprises have obsolete ideas about cooperative cultures, management techniques, and the values of managers and employees. Unfortunately, doing old tasks more efficiently is not the answer to new challenges; a new culture with new values has to be developed.[15]

Table 3.1 Rules for an Innovative Environment

1. Encourage action.
2. Use informal meetings whenever possible.
3. Tolerate failure and use it as a learning experience.
4. Persist in getting an idea to market.
5. Reward innovation for innovation's sake.
6. Plan the physical layout of the enterprise to encourage informal communication.
7. Expect clever **bootlegging** of ideas—secretly working on new ideas on company time as well as on personal time.
8. Put people on small teams for future-oriented projects.
9. Encourage personnel to circumvent rigid procedures and bureaucratic red tape.
10. Reward and promote innovative personnel.

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Bureaucrats and controllers must learn to coexist with—or give way to—the designer and innovator. Unfortunately, this is easier said than done. Organizations can, however, use the following methods to help restructure corporate thinking and encourage an entrepreneurial environment: (1) early identification of potential innovators, (2) top-management sponsorship of innovative projects, (3) creation of innovation goals in strategic activities, (4) promotion of entrepreneurial thinking through experimentation, and (5) development of collaboration between innovators and the organization at large.[16]

Developing a corporate entrepreneurial philosophy provides a number of advantages. One is that this type of atmosphere often leads to the development of new products and services, helping the organization expand and grow. Second, it creates a workforce that can help the enterprise maintain its competitive posture. A third advantage is that it promotes a climate conducive to high achievers and helps the enterprise motivate and keep its best people.

3-3 Corporate Entrepreneurship and Innovation

In recent years, the subject of corporate entrepreneurship/corporate innovation has become quite popular, though very few people thoroughly understand the concept. Most researchers agree that the term refers to entrepreneurial activities that receive organizational sanction and resource commitments for the purpose of innovative results.[17] The major thrust of corporate innovation is to develop the entrepreneurial spirit within organizational boundaries, thus allowing an atmosphere of innovation to prosper.

3-3a Defining the Concept of Corporate Entrepreneurship and Innovation

LO3.3 Define the term *corporate entrepreneurship*

Operational definitions of corporate entrepreneurship/corporate innovation have evolved over the past 40 years through scholars' work. For example, one researcher noted that corporate innovation is a very broad concept that includes the generation, development, and implementation of new ideas or behaviors. An innovation can be a new product or service, an administrative system, or a new plan or program that pertains to organizational members.[18] In this context, corporate entrepreneurship centers on reenergizing and enhancing the firm's ability to acquire innovative skills and capabilities.

Researcher Shaker A. Zahra observed that "corporate entrepreneurship may be formal or informal activities aimed at creating new businesses in established companies through product and process innovations and market developments. These activities may take place at the corporate, division (business), functional, or project levels, with the unifying objective of improving a company's competitive position and financial performance."[19] William D. Guth and Ari Ginsberg have stressed that corporate entrepreneurship encompasses two major phenomena: new venture creation within existing organizations and the transformation of organizations through strategic renewal.[20]

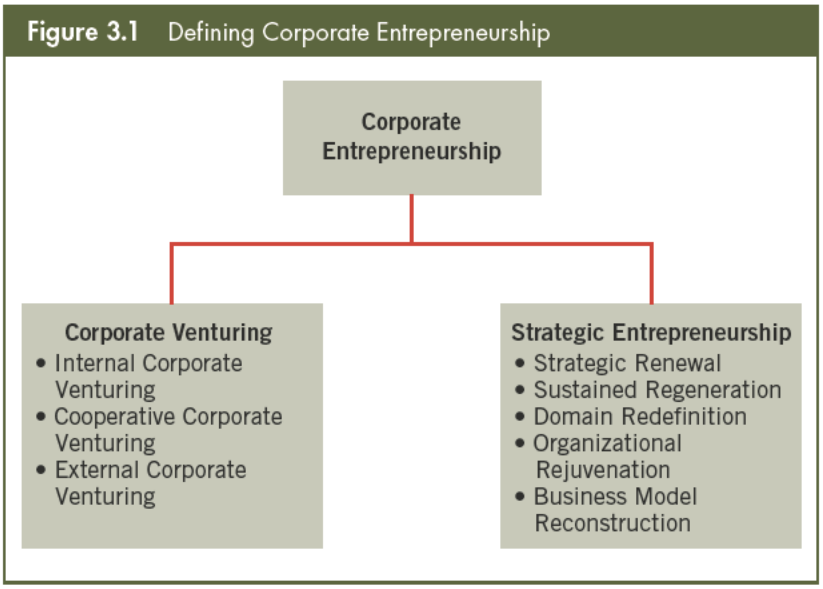
Researchers Michael H. Morris, Donald F. Kuratko, and Jeffrey G. Covin have cited two empirical phenomena as constituting the domain of corporate entrepreneurship—namely, corporate venturing and strategic entrepreneurship. **Corporate venturing** approaches have as their commonality the adding of new businesses (or portions of new businesses via equity investments) to the corporation. This can be accomplished through three implementation modes: internal corporate venturing, cooperative corporate venturing, and external corporate venturing. By contrast, **strategic entrepreneurship** approaches have as their commonality the exhibition of large-scale or otherwise highly consequential innovations that are adopted in the firm's pursuit of competitive advantage. These innovations may or may not result in new businesses for the corporation. With strategic entrepreneurship approaches, innovation can be in any of five areas: the firm's strategy, product offerings, served markets, internal organization (i.e., structure, processes, and capabilities), or business model.[21] Each of these categories of corporate entrepreneurship is outlined in Figure 3.1.

After a thorough analysis of the entrepreneurship construct and its dimensions, recent research has defined corporate entrepreneurship as a process whereby an individual (or a group of individuals), in association with an existing organization, creates a new organization or instigates renewal or innovation within the organization. Under this definition, strategic renewal (which is concerned with organizational renewal involving major strategic and/or structural changes), innovation (which is concerned with introducing something new to the marketplace), and corporate venturing (corporate entrepreneurial efforts that lead to the creation of new business organizations within the corporate organization) are all important and legitimate parts of the corporate entrepreneurship process.[22]

As the field has further evolved, the concept of a corporate entrepreneurship strategy has developed. Researchers R. Duane Ireland, Jeffrey G. Covin, and Donald F. Kuratko define a corporate entrepreneurial strategy as "a vision-directed, organization-wide reliance on entrepreneurial behavior that purposefully and

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Figure 3.1 Defining Corporate Entrepreneurship



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continuously rejuvenates the organization and shapes the scope of its operations through the recognition and exploitation of entrepreneurial opportunity."[23]

3-3b The Need for Corporate Entrepreneurship and Innovation

Many companies today are recognizing the need for corporate entrepreneurship. Articles in popular business magazines (e.g., *BusinessWeek*, *Fortune*, and *U.S. News & World Report*) report the infusion of entrepreneurial thinking into large bureaucratic structures. In fact, in many of today's popular business books, entire sections are devoted to innovation within the corporation.[24] Quite obviously, both business firms and consultants/authors are recognizing the need for in-house entrepreneurship.

This need has arisen in response to a number of pressing problems, including rapid growth in the number of new and sophisticated competitors, a sense of distrust in the traditional methods of corporate management, an exodus of some of the best and brightest people from corporations to become small-business entrepreneurs, international competition, downsizing of major corporations, and an overall desire to improve efficiency and productivity.[25]

The first of these issues, the problem of competition, has always plagued businesses. However, today's high-tech economy supports a far greater number of competitors than ever before. In contrast to previous decades, changes, innovations, and improvements are now very common in the marketplace. Thus, corporations must either innovate or become obsolete.

Another of these problems, losing the brightest people to independent entrepreneurship, is escalating as a result of two major developments. First, entrepreneurship is on the rise in terms of status, publicity, and economic development. This enhancement of entrepreneurship has made the choice more appealing to both young and seasoned employees. Second, in recent years, venture capital has grown into a large industry capable of financing more new ventures than ever before. More significantly, as we will see in greater detail in Chapter 8, "angel investors" have emerged in unprecedented strength, as has equity crowdfunding, which has created a new opportunities for capital funding. Healthy capital funding markets have enabled new entrepreneurs to launch their ideas. As a result, people with innovative ideas are more likely to leave large corporations and strike out on their own.

The modern organization, then, is forced into seeking avenues to develop in-house entrepreneuring. To do otherwise is to wait for stagnation, loss of personnel, and decline. This new "corporate revolution" represents an appreciation for and a desire to develop innovators within the corporate structure.

3-3c Obstacles to Corporate Entrepreneurship and Innovation

LO3.4 Describe obstacles that prevent innovation within corporations

It should be noted that many obstacles exist for the corporate entrepreneurship process. The obstacles to corporate entrepreneurship usually reflect the ineffectiveness of traditional management techniques as applied to innovation development. Although it is unintentional, the adverse impact of a particular traditional management technique can be so destructive that the individuals within an enterprise will tend to avoid corporate entrepreneurial behavior. Table 3.2 provides a list of traditional management techniques, their adverse effects (when the technique is rigidly enforced), and the recommended actions to change or adjust the practice.

Understanding these obstacles is critical to fostering corporate entrepreneurship because they are the foundation points for all other motivational efforts. To gain support and foster excitement for innovation development, managers must remove the perceived obstacles and seek alternative management actions.[26]

After recognizing the obstacles, managers need to adapt to the principles of successful innovative

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Table 3.2 Sources of and Solutions to Obstacles in Corporate Innovation

Traditional Management Practices	Adverse Effects	Recommended Actions
Enforce standard procedures to avoid mistakes	Innovative solutions blocked, funds misspent	Make ground rules specific to each situation
Manage resources for efficiency and ROI	Competitive lead lost, low market penetration	Focus effort on critical issues (e.g., market share)
Control against plan	Facts ignored that should replace assumptions	Change plan to reflect new learning
Plan for the long term	Nonviable goals locked in, high failure costs	Envision a goal, then set interim milestones, reassess after each
Manage functionally	Entrepreneur failure and/or venture failure	Support entrepreneur with managerial and multidiscipline skills
Avoid moves that risk the base business	Missed opportunities	Take small steps, build out from strengths
Protect the base business at all costs	Venturing dumped when base business is threatened	Make venturing mainstream, take affordable risks
Judge new steps from prior experience	Wrong decisions about competition and markets	Use learning strategies, test assumptions
Compensate uniformly	Low motivation and inefficient operations	Balance risk and reward, employ special compensation
Promote compatible individuals	Loss of innovators	Accommodate "boat rockers" and "doers"

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companies. James Brian Quinn, an expert in the innovation field, found the following factors in large corporations that have exhibited successful innovations:

- *Atmosphere and vision.* Innovative companies have a clear-cut vision of—and the recognized support for—an innovative atmosphere.
- *Orientation to the market.* Innovative companies tie their visions to the realities of the marketplace.
- *Small, flat organizations.* Most innovative companies keep the total organization flat and project teams small.
- *Multiple approaches.* Innovative managers encourage several projects to proceed in parallel development.
- *Interactive learning.* Within an innovative environment, interactive learning and the investigation of ideas cut across traditional functional lines in the organization.
- *Skunk Works.* (Skunk Works is a nickname given to small groups that work on their ideas outside of normal organizational time and structure.) Every highly innovative enterprise uses groups that function outside traditional lines of authority. This eliminates bureaucracy, permits rapid turnaround, and instills a high level of group identity and loyalty.[27]

3-4 Corporate Entrepreneurship Strategy

LO3.6 Describe the specific elements of a corporate entrepreneurial strategy

As mentioned earlier, we define a corporate entrepreneurship strategy as a vision-directed, organization-wide reliance on entrepreneurial behavior that purposefully and continuously rejuvenates the organization and shapes the scope of its operations through the recognition and exploitation of entrepreneurial opportunity. As is true for all strategies, a corporate entrepreneurship strategy should be thought of in continuous rather than dichotomous terms. Stated more directly, corporate entrepreneurship strategies vary in their degree of entrepreneurial intensity.

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The Entrepreneurial Process

FutureWorks: Procter & Gamble's "Entrepreneurial Engine"

When you think about Procter & Gamble (P&G), you think of a consumer product giant. They have 300 brands that produce $80 billion in revenue in 80 countries with 130,000 employees. But even at that size, P&G is serious about corporate innovation. It spends nearly $2 billion every year on research and development with another $400 million invested in consumer research. It conducts over 20,000 studies in 100 countries. Why this emphasis on internal innovation? Because the CEO of P&G, Bob McDonald, recognizes that sales promotions may move a company through a season but that true innovation can vault a company into future decades.

However, P&G learned after years of investment and experiments that corporate innovation is sometimes best executed through decentralized innovation units or departments. In this type of structure, senior-level managers worry only about major milestones that need to be achieved in the innovation process. The rest is left to the members of the innovation unit with complete dedication of their time in order to get the innovations to market as quickly as possible.

P&G created one of the most successful innovation units that exists today, named FutureWorks. It is a Corporate New Business Creation unit within P&G that reports to the Corporate Innovation Fund board, which consists of the top officers of the company. That unit is charged with creating, incubating, and scaling transformational new business models, new categories, or service experiences that capitalize on disruptive market innovations. The P&G FutureWorks team is experienced and diverse with close connections to the P&G leadership team and their strategic goals.

Using a technique of "open innovation" where external ideas and solutions are sought out by the organization, P&G has established a Connect and Develop division of FutureWorks for an effective external interface. The mission of that unit is to seek out partners and realize the innovation potential in those external networks. Innovations that in the past could have taken there years or more to get to market could be accelerated within 18 months. By connecting with external partners, P&G has expanded its strategic core businesses into new channels and domains. Some of those new domains of interest include services via franchising, health and well-being, information-based services, breakthrough platform technologies, and emerging markets.

Of particular interest to FutureWorks are models that leverage the power of a P&G brand or a strong external brand (just think of the powerful brand names owned by P&G, such as Crest, Duracell, Tide, Pampers, Charmin, Gillette, and Pringles, to name a few). Some examples of business models that have been developed leveraging some of P&G's brands include Mr. Clean Car Wash and Tide Dry Cleaners. Also, any platform technologies are especially viable if they can bring disruptive cost, capability, and/or a speed advantage to any current business models, retail partners, or even the industry and, finally, information-based ideas that serve the consumer or the retailer and provide unique information.

In order to better finance innovation projects, P&G has established the P&G Corporate Innovation Fund, which provides financing for the development of disruptive innovations and of new businesses (P&G's innovative Crest Whitestrips were funded in this manner).

The vice president and chief innovation czar at P&G, Nathan Estruth, claims that the "magic" is in his team and the culture they have created. He points out that they are characterized by humility and that they are passionate about their work, thrive in ambiguity, and consistently challenge the status quo. The value in all of what FutureWorks is accomplishing is best summed up in the realization of the new businesses, greater efficiencies, and new capabilities that characterize P&G today. P&G is creating their future by seeking breakthrough innovations through a breakthrough development of their own: FutureWorks!

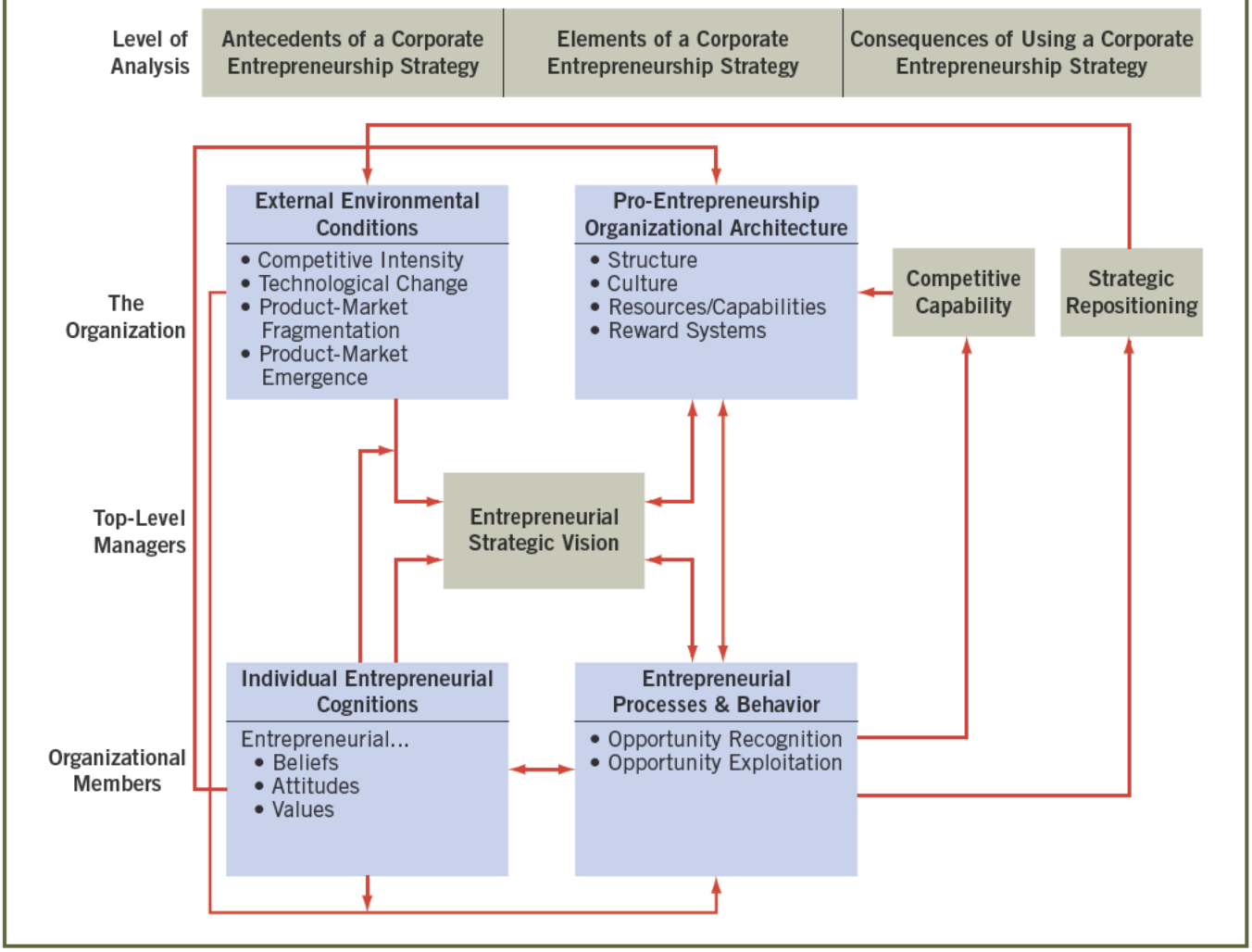
Source: Adapted from numerous sources, including the P&G website for FutureWorks, http://futureworks.pg.com, accessed February 1, 2012; Bruce Brown and Scott D. Anthony, "How P&G Tripled Its Innovation Success Rate," *Harvard Business Review* 89, no. 6 (June 2011): 64–72; and a personal visit to FutureWorks with an interview with Nathan Estruth, July 2011.

Developed by researchers Jeffrey G. Covin, R. Duane Ireland, and Donald F. Kuratko, Figure 3.2 presents a model that illustrates how a corporate entrepreneurship strategy is manifested through the presence of three elements: an entrepreneurial strategic vision, a pro-entrepreneurship organizational architecture, and entrepreneurial processes and behavior as exhibited across the organizational hierarchy.[28] This model has several linkages, including (1) individual entrepreneurial cognitions of the organization's members, (2) external environmental conditions that invite entrepreneurial activity, (3) top management's entrepreneurial strategic vision for the firm, (4) organizational architectures that encourage entrepreneurial processes and behavior, (5) the entrepreneurial processes that are reflected in entrepreneurial behavior, and (6) organizational outcomes that result from entrepreneurial actions.

The model suggests that individual entrepreneurial cognitions and external environmental conditions are the initial impetus for adopting a corporate entrepreneurship

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Figure 3.2 An Integrative Model of Corporate Entrepreneurship Strategy



Source: R. Duane Ireland, Jeffery G. Covin, and Donald F. Kuratko, "Conceptualizing Corporate Entrepreneurship Strategy," *Entrepreneurship Theory and Practice* 33, no. 1 (2009): 24.

strategy, and outcomes are assessed to provide justification for the strategy's continuance, modification, or rejection. The corporate entrepreneurship strategy itself is reflected in the three elements cited previously: an entrepreneurial strategic vision, a pro-entrepreneurship organizational architecture, and entrepreneurial processes and behavior as exhibited throughout the organization. A corporate entrepreneurship strategy cannot be consciously chosen and quickly enacted the way some strategies, such as acquisition, can be—it requires more than just a decision, act, or event. It requires the creation of congruence between the entrepreneurial vision of the organization's leaders and the entrepreneurial actions of those throughout the organization, as facilitated through the existence of a pro-entrepreneurship organizational architecture. Corporate entrepreneurship strategy is about creating self-renewing organizations through the unleashing and focusing of the entrepreneurial potential that exists throughout those organizations. It is also about consistency in approach and regularity in behavior. Firms that engage in corporate entrepreneurship strategies must encourage entrepreneurial behavior on a relatively regular or continuous basis. Obviously, how extensively firms must engage in entrepreneurial behavior before the presence of a corporate entrepreneurship strategy can be claimed is a matter of degree. At one end of the continuum is stability, or the absence of innovation; at the other end is chaos, or overwhelming innovation. Researchers Charles Baden-Fuller and Henk Volberda rightfully assert,

> Resolving the paradox of change and preservation means recognizing that continuous renewal inside a complex firm is misleading. Too much change will lead to chaos, loss of cultural glue, fatigue, and organizational breakdown. While in the short-term, organizations that are chaotic can survive, in the longer term they are likely to collapse.[29]

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Researchers Kathleen Eisenhardt, Shona Brown, and Heidi Neck perhaps best captured where firms with corporate entrepreneurship strategies lie along the innovation continuum in their observations concerning "competing on the entrepreneurial edge." Firms with corporate entrepreneurship strategies remain close to the "edge of time," judiciously balancing the exploitation of current entrepreneurial opportunities with the search for future entrepreneurial opportunities. Such firms are always near chaos, both strategically and structurally, but they have the wisdom and discipline to recognize the possibility of (and avoid) the extreme collapse referred to earlier.[30]

LO3.5 Summarize the considerations involved in reengineering corporate thinking

Thus, for corporate entrepreneurship to operate as a strategy, it must "run deep" within organizations. Top managers are increasingly recognizing the need to respond to the entrepreneurial imperatives created by their competitive landscapes. Minimal responses to these entrepreneurial imperatives—reflecting superficial commitments to corporate entrepreneurship strategy—are bound to fail. Moreover, although top management can instigate the strategy, top management cannot dictate it. Those at the middle and lower ranks of an organization have a tremendous effect on and significant roles within entrepreneurial and strategic processes.[31] Without sustained and strong commitment from these lower levels of the organization, entrepreneurial behavior will never be a defining characteristic of the organization, as is required by corporate entrepreneurship strategy.

Corporate entrepreneurship strategy will be hard to create and, perhaps, even harder to perpetuate in organizations. The presence of certain external environmental conditions may be sufficient to prompt an organization's leaders to explore the possibility of adopting a corporate entrepreneurship strategy. However, the commitment of individuals throughout the organization to making such a strategy work and the realization of personal and organizational entrepreneurial outcomes that reinforce this commitment will be necessary to ensure that entrepreneurial behavior becomes a defining aspect of the organization. Thus, breakdowns in any of the three elements of corporate entrepreneurship strategy or in linkages between or among these elements would undermine the viability of such strategy. Moreover, alignments must be created in evaluation and reward systems such that congruence is achieved in the entrepreneurial behaviors induced at the individual and organizational levels. Although external conditions may be increasingly conducive to the adoption of corporate entrepreneurship strategies, managers should harbor no illusions that the effective implementation of these strategies will be easily accomplished.

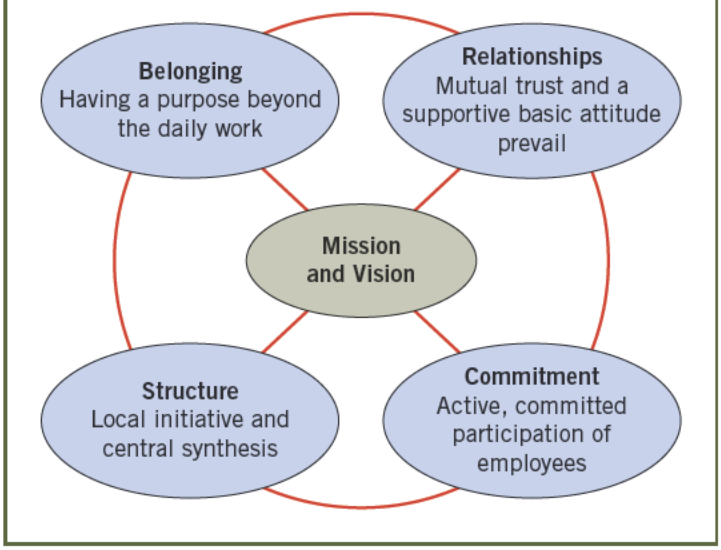
Corporations that create an entrepreneurial strategy find that the ethos of the original enterprise often changes dramatically.[32] Traditions are set aside in favor of new processes and procedures. Some people, unaccustomed to operating in this environment, will leave; others will discover a new motivational system that encourages creativity, ingenuity, risk taking, teamwork, and informal networking, all designed to increase productivity and make the organization more viable. Some people thrive in an entrepreneurial environment; others dislike it intensely.

The five critical steps of a corporate entrepreneurship strategy are (1) developing the vision, (2) encouraging innovation, (3) structuring for an entrepreneurial climate, (4) preparing individual managers for corporate innovation, and (5) developing venture teams. Each of these is now discussed in greater detail.

3-4a Developing the Vision

The first step in planning a corporate entrepreneurship strategy for the enterprise is to share the vision of innovation that the corporate leaders wish to achieve.[33] The vision must be clearly articulated by the organization's leaders; however, the specific objectives are then developed by the managers and employees of the organization. Because it is suggested that corporate entrepreneuring results from the creative talents of people within the organization, employees need to know about and understand this vision. Shared vision is a critical element for a strategy that seeks high achievement (see Figure 3.3). This shared vision requires identification of

Figure 3.3 Shared Vision



Source: Jon Arild Johannessen, "A Systematic Approach to the Problem of Rooting a Vision in the Basic Components of an Organization," *Entrepreneurship, Innovation, and Change* 3, no. 1 (March 1994): 47. Reprinted with permission from Plenum Publishing Corporation, New York.

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Table 3.3 Objectives and Programs for Venture Development

Objectives	Programs
Make sure that current systems, structures, and practices do not present insurmountable roadblocks to the flexibility and fast action needed for innovation.	Reduce unnecessary bureaucracy and encourage communication across departments and functions.
Provide the incentives and tools for intrapreneurial projects.	Use internal "venture capital" and special project budgets. (This money has been termed *intracapital* to signify a special fund for intrapreneurial projects.) Allow discretionary time for projects (bootlegging time).
Seek synergies across business areas so new opportunities are discovered in new combinations.	Encourage joint projects and ventures among divisions, departments, and companies. Allow and encourage employees to discuss and brainstorm new ideas.

Source: Adapted by permission of the publisher from Rosabeth Moss Kanter, "Supporting Innovation and Venture Development in Established Companies," *Journal of Business Venturing* 1, no. 1 (Winter 1985): 56–59. Copyright © 1985 by Elsevier Science Publishing Co., Inc.

specific objectives for corporate entrepreneuring strategies and of the programs needed to achieve those objectives. Author and researcher Rosabeth Moss Kanter has described three major objectives and their respective programs designed for venture development within companies. These are outlined in Table 3.3.

3-4b Encouraging Innovation

As will be discussed in Chapter 5, innovation is the specific tool of the entrepreneur. Therefore, corporations must understand and develop innovation as the key element in their strategy. Numerous researchers have examined the importance of innovation within the corporate environment.[34]

Innovation is described as chaotic and unplanned by some authors,[35] while other researchers insist it is a systematic discipline.[36] Both of these positions can be true, depending on the nature of the innovation. One way to understand this concept is to focus on two different types of innovation: radical and incremental.[37]

Radical innovation is the launching of inaugural breakthroughs such as social networking, mobile computing, cloud storage, online dating, and green technologies. These innovations take experimentation and determined vision, which are not necessarily managed but *must* be recognized and nurtured.

Incremental innovation refers to the systematic evolution of a product or service into newer or larger markets. Examples include microwave popcorn, popcorn used for packaging (to replace Styrofoam), frozen yogurt, and so forth. Many times, the incremental innovation will take over after a radical innovation introduces a breakthrough. The structure, marketing, financing, and formal systems of a corporation can help implement incremental innovation. It has been said that an organization, through its people, can do 1,000 things 1 percent better rather than waiting to do one thing 1,000 percent better.

Both types of innovation require vision and support. This support takes different steps for effective development (see Table 3.4). In addition, both need a champion—a person with a vision and the ability to share it.[38] Finally, both types of innovation require an effort by the top management of the corporation to develop and educate employees concerning innovation and intrapreneurship, a concept known as top-management support.[39]

Encouraging innovation requires a willingness not only to tolerate failure but also to learn from it. For example, one of the founders of 3M, Francis G. Oakie, had an idea to replace razor blades with sandpaper. He believed that men could rub sandpaper on their face rather than use a sharp razor. He was wrong, and the idea failed, but his ideas evolved until he developed a waterproof sandpaper for the auto industry, which was a blockbuster success!

Thus, 3M's philosophy was born. Innovation is a numbers game: the more ideas, the better the chances for a successful innovation. In other words, to master innovation, companies must have a tolerance for failure. This philosophy has paid off for 3M. Antistatic videotape, translucent dental braces, synthetic ligaments for knee surgery, heavy-duty reflective sheeting for construction signs, and, of course, Post-it notes are just some of the great innovations developed by the organization. Overall, the company has a catalog of 60,000 products.[40]

Today, 3M follows a set of innovative rules that encourages employees to foster ideas. The key rules include the following:

- *Don't kill a project.* If an idea can't find a home in one of 3M's divisions, a staffer can devote 15 percent of their time to prove it is workable. For those who need seed money, as many as 90 Genesis grants of $50,000 are awarded each year.
- *Tolerate failure.* Encouraging plenty of experimentation and risk taking allows more chances for a new product hit. The goal: divisions must derive

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Table 3.4 Developing and Supporting Radical and Incremental Innovation

Radical	Incremental
Stimulate through challenges and puzzles.	Set systematic goals and deadlines.
Remove budgetary and deadline constraints when possible.	Stimulate through competitive pressures.
Encourage technical education and exposure to customers.	Encourage technical education and exposure to customers.
Allow technical sharing and brainstorming sessions.	Hold weekly meetings that include key management and marketing staff.
Give personal attention—develop relationships of trust.	Delegate more responsibility.
Encourage praise from outside parties.	Set clear financial rewards for meeting goals and deadlines.
Have flexible funds for opportunities that arise.	
Reward with freedom and capital for new projects and interests.	

Source: Adapted from Harry S. Dent Jr., "Growth through New Product Development," *Small Business Reports*, November 1990, 36.

25 percent of sales from products introduced in the past five years. The target may be boosted to 30 percent in some cases.

- *Keep divisions small.* Division managers must know each staffer's first name. When a division gets too big, perhaps reaching $250 million to $300 million in sales, it is split up.
- *Motivate the champions.* When a 3M employee has a product idea, they recruit an action team to develop it. Salaries and promotions are tied into the product's progress. The champion has a chance to someday run their own product group or division.
- *Stay close to the customer.* Researchers, marketers, and managers visit with customers and routinely invite them to help brainstorm product ideas.
- *Share the wealth.* Technology, wherever it is developed, belongs to everyone.[41]

3-4c Structuring the Work Environment

When establishing the drive to innovate in today's corporations, one of the most critical steps is to invest heavily in an innovative environment. A top-level manager's job is to create a work environment that is highly conducive to innovation and entrepreneurial behaviors. Within such an environment, each employee has the opportunity to "step up to the plate." The willingness and ability to act on one's innate entrepreneurial potential is based on a calculated assessment. Conditions in the internal work environment dictate the perceived costs and benefits associated with taking personal risks, challenging current practices, devoting time to unproven approaches, persevering in the face of organizational resistance, and enduring the ambiguity and stress that entrepreneurial behavior can create. Therefore, credible innovation is more likely in companies where all individuals' entrepreneurial potential is sought and nurtured and where organizational knowledge is widely shared. The managerial challenge becomes that of using workplace design elements to develop an "innovation-friendly" internal environment.

This concept, when coupled with the other elements of an innovation strategy, can enhance the potential for employees to become venture developers. To develop employees as a source of innovations, companies need to provide more nurturing and information-sharing activities.[42] In addition, they need to develop an environment that will help innovative-minded people reach their full potential. Employee perception of an innovative environment is critical for stressing the importance of management's commitment not only to the organization's people but also to the innovative projects.

A firm's internal entrepreneurial climate should be assessed to evaluate in what manner it is supportive for entrepreneurial behavior to exist and how that is perceived by the managers. When attempting to inventory the firm's current situation regarding the readiness for innovation, managers need to identify parts of the firm's structure, control systems, human resource management systems, and culture that inhibit and parts that facilitate entrepreneurial behavior as the foundation for successfully implementing corporate innovation.

One example of an assessment instrument that can be used is the Corporate Entrepreneurship Assessment Instrument (CEAI), which was developed by researchers Donald F. Kuratko and Jeffrey S. Hornsby to provide for a psychometrically sound measurement of key entrepreneurial climate factors.[43] The responses to the CEAI were

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statistically analyzed and resulted in five identified factors. These five factors are critical to the internal environment of an organization seeking to have its managers pursue innovative activity. It is important to understand these factors in order to assess the organization's readiness for corporate entrepreneurial activity. Each of the factors discussed next are aspects of the organization over which management has some control. Each is briefly defined and includes illustrations of specific elements of a firm's environment relative to each dimension.

Management Support

This is the extent to which the management structure itself encourages employees to believe that innovation is, in fact, part of the role set for all organization members. Some of the specific conditions that reflect management support include quick adoption of employee ideas, recognition of people who bring ideas forward, support for small experimental projects, and seed money to get projects off the ground.

Autonomy and Work Discretion

Workers have discretion to the extent that they are able to make decisions about performing their own work in the way they believe is most effective. Organizations should allow employees to make decisions about their work process and should avoid criticizing them for making mistakes when innovating.

Rewards and Reinforcement

Rewards and reinforcement enhance the motivation of individuals to engage in innovative behavior. Organizations must be characterized by providing rewards contingent on performance, providing challenges, increasing responsibilities, and making the ideas of innovative people known to others in the organizational hierarchy.

Time Availability

The fostering of new and innovative ideas requires that individuals have time to incubate ideas. Organizations must moderate the workload of people, avoid putting time constraints on all aspects of a person's job, and allow people to work with others on long-term problem solving.

Organizational Boundaries

These boundaries, real and imagined, prevent people from looking at problems outside their own jobs. People must be encouraged to look at the organization from a broad perspective. Organizations should avoid having standard operating procedures for all major parts of jobs and should reduce dependence on narrow job descriptions and rigid performance standards.[44]

The statistical results from the CEAI demonstrated support for this underlying set of internal environmental factors that organizations need to focus on when seeking to introduce an innovative strategy.[45] These factors, as well as the previous research mentioned, are the foundation for the critical steps involved in introducing a corporate entrepreneurial climate.

An instrument like the CEAI can be used to develop a profile of a firm across the five internal climate dimensions mentioned above. Low scores in one specific dimension of the CEAI suggest the need to focus on that particular dimension for improvement in order to enhance the firm's readiness for entrepreneurial behavior and eventually successful corporate innovation. This can significantly benefit organizations, as it provides an indication of a firm's likelihood of being able to successfully use a corporate innovation process. It highlights the specific dimensions of the internal work environment that should be the focus of ongoing design and development efforts. Further, the CEAI can be used as an assessment tool for evaluating corporate training needs with respect to entrepreneurship and innovation. Determining these training needs sets the stage for improving managers' skills and increasing their sensitivity to the challenges of eliciting and then supporting entrepreneurial behavior.

Another researcher, Vijay Sathe, has suggested a number of areas on which corporations must focus if they are going to facilitate corporate entrepreneurial behavior. The first is to encourage, not mandate, innovative activity. Managers should use financial rewards and strong company recognition rather than rules or strict procedures to encourage corporate entrepreneurship. This is actually a stronger internal control and direction method than traditional parameters.

Another area of focus is the proper control of human resource policies. Managers need to remain in positions long enough to allow them to learn an industry and a particular division. Rather than move managers around in positions, as is the case in many companies, Sathe suggests "selected rotation," in which managers are exposed to different but related territories. This helps managers gain sufficient knowledge for innovation development.

A third factor is for management to sustain a commitment to innovative projects long enough for momentum to occur. Failures will inevitably occur, and learning must be the key aftermath of those failures. Thus, sustained commitment is an important element in managing corporate entrepreneurship.

A final element suggested by Sathe is to bet on people, not on analysis. Although analysis is always important to judge a project's progression, it should be done in a supportive rather than an imposed style. The supportive challenge can help innovators realize errors, test their convictions, and accomplish a self-analysis.[46]

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Table 3.5 The Corporate Innovator's Commandments

1. Come to work each day willing to give up your job for the innovation.
2. Circumvent any bureaucratic orders aimed at stopping your innovation.
3. Ignore your job description—do any job needed to make your innovation work.
4. Build a spirited innovation team that has the "fire" to make it happen.
5. Keep your innovation "underground" until it is prepared for demonstration to the corporate management.
6. Find a key upper-level manager who believes in you and your ideas and who will serve as a sponsor to your innovation.
7. Permission is rarely granted in organizations; thus, always seek forgiveness for the "ignorance" of the rules that you will display.
8. Always be realistic about the ways to achieve the innovation goals.
9. Share the glory of the accomplishments with everyone on the team.

It should be mentioned that the exact rewards for corporate entrepreneuring are not yet agreed on by most researchers.[47] Some believe that allowing the inventor to take charge of the new venture is the best reward. Others say that it is allowing the corporate entrepreneur more discretionary time to work on future projects. Still others insist that special capital, called intracapital, should be set aside for the corporate entrepreneur to use whenever investment money is needed for further research ideas.

In light of these climate elements, it is clear that change in the corporate structure is inevitable if innovative activity is going to exist and prosper. The change process consists of a series of emerging constructions of people, corporate goals, and existing needs. In short, the organization can encourage innovation by relinquishing controls and changing the traditional bureaucratic structure. (See Table 3.5 for the Corporate Innovator's Commandments.)

Managers and employees across a firm are most likely to engage in entrepreneurial behavior when the organizational dimensions to that behavior are well perceived, widely known, and universally accepted. Individuals assess their entrepreneurial capacities in reference to what they perceive to be is a set of organizational resources, opportunities, and obstacles related to entrepreneurial activity. Once it is determined that the value of an environment encouraging entrepreneurial behavior exceeds that of all other organizational behaviors, managers will continuously champion, facilitate, and nurture that innovation-friendly environment.

3-4d Control versus Autonomy

As we have shown, employees engaging in entrepreneurial behavior are the foundation for organizational innovation, so in order to develop "corporate innovation," organizations must establish a process through which individuals in an established firm pursue entrepreneurial opportunities to innovate without regard to the level and nature of currently available resources. However, keep in mind that, in the absence of proper control mechanisms, firms that manifest corporate innovative activity may "tend to generate an incoherent mass of interesting but unrelated opportunities that may have profit potential, but that don't move [those] firms toward a desirable future."[48] Therefore, those factors that drive corporate entrepreneurial activity to produce high levels of innovation performance are likely contingent on a firm's ability to judiciously use control mechanisms for the proper selection and effective guidance on entrepreneurial actions and initiatives.[49]

Examining 145 internal corporate ventures in 72 different corporations, researchers Jeffrey G. Covin, Robert P. Garrett, Donald F. Kuratko, and Dean A. Shepherd found that the greatest learning proficiency for a corporate venture is when the corporate parent organization gives it a "leash length"—indicated by observed levels of top-management support and operational decision-making autonomy. This indicates that while some controls are necessary, the need for support and decision-making authority in the everyday operations of the corporate venture is critical for success.[50]

Although some consultants emphasize the need to "unleash the entrepreneurial hostages" in organizations simply by removing constraints on behavior, it is clear that, in doing so, they may be ignoring opportunities better to align innovations with organizational interests, which results from encouraging, directing, restricting, and prohibiting behaviors and initiatives. Not all corporate entrepreneurial behavior is good for the organization. Yet the literature in the corporate innovation area tends to implicitly regard such behavior as inherently virtuous. This is an

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unfortunate and potentially dangerous bias. As noted by researchers Donald F. Kuratko and Michael G. Goldsby, the encouragement of corporate entrepreneurship can and often does result in counterproductive, rogue behavior by organizational members.[51] Thus, the deliberate design and development of organizational systems reflecting the organizational dimensions for an environment conducive to corporate innovation is critical. As such, the senior manager's task is not simply to build an organization whose core qualities are conducive to innovation but rather to design and develop innovation-facilitating and control-facilitating mechanisms that complement one another such that the innovative potential that resides within the organization is leveraged for the highest and best organizational purposes.

The exhibition of certain controls is not antithetical to the interests of corporate innovation but rather inherent to those interests. As such, observations to the effect that control is the enemy of successful innovation are naive. Managers should understand that innovation is a process amenable to the application of structured, disciplined oversight. The successful pursuit of innovation demands that managers approach innovation challenges with the understanding that the means by which potentially desirable outcomes might be generated can be well understood and deliberately constructed. There are rules, methods, and general process knowledge that can be brought to bear in the facilitation of successful innovation efforts. As such, it's often not the absence of rules and well-understood procedures that results in successful innovation but rather their presence. Managers are well advised to recognize this reality.

3-4e Preparation for Failure

The idea of "learning from failure" is axiomatic in the corporate entrepreneurial community. Researcher Adam Grant refers to the art of rethinking. He states, "If you can master the art of rethinking, I believe you will be better positioned for success at work and happiness in life. Thinking again can help you generate new solutions to old problems and revisit old solutions to new problems." However, dealing with failure on a personal level is something that has not been, until recently, fully examined. Researchers Dean A. Shepherd, Jeffrey G. Covin, and Donald F. Kuratko have written about the importance of managing grief that results from project failure. Grief, which triggers behavioral, psychological, and physiological symptoms, is a negative emotional response to the loss of something important. Managing grief, therefore, represents a particularly salient task in the context of corporate entrepreneurship practice because the amount of commitment essential to project success is often matched by corresponding levels of grief when projects fail.

Organizational routines and rituals are likely to influence the grief recovery of those involved in failed projects. To the extent that an organization's social support systems can effectively channel negative emotions, greater learning and motivational outcomes from project failures are certainly possible. The inevitability of project failure tests social support mechanisms and failure-related coping skills of corporate managers, giving dedicated innovation units with adequate social supports for dealing with grief an operational edge that also strengthens coping self-efficacy of individuals.

3-4f Developing Management

LO3.7 Explain the methods of developing managers for corporate entrepreneurship

Executive leaders must create an understanding of the innovation process for their employees. Having assessed if the firm's internal work environment supports innovative activity, senior managers should also determine if corporate innovation and entrepreneurial behavior are understood by the firms' employees. Key decision makers must find ways to explain the purpose of using a corporate innovation process to those from whom entrepreneurial behaviors are expected.

Understanding and supporting a corporate innovation process should not be left to chance. Experience demonstrates that executives need to develop a program with the purpose of helping all parties who will be affected by corporate innovation to understand the value of the entrepreneurial behavior that the firm is requesting of them as the foundation for a successful innovation.

As a way for organizations to develop that understanding for innovation and entrepreneurial activity, a corporate entrepreneurship/innovation training program often induces the change needed in the work atmosphere. It is not our intent to elaborate completely on the content of a training program here, but a brief summary of an actual program is presented to provide a general understanding of how such a program is designed to introduce an entrepreneurial environment in a company. This award-winning training program is intended to create an awareness of entrepreneurial opportunities in organizations. The Corporate Innovation Training Program consists of six modules, each designed to train participants to support corporate innovations in their own work area.[52] The modules and a brief summary of their contents are as follows:

1. *The entrepreneurial experience*. An enthusiastic overview of the entrepreneurial experience, in which participants are introduced to the entrepreneurial revolution that has taken place throughout the world over the past three decades. Participants are challenged to think innovatively and recognize the need for breaking out of the old paradigms in today's organizations.
2. *Innovative thinking*. The process of thinking innovatively is foreign to most traditional organizations. The misconceptions about thinking innovatively

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are reviewed, and a discussion of the most common inhibitors is presented. After completing an innovation inventory, managers engage in several exercises designed to facilitate their own innovative thinking.

3. *Idea acceleration process*. Managers generate a set of specific ideas on which they would like to work. The process includes examining a number of aspects of the corporation, including structural barriers and facilitators. Additionally, managers determine resources needed to accomplish their projects.
4. *Barriers and facilitators to innovative thinking*. The most common barriers to innovative behavior are reviewed and discussed. Managers complete several exercises that will help them deal with barriers in the workplace. In addition, video case histories are shown that depict actual corporate innovators that have been successful in dealing with corporate barriers.
5. *Sustaining innovation teams*. The concept of forming innovation teams (I-teams) to focus on specific innovations is examined. Managers work together to form teams based on the ideas that have been circulating among the entire group. Team dynamics are reviewed for each group to understand.
6. *The innovation action plan*. After managers examine several aspects of facilitators and barriers to behaving innovatively in their organization, teams are asked to begin the process of completing an action plan. The plan includes setting goals, establishing an I-team, assessing current conditions, developing a step-by-step timetable for project completion, and project evaluation.

This type of program should be ongoing in nature. As new innovative opportunities surface in a firm's external environment, as the internal work environment changes,

The Entrepreneurial Process

Internal Innovators

Emphasizing that the success of corporate innovators is due to their dedication to pursuing a new, outside-the-box idea that benefits their employers, we look at a few young managers who adopted an entrepreneurial attitude and creative problem solving to rise through their organization's hierarchy.

Matthew Zubiller, a corporate strategist at pharmaceutical company McKesson Corporation who started a high-tech health care business in an atmosphere unaccustomed to internal start-ups. Using the company's health care information technology unit as a starting point, Zubiller developed Advanced Diagnostics Management, a unit centered on a high-tech tool for physicians related to genetic testing. He likely had to overcome a number of traditional management practices in this large bureaucratic company, which was unaccustomed to internal innovation, with responses such as "It's not in our budget" or "That's a weird idea." To achieve internal support, he created a "shadow board" of company executives who advised the venture creation and helped secure $5 million in support. As a result of his efforts, Zubiller was promoted to vice president.

Kori Reed, a public relations manager at ConAgra and an expert in child hunger. Reed recognized that ConAgra could benefit by linking its products to initiatives to fight child hunger. She used her existing knowledge of antihunger campaigns and interest in combating childhood hunger to identify an opportunity. She noted the incongruity between working for a food products company, overflowing with food abundance, and starving and undernourished children. She brought executives into an advisory committee and made antihunger language a cornerstone of the company's marketing campaign. Reed convinced senior executives that the organization needed a vice president of this cause, to which she was then promoted.

Pam Rogers Klyn, a product development manager at Whirlpool Corporation who focused on cost control efforts. Rather than having a "special committee" team dedicated to cutting costs, she advocated for a company-wide emphasis on cost savings, stressing small efforts like turning off lights and tying annual bonuses to cost goals. In developing and implementing this idea, she worked closely with her CEO and gave him a lot of credit. By linking cost savings requirements to yearly bonuses, Whirlpool's North American division was able to save over $850 million in one year.

One clear commonality among these individuals is their effort to gain senior leadership buy-in and involvement. In each case, they worked with a select few, picking individuals who could see the bigger picture while being excited about a small, focused effort. A successful corporate entrepreneurship program needs the executive support that can help build the new venture from the inside. Corporate bureaucracies usually require a champion for any change. Getting permission is always the most challenging part of any new idea, but having a champion means having some help moving the process along. It always takes individuals who are self-starters with a strong drive to achieve and an opportunity orientation.

Source: Adapted from Joann S. Lublin, "Finding Their Way to the Fast Track," *Wall Street Journal*, January 19, 2012, and Donald F. Kuratko, Michael G. Goldsby, and Jeffrey S. Hornsby, *Innovation Acceleration: Transforming Organizational Thinking* (Upper Saddle River, NJ: Pearson/Prentice Hall, 2012).

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and as new employees join the organization, it is appropriate for those from whom entrepreneurial behavior is expected to work together to find the best ways to proceed to implement a corporate innovation process. In this sense, efforts to successfully engage in corporate innovation must themselves be innovative—changing in response to ever-changing conditions in the firm's internal and external environments.

3-4g Developing I-Teams

I-teams and the potential they hold for producing innovative results are recognized as a twenty-first-century productivity breakthrough. Certainly, no one doubts that their popularity is on the rise. Companies that have committed to an I-team approach often label the change they have undergone a "transformation" or "revolution." This modern breed of work team is a new strategy for many firms. It is referred to as self-directing, self-managing, or high performing, although in reality, an I-team fits all of those descriptions.[53]

In examining the entrepreneurial development of corporations, Robert Reich found that entrepreneurial thinking is not the sole province of the company's founder or its top managers. Rather, it is diffused throughout the company, where experimentation and development occur all the time as the company searches for new ways to build on knowledge already accumulated by its workers. Reich defines **collective entrepreneurship** as follows:

> In collective entrepreneurship, individual skills are integrated into a group; this collective capacity to innovate becomes something greater than the sum of its parts. Over time, as group members work through various problems and approaches, they learn about each other's abilities. They learn how they can help one another perform better, what each can contribute to a particular project, how they can best take advantage of one another's experience. Each participant is constantly on the lookout for small adjustments that will speed and smooth the evolution of the whole. The net result of many such small-scale adaptations, effected throughout the organization, is to propel the enterprise forward.[54]

In keeping with Reich's focus on collective entrepreneurship, I-teams offer corporations the opportunity to use the talents of individuals without losing a sense of teamwork.

An I-team is composed of two or more people who formally create and share ownership of a new organization.[55] The unit is semiautonomous in the sense that it has its own budget as well as a leader with the freedom to make decisions within broad guidelines. Sometimes the leader is called an "innovation champion" or a "corporate entrepreneur." The unit often is separated from other parts of the firm—in particular, from parts involved with daily activities. This prevents the unit from engaging in procedures that can stifle innovative activities. If the innovation proves successful, however, it eventually is treated the same as other outputs the organization produces. It is then integrated into the larger organization.[56]

In many ways, an I-team is a small business operating within a large business, and its strength is its focus on design issues (i.e., on structure and process) for innovative activities.

Specific entrepreneurial strategies vary from firm to firm. However, they all follow similar patterns of seeking a proactive change of the status quo and a new, flexible approach to operations management.

3-5 Sustaining a Corporate Entrepreneurship Strategy

While entrepreneurial actions are a phenomenon that have captivated the interest of executives in many corporate boardrooms, there is a danger that managers can get too caught up in the excitement of the concept of innovation or inspiring stories of individual corporate innovators. It is easy to become enamored with the idea of innovation, but the true value of innovation lies in the extent to which executive leaders are committed to making it a part of the overall corporate strategy to create sustainable competitive advantage.

It is well documented in the conceptual literature that managers at all structural levels have critical strategic roles to fulfill for the organization to be successful. Senior-, middle-, and first-level managers possess distinct responsibilities with respect to each subprocess. *Senior-level managers* have ratifying, recognizing, and directing roles that in turn are associated with particular managerial actions.[57] Researchers Donald F. Kuratko, R. Duane Ireland, Jeffrey G. Covin, and Jeffrey S. Hornsby contend that *middle-level managers* endorse, refine, and shepherd entrepreneurial opportunities and identify, acquire, and deploy resources needed to pursue those opportunities. *First-level managers* have experimenting roles that correspond to the competence definition subprocess, adjusting roles that correspond to the competence modification subprocess, and conforming roles that correspond to the competence deployment subprocess.

Thus, organizations that pursue corporate entrepreneurship strategies likely exhibit a cascading yet integrated set of entrepreneurial actions at the senior, middle, and first levels of management.

At the senior level, managers act in concert with others throughout the firm to identify effective means through which new businesses can be created or existing

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ones reconfigured. Corporate entrepreneurship is pursued in light of environmental opportunities and threats with the purpose of creating a more effective alignment between the company and conditions in its external environment. The entrepreneurial actions expected of middle-level managers are framed around the need for this group to propose and interpret entrepreneurial opportunities that might create new business for the firm or increase the firm's competitiveness in current business domains. First-line managers exhibit the "experimenting" role as they unearth the operational ideas for innovative improvements. An important interpretation of previous research has been the belief that managers would surface ideas for entrepreneurial actions from every level of management, particularly the first-line and middle levels. Therefore, managers across levels are jointly responsible for their organization's entrepreneurial actions.[58]

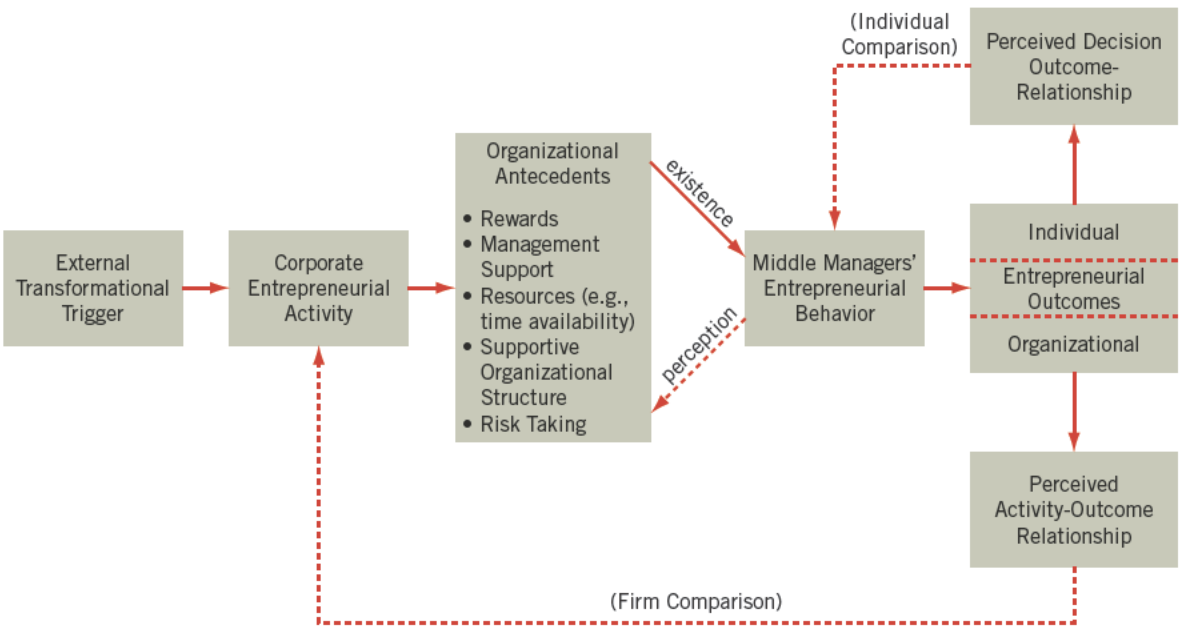
LO3.8 Illustrate the interactive process of corporate entrepreneurship

An organization's sustained effort in corporate entrepreneurship is contingent on individual members continuing to undertake innovative activities and on positive perceptions of the activity by the organization's executive management, which will in turn support the further allocation of necessary organizational antecedents. Figure 3.4 illustrates the importance of perceived implementation/output relationships at the organizational and individual levels for sustaining corporate entrepreneurship.[59]

The first part of the model is based on theoretical foundations from previous strategy and entrepreneurship research. The second part of the model considers the comparisons made at the individual and organizational levels on organizational outcomes, both perceived and real, that influence the continuation of the entrepreneurial activity.

The model demonstrates that a transformational trigger (something external or internal to the company that causes a change to take place) initiates the need for strategic adaptation or change. One such change that can be chosen is corporate entrepreneurial activity. Based on this choice of strategic direction, the proposed model centers around the individual's decision to behave entrepreneurially. Sustained entrepreneurial activity is the result of the perception of the existence of several organizational antecedents, such as top-management support, autonomy, rewards, resources, and flexible organizational boundaries. The outcomes realized from this entrepreneurial activity are then compared at both the individual and the organizational level

Figure 3.4 A Model of Sustained Corporate Entrepreneurship



Source: Donald F. Kuratko, Jeffrey S. Hornsby, and Michael G. Goldsby, "Sustaining Corporate Entrepreneurship: Modeling Perceived Implementation and Outcome Comparisons at Organizational and Individual Levels," *International Journal of Entrepreneurship and Innovation* 5, no. 2 (May 2004): 79.

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to previous expectations. Thus, corporate entrepreneurial activities are a result of an equity perception by both the individual and the organization. Both must be satisfied with the outcomes for the entrepreneurial activities to continue from the organizational perspective as well as the individual perspective. Satisfaction with performance outcomes serves as a feedback mechanism for either sustaining the current strategy or selecting an alternative one. Individuals, as agents of the strategic change, must also be satisfied with the intrinsic and extrinsic outcomes they receive for their entrepreneurial behavior. While it may be a "chicken-and-egg" question as to whether individual behavior or organizational strategy should change first, the model suggests that—for a major strategic change—both are instrumental in making the change successful.

Diversity in Entrepreneurship

Diversity in Color Does Not Equal Diversity in Thought

The challenges of the COVID-19 pandemic, combined with the social upheaval of the 2020 protests, brought the importance of diversity, equity, and inclusion (DEI) to the forefront and prompted many companies to take more aggressive actions. We are seeing companies starting to add new office locations as a way to recruit ethnically diverse talent. Atlanta, in particular, has drawn a number of boldfaced names, including Microsoft and Google, which are investing $75 million and $25 million, respectively, into new work facilities. Not only is Atlanta the birthplace of Martin Luther King Jr. and home to 16 Fortune 500 companies, including Coca-Cola and Home Depot, but it also has half a dozen historically Black colleges and universities and a city population that is 51 percent Black. In contrast, only 2 percent of Silicon Valley is Black. These colleges and universities are especially important for companies seeking to diversify their talent because they graduate 40 percent of Black STEM graduates in science, technology, engineering, and mathematics even though they educate just 3 percent of college students.

For Airbnb, which is setting up a technical hub with several hundred employees in Atlanta this year, the location is "an opportunity to make manifest our commitment around diversity," according to Airbnb's North America public policy director Laphonza Butler. Airbnb pledged to have 20 percent of U.S. employees from underrepresented groups by 2025, so they needed to "consider places that looked very different to get the results we needed," explained Butler. Asset management company BlackRock opened an Atlanta office in 2018. They claim that the move has paid dividends, as 26 percent of their 340 Atlanta-based employees are Black, while 11 percent are Latino. In contrast, the company's overall American workforce is 5 percent Black and 6 percent Latino. "Demographics and available talent definitely played a part in our decision," said Toretha McGuire, BlackRock's global head of talent acquisition, about the move to Atlanta.

DEI is indeed a long overdue topic right now, but it begs a question whether these companies are focusing too much on meeting their "diversity numbers." In response to the demand for more diverse hiring practices, some companies have resorted to quotas that ultimately miss the point. Is their view of what diversity means too narrow? In the world dominated by straight White males, a Korean lesbian woman would certainly tick many boxes. Seeing people from all walks of life, genders, age-groups, belief systems, races, and personal identifications is a good start toward creating diverse teams. However, just because a person looks and speaks differently does not mean that they think differently too—and therein lies the problem. Until a company starts to hire individuals with different perspectives, it will fail to meet the needs of a truly diverse group of people and will continue to develop products with one specific user in mind. This happens because that same user archetype is the person designing the product. Having everyone in the room agreeing might be pleasant, but it exposes a company to blind spots because everyone thinks the same way. With competitive environments intensifying, missing out on an opportunity because a team failed to see it is not a good thing.

What is even worse is that many companies with these recruitment practices struggle to maintain racially diverse workforces. When there are only a handful of employees from underrepresented groups, it is hard to not treat them like tokens, and it can be challenging for these employees to feel like they truly belong. Instead of focusing on numbers, companies should focus on their culture and mission. They need to bake diversity into the fabric of the company to foster balanced cultural understanding and expose employees to an inclusive workplace. Every single perspective is valuable because it allows companies to see their products through different sets of eyes. The diversity in teams is a superpower—no other business can exactly replicate the dynamic that generates the company's success. For DEI to be effective organizations should be forming teams that agree on values but differ on perspectives just enough to spark a much better solution—one that perhaps would not have happened without the debate.

Source: Adapted from Te-Ping Chen, "The New Push for Corporate Diversity Comes with an Atlanta Address," *Wall Street Journal*, March 20, 2021; Victoria Maitland "If You Only Hire Like-Minded People, You Will Fail," *Entrepreneur*, December 2021; and Jori Ford, "Most Tech Companies Are Going About Diversity All Wrong," *Entrepreneur*, July 2018.

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The Entrepreneurial Process

Corporate Innovation Initiatives in Top Tech Companies

Google

Googleplex is Google's famously innovative corporate headquarters

- Think 10X is similar to the idea represented by X's goal to improve current solutions 10-fold.
- The 70/20/10 system is a principle for everyone to spend 70 percent of their time on their core job, 20 percent on expanding adjacent business, and 10 percent on something creative.

X-Lab is Alphabet's secretive innovation incubator developing Google's "moonshots" and riskier projects

- Current projects include Google Glass, Makani, and FSOC (free-space optical communication).
- Graduated projects include Waymo, Loon, and Wing (similar to Amazon Prime Air).

Amazon

Amazon Lab126 is Amazon's innovation incubator for the research and development of high-profile consumer electronics devices.

- Developed Amazon's Kindle e-readers and tablets
- Recently released Amazon Echo, Echo Dot, and Amazon Tap

Adobe

Adobe Labs provides customers the opportunity to experience and evaluate new and emerging innovations, tech, and products from Adobe.

- Adobe Kickbox is a new innovation process that Adobe created to drive innovation within Adobe.
- Adobe open-sourced the program for all companies to use.

Summary

Corporate entrepreneurship is the process of profitably creating innovation within an organizational setting. Most companies are realizing the need for corporate entrepreneurship as a response to (1) the rapidly growing number of new, sophisticated competitors; (2) a sense of distrust in the traditional methods of corporate management; and (3) an exodus of some of the best and brightest people from corporations to become small-business entrepreneurs.

To create the right climate for in-house entrepreneurship, companies must develop the following five characteristics: (1) explicit goals, (2) a system of feedback and positive reinforcement, (3) an emphasis on individual responsibility, (4) rewards based on results, and (5) do not punish failures. Organizations create corporate entrepreneurship in a number of ways. The first step is to understand the obstacles to corporate venturing; these usually are based on the adverse impact of traditional management techniques. The next step is to adopt innovative principles that include atmosphere and vision, multiple approaches, interactive learning, and Skunk Works.

Specific strategies for corporate entrepreneurship entail the development of both vision and innovation. Two types of innovation exist: radical and incremental. To facilitate the development of innovation, corporations need to focus on the key factors of top-management support, time, resources, and rewards. Thus, commitment to and support of innovative activity are critical.

I-teams are the semiautonomous units that have the collective capacity to develop new ideas. Sometimes referred to as self-managing or high-performance teams, I-teams are emerging as the new breed of work teams formed to strengthen innovative developments.

At the end of this chapter, we discussed the process of corporate entrepreneurship by examining the role of middle managers in corporate entrepreneurial activity and the concept of sustained corporate entrepreneurship.

Key Terms

bootlegging
champion
collective entrepreneurship
corporate entrepreneurship
Corporate Entrepreneurship Assessment Instrument (CEAI)
corporate venturing
incremental innovation
innovation team (I-team)
interactive learning
intracapital
intrapreneurship
radical innovation
Skunk Works
strategic entrepreneurship
top-management support

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Review and Discussion Questions

1. In your own words, what is corporate entrepreneurship?
2. What are two reasons that such a strong desire to develop corporate entrepreneurs has arisen in recent years?
3. What are some of the corporate obstacles that must be overcome to establish a corporate entrepreneurial environment?
4. What are some of the innovative principles identified by James Brian Quinn that companies need to establish?
5. A number of corporations today are working to reengineer corporate thinking and encourage an innovative environment. What types of steps would you recommend? Offer at least three and explain each.
6. What are five useful rules for innovation?
7. What are three advantages of developing a corporate entrepreneurial philosophy?
8. Identify the four key elements on which managers should concentrate to develop a corporate entrepreneurship strategy.
9. Explain the differences between radical and incremental innovation.
10. Identify the five specific entrepreneurial climate factors that organizations need to address in structuring their environment.
11. Why are innovation teams emerging as part of a new strategy for many corporations?
12. What are the roles of middle managers in corporate entrepreneurship? Be specific.
13. Describe the elements that are involved in sustaining corporate entrepreneurship.

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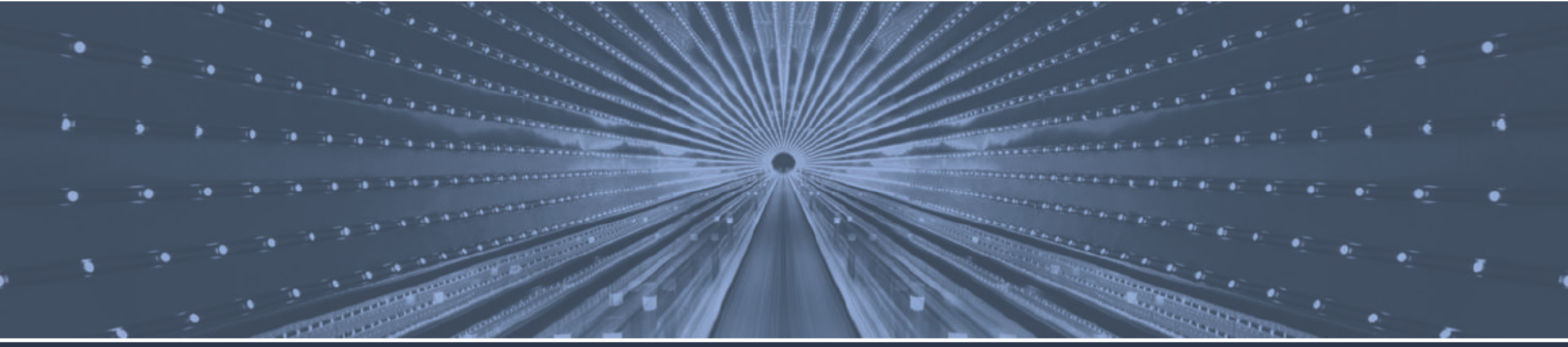
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Chapter 4

The Global Entrepreneurial Mindset: Social Entrepreneurship

Learning Objectives

4.1. Describe the social entrepreneurship movement

4.2. Summarize common characteristics displayed by social entrepreneurs

4.3. Discuss the challenges of social enterprise

4.4. Explain the concept of *shared value*

4.5. Explain the value of benefit corporations

4.6. Explore the challenges of poverty and the liability of newness

4.7. Describe the global opportunities and challenges for social entrepreneurs

4.8. Summarize the newest developments that have expanded the global marketplace

4.9. Explain the methods of entering the international arena

4.10. Outline the key steps for entrepreneurs seeking global markets

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Entrepreneurial Thought

No generation has had the opportunity, as we have now, to build a global economy that leaves no one behind. It is a wonderful opportunity, but also a profound responsibility.

—**Bill Clinton, *42nd President of the United States***

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4-1 Social Entrepreneurship

LO4.1 Describe the social entrepreneurship movement

Social entrepreneurship is a form of entrepreneurship that exhibits characteristics of nonprofits, governments, and businesses, combining a private-sector focus on innovation, risk taking, and large-scale transformation with social problem solving. The social entrepreneurship process begins with a perceived social opportunity translated into an enterprise concept; resources are then ascertained and acquired to execute the enterprise's goals.[1] In recent years, social entrepreneurship has taken many forms. For example, the Schwab Foundation for Social Entrepreneurship has supported the world's leading social entrepreneurs in their efforts to create a more just, equitable, and sustainable world. They have supported 400 social entrepreneurs, along with social intrapreneurs in the public and private sectors, and thought leaders continue to be engaged in the foundation's activities. Some of the more recent social entrepreneurs in 2022 include the following:

- Eleanor Allen is the CEO of Water for People, which is a global nonprofit working in nine countries in Africa, Latin America, and India to help develop sustainable water and sanitation services. It is recognized as an innovative leader in the water, sanitation, and hygiene sector through its innovative approach to development, which brings together local entrepreneurs, technology, governments, and communities to create quality, reliable, and lasting systems and services.
- Simon Bakker is founder of Kennemer, an Asian agribusiness specializing in the sustainable growing and sourcing of cacao beans and is the Philippines' leading supplier to the international market. Starting with 200 farmers in 2012, Kennemer engaged more than 17,000 farmers and planted over 19 million cacao trees in 2022. With its inclusive business model, the company provides end-to-end support to smallholder farmers, including inputs, technical assistance, a guaranteed market, and long-term agri-financing through its finance company Agronomika.
- K. Day is the cofounder and president of World Bicycle Relief. Working in partnership with nongovernmental organizations (NGOs), corporations, and government agencies, World Bicycle Relief executes bicycle programs that empower recipients to overcome the barriers of distance to health care, education, and economic development. World Bicycle Relief employs over 100 people in the United States and Africa and runs or supports six bicycle assembly facilities in Angola, Kenya, Malawi, South Africa, Zambia, and Zimbabwe. As of 2022, well over 225,000 specially designed, locally assembled bicycles had been distributed, and over 1,000 field mechanics have been trained.
- Jean-Daniel Muller is the cofounder of Siel Bleu. This association aims to improve and maintain the health and well-being of vulnerable people by using adapted physical activities to increase participants' autonomy, independence, and social inclusion. Among the beneficiaries of these activities are seniors in elder care homes, young seniors, and people and children with illnesses or disabilities. The association's main goal is to make activities affordable because health should not be considered a luxury good. To achieve this goal, Siel Bleu continues to excel with its economic model through innovative partnerships and funding initiatives. In 2022, there were 600 employees providing these activities throughout France and for more than 120,000 people each week. This model has been duplicated in Belgium, Ireland, and Spain, where 150 employees work for the well-being of vulnerable people.
- David Auerbach, Lindsay Stradley, and Ani Vallabhaneni cofounded a Kenya-based social enterprise, Sanergy, which offers a systems-based solution that addresses the societal grand challenge of water and sanitation. Sanergy is at the root of a responsible innovation: a franchising system of low-cost, high-quality toilets—Fresh Life Toilets—deployed in the urban slums of Nairobi with involvement from Nairobi NGOs and marginalized citizens on how these toilets can be best used and who should get them. In 2011, Sanergy opened the first Fresh Life-Toilet in Mukuru Kwa Njenga slum. By 2022, Sanergy had over 400 employees, 60 percent of whom live in the communities they serve.
- Tracey Chambers is the cofounder and chief operating officer of The Clothing Bank (TCB). TCB's mission is to create income-generating opportunities for unemployed South Africans so that they can eradicate poverty in their lives. It achieves this by helping the unemployed become self-employed by starting businesses. TCB develops strategic partnerships with most of South Africa's retailers, who donate all of their excess (customer returns and end-of-season or bulk merchandise) to this project. The product is then used as a tool to teach unemployed mothers how to start small retail trading businesses. Mothers are recruited and enrolled in a comprehensive two-year holistic program that enables them to learn business and life skills so that they can run a sustainable business within two weeks of joining the program, trading in the clothing purchased from

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TCB with the aim to earn at least $330 per month. By 2022, TCB had an annual growth of over 700 women, pioneering a number of micro and social franchises in the education sector.[2]

- For the past decade, the World Economic Forum, which annually brings together business, government, and national leaders who are "committed to improving the state of the world," has hosted the Social Entrepreneurs' Summit. In partnership with the Schwab Foundation, the forum convenes social entrepreneurs as one of its special-interest communities, placing social entrepreneurship on par with only nine other interest groups, including global growth companies, international media, and labor leaders.[3]

Definitions of social entrepreneurship, likewise, have taken many forms,[4] but one that resonates with many scholars and practitioners was developed by researchers Johanna Mair and Ignasi Marti. They "view social entrepreneurship as a process of creating value by combining resources in new ways. . . . These resource combinations are intended primarily to explore and exploit opportunities to create social value by stimulating social change or meeting social needs. . . . When viewed as a process, social entrepreneurship involves the offering of services and products but can also refer to the creation of new organizations. Importantly, social entrepreneurship . . . can occur equally well in a new organization or in an established organization, where it may be labeled 'social intrapreneurship.' Like intrapreneurship in the business sector, social entrepreneurship can refer to either new venture creation or entrepreneurial process innovation."[5] Social entrepreneurship can also be considered a vehicle for sustainable development, which G. H. Brundtland succinctly defined as "meeting the needs of the present without compromising the ability of future generations to meet their needs."[6]

4-1a Defining the Social Entrepreneur

LO4.2 Summarize common characteristics displayed by social entrepreneurs

The term *social entrepreneur* has come to mean a person (or small group of individuals) who founds and/or leads an organization or initiative engaged in social entrepreneurship. Social entrepreneurs are sometimes referred to as "public entrepreneurs," "civic entrepreneurs," or "social innovators." Noted expert Arthur C. Brooks outlines the following activities that characterize the social entrepreneur:

- Adoption of a mission to create and sustain social value (beyond personal value)
- Recognition and relentless pursuit of opportunities for social value
- Engagement in continuous innovation and learning
- Action beyond the limited resources at hand
- Heightened sense of accountability[7]

Numerous publications have brought the term *social entrepreneurship* into wider recognition. For example, in recent years, the *New York Times*, *The Economist*, *Forbes,* and the *Harvard Business Review* have all published stories that focus on social entrepreneurship.[8]

As social entrepreneurship rapidly finds its way into the vocabulary of policymakers, journalists, academics, and the general public, the world faces incredible societal challenges. The social entrepreneurship boom and its promise as a means to address daunting social problems across the globe are of particular importance for every entrepreneur.

By adopting some of the same principles that have been so effective in successful entrepreneurship, all leaders have a similar opportunity to support social entrepreneurship—and thereby generate transformative, financially sustainable solutions to social problems that face the nation. As stated in an article for the *Stanford Social Innovation Review*, "Social entrepreneurship, we believe, is as vital to the progress of societies as is entrepreneurship to the progress of economies, and it merits more rigorous, serious attention than it has attracted so far."[9]

Ashoka founder Bill Drayton has famously commented that "social entrepreneurs are not content just to give a fish or teach how to fish. They will not rest until they have revolutionized the fishing industry."[10] Like other entrepreneurs, social entrepreneurs are creative thinkers continuously striving for innovation, which can involve new technologies, supply sources, distribution outlets, or methods of production. Innovation may also mean starting new organizations or offering new products or services. Innovative ideas can be completely new inventions or creative adaptations of existing ones.[11]

Social entrepreneurs are change agents; they create large-scale change using pattern-breaking ideas, they address the root causes of social problems, and they possess the ambition to create systemic change by introducing a new idea and persuading others to adopt it.[12] These types of transformative changes can be national or global. They also can be highly localized—but no less powerful—in their impact. Most often, social entrepreneurs who create transformative changes combine innovative practices, a deep knowledge of their social issue area, and cutting-edge research to achieve their goals. For entrepreneurs working in the social realm, innovation is not a one-time event—rather, it is a lifetime pursuit.

4-1b Defining the Social Enterprise

With the huge growth and interest in social entrepreneurship that we have mentioned comes the challenges to the boundaries of what is and what isn't a social enterprise.

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Because social causes can be so different and many times very personal, it can be very tough to decipher.[13]

There is general agreement that social entrepreneurs and their ventures are driven by social goals, that is, the desire to benefit society in some way. In other words, the social entrepreneur aims to increase **social value**, that is, to contribute to the welfare or well-being in a given community. However, arguments begin over the location of the social goals and the purposes of the social goals.

Researcher J. Gregory Dees believes that the social mission is the most important criterion, *not* wealth creation. He sees wealth as a means to an end for social entrepreneurs. The claim that any wealth generated is just a means to the social end suggests that financial benefit to the entrepreneur has no place among the goals of the undertaking.[14]

Thus, many critics argue that the location of any social enterprise should be in the world of not-for-profit organizations. For example, one research article asked the question of whether earned income is essential to social entrepreneurship. The answer was an emphatic "no," as the researchers claimed that social entrepreneurship is about finding new and better ways to create and sustain social value.[15] There are, in fact, social entrepreneurs inventing ways to alleviate poverty, create sources of water, or provide health solutions without necessarily looking for any income from their beneficiaries.

However, for-profit enterprises have made a significant contribution to the world of social entrepreneurship. Whether you point to Ben & Jerry's or the majority of the *Forbes* "30 under 30" list of the top social entrepreneurs,[16] it is evident that for-profit social entrepreneurs are establishing themselves and providing social value with their enterprises. For example, in 2008, Blake Mycoskie launched TOMS Shoes with the idea that for every pair of TOMS shoes sold, a pair would be donated to a child in need (initially to children in South America), now known as the "one-for-one system." Having given over 60 million pairs of shoes, he clearly had a mission that turned into a company. This is a successful example of using business to solve problems rather than relying on a charity or nonprofit firm. By creating brand-loyal customers, there is greater opportunity to have long-term revenue and make a bigger impact with a sustainable business model rather than hoping for continued donations. The success of TOMS Shoes has inspired other companies to adopt the one-for-one system, which furthers the impact of social entrepreneurship companies. For example, Warby Parker, an American online retailer of prescription glasses, contact lenses, and sunglasses, uses the one-for-one social entrepreneurship model. For each pair of glasses purchased, the company pays for the production of another pair of eyeglasses for the nonprofit organization VisionSpring. As of 2022, the company has distributed over 10 million pairs of glasses through their "Buy a Pair, Give a Pair" program.[17] Thus, it would appear pointless to disqualify for-profit social entrepreneurs if in fact social goals are being accomplished.

It seems that the best way to alleviate the arguments is to accept social entrepreneurship activity along a continuum. One team of researchers offered an explanation of having at one extreme those social entrepreneurs who are driven exclusively by producing social benefits and at the other extreme social entrepreneurs who are motivated by profitability with social benefits being the means. In between these extremes, many nuances can exist.[18]

There has been a significant increase in the emphasis of social value creation by all organizations, including for-profit organizations because (1) customers want to buy from these companies, (2) employees want to work for them, (3) investors are willing to invest in them, and (4) entrepreneurs hope to start them. The challenge has been for established organizations to find a way to measure their culture for how conducive the organization is to creating social value. However, research has yet to examine corporate entrepreneurial strategies for creating social value due to the lack of any instrument suitable for the unique features that the task introduces. Researchers Donald F. Kuratko, Jeffery S. McMullen, Jeffrey S. Hornsby, and Chad Jackson sought to establish a scale that would measure organizational antecedents for corporate entrepreneurship intended to create social value titled the Social Corporate Entrepreneurship Scale.[19] Because sustained efforts in creating social as well as financial value depend on individual members' willingness to undertake innovative activities based on their positive perceptions of the necessary organizational antecedents to social corporate entrepreneurship, this new scale offers an opportunity to measure those perceptions. That is, using the new scale, managers can analyze whether employees perceive the environment as conducive to social corporate entrepreneurship behaviors. The study of 152 company managers tested the new instrument and revealed five factors: (1) firm transparency, (2) social proactiveness, (3) rewards, (4) work discretion, and (5) time availability correlated with the number of new ideas suggested. This research was exploratory in nature, but the results provided support for organizations seeking to measure the positive perceptions of individuals concerning the necessary organizational antecedents to social corporate entrepreneurship. If firms are going to emphasize social value more, managers and employees will likely need to monitor the environment and continually revisit the ways they create, deliver, and capture social value, just as they have done with financial value. As such, new instruments such as this one are needed to measure individual perceptions of the current organizational environment to determine whether it is conducive to individual efforts to create social value.[20]

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4-1c Measuring the Impact of Social Entrepreneurship

As social entrepreneurship gained visibility and traction among practitioners, there emerged a greater interest by academic researchers. Initially, researchers examined the motives that would lead some entrepreneurs down a social path.[21] However, the research focus shifted to examining the strategies that social entrepreneurs use to balance the tensions between their economic and non-economic goals in their organizations.[22] As researchers Sophie Bacq and Ruth Aguilera stated, "In the face of intractable societal grand challenges, organizations increasingly resort to responsible innovation—that is, they pledge to create value for multiple stakeholders through developing new products or services that avoid doing harm and improve conditions for people and the planet."[23]

Because practitioners have questioned whether social entrepreneurship actually yields more meaningful social benefits than traditional state, NGO, or entrepreneurial initiatives,[24] there has been a recent development to examine the outcomes of social entrepreneurship.

One approach to this dilemma has been to measure a given venture's outcomes from the perspective of the specific group or groups it seeks to serve. This approach has led researchers to conceptualize new overarching metrics, such as civic wealth;[25] community resilience;[26] community development, regeneration, and renewal;[27] and community well-being.[28]

Another approach has been to measure the success of social ventures in terms of their ability to scale up their solutions. However, most social enterprises start small but attempt to solve large issues, such as poverty, climate change, and the loss of biodiversity. It is interesting to note that organizational scaling does not guarantee scaling of social impact. Social enterprises can scale their impact either by increasing the number of people they serve (such a "scale breadth" strategy has been adopted by many micro-finance organizations that have made their purpose to increase the number of borrowers they serve) or by improving their services to beneficiaries, known as "scale depth."[29]

The Entrepreneurial Process

Hot Dogs, Ex-Convicts, and Social Enterprise

There are numerous ways to use an entrepreneurial means to solve a societal issue. However, some of those entrepreneurial means can be called into question as "pushing the boundaries" when the cause itself causes an issue.

In Chicago, Illinois, a hot-dog stand opened with a unique twist: hire ex-convicts who need a chance to be rehabilitated into society as employees. Felony Franks, where "the food is so good, it's criminal," began with a social purpose. By providing employment to a population that might otherwise have no options for work, entrepreneur James Andrews was hoping to alleviate the homeless problem.

This all sounds like a perfect application of entrepreneurial principles to solve a societal problem. However, not everyone buys into that mantra. The neighborhood rose up against Mr. Andrews and his clever concept. They see it as exploitation of these ex-convicts and the real drug problems that do plague the neighborhood. Over 70 people came to a town meeting to voice their displeasure. Some even felt that this business would harm the efforts to clean up the neighborhood, such as those of the drug rehabilitation centers, by making crime seem glamorous rather than trying to deter crime. Most significantly, the people complained that other local businesses were hiring ex-convicts, but they kept it low key in order to not bring attention to these individuals as they try to reinsert themselves into society.

While some people may believe that Felony Franks is exploiting these ex-convicts for profit, Mr. Andrews has invested over $160,000 into this venture, and he believes in his concept, claiming no "ulterior" motive. But the neighbors see it differently. They see an entrepreneur capitalizing on a neighborhood problem and using a serious issue for the benefit of sales. San Francisco and New Jersey are two cities known to have businesses step up and hire ex-convicts with no backlash or questions. However, they, unlike Felony Franks, did not employ clever slogans about the criminal issues to boost sales.

In 2012, due to a slow economy and a sluggish business, Mr. Andrews was forced to finally close his operation. However, the courage and creativity displayed by Mr. Andrews in establishing such a unique venture leads to a more significant underlying issue. In the future, what perception will society have when entrepreneurs use their creativity to seemingly blur the boundaries of social venture and capitalistic profit?

Source: Adapted from Julie Jargon, "Slaw and Order: Hot-Dog Stand in Chicago Triggers a Frank Debate," *Wall Street Journal*, October 13, 2009, and "Owner: Crime-Themed Hot Dog in Chicago Is Slated to Close Citing Slow Business," *Chicago Tribune*, June 3, 2012, http://www.chicagotribune.com/news/local/sns-ap-il-felonyfranks,0,6979309.story?obref=obnetwork, accessed June 14, 2012.

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The COVID-19 pandemic caused researchers to recognize that to scale a social enterprise, it had to overcome systemic barriers to their efforts and foster supportive ecosystems through interactions with local activists, communities, corporations, governments, and other actors.[30] A systems approach demonstrates the need to connect social entrepreneurs with supporters, communities, governments, activists, and large corporations when evaluating the outcomes of social entrepreneurship. A measure of success, in this case, would then be the extent of change brought to existing institutions following social entrepreneurial action.

4-2 Social Enterprise and Sustainability

LO4.3 Discuss the challenges of social enterprise

It is obvious from the preceding section that, in the twenty-first century, social enterprise has emerged as a major issue among entrepreneurial thinkers.[31] Although it takes various forms in different industries and companies, the basic challenge of social enterprise—addressing the obligations of a business to society—is the same for all. These obligations can extend into many different areas, as presented in Table 4.1, but questions concerning the *extent* to which corporations should be involved in these areas is open to debate.

4-2a Sustainable Entrepreneurship

Researchers Dean A. Shepherd and Holger Patzelt define **sustainable entrepreneurship** as being "focused on the preservation of nature, life support, and community in the pursuit of perceived opportunities to bring into existence future products, processes, and services for gain, where gain is broadly construed to include economic and noneconomic gains to individuals, the economy, and society."[32]

Sustainable development is perhaps the most prominent topic of our time. Common are reports of ozone depletion, climate change, and the destruction of biodiversity that demonstrate the negative and potentially deadly consequences these processes hold for living species. However, scholars have claimed that entrepreneurial action can preserve ecosystems, counteract climate change, reduce environmental degradation and deforestation, improve agricultural practices and freshwater supply, and maintain biodiversity.[33]

Sustainable entrepreneurship includes the following:

- *Ecopreneurship*. Environmental entrepreneurship with entrepreneurial actions contributing to preserving the natural environment, including the Earth, biodiversity, and ecosystems, is called **ecopreneurship**.
- *Social entrepreneurship*. This encompasses the activities and processes undertaken to discover, define, and exploit opportunities in order to enhance social wealth by creating new ventures or managing existing organizations in an innovative manner.
- *Corporate social responsibility*. This refers to actions that appear to further some social good beyond the interests of the firm and that are required by law and often denote societal engagement of organizations.[34]

Since many innovative initiatives carried out by social entrepreneurs have experienced challenges in becoming sustainable and effective, there are questions as to whether individuals possess the talent and skills of entrepreneurs in conjunction with socially motivated goals. Yet there have been a number of examples of entrepreneurs who have carried out the social mission utilizing the entrepreneurial process. One certain asset has been the Internet for disseminating information across the globe. Social ideas are shared with broader audiences, and networks can be developed at a much faster rate. In addition, social venture capitalists are increasing in greater numbers, raising funds for socially motivated causes. In fact, what is now referred to as **social impact investing** has started to bring opportunities to harness entrepreneurial ideas and capital markets to finance social initiatives.[35] Increasing the funding capability of social entrepreneurship will increase the likelihood of more efficient, sustainable, and effective social initiatives.

4-2b Ecopreneurship

The twenty-first century is one of greater environmental concern. The reawakening of the need to preserve and protect our natural resources has motivated businesses toward a stronger *environmental awareness*. As illustrated in Table 4.1, the environment stands out as one of the major challenges of social enterprise. *Green capitalism,* also referred to as *green entrepreneurship*, has emerged as a powerful new force in examining the manner in which business is conducted in relation to the environment.[36] This term refers to a concept of *ecologically* sustainable development being transformed into *economically* sustainable development. Our recent "throwaway" culture has endangered our natural resources, from soil to water to air. Researchers Paul Hawken (coauthor of *Natural Capitalism: Creating the Next Industrial Revolution*) and William McDonough state, "Industry is being told that if it puts its hamburgers in coated-paper wrappers, eliminates emissions, and plants two trees for every car sold, we will be on the way to an environmentally sound world. Nothing could be further from the truth. The danger lies not in the half measures but in the illusions they foster, the belief that subtle course corrections can guide us to a good life that will include a 'conserved' natural world and cozy shopping malls."[37]

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Table 4.1 Examples of Social Enterprise Obligations

Environment	Pollution control Restoration or protection of environment Conservation of natural resources Recycling efforts
Energy	Conservation of energy in production and marketing operations Efforts to increase the energy efficiency of products Other energy-saving programs (e.g., company-sponsored carpools)
Fair business practices	Employment and advancement of women and minorities Employment and advancement of disadvantaged individuals (disabled, Vietnam veterans, ex-offenders, former drug addicts, mentally retarded, and hard-core unemployed) Support for minority-owned businesses
Human resources	Promotion of employee health and safety Employee training and development Remedial education programs for disadvantaged employees Alcohol and drug counseling programs Career counseling Child day care facilities for working parents Employee physical fitness and stress management programs
Community involvement	Donations of cash, products, services, or employee time Sponsorship of public health projects Support of education and the arts Support of community recreation programs Cooperation in community projects (recycling centers, disaster assistance, and urban renewal)
Products	Enhancement of product safety Sponsorship of product safety education programs, reduction of polluting potential of products, improvement in nutritional value of products, improvement in packaging and labeling

Source: Adapted from Richard M. Hodgetts and Donald F. Kuratko, *Management,* 3rd ed. (San Diego, CA: Harcourt Brace Jovanovich, 1991), 670.

This quote illustrates the enormous challenges entrepreneurs confront as they attempt to build socially responsible organizations for the future. Of the 100 million enterprises worldwide, a growing number are attempting to redefine their social responsibilities because they no longer accept the notion that the business of business is business. Because of an international ability to communicate information widely and quickly, many entrepreneurs are beginning to recognize their responsibility to the world around them. Entrepreneurial organizations, the dominant inspiration for change throughout the world, are beginning the arduous task of addressing social-environmental problems.

Entrepreneurs need to take the lead in designing a new approach to business in which everyday acts of work and life accumulate—as a matter of course—into a better world. One theorist has developed the term ecovision to describe a possible leadership style for innovative organizations.[38] Ecovision encourages open and flexible structures that encompass the employees, the organization, and the environment, with attention to evolving social demands.

The environmental movement consists of many initiatives connected primarily by values rather than by design. A plan to create a sustainable future should realize its objectives through a practical, clearly stated strategy. Some of the key steps recommended by Hawken and McDonough are as follows:

1. *Eliminate the concept of waste*. Seek newer methods of production and recycling.
2. *Restore accountability*. Encourage consumer involvement in making companies accountable.
3. *Make prices reflect costs*. Reconstruct the system to incorporate a "green fee" where taxes are added to energy, raw materials, and services to encourage conservation.

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4. *Promote diversity*. Continue researching the needed compatibility of our ever-evolving products and inventions.
5. *Make conservation profitable*. Rather than demanding "low prices" to encourage production shortcuts, allow new costs for environmental stewardship.
6. *Insist on the accountability of nations*. Develop a plan for every trading nation of sustainable development enforced by tariffs.[39]

4-3 Shared Value and the Triple Bottom Line

LO4.4 Explain the concept of *shared value*

Companies have traditionally viewed value creation with a narrow scope. They have tended to optimize short-term financial performance while ignoring the elements that determine their long-term success. These elements could include the viability of key suppliers or the economic distress of the communities in which they exist. Researchers Michael E. Porter and Mark R. Kramer believe that companies must take the lead in bringing business and society back together. The solution lies in a concept they refer to as **shared value**. It is an approach to creating economic value that also creates value for society by addressing its needs and challenges. It connects company success with social progress. Shared value is more than social responsibility or sustainability. It is a transformation of business thinking recognizing societal weaknesses that create internal costs for firms (e.g., wasted energy, accidents, and inadequacies in education). By addressing those issues through using innovations and methods, productivity can be increased, and newer markets can be expanded.[40]

The **triple bottom line** (**TBL**) is an accounting framework that goes beyond the traditional measures of profit, return on investment, and shareholder value to include environmental and social dimensions. By focusing on comprehensive investment results—that is, with respect to performance along the interrelated dimensions of *profits*, *people*, and the *planet*—TBL reporting can be an important tool to support sustainability goals.[41] It measures three dimensions of performance: economic, environmental, and social. Let's examine each measure.

4-3a Bottom-Line Measures of Economic Performance

Economic measures deal with the bottom line and income flows, such as income, expenditures, taxes, business climate factors, employment, and business diversity factors. Examples include the following:

- Personal income
- Cost of underemployment
- Establishment sizes
- Job growth
- Employment distribution by sector
- Percentage of firms in each sector
- Revenue by sector contributing to gross state product

4-3b Bottom-Line Measures of Environmental Performance

Environmental measures are related to natural resources and reflect potential influences to its viability. Air and water quality, energy consumption, natural resources, solid and toxic waste, and land use are examples. Long-range trends for environmental variables help organizations identify the impacts a project or policy would have on the area. Specific examples include the following:

- Hazardous chemical concentrations
- Selected priority pollutants
- Electricity consumption
- Fossil fuel consumption
- Solid waste management
- Hazardous waste management
- Change in land use/land cover

4-3c Bottom-Line Measures of Social Performance

Social measures refer to social dimensions of a community or region, such as education, social resources, health and well-being, and quality of life. Examples include the following:

- Unemployment rate
- Median household income
- Relative poverty
- Percentage of population with a postsecondary degree or certificate
- Average commute time
- Violent crimes per capita
- Health-adjusted life expectancy

4-4 Benefit Corporations: Promoting Sustainable Enterprises

LO4.5 Explain the value of benefit corporations

A new form of corporation introduced in the United States, the **benefit corporation**, has been enacted in 14 states, and bills are moving forward in several others.

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The Entrepreneurial Process

L3C: A New Legal Form for Social Enterprises

A new legal form of business entity in the United States has been created to bridge the gap between nonprofit and for-profit investing. The new form, known as the low-profit, limited liability company, or L3C, provides a structure that facilitates investments in socially beneficial, for-profit ventures. L3Cs have been touted as "for profits with nonprofit souls."

The L3C is a new type of limited liability company (LLC) designed to attract private investment and philanthropic capital in ventures designed to provide a social benefit. Unlike a standard LLC, the L3C has an explicit primary charitable mission and only a secondary profit concern. But unlike a charity, the L3C is free to distribute profits, after taxes, to owners or investors.

A principal advantage of the L3C is its qualification as a program-related investment (PRI). That means it is an investment with a socially beneficial purpose that is consistent with a foundation's mission. Because foundations can directly invest only in for-profit ventures that have qualified as PRIs, many foundations refrain from investing in for-profit ventures due to the uncertainty of whether they would qualify as PRIs or use costly time and resources to acquire a Private Letter Ruling from the Internal Revenue Service to verify that the venture is a valid PRI. An L3C's operating agreement minimizes this problem by specifically outlining its respective PRI-qualified purpose in being formed, making it easier for foundations to identify social-purpose businesses as well as helping to ensure that their tax exemptions remain secure. Thus, L3Cs could attract a greater amount of private capital from various sources in order to serve their charitable or education goals. It is the perfect vehicle for economic development, medical research, operation of social service agencies, museums, concert venues, housing, and any other activity with both a charitable purpose and a revenue stream.

The L3C was created by Robert Lang, CEO of the Mary Elizabeth & Gordon B. Mannweiler Foundation. In 2008, Vermont became the first state to recognize the L3C as an official legal structure. Similar legislation has since been pushed in other states, such as Georgia, Michigan, Montana, and North Carolina. Although Vermont currently remains the only state to authorize the L3C, it has national applicability because L3Cs formed in Vermont can be used in any state or territory, so it is legal in all 50 states. The L3C is a brand that signifies to the world that it puts mission before profit yet is self-sustaining. As a brand, it makes these concepts easy to grasp and thereby will be frequently used.

Benefit corporations are exactly the same as traditional corporations except for a few specific elements that make them more socially sustainable enterprises:

1. *Purpose*. to create a material positive impact on society and the environment
2. *Accountability*. to have a fiduciary duty to consider the interests of workers, the community, and the environment
3. *Transparency*. to report annually to the public on overall social and environmental performance with a credible and transparent third-party standard

Benefit corporations and *certified* B corporations are terms that are often used interchangeably. However, while they share similar features, they also have a few important differences. A certified B corporation is a certification conferred by the nonprofit B Lab. Benefit corporation is a legal status administered by the state. Benefit corporations do *not* need to be certified. Certified B corporations have been certified as having met a high standard of overall social and environmental performance and, as a result, have access to a portfolio of services and support from B Lab that benefit corporations do not. See also the Entrepreneurial Process box concerning the new legal form of organization known as L3C corporations, which also relate to social enterprises. We discuss more on these new legal forms of organization in Chapter 9.

4-5 Global Poverty and Entrepreneurship

LO4.6 Explore the challenges of poverty and the liability of newness

Global extreme poverty rose in 2020 for the first time in over 20 years as the disruption of the COVID-19 pandemic compounded the forces of conflict and climate change, which were already slowing progress in the reduction of poverty. About 100 million additional people are living in poverty as a result of the pandemic. The latest research suggests that the effects of the COVID crisis will almost certainly be felt in most countries through 2030. Under these conditions, the goal of bringing the global absolute poverty rate to less than 3 percent by 2030, which was already at risk before the crisis, is now beyond reach without swift, significant, and substantial policy action.[42]

The disadvantage associated with poverty goes well beyond severe financial constraints. The poverty

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experience includes substandard literacy levels and school dropout rates, lack of employment opportunities and underemployment in labor-intensive jobs, inadequate housing conditions, food insecurity, chronic medical conditions, teenage childbearing, lack of dependable means of transportation, constant fatigue, physical insecurity, and limited social networks.[43]

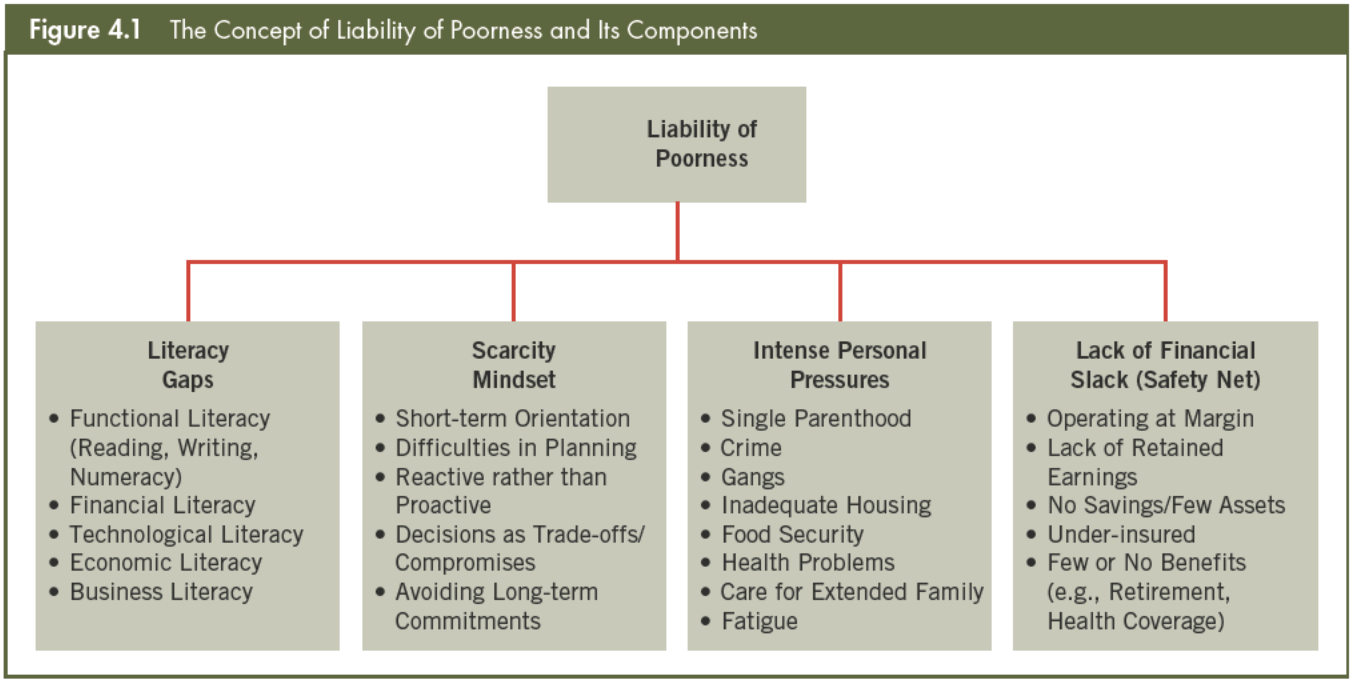
In recent years, there has been growing interest in poverty and entrepreneurship and particularly in the role of venture creation as a pathway out of poverty.[44] People whose incomes are below the federal poverty threshold start millions of small ventures across the globe each year, with mixed findings as to whether their start-up rates are lower or higher than the average for a society. The establishment of a new venture allows some poverty entrepreneurs to survive or supplement other income sources in the family. For others, a successful venture enables them to escape poverty and become less dependent on public and private forms of support. Most important, starting one's own business can contribute to enhanced self-efficacy, skills development, self-identity, pride, dignity, and the ability to give back to the community.[45] However, researchers Michael H. Morris, Susana Santos, and Xaver Neumeyer contend that poverty conditions lead the poor to launch "commodity" ventures that lack differentiation, technology, and purchase capabilities and that are labor intensive and earn small margins.[46]

Researchers Michael H. Morris, Donald F. Kuratko, David B. Audretsch, and Susana Santos created a new term for the unique struggles that poverty entrepreneurs confront. They label it the liability of poorness. They define this concept as *the potential for failure of a new venture that is associated with problems that the entrepreneur struggles to adequately address because of characteristics and influences deriving from a poverty background*. It is a multidimensional construct that includes literacy issues, a scarcity mentality, intense nonbusiness pressures, and the lack of any sort of safety margin (refer Figure 4.1).

The collective impact of these challenges has profound implications for the nature of the venture that the low-income entrepreneur creates. In effect, the liability of poorness puts the individual at a relative disadvantage compared to other entrepreneurs. The liability of poorness increases the risk exposure that a low-income person has when launching a venture. It can force the poverty entrepreneur to start smaller, develop more slowly, and be more conservative in decision making. It produces a more fragile business, undermining the ability to survive shocks, disruptions, and setbacks. The liability of poorness places the poverty entrepreneur at a relative disadvantage, and thus it is important that we find ways to level the playing field.[47]

Unfortunately, most of the available policies and programs supporting entrepreneurship prioritize growth-oriented and scalable enterprises.[48] The challenge ahead is to make venture creation by those experiencing poverty a priority in terms of both policy formulation and the activities of local entrepreneurial ecosystems.[49]

Figure 4.1 The Concept of Liability of Poorness and Its Components



Source: Adapted from: Michael H. Morris, Donald F. Kuratko, David B. Audretsch, & Susana Santos (2022). Overcoming the Liability of Poorness: Disadvantage, Fragility and the Poverty Entrepreneur. *Small Business Economics*, 58(1), 45.

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4-6 The Global Marketplace

LO4.7 Describe the global opportunities and challenges for social entrepreneurs

Capitalism is the world's dominant economic system, having, over recent decades, replaced many socialistic and centrally planned systems worldwide. Like capitalism, entrepreneurship has expanded its reach across the globe and is now an engine for economic growth not only in America but elsewhere in the world. The past two decades, in particular, have witnessed the emergence of a new breed of global entrepreneur who relies on global networks for resources, design, and distribution. The trend has escalated the global economy, allowing it to reach new heights. By all accounts, the pace and magnitude of this global economy are likely to continue to accelerate. Adept at recognizing opportunities, the new breed of global entrepreneur recognizes that success in the global marketplace requires agility, certainty, ingenuity, and a global perspective. These global entrepreneurs and social entrepreneurs are the true vanguard for the third decade of the twenty-first century.[50]

In the sections that follow, we discuss new developments in the global marketplace that directly affect entrepreneurial opportunities. We also examine the various methods of international participation. Finally, we focus on researching the foreign market with the threats and risks to be considered.

4-6a Global Entrepreneurs

LO4.8 Summarize the newest developments that have expanded the global marketplace

Global entrepreneurs are opportunity-minded and open-minded, able to see different points of view and weld them into a unified focus. They rise above nationalistic differences to see the big picture of global competition without abdicating their own nationalities. They have a core language plus a working knowledge of others. They confront the learning difficulties of language barriers head-on, recognizing the barriers that such ignorance can generate. The global entrepreneur is required to wear many hats, taking on various assignments, gaining experience in various countries, and seizing the opportunity to interact with people of different nationalities and cultural heritages.

4-6b Global Thinking

"Global thinking" is important because today's consumers can select products, ideas, and services from many nations and cultures. Entrepreneurs who expand into foreign markets must be global thinkers in order to design and adopt strategies for different countries. Therefore, one of the most exciting and promising avenues for entrepreneurs to expand their businesses is by participating in the global market. Each year, thousands of smaller enterprises are actively engaged in the international arena. Two of the primary reasons for this emerging opportunity are the decline in trade barriers, especially among major trading nations, and the emergence of major trading blocs that have been brought about by the United States–Mexico–Canada Agreement (formerly known as the North American Free Trade Agreement) and the European Union. In addition, over the past decade, the Asia-Pacific region has become a hotbed for entrepreneurial opportunity.[51]

4-6c Diaspora Networks

Diaspora networks are relationships among ethnic groups that share cultural and social norms. While they are not new, as diasporas have been a part of the world for thousands of years, the new global economy has made them more powerful as vehicles for communication and trust. There has been a 40 percent increase in first-generation migrants since 1990 with over 200 million worldwide.

Through the Internet and social media sites (Facebook, LinkedIn, Twitter, and so on), diasporas are linking together stronger than ever, offering potential linkages for global entrepreneurs.

Remember, in most emerging markets, laws can be uncertain, and courts cannot be trusted to enforce contracts. Thus, it is hard to conduct business with strangers and preferable to deal with someone you trust. Personal connections through a diaspora network make this feasible. These networks of kinship and language make it easier for an entrepreneur to do business across borders.

Diaspora networks have three powerful advantages for global entrepreneurs. First, they speed the flow of information across borders; second, they create a bond of trust; and, third, they create connections that help entrepreneurs collaborate within a country and across ethnicities.

This new type of "hyperconnectivity" enables global entrepreneurs to collaborate instantaneously and intimately to their communities of ethnic origin.[52]

4-6d Global Organizations and Agreements

Throughout the world today, significant developments have occurred that facilitate the expansion of the global marketplace. Organizations, unifications, and trade agreements are some of the vehicles that have developed to enhance global business. In this section, we examine the most significant international developments.

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The World Trade Organization

The **World Trade Organization (WTO)** was established on January 1, 1995. The WTO is the umbrella organization governing the international trading system. Its job is to oversee international trade arrangements, but contrary to popular belief, the WTO does not replace the General Agreement on Tariffs and Trade (GATT). An amended GATT remains one of the legal pillars of the world's trade system and, to a lesser extent, the world investment system.[53]

Located in Geneva, Switzerland, the WTO employs over 600 staff, and its experts—lawyers, economists, statisticians, and communications experts—assist WTO members on a daily basis to ensure, among other things, that negotiations progress smoothly and that the rules of international trade are correctly applied and enforced. The budget for the WTO is over U.S.$220 million, and its functions include administering WTO trade agreements, handling trade negotiations or trade disputes, monitoring national trade policies, and providing technical assistance and training for developing countries.

Membership in the WTO has increased from the 76 nations that founded the organization in 1995 to 164 members representing more than 98 percent of the global trade and global gross domestic product (GDP). Thus, the WTO includes virtually all of the developed world and most of the developing countries; these nations collectively account for more than 90 percent of the world's trade and virtually all of its investment.[54]

United States–Mexico–Canada Agreement

The **United States–Mexico–Canada Agreement (USMCA)**, formerly known as the North American Free Trade Agreement (NAFTA), is an international agreement among the United States, Mexico, and Canada that eliminates trade barriers among the three nations.[55] It created the world's largest free trade area, linking 444 million people and producing $17 trillion in goods and services annually. Estimates are that NAFTA increases U.S. GDP by as much as 0.5 percent a year because it eliminates tariffs and creates agreements on international rights for business investors. This reduces the cost of trade, which spurs investment and growth, especially for entrepreneurial businesses. Eliminating tariffs also reduces inflation by decreasing the costs of imports. Thus, new opportunities have arisen for entrepreneurs in North America. The importance of the agreement can be clearly seen when exports and imports among the three partners are examined.

As USMCA has developed and trade barriers have been reduced, the amount of trade among the three partners continues to increase. Perhaps even more important, the competition that has been created by the removal of trade barriers has forced more entrepreneurial firms to increase their quality and overall competitiveness. In turn, this has made firms more competitive when doing business in Asia, South America, Europe, and other international markets.

With regard to the name change, former U.S. president Donald Trump sought to replace NAFTA with a new agreement, beginning negotiations with Canada and Mexico. In September 2018, the United States, Mexico, and Canada reached an agreement to replace NAFTA with USMCA, and all three countries had ratified it by March 2020. NAFTA remained in force until USMCA was implemented. In April 2020, Canada and Mexico notified the United States that they were ready to implement the agreement. The USMCA took effect on July 1, 2020, replacing NAFTA. The new law involved only small changes.

Of particular importance to entrepreneurs is the fact that markets have increased for both exports and imports. (See Table 4.2 for the 10 largest trading partners for the United States.) The most efficient firms find themselves able to provide higher quality and lower prices than their competitors, and no tariffs or quotas will keep out their goods. At the same time, entrepreneurs in all three countries will find themselves protected from foreign competition because of local content laws. For example, USMCA has created a trade surplus in services for the United States.

More than 40 percent of U.S. GDP is services, such as financial services and health care. These aren't easily

Table 4.2 Top 10 Largest Trading Partners for the United States

1. Mexico:	$486.6 billion
2. Canada:	$484.0 billion
3. China:	$465.4 billion
4. Japan:	$157.1 billion
5. Germany:	$148.3 billion
6. South Korea:	$120.0 billion
7. United Kingdom:	$87.0 billion
8. Taiwan:	$82.1 billion
9. Vietnam:	$82.0 billion
10. India:	$81.5 billion

In terms of imports, however, the United States receives the most amount of goods from China. At $360.4 billion, China accounts for roughly 17.5 percent of U.S. imports, followed by Mexico at $282.5 billion and Canada at $259.1 billion.

Source: U.S. Census Bureau, 2021.

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transported, so being able to export them to nearby countries is important. NAFTA boosted U.S. service exports to Canada and Mexico and eliminated trade barriers in nearly all service sectors, which are often highly regulated. The USMCA f required governments to publish all regulations, lowering the hidden costs of doing business.

In addition, USMCA offers strong protection for patents, copyrights, industrial design rights, trade secret rights, and other forms of intellectual property. Many entrepreneurs could find that their success in this market bloc will prepare them to do business elsewhere, including the European Union.

The European Union

The **European Union (EU)** was founded in 1957 as the European Economic Community and in 1992 became a full-fledged economic union. The EU is an economic and political union of 27 member states that are located primarily in Europe. The objectives of the EU include (1) the elimination of custom duties among all member states, (2) the free flow of goods and services among all members, (3) the creation of common trade policies toward all countries outside the EU, (4) the free movement of capital and personnel within the bloc, (5) the encouragement of economic development throughout the bloc, and (6) monetary and fiscal coordination among all members.[56]

The EU remains one of the major markets for American goods and services as well as for foreign direct investment. Like the North American trading bloc, the goal of many entrepreneurs is to gain admission into this market so that the benefits that accrue to insiders can be realized. Containing some 5.8 percent of the world population in 2020, the EU had generated a nominal GDP of around U.S.$17.1 trillion in 2021, constituting approximately 18 percent of global nominal GDP. Due to its global influence, the EU has been described by some scholars as an emerging superpower In 2020, the United Kingdom became the only member state to leave the EU.

Another potential strategy is to work with EU partners in the American market by helping them extend their worldwide coverage. This reason is best explained in terms of global trade. Research reveals that a huge amount of international trade is conducted by three groups: the United States, EU countries, and the Asia-Pacific region.[57] This helps explain why entrepreneurs now are looking for emerging opportunities in the EU and EU-based firms.

4-6e Venturing Abroad

As global opportunities expand, entrepreneurs are becoming more open-minded about internationalizing. In past years, U.S. entrepreneurs shuddered at the thought of "going international" because it was just too big a step, too risky, and too uncertain. However, the twenty-first century has witnessed the global marketplace become a reality, and entrepreneurs have rushed enthusiastically to capture a share of this global marketplace with prime targets, including China, India, Asia-Pacific nations, Latin America, Africa, and Eastern Europe.

Gradual Internationalization

LO4.9 Examine the methods of entering the international arena

Whether their motives are for pure economic gain or to share knowledge and resources, entrepreneurs tend to act in rational ways. They acquire raw material and capital where they are most abundant, manufacture products where wages and other costs are lowest, and sell in the most profitable markets. If everyone does their assigned tasks, the economic law of comparative advantage will benefit everyone.[58]

Countries vary with respect to the quantity and proportion of resources they possess, which forms the basis for a competitive advantage of nations. **Resource-rich countries** (those having extractive assets) include the nations that are part of the Organization of the Petroleum Exporting Countries; Canada; Venezuela; labor-rich, rapidly developing countries, including Brazil, India, and the Philippines; and select countries in South and Central America. **Market-rich countries**, such as the countries of Europe, Hong Kong, Singapore, India, China, and the United States, have purchasing power. Each country has something that others need, thus forming the basis of an interdependent international trade system.

Internationalization can be viewed as the outcome of a sequential process of incremental adjustments to changing conditions of the firm and its environment. This process progresses step-by-step as risk and commitment increase and entrepreneurs acquire more knowledge through experience. The entrepreneur's impression of the risks and rewards of internationalizing can be determined by feasibility studies of the potential gains to be won.

As noted above, the principal advantage of trading internationally is enhanced prospects for growth through market expansion. Other advantages include utilizing idle capacity, minimizing cyclical or seasonal slumps, getting acquainted with manufacturing technology used in other countries, learning about products not sold domestically, learning about other cultures, acquiring growth capital more easily in other countries, and having the opportunity to travel for business and pleasure.[59]

International at Inception

Some entrepreneurial businesses internationalize immediately. They are "born global." Multinational from inception, these companies break the traditional

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expectation that a business must enter the international arena incrementally, becoming global only as it grows older and wiser. According to researchers Ben Oviatt and Patricia P. McDougall, seven characteristics of successful global start-ups are (1) global vision from inception, (2) internationally experienced management, (3) a strong international business network, (4) preemptive technology or marketing, (5) a unique intangible asset, (6) a linked product or service, and (7) tight organizational coordination worldwide.[60]

4-6f Methods of Going International

The entrepreneur can actively engage in the international market in a number of ways, including importing, exporting, international alliances and joint ventures, direct foreign investment, and licensing.[61] Each of these methods involves increasing levels of risk.

Importing

Importing is buying and shipping foreign-produced goods for domestic consumption. Each year, the United States imports an increasing amount of goods. How does an entrepreneur become aware of import opportunities? One way is to attend trade shows and fairs where firms gather to display their products and services. Some of these shows are international in flavor, with firms from different countries exhibiting their products and services. The trade show gives the prospective customer the opportunity to window-shop. Another way is to monitor trade publications. Often, firms will advertise in trade publications to make themselves known to potential customers.

Exporting

When an entrepreneurial firm decides to participate actively in the international arena as a seller rather than a buyer, it becomes an exporter. **Exporting** is the shipping of a domestically produced good to a foreign destination for consumption. Exporting is important for entrepreneurs because it often means increased market potential. Instead of limiting its market to the United States, the firm now has a broader sales sphere. According to the **learning curve concept**, increased sales will lead to greater efficiencies along the cost curve, which in turn will lead to increased profits. (The learning curve essentially states that as more and more units are produced, the firm becomes more efficient at production of the units, thereby lowering the cost per unit. The lower unit cost thus enables the firm to compete more effectively in the marketplace.) It should be pointed out, however, that exporting normally will take three to five years to become profitable. Even if the firm is producing more units efficiently, it will take time to learn the intricacies and efficiencies of international business. Exporting has been increasing as a method for venture growth and increased profitability among entrepreneurial firms.

International Alliances and Joint Ventures

Another alternative available to the entrepreneur in the international arena are **international alliances**. There are three main types of these strategic alliances: informal international cooperative alliances, formal international cooperative alliances, and international joint ventures. (Table 4.3 provides a summary of these alliances.)

In general, informal alliances are agreements between companies from two or more countries, and they are not legally binding. Because the contract offers no legal protection, most entrepreneurs would either limit their involvement or avoid it altogether. The formal alliance usually requires a formal contract with specifics about what each company must contribute. The agreement then usually involves greater commitment by each company with the transfer of proprietary information. These forms have become more popular in the high-tech industry because of the higher costs associated with internal research and development.

Table 4.3 Types of International Alliances

Alliance Type	Degree of Involvement	Ease of Dissolution	Legal Entity
Informal international cooperative alliance	Limited in scope and time	Easy and convenient for either side	None
Formal international cooperative alliance	Deeper involvement; exchange of proprietary knowledge	More difficult to dissolve due to legal obligations and commitment	None
Internal joint venture	Deep involvement; requires exchange of financial information, proprietary knowledge, and resources	Most difficult to dissolve due to the significant investment of both companies and the existence of a legal entity	Separate company

Source: Adapted from John B. Cullen and K. Praveen Parboteeah, *Multinational Management: A Strategic Approach*, 6th ed. (Mason, OH: Cengage/South-Western, 2014), 352.

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The **joint venture** is the more traditional self-standing legal entity. A joint venture occurs when two or more firms analyze the benefits of creating a relationship, pool their resources, and create a new entity to undertake productive economic activity. A joint venture thus implies the sharing of assets, profits, risks, and venture ownership with more than one firm.[62] A joint venture can take one of several different forms. In some countries, for example, it is not uncommon for a company to form a joint venture with the state or with a state-owned firm.

Advantages of Joint Ventures A firm may decide to participate in a joint venture for several reasons.[63] One is that the firm would be able to gain an intimate knowledge of the local conditions and government where the facility is located. Another is that each participant would be able to use the resources of the other firms involved in the venture. This allows participating firms a chance to compensate for weaknesses they may possess. Finally, both the initial capital outlay and the overall risk would be lower than if the firm were setting up the operation alone.

Additional advantages of a joint venture relate to the strategic fit of the domestic firm with the foreign firm. One study examined the strategic fit of domestic firms (D-type) with Third World firms (TW-type) in a joint venture. The dimensions of corporate-level advantages, operational-level advantages, and environmental advantages were all compared to the strategic fit of the partners in the joint venture.[64]

Disadvantages of Joint Ventures One of the disadvantages associated with joint ventures is the problem of fragmented control.[65] For example, a carefully planned logistics flow may be hampered if one of the firms decides to block the acquisition of new equipment. This type of problem can be avoided or diminished in a number of ways: (1) One party can control more than 50 percent of the voting rights. This will normally give formal control; however, even a minority opposing view can carry considerable influence. This can be particularly true if the differences of opinion reflect different nationalities. (2) Only one of the parties is made responsible for the actual management of the venture. This may be complemented by a buyout clause. In case of a disagreement among the owners, one party can purchase the equity of the other. (3) One of the parties can control either the input or the output, exerting significant control over the venture decisions despite voting and ownership rights.

The joint venture can be a powerful tool for growth in the international market. If used properly, it will effectively combine the strengths of the partners involved and thereby increase its competitive position.[66]

Direct Foreign Investment

A *direct foreign investment* is a domestically controlled foreign production facility. This does not mean the firm owns a majority of the operation. In some cases, less than 50 percent ownership can constitute effective control because the stock ownership is widely dispersed. On the other hand, the entrepreneur may own 100 percent of the stock and not have control over the company. In some instances, the government may dictate whom a firm may hire, what pricing structure the firm must use, and how earnings will be distributed. This causes some concern as to exactly who is in control of the organization. Because of the difficulty of identifying direct investments, governmental agencies have had to establish arbitrary definitions of the term. A direct foreign investment typically involves ownership of 10 to 25 percent of the voting stock in a foreign enterprise.[67]

A firm can make a direct foreign investment by several methods. One is to acquire an interest in an ongoing foreign operation. This initially may be a minority interest in the firm but enough to exert influence on the management of the operation. A second method is to obtain a majority interest in a foreign company. In this case, the company becomes a subsidiary of the acquiring firm. Third, the acquiring firm may simply purchase part of the assets of a foreign concern in order to establish a direct investment. An additional alternative is to build a facility in a foreign country.

Direct investment can be an exciting venture for entrepreneurial firms making efforts to increase their sales and their competitive positions in the marketplace. However, it is sometimes not practical for a firm to make a direct investment in a foreign location. If the firm has a unique or proprietary product or manufacturing process, it may want to consider the concept of licensing.

Licensing

Licensing is a business arrangement in which the manufacturer of a product (or a firm with proprietary rights over certain technology or trademarks) grants permission to some other group or individual to manufacture that product in return for specified royalties or other payments. Foreign licensing covers myriad contractual arrangements in which the business (licenser) provides patents, trademarks, manufacturing expertise, or technical services to a foreign business (licensee). Under such an arrangement, the entrepreneur need not make an extensive capital outlay to participate in the international market. Nor does the licenser have to be concerned with the daily production, marketing, technical, or management requirements; the licensee will handle all of this. The foreign firm merely looks to the domestic firm for expertise and, perhaps, an additional opportunity to sell a product owned by the licenser.

For developing an international licensing program, three basic types of programs are available:

1. *Patents*. If the entrepreneur decides to use the patent approach, they should begin with a valid U.S. patent. Within one year, the entrepreneur should

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then file for patents in the countries where business will be transacted. Although this step can be expensive, it is essential because this action will give the entrepreneur a stronger bargaining position. With the passage of the America Invents Act of 2011, the United States adjusted its patent system from "first to invent" to the international system of "first to file." It's being referred to as "patent harmonization" in order to be compatible with the international marketplace. The new system includes safeguards for small inventors, such as an inexpensive system for provisional patents. The goals are to make the patent process more efficient and to offer better foreign protection for inventors.[68] Currently, a single patent filing can cost tens of thousands of dollars if you include all the attorney fees. The entrepreneur must file multiple applications as a defense against competitors—particularly in a global economy. A rule of thumb is that gaining sufficient protection for a patent internationally can cost about $100,000. Filing 10 related patents to create a protective "picket fence" around their invention could cost the entrepreneur $1 million. Self-defense has increased the cost of international patent protection.[69]

2. *Trademarks*. Due to the difficulties that can occur in direct translations, it may be advisable for the entrepreneur to have more than one trademark licensed for the same product. The entrepreneur should keep in mind, however, that if the product is not well recognized in the international market, they will not be able to use it as a major incentive in the bargaining phase. Sometimes licensees will want the patent rights but prefer to use their own trademarks. This can be particularly true if the foreign firm is well established.
3. *Technical know-how*. This type of licensing is often the hardest to enforce since it depends on the security of secrecy agreements. (The licenser should sign an agreement to prevent the licensee from legally revealing trade secrets.) In some localities, governments have strict regulations governing the use of technical know-how licensing. Frequently, one may protect the technical capabilities for only five years before the licensee is free to use this know-how without paying royalties. However, keep in mind that this may differ from country to country, depending on the particular regulations. Because this is a complex process, the entrepreneur must continue to develop their technical capabilities to ensure an ongoing international need for the company's services.[70]

To be competitive with larger firms, entrepreneurial businesses have to be on the cutting edge of bringing in new and innovative technology. Moreover, some entrepreneurial firms may not have the financial resources available to participate in the international marketplace by exporting, joint venture, or direct investment. For many of these firms, international licensing is a viable and exciting method of expanding operations.[71]

4-6g Researching Foreign Markets

LO4.10 Outline the key steps for entrepreneurs seeking global markets

Before entering a foreign market, it is important to study the *unique culture* of potential customers. Different concepts of how the product is used, demographics, psychographics, and legal and political norms are usually different from those in the United States. Therefore, it is necessary to conduct market research to identify these important parameters:

- *Government regulations*. Must you conform to import regulations or patent, copyright, or trademark laws that would affect your product?
- *Political climate*. Will the relationship between government and business or political events and public attitudes in a given country affect foreign business transactions, particularly with the United States?
- *Infrastructure*. How will the packaging, shipping, and distribution system of your export product be affected by the local transportation system, for example, air, land, or water?
- *Distribution channels*. What are the generally accepted trade terms at both wholesale and retail levels? What are the normal commissions and service agency charges? What laws pertain to and distribution agreements?
- *Competition*. How many competitors do you have, and in what countries are they located? On a country-by-country basis, how much market share does each of your competitors have, and what prices do they charge? How do they promote their products? What distribution systems do they use?
- *Market size*. How big is the market for your product? Is it stable? What is its size individually and country by country? In what countries are markets opening, expanding, maturing, or declining?
- *Local customs and culture*. Is your product in violation of cultural taboos? How can entrepreneurial businesses learn about international cultures and thus know what is acceptable and what is not? A number of approaches can be employed. One of the most helpful is international business travel. This provides the individual with firsthand information

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regarding cultural dos and don'ts. Other useful methods include training programs, formal educational programs, and reading the current literature.[72]

International Threats and Risks

Foreign markets may present dangers that must be monitored carefully. For example, *ignorance* and *uncertainty*, combined with *lack of experience* in problem solving in a foreign country, present a major issue. *Lack of information* about resources to help solve problems contributes to the unfamiliarity. *Restrictions* imposed by the host country often contribute to the risk. Many host countries demand development of their exports and insist on training and development of their nationals. They can also demand that certain positions in management and technological areas be held by nationals. Many seek technologically based industry rather than extractive industry. In other instances, the host country may require that it own controlling interest and/or limit the amount of profits or fees entrepreneurs are allowed to take out of the country.

Political risks include unstable governments, disruptions caused by territorial conflicts, wars, regionalism, illegal occupation, and political ideological differences. *Economic risks* that need to be monitored include changes in tax laws, rapid rises in costs, strikes, sudden increases in raw materials, and cyclical/dramatic shifts in gross national product. Social risks include antagonism among classes, religious conflict, unequal income distribution, union militancy, civil war, and riots. *Financial risks* incorporate fluctuating exchange rates, repatriation of profits and capital, and seasonal cash flows.[73]

Foreign government import regulations can affect a company's ability to export successfully. These regulations represent an attempt by foreign governments to control their markets, to protect a domestic industry from excessive foreign competition, to limit health and environmental damage, or to restrict what they consider excessive or inappropriate cultural influence.

Most countries have import regulations that are potential barriers to exported products. Exporters need to be aware of import tariffs and consider them when pricing their products. While most countries have reduced their tariffs on imported goods, there are still major restrictions on global trading, such as nontariff barriers. Nontariff barriers include prohibitions, restrictions, conditions, or specific requirements that can make exporting products difficult and sometimes costly.

Many entrepreneurs have avoided international trade because they believe it is too complicated and fraught with bureaucratic red tape. They also believe that international trade is profitable only for large companies that have more resources than smaller businesses. Other perceived drawbacks to international trade include becoming too dependent on foreign markets, foreign government instability that could cause problems for domestic companies, tariffs and import duties that make it too expensive to trade in other countries, products manufactured in the United States that may need significant modification before they are accepted by people in other countries, and foreign cultures, customs, and languages that make it difficult for Americans.[74]

In pursuing international trade, entrepreneurs face the risks of confiscation, expropriation, domestication, and other government interference. Entrepreneurs may take out insurance to cover some political and economic risks. The U.S. International Development Finance Corporation (previously named the Overseas Private Investment Corporation) can cover three types of risk: currency inconvertibility insurance, expropriation insurance, and political environment insurance.

Key Questions and Resources

International marketing research is critical to the success of entrepreneurial businesses in overseas markets. Entrepreneurial enterprise owners can tap a host of sources to obtain needed information directed toward answering the following three questions:

1. *Why is the company interested in going international?* The answer to this question will help the firm set its international objectives and direct the marketing research effort. For example, if the entrepreneurial business owner wants to establish and cultivate an overseas market, then the firm will be interested in pinpointing geographic areas where future market potential is likely to be high. If the business owner wants to use the market to handle current overproduction, then the company will be interested in identifying markets that are most likely to want to make immediate purchases. Regardless, the firm will have established a focus for its marketing research efforts.
2. *What does the foreign-market assessment reveal about the nature and functioning of the markets under investigation?* The answer to this question, which often is comprehensive in scope, helps identify market opportunities and provide insights regarding the specific activities of these individual markets. For example, if the firm identifies potential markets in Brazil, Africa, and China, the next step is to evaluate these opportunities. This can be done by gathering information related to the size of the markets, competition that exists in each, the respective government's attitude to foreign businesses, and steps that will have to be taken to do business in each location. Based on this information, a cost/benefit analysis

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The Entrepreneurial Process

Global Entrepreneurship in Israel

Despite a population of fewer than 9 million people, Israel has become known as a "start-up nation." It boasts highest number of start-ups per capita and the highest number of unicorns per capita. Yet the secret to its success paradoxically lies in its small size. Surrounded by the Mediterranean Sea and non-democratic markets, Israel lacks a large domestic market, so any start-up that aspires to succeed must look outward from day zero. This limited domestic market fosters an entrepreneurial mindset, as entrepreneurs are faced with scarce resources and must find new innovative ways to start and grow their business. It is not surprising to find an Israeli company with a tech team from Tel Aviv and management in Silicon Valley. Israel's symbiotic relationship with other tech hubs encourages entrepreneurs to develop products with built-in expansion plans and global partners. This fosters a more agile and adaptable ecosystem as start-ups constantly enter new markets and reinvent organizational structures. One famous example of this cross-border collaboration is Waze, the mobile navigation app. Waze officially moved to Palo Alto, California, in 2010, although it continued to employ the majority of its talent in Israel. The necessities, including larger networks, wider media coverage, and more acquisition opportunities, urged Waze to move out of Israel. In 2013, the company was successfully acquired by Google for more than $1 billion.

Besides stimulating a global mindset and resourcefulness, Israel is also a highly diversified country. It is an established Jewish democratic state, home to Jewish people from all over the world. One of its largest cities, Tel Aviv, is considered as one of the most welcoming to the LGBTQ+ community. In addition, about one-fifth of the Israeli population consists of Arabs and about 4 percent vegans, which makes Israel a country with the highest number of vegans per capita in the world. Diversity is a key component of an entrepreneurial spirit that enables Israeli companies to diversify their talents and further drive their innovation and business results. The high-tech environment is changing exponentially, which makes this diverse pool of talent a key advantage for start-ups by promoting the formation of teams more capable of evolving, adapting, and changing with the ever-changing environment.

Nevertheless, one of the key reasons for Israel's entrepreneurial development is its incredibly supportive government, which fosters a collaborative and innovative ecosystem through the Israel Innovation Authority. They have numerous incentive programs for early stage companies. This includes programs for ideation as well as seed incentive programs to help entrepreneurs in any stage of the process and transform their idea into reality. Their incubator program gives entrepreneurs a grant of up to 85 percent of the approved research and development budget and further investment financing of up to 15 percent from the incubator to supplement state funding, thus fulfilling 100 percent of the budget. Physical space, infrastructure, administrative services, technological and business guidance, legal advice, and access to partners are just some of the numerous tools that the program makes available to the entrepreneur. The entrepreneur is not required to establish a company before the project is approved by the Innovation Authority or invest any personal money. This gives entrepreneurs an ideal opportunity to develop their idea without monetary constraints in a supporting and challenging ecosystem that stimulates the entrepreneurial mind.

Prime Minister Benjamin Netanyahu stated, "Israel is a nation that sanctifies innovation. We've achieved great heights, but we cannot stop now; we want to continue climbing." As a melting pot of cultures, Israel unites academia, private initiatives, and government agencies to serve as one of the leading start-up ecosystems in the world, giving entrepreneurs the opportunity, resources, and motivation to innovate the products of tomorrow.

Source: Adapted from Oded Agam, "Learning from Israel's Successful Innovation Ecosystem," *Forbes*, July 2021; Leo Schwartz, "Tel Aviv's Symbiotic Relationship with Silicon Valley," *Rest of World*, July 2021; and Israel Innovation Authority, https://www.innovationisrael.org.il/en, accessed January 25, 2022.

can be conducted and a decision made regarding the market(s) to be pursued.

3. *What specific market strategy is needed to tap the potential of this market?* The answer to this question involves a careful consideration of the marketing mix: product, price, place, and promotion. What product should the firm offer? What specific features should it contain? Does it need to be adapted for the overseas market, or can the firm sell the same product it sells domestically? At what stage in the product life cycle will this product be? How much should the firm charge? Can the market be segmented so that a variety of prices can be set? How will the product move through the marketing channel? What type of promotional efforts—advertising, sales promotion, personal selling, or a combination of these—will be needed?

Once these questions have been answered, the entrepreneurial business owner will be in a position to begin implementing the international phase of the firm's strategy.

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Diversity in Entrepreneurship

Why Female Entrepreneurs Still Need Support

Sara Blakely, who at the age of 29 became the youngest self-made woman billionaire in the world, is looking to make a further push for women in corporate America. Throughout her career, she has invested in female founders, hired women for leadership positions, and featured female-founded companies in Spanx's catalog, which has millions of readers and has been in circulation since 2004. She recently signed over a majority stake in her shapewear company Spanx to the private equity shop Blackstone with a commitment to boosting other women in the business world. This includes an all-female board and support from female investors, including Oprah Winfrey, Reese Witherspoon, and Whitney Wolfe Herd. We are increasingly experiencing "the divine feminine rising," Blakely reflected. Women in strong positions are setting an example for other women that femininity is a strength that should be harnessed and that women need to have a voice in the business world.

In fact, an increasing number of women across the world have established start-ups in different niches, with nearly 13 million women-owned businesses in the United States. This figure represents 42 percent of all companies in the country, which means that women own four out of 10 businesses, generating about $1.8 trillion annually. These numbers do not really raise any concerns, so why are we still seeing such a push for supporting women entrepreneurs? For that, we need to look at a separate set of numbers. Women still face more barriers to starting a business compared to men. There is a large funding disparity, as only 2.3 percent of venture capital goes to women entrepreneurs. Consequently, only 2 percent of women-owned start-ups generate $1 million, something that men are 3.5 times more likely to achieve.

It is not surprising, then, that women in powerful positions are supporting the climb of other women. But what lies at the core of these barriers? Unfortunately, the business world is still plagued by gender bias. Business has traditionally been associated with traits typically displayed by a man. A woman exhibiting signs of business acumen is thus often regarded as aggressive and unnerving. Blakely herself recalls a moment when, at the age of 29, she spoke with several men at a cocktail party who came to know about her business from a local Atlanta newspaper. They said, "Business is war, Sara. I hope you're ready." That night, Blakely decided that she was going to honor the traditionally feminine principles of intuition, empathy, kindness, and vulnerability (qualities that are among the most valuable in positions of leadership) as she steered the business to a billion-dollar success. Most aspects of life, including business, are built on a patriarchal foundation. Blakely displays the importance of combating these stereotypes to create a favorable business environment for everyone.

Additionally, statistics show that 48 percent of women in business lack competent advisers. Establishing a start-up comes with many challenges; even most experienced entrepreneurs fall back on mentors and investors for guidance to improve their ideas and implement the right business strategies. Seasoned venture capital investors can guide entrepreneurs on their path to success, a network to which most women entrepreneurs do not get access. To combat this, there are an increasing number of women-focused networking events, such as WomenNetwork, WIN Conference, and Ellevate Network.

Women entrepreneurs were also disproportionately affected by the COVID-19 pandemic, as they are more likely to run hospitality, wholesale, and retail businesses, which have suffered greatly due to shutdowns. The reduced demand for services, closures due to lockdowns, and increased pressures from juggling household tasks with running a business from home have threatened the progress toward closing the gender gap in entrepreneurship as more women struggled to keep their businesses afloat. Even though the household dynamic has been changing, there is still a greatexpectation for women to take care of children and household chores. This stereotype prevents many women from achieving work–life balance and robs them of an equal opportunity at running a business. Indeed, stay-at-home parents account for about 18 percent of parents in the United States, most of whom are women.

The increasing number of female-centered organizations, female-focused mentorship groups, and female networking conferences shows notable progress toward closing the gender gap. However, women entrepreneurs seem to be facing a much tougher barrier, ingrained in the soul of corporate America and in the world at large. These gender stereotypes skew people's perceptions and take generations to reform. It is why the push for women entrepreneurs cannot stop here but must go beyond women by including everyone across the full gender continuum in the creation of a business world available for all.

Source: Adapted from Sohil Goorha, "Overcoming Some of the Barriers to Women Entrepreneurship," *Forbes*, September 2021, and Eliza Haverstock, "'I Feel the Divine Feminine Rising'—Spanx Founder Sara Blakely on How Intuition Led to Her $1.2 Billion Blackstone Exit," *Forbes*, December 2021.

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Summary

The challenge of social enterprise has emerged in the twenty-first century as a major issue for entrepreneurs. Social enterprise consists of obligations that a business has to society. The boom in social entrepreneurship and its promise of ending daunting social problems across the globe are of particular importance. Studies reveal that entrepreneurs recognize social enterprise as part of their role and that the structure of smaller firms allows entrepreneurs to influence their organizations more personally. Social entrepreneurs are change agents: they create large-scale change with pattern-breaking ideas, they address the root causes of social problems, and they possess the ambition to create systemic change.

With the huge growth and interest in social entrepreneurship that we mention in the chapter comes the challenges to the boundaries of what is and what isn't a social enterprise. Because social causes can be so different and, at times, so oddly personal, enterprises that embrace them can be very tough to decipher. It seems that the best way to end the confusion is to accept social entrepreneurship activity as a continuum, with one extreme being social entrepreneurs driven exclusively by producing social benefits and the other extreme being social entrepreneurs motivated primarily by profitability with social benefits being the means. We also discussed the importance of measuring the actual impact of social entrepreneurship initiatives.

Sustainable development is perhaps the most prominent topic of our time when it comes to business and entrepreneurship. Scholars suggest that entrepreneurial action can preserve ecosystems, counteract climate change, reduce environmental degradation and deforestation, improve agricultural practices and freshwater supply, and maintain biodiversity. Sustainable entrepreneurship includes *ecopreneurship* (i.e., environmental entrepreneurship), with entrepreneurial actions contributing to preserving the natural environment.

The chapter included coverage of a concept referred to as "shared value." It is an approach to creating economic value that also creates value for society by addressing its needs and challenges. It connects company success with social progress. This concept, coupled with "triple bottom line" thinking (*profits*, *people*, and the *planet*), will shape the transformation of organizations in the twenty-first century.

In recent years, there has been growing interest in poverty and entrepreneurship and particularly in the role of venture creation as a pathway out of poverty. In the chapter, we discussed the "liability of poorness," defined as *the potential for failure of a new venture that is associated with problems that the entrepreneur struggles to adequately address because of characteristics and influences deriving from a poverty background*. It is a multidimensional construct that includes literacy issues, a scarcity mentality, intense nonbusiness pressures, and the lack of any sort of safety margin. One solution is to make venture creation by those experiencing poverty a priority in terms of both policy formulation and the activities of local entrepreneurial ecosystems.

Doing business globally is rapidly becoming a profitable and popular strategy for many entrepreneurial ventures. The USMCA, the EU, and the WTO are examples of the powerful economic forces creating opportunities for global entrepreneurs.

This chapter examined why entrepreneurs seek to internationalize and discussed five ways to actively engage in the international markets: importing, exporting, joint ventures, direct foreign investment, and licensing. Researching the foreign market was described as well as the threats and risks to be avoided.

The last part of the chapter examined the five steps for entering the international marketplace: (1) conduct research, (2) prepare a feasibility study, (3) secure adequate financing, (4) file the proper documents, and (5) draw up and implement the plan.

Key Terms

B corporation
benefit corporation
diaspora networks
ecopreneurship
ecovision
European Union (EU)
exporting
global entrepreneurs
importing
international alliances
joint venture
learning curve concept
liability of poorness
licensing
market-rich countries
political risks
resource-rich countries
shared value
social entrepreneurship
social impact investing
social value
sustainable entrepreneurship
triple bottom line (TBL)
United States–Mexico–Canada Agreement (USMCA)
World Trade Organization (WTO)

Review and Discussion Questions

1. Outline a few of the current trends that illustrate the social entrepreneurship movement.
2. Define a *social entrepreneur.*
3. Describe the challenging boundaries involved with social enterprise.
4. Social enterprise can be classified into distinct categories. List some of the categories.
5. How would you describe *sustainable entrepreneurship*?

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6. What is *ecopreneurship,* and how does *ecovision* play a role? Outline some specific recommendations for entrepreneurs to consider that promote environmental awareness.
7. Explain the concepts of *shared vision* and *triple bottom line*.
8. Describe how entrepreneurship is a solution to global poverty and the liability of poorness.
9. What are diaspora networks, and why are they important for global entrepreneurs?
10. How do the following organizations impact international entrepreneurship: USMCA, WTO, and the EU?
11. Identify the various methods available to entrepreneurs to "go international."
12. What are the forms of international alliances?
13. How does a joint venture work? What are the advantages of this arrangement? What are the disadvantages?
14. How does a licensing arrangement work? What are the advantages and disadvantages of such an arrangement?
15. When entering the international marketplace, entrepreneurs should follow what five specific steps?

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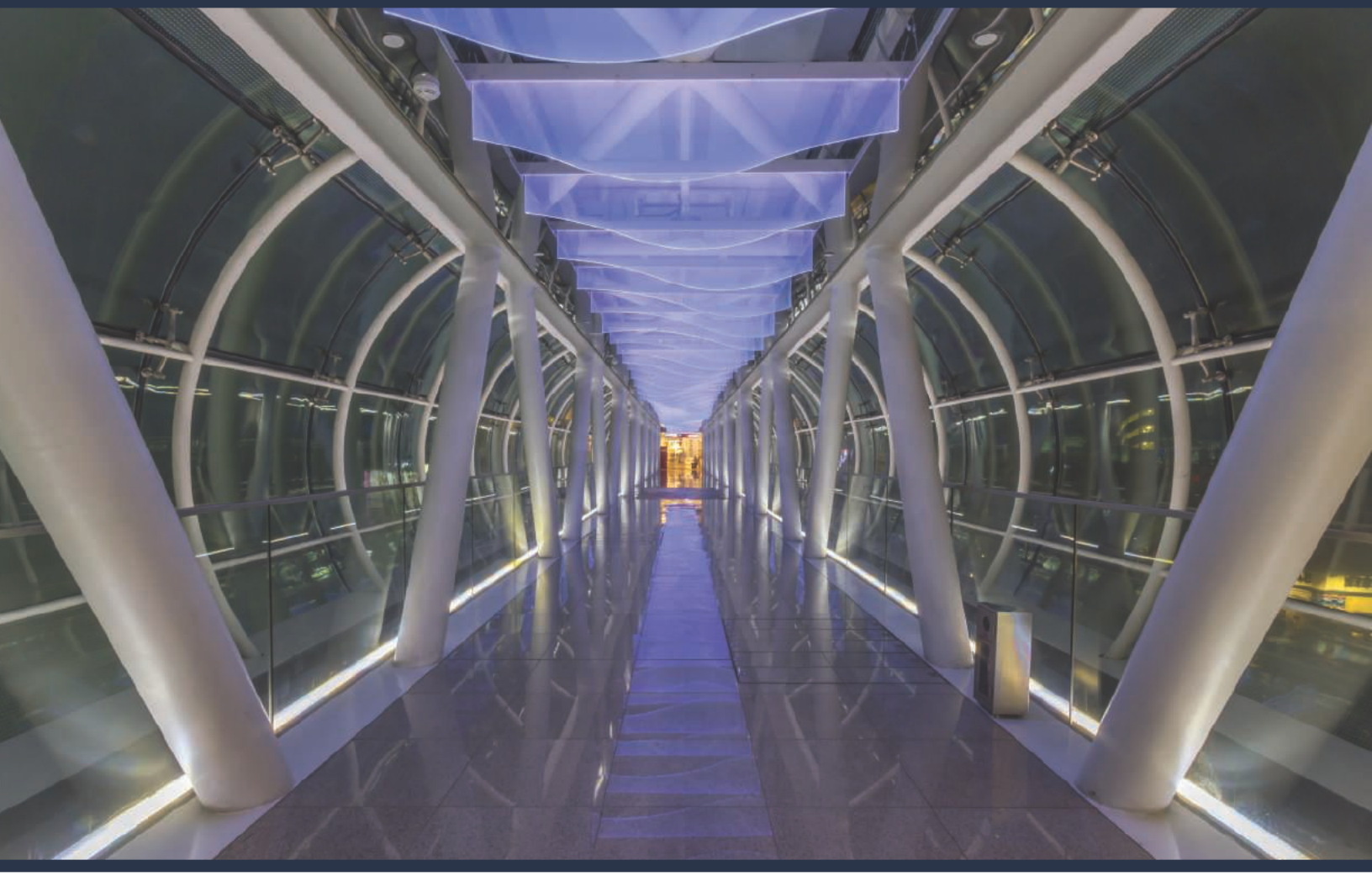
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Part 2 | Initiating Entrepreneurial Ventures



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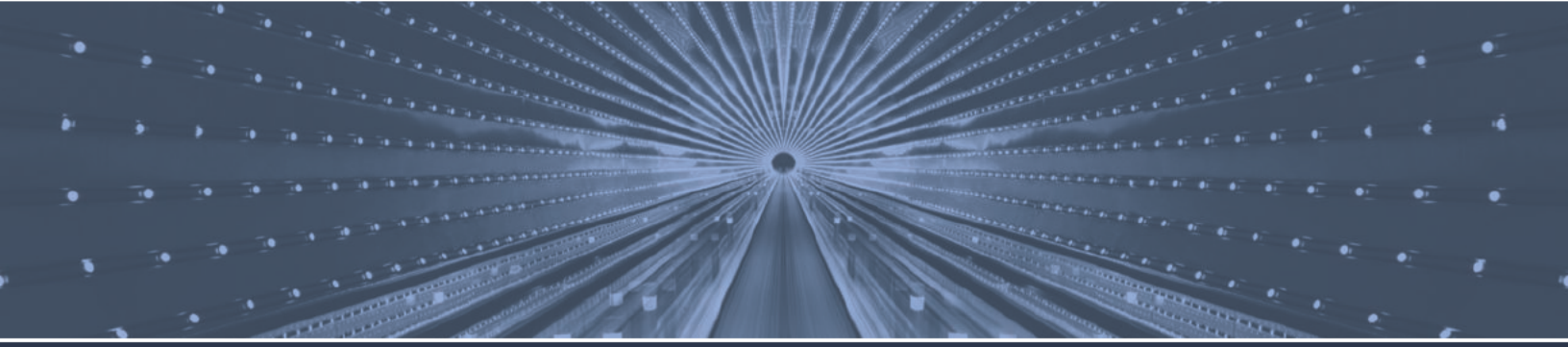
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Chapter 5

Innovation: The Creative Pursuit of Ideas

Learning Objectives

5.1. Summarize the opportunity identification process

5.2. Explain the sources of innovative ideas for entrepreneurs

5.3. Outline the major components of the creative process: knowledge accumulation, incubation process, idea experience, evaluation, and implementation

5.4. Describe ways of developing personal creativity: recognize relationships, develop a functional perspective, use your "brains," and eliminate muddling mindsets

5.5. Identify the arenas of creativity

5.6. Examine the factors for a creative climate

5.7. Introduce the four major types of innovation

5.8. Review some of the major myths associated with innovation and define the ten principles of innovation

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Entrepreneurial Thought

There is no doubt that creativity is the most important human resource of all. Without creativity, there would be no progress, and we would be forever repeating the same patterns.

—Edward de Bono

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5-1 Opportunity Identification: The Search for New Ideas

LO5.1 Summarize the opportunity identification process

Opportunity identification is central to the domain of entrepreneurship. "At its core entrepreneurship revolves around the questions of why, when, and how opportunities for the creation of goods and services in the future arise in an economy. Thus, opportunity recognition is the progenitor of both personal and societal wealth."[1] It has been argued that understanding the opportunity identification process is one of the primary challenges of entrepreneurship research.[2]

This chapter is a study of the creative pursuit of new ideas and the innovation process: two major topics that are keys to understanding entrepreneurial opportunities. It examines the sources that can be useful in searching out innovative ideas and the avenues that lead to their discovery. First, let's examine some productive sources of innovative ideas.

5-1a Sources of Innovative Ideas

LO5.2 Explain the sources of innovative ideas for entrepreneurs

Entrepreneurs, ever alert to opportunities that inhabit the external and internal environments around them, often spot potential opportunities that others simply cannot recognize. Where do they find inspiration? All of the following places:

Trends

Trends signal shifts in the current paradigm (or thinking) of the major population. The close observation of trends—whether societal, technological, economic, or governmental—and the valuable insights that emanate therefrom constitute an abundant source of potential entrepreneurial ideas:

Societal trends. aging demographics, health and fitness growth, senior living

Technology trends. mobile (smartphone) technology, e-commerce, social media

Economic trends. higher disposable incomes, dual wage-earner families, performance pressures

Government Trends: increased regulations, petroleum prices, terrorism

Unexpected Occurrences

Unexpected occurrences are successes or failures that, because they were unanticipated or unplanned, often prove to be major sources of innovation. The infamous 9/11 terrorist attack on the United States is a good example of an unexpected occurrence; it produced an influx of innovative solutions to new homeland security challenges.

Incongruities

Incongruities exist in the gap between expectations and reality. For example, when Fred Smith proposed overnight mail delivery, he was told, "If it were that profitable, the U.S. Post Office would be doing it." It turned out that Smith was right. An incongruity existed between the assumption that a new, faster level of mail service would never make economic sense given that mail delivery was, at the time, a three-day affair. So Smith started FedEx.

Process Needs

Venture capitalists often refer to process needs in the marketplace as "pain" and to innovative solutions to these needs as "painkillers." When the need is to do something better, innovative new medical devices, healthier foods, more effective pharmaceuticals, and time-saving devices can be the result.

Industry and Market Changes

Continual shifts in the marketplace caused by changes in consumer attitudes, advancements in technology, and growth in the structure, design, or definition of markets or industries are sources of emerging opportunity. An example can be found in the health care industry, where inpatient care has undergone radical changes and at-home health care and preventive medicine have replaced hospitalization and surgery as primary focus areas.

Demographic Changes

Changes in population size, age, education, occupation, geographic locality, and similar demographic variables often catalyze new entrepreneurial opportunities. For example, as the average population age in Florida and Arizona has increased (due largely to the influx of retirees), land development, recreation, and health care industries all have profited.

Perceptual Changes

Perceptual changes in people's interpretation of facts and concepts may be intangible but meaningful. The perceived need to be healthy and physically fit has created a demand

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Table 5.1 Sources of Innovative Ideas

Source	Examples
Unexpected occurrences	Unexpected success: Uber; unexpected tragedy: 9/11 terrorist attack, COVID-19
Incongruities	Overnight package delivery
Process needs	Sugar-free products, caffeine-free coffee, microwave ovens
Industry and market changes	Health care industry: changing to home health care
Demographic changes	Retirement communities for older people
Perceptual changes	Exercise (aerobics) and the growing concern for fitness
Knowledge-based concepts	Mobile (smartphone) technology, pharmaceutical industry, robotics

for both health foods and health facilities throughout the country. People's desire to better use their personal time has been a boon to the travel industry, which, capitalizing on consumers' desires to "see the world" while they are young and healthy, has led to increasing interest in time-share condominiums and travel clubs.

Knowledge-Based Concepts

Inventions, which are the product of new thinking, new methods, and new knowledge, often require the longest time period between initiation and market implementation because of the need for testing and modification. For example, cell phone technology has advanced to include not just phone service but also cameras, Internet access, and music. This has revolutionized the way we use cell phones today. These concepts were not thought possible 20 years ago; some examples of these innovation sources are presented in Table 5.1.

5-1b The Knowledge and Learning Process

Once sources of ideas are recognized, entrepreneurs must use their existing knowledge base, acquired through work, experience, and education, to hone ideas into actual opportunities. General industry knowledge, prior market knowledge, prior customer understanding, specific interest knowledge, or any previous knowledge helps entrepreneurs to distill unusual sources of innovative ideas into potential opportunities.[3]

In addition to simply having a particular experience in their knowledge base, entrepreneurs must be able to learn from their experiences. Researcher Andrew C. Corbett has identified the importance of acquiring and transforming information, knowledge, and experience through the learning process. His research lends credence to theories about the cognitive ability of individuals to transform information into recognizable opportunities.[4] How an individual entrepreneur acquires, processes, and learns from prior knowledge is critical to the opportunity identification process. With that in mind, we next examine the imagination and creativity needed to transform experiences into entrepreneurial insight and know-how.

5-2 Entrepreneurial Imagination and Creativity

Entrepreneurs blend imaginative and creative thinking with a systematic, logical process ability. This combination is a key to successful innovation. In addition, potential entrepreneurs are always looking for unique opportunities to fill needs or wants. They sense economic potential in business problems by continually asking, "What if?" or "Why not?" They develop an ability to see, recognize, and create opportunity where others find only problems. It has been said that the first rule for developing entrepreneurial vision is to recognize that problems are to solutions what demand is to supply. Analysis that blends creative thinking with systematic inquiry such that problems are looked at from every possible angle is a hallmark of the entrepreneurial imagination. Even more significantly, researchers Alexander S. Kier and Jeffery S. McMullen have shown that teams with similar imaginativeness profiles are stronger in the ideation process.[5] What is the problem? Whom does it affect? How does it affect them? What costs are involved? Can it be solved? Would the marketplace pay for a solution? Entrepreneurs continually and imaginatively cycle through these types of questions.

5-2a The Role of Creative Thinking

LO5.3 Outline the major components of the creative process: knowledge accumulation, incubation process, idea experience, evaluation, and implementation

It is important to recognize the role of creative thinking in the innovative process. **Creativity** is the generation of ideas that results in the improved efficiency or effectiveness of a system.[6]

Two important components of creative problem solving are process and people. Process is goal oriented; it is designed to attain a solution to a problem. People are the resources that determine the solution. The process remains the same, but the approach that people take

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toward problem solving varies: sometimes, they will adapt a solution, and at other times, they will formulate a highly innovative solution.[7] Table 5.2 compares the approaches of adaptors versus innovators.

One study examined the validity of these two approaches for distinguishing innovative entrepreneurs from adaptive entrepreneurs and found their application very effective.[8] Thus, understanding the problem-solving orientation of individuals helps develop their creative abilities.

5-2b The Nature of the Creative Process

Creativity is a process that can be developed and improved.[9] Everyone is creative to some degree. However, as is the case with many abilities and talents (athletic, artistic, and so on), some individuals have a greater aptitude for creativity than others. Also, some people have been raised and educated in an environment that encouraged them to develop their creativity. They have been taught to think and act creatively. For others, the process is more difficult because they have not been positively reinforced; if they are to be creative, they must learn how to implement the creative process.[10]

Many people incorrectly believe that only geniuses can be creative.[11] Most people also wrongly assume that some people are born creative whereas others are not and that only the gifted or highly intelligent person is capable of generating creative ideas and insights. The real barriers to creative thinking are sometimes the inadvertent "killer phrases" that we all routinely use in our communications. Table 5.3 lists 10 key idea "killers" we hear every day. People may not intentionally seek to kill creative ideas, but their negative expressions often quash creative ideas from further development.[12]

Table 5.3 The Most Common Idea Killers

1. "Naah."
2. "Can't" (said with a shake of the head and an air of finality).
3. "That's the dumbest thing I've ever heard."
4. "Yeah, but if you did that . . ." (poses an extreme or unlikely disaster case).
5. "We already tried that—years ago."
6. "I don't see anything wrong with the way we're doing it now."
7. "We've never done anything like that before."
8. "We've got deadlines to meet—we don't have time to consider that."
9. "It's not in the budget."
10. "Where do you get these weird ideas?"

Source: Kuratko and Hodgetts, *Entrepreneurship*, 8th ed. © 2009 Cengage Learning.

Creativity is not some mysterious and rare talent reserved for a select few. It is a distinct way of looking at the world that is often illogical. The creative process involves seeing relationships among things that others have not seen (e.g., the use of USB flash drives, known as thumb drives, to store or transfer data).[13]

The creative process has four commonly agreed-on phases or steps. Most experts agree on the general nature and relationships among these phases, although they refer to them by a variety of names.[14] Experts also agree that these phases do not always occur in the same order for every creative activity. For creativity to occur, chaos is necessary—but a structured and focused chaos. We shall examine this four-step process using the most typical structural development.

Phase 1: Background or Knowledge Accumulation

Successful creations are generally preceded by investigation and information gathering. This usually involves extensive reading, conversations with others working in the field, attendance at professional meetings and workshops, and a general absorption of information relative to the problem or issue under study. Additional investigation in both related and unrelated fields is sometimes involved. This exploration provides the individual with a variety of perspectives on the problem, and it is particularly important to the entrepreneur, who needs a basic understanding of all aspects of the development of a new product, service, or business venture.

Table 5.2 Two Approaches to Creative Problem Solving

Adaptor	Innovator
Employs a disciplined, precise, methodical approach	Approaches tasks from unusual angles
Is concerned with solving rather than finding problems	Discovers problems and avenues of solutions
Attempts to refine current practices	Questions basic assumptions related to current practices
Tends to be means oriented	Has little regard for means; is more interested in ends
Is capable of extended detail work	Has little tolerance for routine work
Is sensitive to group cohesion and cooperation	Has little or no need for consensus; often is insensitive to others

Source: Michael Kirton, "Adaptors and Innovators: A Description and Measure," *Journal of Applied Psychology*, October 1976, 623. Copyright © 1976 by The American Psychological Association.

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People practice the creative search for background knowledge in a number of ways. Some of the most helpful are to (1) read in a variety of fields; (2) join professional groups and associations; (3) attend professional meetings and seminars; (4) travel to new places; (5) talk to anyone and everyone about your subject; (6) scan magazines, newspapers, and journals for articles related to the subject; (7) develop a subject library for future reference; (8) carry a small notebook and record useful information; and (9) devote time to pursue natural curiosities.[15]

Phase 2: The Incubation Process

Creative individuals allow their subconscious to mull over tremendous amounts of information gathered during the preparation phase. This incubation process often occurs while they are engaged in activities totally unrelated to the subject or problem. It happens even when they are sleeping. This accounts for the advice frequently given to a person who is frustrated by what appears to be an unsolvable problem: "Why don't you sleep on it?"[16] Getting away from a problem and letting the subconscious mind work on it allows creativity to spring forth. Some of the most helpful steps to induce incubation are to (1) engage in routine, "mindless" activities (cutting the grass or painting the house); (2) exercise regularly; (3) play (sports, board games, or puzzles); (4) think about the project or problem before falling asleep; (5) meditate or practice self-hypnosis; and (6) sit back and relax on a regular basis.[17]

Phase 3: The Idea Experience

This phase of the creative process is often the most exciting because it is when the idea or solution the individual is seeking is discovered. Sometimes referred to as the "eureka factor," this phase is also the one the average person incorrectly perceives as the only component of creativity.[18]

As with the incubation process, new and innovative ideas often emerge while the person is busy doing something unrelated to the enterprise, venture, or investigation (e.g., taking a shower, driving on an interstate highway, or leafing through a newspaper).[19] Sometimes the idea appears as a bolt out of the blue. In most cases, however, the answer comes to the individual incrementally. Slowly but surely, the person begins to formulate the solution. Because it is often difficult to determine when the incubation process ends and the idea experience phase begins, many people are unaware of moving from Phase 2 to Phase 3.

The Entrepreneurial Process

Remote Work Fails to Produce Creative Ideas

Until recently, much has been written and discussed about the benefits of working remotely for both employees and employers: cost savings, work–life balance, quiet, a reduction in absenteeism, more time to devote to work, no commute time, and increased productivity, to name a few. Researchers are now discovering what isn't working for companies with remote employees trying to collaborate. Most insightful has been that of idea generation and creativity.

Recent studies have shown that creative types of work require individuals to be together, where they can be unfocused and free to generate fluid ideas via dialogue. People need to walk around, brainstorm, and use physical space to generate as many ideas as they can. The generation of more ideas may ultimately result in the best ideas being the final ones chosen.

Out of politeness, remote work requires that one continue to look at a screen while discussing ideas, but this can curb creativity. The screen limits how much information can be shared between participants. There is limited flexibility to move around, more breaks in communication, and less fluid communication with the participants.

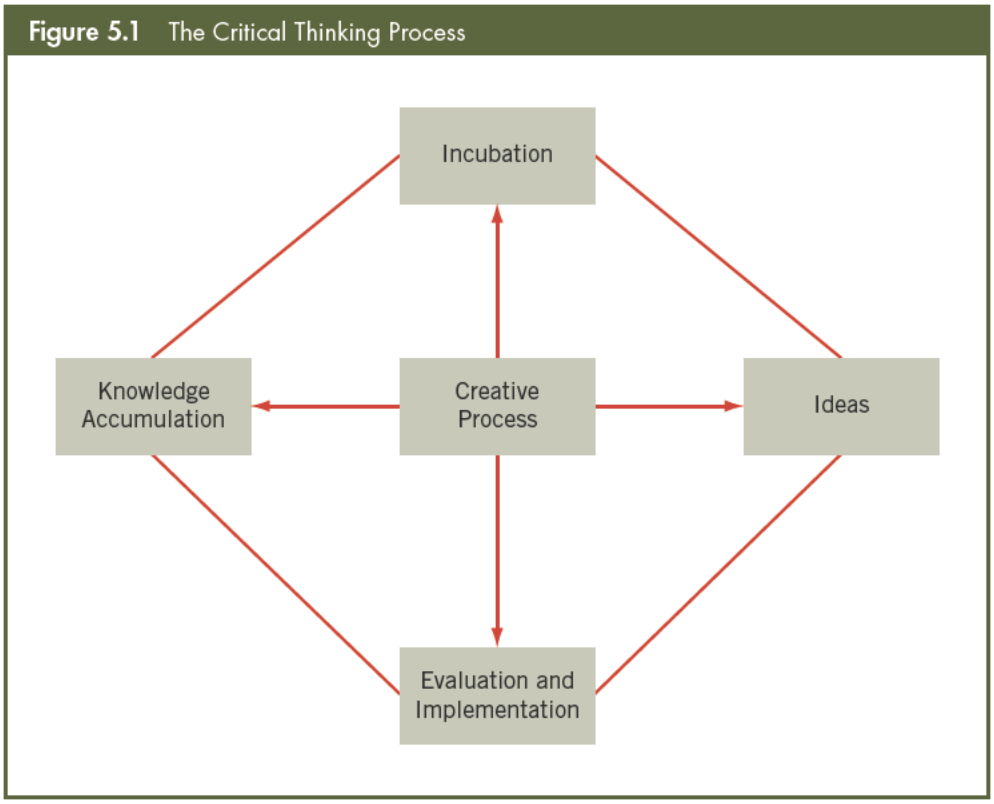
The results of the studies show that in-person collaboration versus on-screen collaboration generates 15 to 17 percent more ideas. Alternatively, analytical decision making, such as selecting the best idea of those generated creatively, can be done equally well remotely or in person. The studies show that the results were equally good.

What does this tell us? Creativity and idea generation are group and in-person efforts. Each company will have to decide whether the trade-off of remote work is worth the impact on creative efforts or whether this part of teamwork can or should be kept in house.

Source: Adapted from Seth Borenstein, "Ideas on Mute? Study: Remote Meetings Dampen Brainstorming," *AP News*, April 27, 2022, https://apnews.com/article/science-business-psychology-338e18b80ee701d754d8c565cf86479c; Emöke-Ágnes Horvát and Brian Uzzi, Virtual Collaboration Hinders a Key Component of Creativity, April 27, 2022, https://media.nature.com/original/magazine-assets/d41586-022-00126-2/d41586-022-00126-2.pdf; "Technology: Videoconferencing Hinders Creativity, Study Finds," *Forbes India*, April 28, 2022, https://www.forbesindia.com/article/lifes/videoconferencing-hinders-creativity-study-finds/75801/1; and Finn Faldi, "Why Working from Home Is Beneficial for the Employer and Employee," *Entrepreneur*, March 17, 2020, https://www.entrepreneur.com/growing-a-business/why-working-from-home-is-beneficial-for-the-employer-and/347292.

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Figure 5.1 The Critical Thinking Process



Following are ways to speed up the idea experience: (1) daydream and fantasize about your project, (2) practice your hobbies, (3) work in a leisurely environment (e.g., at home instead of at the office), (4) put the problem on the back burner, (5) keep a notebook at bedside to record late-night or early-morning ideas, and (6) take breaks while working.[20]

Phase 4: Evaluation and Implementation

This is the most difficult step of a creative endeavor and requires a great deal of courage, self-discipline, and perseverance. Successful entrepreneurs can identify ideas that are workable and that they have the skills to implement. More important, they do not give up when they run into temporary obstacles.[21] Often, they will fail several times before they successfully develop their best ideas. In some cases, entrepreneurs will take the idea in an entirely different direction or will discover a new and more workable idea while struggling to implement the original one.

Another important part of this phase is the reworking of ideas to put them into final form. Frequently, an idea emerges from Phase 3 in rough form, so it needs to be modified or tested to achieve its final shape. Some of the most useful suggestions for carrying out this phase are to (1) increase your energy level with proper exercise, diet, and rest; (2) educate yourself in the business-planning process and all facets of business; (3) test your ideas with knowledgeable people; (4) take notice of your intuitive hunches and feelings; (5) educate yourself in the selling process; (6) learn about organizational policies and practices; (7) seek advice from others (friends, experts, and so on); and (8) view the problems you encounter while implementing your ideas as challenges.[22]

Figure 5.1 illustrates the four phases of the creative thinking process. If a person encounters a major problem while moving through the process, it is sometimes helpful to go back to a previous phase and try again. For example, if an individual is unable to formulate an idea or solution (Phase 3), a return to Phase 1 often helps. By immersing oneself in the data, the individual allows the unconscious mind to begin anew processing the data, establishing cause–effect relationships, and formulating potential solutions.

5-2c Developing Your Creativity

LO5.4 Describe ways of developing personal creativity: recognize relationships, develop a functional perspective, use your "brains," and eliminate muddling mindsets

You can do a number of things to improve your own creative talents; one of the most helpful is to become aware of some of the habits and mental blocks that stifle creativity.[23] Of course, as with most processes, your development will be more effective if you regularly practice exercises designed to increase your creative abilities. The

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following section is designed to improve your awareness of some of the thought habits that limit your creativity and to assist you in developing a personalized creativity improvement program.

5-3 Recognizing Relationships

Many inventions and innovations are a result of the inventor's ability to see new and different relationships among objects, processes, materials, technologies, and people.[24] Examples range widely and include (1) adding fruit juice to soft drinks to create Slice, (2) combining combustion engine technology with the wheel to create the automobile, and (3) using a 330-pound defensive football player as a running back and pass receiver.

If you wish to improve your creativity, it helps to look for different or unorthodox relationships among the elements and people around you. This activity involves *perceiving in a relational mode*. You can develop this talent by viewing things and people as existing in a complementary or **appositional relationship** with other things and people. Simply stated, things and people exist in the world in relation to other things and people. Creative people seem to be intuitively aware of this phenomenon and have developed a talent for recognizing new and different relationships. These relationships often lead to visions that result in new ideas, products, and services.[25] In order to develop the ability to recognize new relationships, you must practice perceiving in a relational mode. The following exercise helps with this development.

5-4 A Creative Exercise

Analyze and elaborate on how the following pairs relate to each other in a complementary way: nut and bolt, chocolate cake and vanilla ice cream, grass clippings and tomato plants, peanut butter and jelly, athlete and coach, humanity and water, winning and losing, television and laptop computers, and managers and production workers.

5-4a Developing a Functional Perspective

If expanded, the principle of perceiving in a relational mode helps develop a **functional perspective** toward things and people. A creative person tends to view things and people in terms of how they can satisfy their needs and help complete a project. For example, a homemaker who cannot find a screwdriver often will use a butter knife to tighten a loose screw, or a cereal manufacturer will add fruit to its product to create a new product line that appeals to a health-conscious market.

If you wish to become more innovative and creative, you need to visualize yourself in complementary relationships to the things and people of the world. You must learn to look at them in terms of how they complement attempts to satisfy your own needs and to complete your projects. You must begin to look at things and people in nonconventional ways and from a different perspective.[26] The following exercise is designed to help you develop a functional perspective. By doing this exercise, a person can actually begin to increase their creative abilities by relating different perspectives of ordinary objects.

A Functional Exercise

Think of and write down all of the ways you can imagine for the following items to be used (spend a couple of minutes on each item):

- An egotistical staff member
- A large pebble
- A fallen tree branch
- A chair
- A computer "whiz kid"
- An obsessively organized employee
- The office "gossip"
- An old hubcap
- A new administrative assistant
- An empty roll of masking tape
- A yardstick
- An old coat hanger
- The office "tightwad"
- This exercise

5-4b Using Your Brains

Ever since split-brain studies were conducted in the 1950s and 1960s, experts on creativity, innovation, and self-development have emphasized the importance of developing the skills associated with both hemispheres of the brain.[27]

The **right brain** hemisphere helps an individual understand analogies, imagine things, and synthesize information. The **left brain** hemisphere helps the person analyze, verbalize, and use rational approaches to problem solving. Although these two brain hemispheres process information differently and are responsible for different brain activities and skills (see Table 5.4), they are integrated through a group of connecting nerve fibers called the corpus callosum. Because of this connection and the nature of the relationship between the activities of each hemisphere, each hemisphere should be viewed as existing and functioning in a complementary relationship with the other hemisphere.[28]

The creative process involves logical and analytical thinking in the knowledge accumulation, evaluation,

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Table 5.4 Processes Associated with the Two Hemispheres of the Brain

Left Hemisphere	Right Hemisphere
Verbal	Nonverbal
Analytical	Synthesizing
Abstract	Seeing analogies
Rational	Nonrational
Logical	Spatial
Linear	Intuitive
	Imaginative

Source: Tasneem Sayeed, "Left vs. Right Brain: Which Hemisphere Dominates You?," *Hub Pages*, http://tasneemsayeed.hubpages.com/hub/Left_Right_Brain, accessed February 10, 2012, and Kendra Cherry, "Left Brain vs. Right Brain: Understanding the Myth and Reality of Left Brain and Right Brain Dominance," *About.com*, http://psychology.about.com/od/cognitivepsychology/a/left-brain-right-brain.htm, accessed February 10, 2012.

and implementation stages. In addition, it calls for imagination, intuition, analogy conceptualization, and synthesizing in the incubation and idea creation stages. So, to become more creative, it is necessary to practice and develop both right- and left-hemisphere skills. The following problem-solving exercise is designed to demonstrate the effectiveness of combining the skills of both hemispheres when solving problems.

A Brain Exercise

Assume you have an idea that will save your organization time and money in processing customer complaints. Your supervisor has been extremely busy and has been unwilling to stop and listen to your idea. Review the information in Table 5.4 and complete the steps below:

1. Write down all of the left-hemisphere-type solutions to this problem you can think of in five minutes.
2. Write down all of the right-hemisphere-type solutions to this problem you can think of in five minutes.
3. Compare these lists and combine two or more solutions from each list that will result in a unique and innovative way to solve this problem.
4. Repeat steps 1, 2, and 3 using a current problem you are facing at work or at home.

Our society and its educational institutions reward individuals who have been successful at developing their logical, analytical, and rational left-brain skills. Little emphasis, however, has been placed on practicing and using right-brain skills. Table 5.5 represents some ways you can practice developing both left- and right-hemisphere skills.[29]

5-4c Eliminating Muddling Mindsets

A number of mental habits block or impede creative thinking. It has been estimated that adults use only 2 to 10 percent of their creative potential.[30] For example, many individuals tend to make quick judgments about new things, people, and ideas. Another inclination is to point out the negative components of a new or different idea because of the psychological discomfort associated with change. Some common mental habits that inhibit creativity and innovation are "either/or" thinking, security hunting, stereotyping, and probability thinking. These habits, or muddling mindsets, tend to hinder creative thought processes, and different thought processes must be used to enhance creative thinking:[31]

- *Either/or thinking*. Because of the speed of change in the modern world, personal lives are filled with a great deal of uncertainty and ambiguity. People often get bogged down with striving for an unreasonable amount of certainty in their lives. This leads to either/or thinking. But the creative person learns to accept a reasonable amount of ambiguity in their work and life. In fact, many exceptionally creative people thrive in an uncertain environment and find it exhilarating.[32]
- *Security hunting (or perfectionism)*. Many people try to make the right decision or take the correct action every time. This is security hunting (or perfectionism). In doing so, they rely on averages, stereotypes, and probability theory to minimize their risks. They actually seek a sense of perfectionism. Although this strategy often is appropriate, at times, a creator or innovator must take some calculated risks.[33] Sometimes these risks result in the innovator being wrong and making mistakes. Yet by recognizing this as part of the innovation game, the creative person learns from their mistakes and moves on to create bigger and better things. We all know that Thomas Edison failed numerous times when searching for the correct materials to use inside the incandescent lightbulb.
- *Stereotyping*. It is ironic that, although averages and stereotyping are fabricated abstractions, people act and make decisions based on them as if these were data entities that exist in the real world. For example, one could hypothesize that the average homemaker is female, 38 years old, and five feet, four inches tall and has two children, a part-time job, and 14.5 years of formal education. If one tried to find a person who fits this description, however, the chances of success would be small. In short, the more descriptive the abstraction or stereotype, the less real it becomes. Predicating actions from stereotypes and averages can cause an individual to act on the basis of a distorted picture of reality. More important, relying on these abstractions can limit a person's perception of the real entities and possibilities in the

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The Entrepreneurial Process

Developing Creativity

What color is the sky when you dream? Do you consider yourself to be creative? *Creativity* has been defined as having the quality or power of creating. People are innately creative. Really. Let your creativity out of the playpen! Millions of dollars are made from truly simple creative endeavors. You can cash in too if you use some of these methods to boost your creativity.

1. *Brainstorm!* This is the old-school way to drum up creative ideas and solve problems, but it's still by far the best. The corporate world was woken up when Alex Osborn introduced this concept in the 1950s. Established rules were easy to follow:
   - Shout out or write down every solution that comes to mind.
   - Off-the-wall ideas are welcome.
   - Criticize nothing.
   - Organize later.
2. *Opposites attract*. Here's an interesting concept: synectics. Similar to the word itself, synectics involves putting two "nonsensical" things together to see what happens. Examples include these: "Imagine a restaurant with no waiters, tables, or silverware" (McDonald's); "Imagine a bookstore with no books—and no store" (Amazon.com); and "Imagine moving trucks with no movers" (U-Haul). Don't hesitate to explore that which is strange!
3. *THINKubate*. Gerald Haman created (there's that word again) the "THINKubator"—a playground where businesspeople, entrepreneurs, and the like can go to escape the humdrum environment of offices and "can't doers." The playground houses comfortable seating, toys, and fun pictures, and it offers an environment that favors brain stimulation and idea creation. It must work because Haman has developed numerous products for Procter & Gamble and Arthur Andersen.
4. *Trigger great ideas*. Triggers are everyday items that can be used to stimulate the brain: abstract photos, inspiring quotes, uncompleted ideas, tips, and so on. Place trigger items in various places you look or visit often, such as the refrigerator door, your dashboard, or your phone. You never know when a connection will be made.
5. *Connect*. Every person you meet or place you visit might be an opportunity waiting to happen. The key is to be prepared for that opportunity when it arises. Creativity consultant Jordan Ayan suggests building up your CORE: curiosity, openness, risk, and energy. These traits can be enhanced by reading up on trends, attending trade shows, browsing, and trying new things. Spotting open windows isn't necessarily easy, but increasing the number of windows can be.
6. *Always celebrate failure*. Try and try again. What doesn't kill you only makes you stronger. Dare to be great! Get the idea? Don't suffer from insanity! Enjoy every minute of it!
7. *Make 'em laugh*. Humor is a great way to relieve stress. Use it in your creative endeavors. Can you imagine Dennis the Menace helping you build your prototype? How about letting the Disney World characters coauthor your business plan? Let your youngest relative in on your invention. Humor and laughter certainly encourage creativity.
8. *Sweat it*. Yes! Sweat it out! Exercise gets the creative juices—endorphins—flowing. Let the mind wander while you're jogging, or ride the exercise bike while reading the year-end reports. Just be sure to keep a notepad handy to jot down all of your great ideas!
9. *Remember your wildest dreams*. Has anyone ever replied to you with the statement "In your dreams!" Well, go figure. Dreams are a great place to start when it comes to unleashing creativity. Elias Howe once had a dream in which cannibals were piercing his flesh with spears. Thus was the sewing machine invented. Don't ignore daydreams or spur-of-the-moment ideas, either. Your subconscious could be trying to tell you something.

Source: Adapted from Nick D'Alto, "Think Big," *Business Start Ups*, January 2000, 61–65.

world. Creativity expert Edward deBono argues that people must alter their thinking to enhance their creativity; only new patterns of thinking will lead to new ideas and innovations.[34]

- *Probability thinking*. In their struggle to achieve security, many people also tend to rely on the theory of probability thinking to make decisions. An overreliance on this decision-making method, however, can distort reality and prohibit one from taking calculated risks that may lead to creative endeavors.

Probability experts report that the predictive power of probability theory increases in proportion to the number of times an event is repeated. If a person wishes to predict the probability of tossing the number 3 when rolling dice a certain number of times, probability theory is extremely useful. However, if the person wishes to know the likelihood of rolling a 4 with one roll of the dice, the predictive ability of probability theory is much less valuable.

In the creative game, often an individual is looking at an opportunity or situation that may occur only once in a

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Table 5.5 Ways to Develop Left- and Right-Hemisphere Skills

Left-Hemisphere Skills	Right-Hemisphere Skills
1. Step-by-step planning of your work and life activities	1. Using metaphors and analogies to describe things and people in your conversations and writing
2. Reading ancient, medieval, and scholastic philosophy, legal cases, and books on logic	2. Taking off your watch when you are not working
3. Establishing timetables for all of your activities	3. Suspending your initial judgment of ideas, new acquaintances, movies, TV programs, and so on
4. Using and working with a computer program	4. Recording your hunches, feelings, and intuitions and calculating their accuracy
5. Detailed fantasizing and visualizing of things and situations in the future	
6. Drawing faces, caricatures, and landscapes	

lifetime. In a single-event situation, intuition and educated guesses are just as useful as (if not more useful than) logic and probability.[35] One way of increasing your creative capacities is to practice looking at some of the situations in your life as a 50/50 game and then begin to take some risks. Additionally, the following problem-solving exercises are designed to help eliminate muddling mindsets:

- Practice taking small risks in your personal life and at work, relying on your intuition and hunches. Keep a log of these risks and chart their accuracy and consequences. For example, try to draw an inside straight in your next family poker game.
- Go out of your way to talk to people who you think conform to a commonly accepted stereotype.
- Take on a number of complex projects at work and at home that do not lend themselves to guaranteed and predictable results. Allow yourself to live with a manageable amount of ambiguity. Notice how you react to this ambiguity.
- When an idea is presented to you, first think of all the positive aspects of the idea, then of all the negative aspects, and finally of all the interesting aspects.
- When listening to people, suspend initial judgment of them, their ideas, and their information and simply listen.
- Try making some decisions in the present. That is, do not let your personal history or your estimates about the future dominate your decision-making process.[36]

5-5 Arenas of Creativity

LO5.5 Identify the arenas of creativity

Remember, people are inherently creative. Some act on that creativity all of the time, while others stifle it, and most of us fall somewhere in between the two. The reality is that people often do not recognize when or how they are being creative. Furthermore, they fail to recognize the many opportunities for creativity that arise within their jobs on a daily basis. Creativity researcher William Miller argues that people often do not recognize when they are being creative and that they frequently overlook opportunities to be creative. He suggests that the path to creativity begins by first recognizing all of the ways in which we are or can be creative. People in organizations can channel their creativity into seven different arenas:

- *Idea creativity.* Thinking up a new idea or concept, such as an idea for a new product or service or a way to solve a problem.
- *Material creativity.* Inventing and building a tangible object, such as a product, an advertisement, a report, or a photograph.
- *Organization creativity.* Organizing people or projects and coming up with a new organizational form or approach to structuring things. Examples could include organizing a project, starting a new type of venture, putting together or reorganizing a work group, and changing the policies and rules of a group.
- *Relationship creativity.* An innovative approach to achieving collaboration, cooperation, and win-win relationships with others. The person who handles a difficult situation well or deals with a particular person in an especially effective manner is being creative in a relationship or one-on-one context.
- *Event creativity.* Producing an event such as an awards ceremony, team outing, or annual meeting. The creativity here also encompasses decor, ways in which people are involved, sequence of happenings, setting, and so on.
- *Inner creativity.* Changing one's inner self, being open to new approaches to how one does things and thinking about oneself in different ways, or achieving

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a change of heart or finding a new perspective or way to look at things that is a significant departure from how one has traditionally looked at them.

- *Spontaneous creativity.* Acting in a spontaneous or spur-of-the-moment manner, such as coming up with a witty response in a meeting, an off-the-cuff speech, a quick and simple way to settle a dispute, or an innovative appeal when trying to close a sale.[37]

5-6 The Creative Climate

LO5.6 Examine the factors for a creative climate

Creativity is most likely to occur when the business climate is right. No enterprise will have creative owners and managers for long if the right climate is not established and nurtured. Following are some important characteristics of this climate:

- A trustful management that does not overcontrol employees
- Open channels of communication among all business members
- Considerable contact and communication with outsiders
- A large variety of personality types
- A willingness to accept change
- An enjoyment in experimenting with new ideas
- Little fear of negative consequences for making a mistake
- The selection and promotion of employees on the basis of merit
- The use of techniques that encourage ideas, including suggestion systems and brainstorming
- Sufficient financial, managerial, human, and time resources for accomplishing goals[38]

5-7 Innovation and the Entrepreneur

Innovation is a key function in the entrepreneurial process. Researchers and authors in the field of entrepreneurship agree, for the most part, with renowned consultant and author Peter F. Drucker about the concept of innovation: "Innovation is the specific function of entrepreneurship. . . . It is the means by which the entrepreneur either creates new wealth-producing resources or endows existing resources with enhanced potential for creating wealth."[39]

Innovation is the process by which entrepreneurs convert opportunities (ideas) into marketable solutions. It is the means by which they become catalysts for change.[40] We demonstrated in the earlier parts of this chapter that the innovation process starts with a good idea. The origin of an idea is important, and the role of creative thinking may be vital to that development.[41] A major difference exists between an idea that arises from mere speculation and one that is the product of extended thinking, research, experience, and work. More important, a prospective entrepreneur must have the desire to bring a good idea through the development stages. Thus, innovation is a combination of the vision to create a good idea and the perseverance and dedication to remain with the concept through implementation.

5-7a The Innovation Process

Most innovations result from a conscious, purposeful search for new opportunities.[42] This process begins with the analysis of the sources of new opportunities. Drucker has noted that, because innovation is both conceptual and perceptual, would-be innovators must go out and look, ask, and listen. Successful innovators use both the right side and the left side of their brains. They look at figures. They look at people. They analytically work out what the innovation has to be to satisfy the opportunity. Then they go out and look at potential product users to study their expectations, values, and needs.[43]

Most successful innovations are simple and focused. They are directed toward a specific, clear, and carefully designed application. In the process, they create new customers and markets. Today's mobile technology (cell phones) is a good example. Although this technology is highly sophisticated, it has become easy to use, and it appeals to a specific market niche: people who want their technology all in one and on the go.

Above all, innovation often involves more work than genius. As Thomas Edison once said, "Genius is 1 percent inspiration and 99 percent perspiration." Moreover, innovators rarely work in more than one area. For all his systematic innovative accomplishments, Edison worked only in the field of electricity.

5-7b Types of Innovation

LO5.7 Introduce the four major types of innovation

Four basic types of innovation exist (see Table 5.6). These extend from the totally new to modifications of existing products or services. Following are the four types, in order of originality:

- *Invention.* **Invention** is the creation of a new product, service, or process—often one that is novel or untried. Such concepts tend to be "revolutionary."
- *Extension.* **Extension** is the expansion of a product, service, or process already in existence. Such concepts make a different application of a current idea.

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Table 5.6 Innovation in Action

Type	Description	Examples
Invention	Totally new product, service, or process	Wright brothers—airplane Thomas Edison—lightbulb Alexander Graham Bell—telephone
Extension	New use or different application of an already existing product, service, or process	Ray Kroc—McDonald's Mark Zuckerberg—Facebook Barry Sternlicht—Starwood Hotels & Resorts
Duplication	Creative replication of an existing concept	Walmart—department stores Gateway—personal computers Pizza Hut—pizza parlor
Synthesis	Combination of existing concepts and factors into a new formulation or use	Fred Smith—FedEx Howard Schultz—Starbucks

The Entrepreneurial Process

Metaverse: The Innovation for the Future?

Ever since Facebook's cofounder Mark Zuckerberg renamed his company to Meta Platforms Inc. in 2021, the interest in the metaverse has been gaining new momentum. Meta has sold virtual reality (VR) headsets for years, while Microsoft sells an augmented reality (AR) headset. However, most eyes are directed at Apple as a company with a real potential to push the metaverse mainstream. Longtime Apple analyst Katy Huberty of Moran Stanley said that "in conversations with venture-backed AR/VR companies, the consensus view is that the real catalyst for mass market AR/VR adoption will come when Apple enters the market."

So far, the metaverse is mostly hopes and dreams, and it might be hard to imagine how this technology will change our lives. While the current hardware can be expensive and clunky, with technological advancements, this is all expected to change—and rapidly—into a much more cost-effective and comfortable experience. Experts see strong potential benefits from this technology, which is urging companies to invest in the coming years. Its applications are especially discussed in the context of work, projecting that the metaverse will enable us to become more productive, expand the pool of potential job candidates, and even create new jobs.

Instead of searching for a meeting room space, we will log into virtual spaces that are so realistic that they will seem as if we are physically in the same room. We will see each other in the form of avatars that will look exactly like us if we choose. And we will be able to touch and manipulate virtual versions of goods like machinery or fabrics, enabling a safer, more efficient, more collaborative, and more cost-effective work environment.

Any colleague in any location will be able to log into the virtual world—we will not even have to walk across a corporate campus. The purpose of the meetings will go far beyond a Zoom session, as metaverse functionality will enable workers to collaborate on designing toys, furniture, or three-dimensional buildings. Employees whose jobs include handling dangerous or expensive equipment will be able to safely practice or experiment in the virtual world. AR and VR are already used in military, law enforcement, and health care to train workers, and these technologies will only become more sophisticated and widespread.

This freedom of location associated with the metaverse could further expand the current trend of workers living far away from their employers, giving job seekers and companies more options. This might be further magnified by new jobs created in the virtual world. New virtual shops, entertainment venues, and classrooms will all need ongoing support and people to build them. Other new jobs might be so different from today that we cannot really imagine them. Before the surge of the Internet, nobody would have thought that there would be people performing a job of a "social media influencer."

We will have to wait and see how the metaverse will transform our jobs and our lives. Of course, this will not come without its challenges. The insignificance of physical location may create greater competition for jobs or an increased turnover of employees. The explosion of new data may enable employers to closely monitor workers' behavior, raising privacy issues. New virtual offices will grapple with the need for new rules and etiquette, such as avatar dress codes. As with any modern technology, new challenges will inevitably arise, but so will new opportunities.

Source: Adapted from Tim Higgins, Apple's Metaverse Prospects Produce Real Optimism for Investors, *Wall Street Journal*, January 22, 2022; and Sarah E. Needleman and Kathryn Dill, "Why the Metaverse Will Change the Way You Work," *Wall Street Journal*, February 7, 2022.

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- *Duplication*. **Duplication** is the replication of an already existing product, service, or process. The duplication effort, however, is not simply copying but also adding the entrepreneur's own creative touch to enhance or improve the concept and beat the competition.
- *Synthesis*. **Synthesis** is the combination of existing concepts and factors into a new formulation. This involves taking a number of ideas or items already invented and finding a way that they can form a new application.[44]

5-7c The Major Misconceptions of Innovation

LO5.8 Review some of the major myths associated with innovation and define the ten principles of innovation

The entire concept of innovation conjures up many thoughts and misconceptions; it seems that everyone has an opinion as to what innovation entails. In this section, we outline some of the commonly accepted innovation misconceptions and provide reasons why these are misconceptions and not facts.[45]

- *Innovation is planned and predictable*. This statement is based on the old concept that innovation should be left to the research-and-development department under a planned format. In truth, innovation is unpredictable and may be introduced by anyone.
- *Technical specifications must be thoroughly prepared*. This statement comes from the engineering arena, which drafts complete plans before moving on. Thorough preparation is good, but it sometimes takes too long. Quite often, it is more important to use a try/test/revise approach.
- *Innovation relies on dreams and blue-sky ideas*. As we have demonstrated in this chapter, the creative process is extremely important to recognizing innovative ideas. However, accomplished innovators are very practical people and create from opportunities grounded in reality—not daydreams.
- *Big projects will develop better innovations than smaller ones*. This statement has been proven false time and time again. Larger firms are now encouraging their people to work in smaller groups, where it often is easier to generate creative ideas. In Chapter 3, we discussed the importance of I-teams as a method of getting smaller teams to work on innovative projects.
- *Technology is the driving force of innovation success*. Technology is certainly one source for innovation, but it is not the only one. As we outlined earlier in this chapter, numerous sources exist for innovative ideas; technology is certainly a driving factor in many innovations, but it is not the only success factor. Moreover, the customer or market is the driving force behind any innovation. Market-driven or customer-based innovations have the highest probability of success.

5-8 Principles of Innovation

Potential entrepreneurs need to realize that innovation principles exist. These principles can be learned and—when combined with opportunity—can enable individuals to innovate. The major motivation principles are as follows:

- *Be action oriented*. Innovators always must be active and searching for new ideas, opportunities, or sources of innovation.
- *Make the product, process, or service simple and understandable*. People must readily understand how the innovation works.
- *Make the product, process, or service customer based*. Innovators always must keep the customer in mind. The more an innovator has the end user in mind, the greater the chance the concept will be accepted and used.
- *Start small*. Innovators should not attempt a project or development on a grandiose scale. They should begin small and then build and develop, allowing for planned growth and proper expansion in the right manner and at the right time.
- *Aim high*. Innovators should aim high for success by seeking a niche in the marketplace.
- *Try/test/revise*. Innovators always should follow the rule of *try*, *test*, and *revise*. This helps work out any flaws in the product, process, or service.
- *Learn from failures*. Innovation does not guarantee success. More important, failures often give rise to innovations.[46]
- *Follow a milestone schedule*. Every innovator should follow a schedule that indicates milestone accomplishments. Although the project may run ahead of or behind schedule, it still is important to have a schedule in order to plan and evaluate the project.
- *Reward heroic activity*. This principle applies more to those involved in seeking and motivating others to innovate. Innovative activity should be rewarded and given the proper amount of respect. This also

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means tolerating and, to a limited degree, accepting failures as a means of accomplishing innovation. Innovative work must be viewed as a heroic activity that will reveal new horizons for the enterprise.

- *Work, work, work.* This is a simple but accurate exhortation with which to conclude the innovation principles. It takes work—not genius or mystery—to innovate successfully.[47]

Diversity in Entrepreneurship

Black Entrepreneurs Matter

When Ashlee Wisdom launched an early version of her health and wellness website called Health in Her Hue, more than 34,000 users, mostly Black, visited the platform in the first two weeks. "It wasn't the most fully functioning platform," recalls Wisdom. Yet the platform quickly became popular by addressing an important need in the market: culturally competent care. Health in Her Hue connects women of color to culturally sensitive doctors, nurses, and therapists nationally who can better understand their needs and issues. Inspired by their own experiences, plus those of their parents and grandparents, Black entrepreneurs like Wisdom are launching start-ups that aim to address the challenges faced by Black communities. The surge of these platforms—by Black people, for Black people—stems from the fact that Black entrepreneurs often see problems and solutions that others might miss. Without their view of the world, entire categories and products simply would not exist.

In Memphis, Tennessee, Erica Plybeah is focused on addressing transportation challenges. Her company, MedHaul, seeks to provide low-cost rides to and from medical appointments. While MedHaul is for everyone, Plybeah knows that people of color and anyone from rural areas or low-income households are more likely to face transportation hurdles. Her idea comes from years of watching her mother take care of her grandmother in the Mississippi Delta, where transportation options were scarce. Her grandmother had two amputated legs due to complications with type 2 diabetes and was fully dependent on Plybeah's mother, who was also working. "Trying to schedule all of her doctor's appointments around her work schedule was just a nightmare," Plybeah explained. MedHaul has since received funding from Citi Impact Fund that will help Plybeah scale the company to support more people in need of quality, dependable transportation.

In the digital space, Isaac Hayes III recognizes the struggle of Black artists to own their creative content and benefit from their cultural influence. In the past, Black musicians and other artists have been regularly taken advantage of for their creative labor. As an example, his late father was the legendary singer Isaac Hayes Jr., who helped solidify Stax Records as one of soul's greatest labels. At one point, the record company defaulted on his royalty payments, forcing him into bankruptcy and costing him the royalties to music he had made at the height of his career, including his Academy Award–winning *Shaft* soundtrack. With the rise of TikTok and YouTube, exploitation remains albeit on a different platform: social media. Creators on these platforms create dances that go viral and memes that become inside jokes to millions of viewers. The social media apps profit from this craze, attracting more and more users and thus attracting more advertising dollars, while the creators might get "exposure" (if they get any credit at all). The nature of these platforms makes it practically impossible to copyright the dances they invent, trademark the catchphrases they popularize, or otherwise profit from the virality they create. While there are some influencers out there getting paid for their efforts, Black creators are still typically paid less than their White counterparts.

Take the example of Jalaiah Harmon. While Harmon choreographed the defining dance craze on TikTok called the Renegade, it was Charli D'Amelio who popularized it—at first without crediting Harmon. Although Harmon has since starred in (and choreographed) a Sufjan Stevens music video and signed endorsement deals with LG and Samsung, her fame still pales in comparison to D'Amelio's, with a Super Bowl commercial, a Dunkin' Donuts drink, and a Hulu docuseries, making D'Amelio TikTok's second-highest-paid influencer on a *Forbes* list where all but two creators are White. To address this problem, Hayes introduced a new app called Fanbase, which allows users to monetize the social media interactions. The app is similar to Instagram in its functions except that creators get to profit from the content that they create. Creators get paid a percentage from users' "loves" and a 50 percent cut from subscribers, so even those who do not traditionally consider themselves influencers can make a couple hundred a month. "That's crazy because that's a bill," says Hayes.

We need more Black entrepreneurs like Wisdom, Plybeah, and Hayes, who can better recognize the structural challenges faced by their communities. We need diversity in entrepreneurship to address a diverse set of challenges and fuel economic prosperity for all. Perhaps most important, we need more Black entrepreneurs who, with these new innovations, can show Black communities that they have inimitable contributions to make to the entrepreneurial landscape.

Source: Adapted from Christina Lee, "Isaac Hayes III Wants to Help Social Media Creators Monetize Their Content," *Atlanta Magazine*, January 2022, and Cara Antony, "How Black Tech Entrepreneurs Are Tackling Health Care's Race Gap," *National Public Radio*, November 2021.

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Summary

This chapter examined the importance of creative thinking and innovation to the entrepreneur. Opportunity identification was discussed in relation to the knowledge and learning needed to recognize good ideas. The sources of innovative ideas were outlined and examined. The creativity process was then described, and ways to develop creativity were presented. Exercises and suggestions were included to help the reader increase the development of their creativity. The nature of the creative climate also was presented.

The four basic types of innovation—invention, extension, duplication, and synthesis—were explained. The last part of the chapter reviewed the misconceptions commonly associated with innovation and presented the major innovation principles.

Key Terms

appositional relationship
creative process
creativity
duplication
either/or thinking
extension
functional perspective
incongruities
innovation
invention
left brain
muddling mindsets
opportunity identification
probability thinking
right brain
security hunting
stereotyping
synthesis

Review and Discussion Questions

1. Describe opportunity identification for the entrepreneur.
2. How are prior knowledge and learning important to the recognition of opportunities?
3. What are the major sources of innovative ideas? Explain and give an example of each.
4. What is the difference between an adaptor and an innovator?
5. What are four major components in the creative process?
6. What are the four steps involved in developing personal creativity?
7. In your own words, state what is meant by the term *innovation.*
8. What are four major types of innovation?
9. Briefly describe the five major misconceptions commonly associated with innovation.
10. Identify and describe five of the innovation principles.

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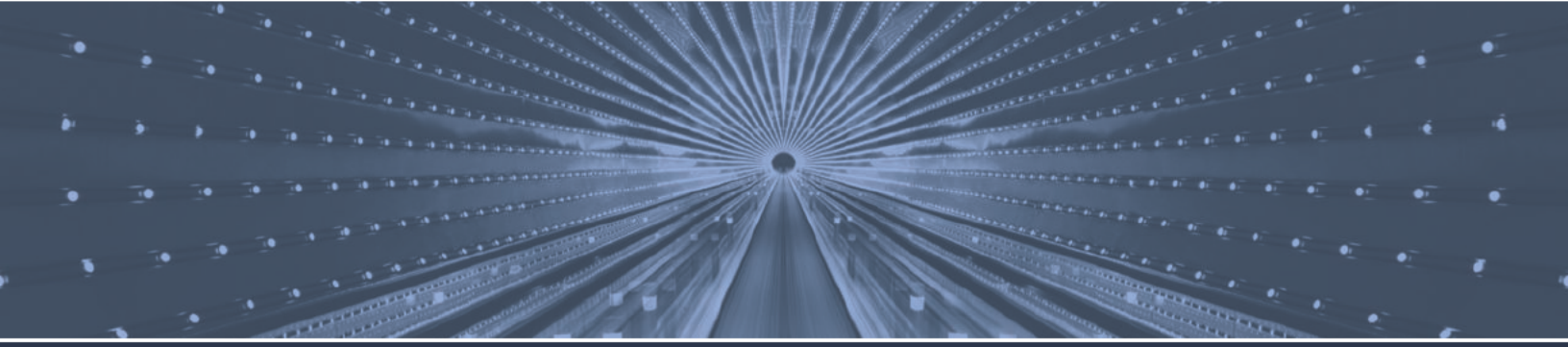
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Chapter 6

Assessment of Entrepreneurial Opportunities

Learning Objectives

6.1. Explain the challenge of new-venture start-ups
6.2. Review common pitfalls in the selection of new-venture ideas
6.3. Present critical factors involved in new-venture development
6.4. Study certain factors that underlie venture success
6.5. Explain the critical need for an effective entrepreneurial team
6.6. Examine why new ventures fail
6.7. Analyze the traditional venture evaluation process methods: profile analysis, the feasibility criteria approach, and the comprehensive feasibility method
6.8. Highlight the contemporary venture evaluation methods: design methodology and the Lean Startup methodology
6.9. Present the importance of new-venture legitimacy and the unique strategies for the differing audiences

Entrepreneurial Thought

To avoid all mistakes in the conduct of a great enterprise is beyond man's powers. . . . But, when a mistake has once been made, to use his reverses as lessons for the future is the part of a brave and sensible man.

—**Minucius (A.D. 209)**

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6-1 The Challenge of New-Venture Start-Ups

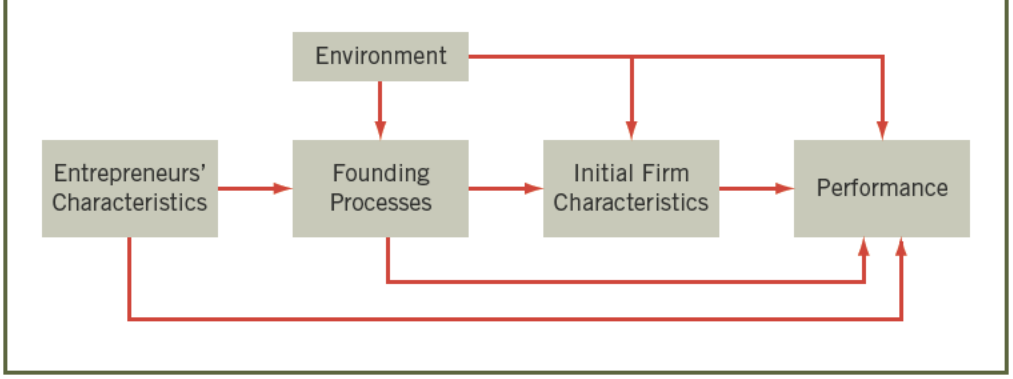
LO6.1 Explain the challenge of new-venture start-ups

During the past two decades, the number of new-venture start-ups has been consistently high. It is reported that more than 400,000 new firms have emerged in the United States every year since 2010; that works out to approximately 1,100 business start-ups per day. In addition, the ideas for potential new businesses are also surfacing in record numbers; the U.S. Patent Office currently receives approximately 600,000 patent applications per year.[1]

The reasons that entrepreneurs start new ventures are numerous. One study reported seven components of new-venture motivation: (1) the need for approval, (2) the need for independence, (3) the need for personal development, (4) welfare (philanthropic) considerations, (5) perception of wealth, (6) tax reduction and indirect benefits, and (7) following role models.[2] These motivations are similar to the characteristics discussed in Chapter 3 on the entrepreneurial mindset. Although researchers agree that many reasons exist for starting a venture, the entrepreneurial motivations of individuals usually relate to the *personal characteristics* of the entrepreneur, the *environment*, and the *venture* itself. The complexity of these factors makes the assessment of new ventures extremely difficult. One study examined the importance of start-up activities to potential entrepreneurs (those attempting to start a venture). Entrepreneurs who successfully started a business "were more aggressive in making their business real; that is, they undertook activities that made their businesses tangible to others: they looked for facilities and equipment, sought and got financial support, formed a legal entity, organized a team, bought facilities and equipment, and devoted full time to the business. Individuals who started businesses seemed to act with a greater level of intensity. They undertook more activities than those individuals who did not start their businesses. The pattern of activities seems to indicate that individuals who started firms put themselves into the day-to-day process of running an ongoing business as quickly as they could and that these activities resulted in starting firms that generated sales (94 percent of the entrepreneurs) and positive cash flow (50 percent of the entrepreneurs)."[3] Another study examined the quantitative and qualitative managerial factors that contribute to the success or failure of a young firm, and the results showed that firms do not have equal resources starting out. More important, the successful firms made greater use of professional advice and developed more detailed business plans.[4] Yet another study examined the importance of obtaining legitimacy with the early stakeholders as a prerequisite to venture survival.[5] As researcher Arnold C. Cooper points out, the challenges to predicting new-firm performance include environmental effects (the risk of new products or services, narrow markets, and scarce resources), the entrepreneur's personal goals and founding processes (reasons for start-up), and the diversity of the ventures themselves (differing scales and potential).[6] (See Figure 6.1 for an illustration.) Some of the latest research studies are emphasizing the importance of "fit" for the entrepreneur with the organization—the idea that an individual's cognitive abilities must match with the organization or venture that they are attempting to develop.[7]

In addition to the problems presented by the complexity of the factors in new-venture performance, it is difficult to obtain reliable data concerning start-up performance and failure. Surveys by phone and mail have been used with owners, employees, and competitors to obtain measures of sales, profit, technology, market

Figure 6.1 The Elements Affecting New-Venture Performance



Source: Arnold C. Cooper, "Challenges in Predicting New Firm Performance," *Journal of Business Venturing* 8, no. 3 (1993): 243.

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share, and so on.[8] The results are not completely comparable to all ventures or all industries. It is from this pioneering work, however, that more and better data are being gathered for the evaluation of new ventures.

It should be understood that new-venture assessment begins with the idea and venture selection stage. However, most studies of new-venture development deal with established start-up businesses. A "fully developed new firm" has been described as one that requires the full-time commitment of one or more individuals, is selling a product or service, has formal financial support, and has hired one or more individuals.[9]

Therefore, as ideas develop into new-venture start-ups, the real challenge is for those firms to survive and grow. In order to do this, they need to have a clear understanding of the critical factors for selecting ventures, the known reasons for venture failure, and an effective evaluation process.

6-2 Pitfalls in Selecting New Ventures

LO6.2 Review common pitfalls in the selection of new-venture ideas

The first key area of analysis is the selection of a new venture. This stage of transition—from an idea to a potential venture—can be the most critical for understanding new-venture development. Following are six of the most important pitfalls commonly encountered in the process of selecting a new venture.

6-2a Lack of Objective Evaluation

Many entrepreneurs lack objectivity. Engineers and technically trained people are particularly prone to falling in love with an idea for a product or service. They seem unaware of the need for the scrutiny they would give to a design or project in the ordinary course of their professional work. The way to avoid this pitfall is to subject all ideas to rigorous study and investigation.[10]

6-2b No Real Insight into the Market

Many entrepreneurs do not realize the importance of developing a marketing approach in laying the foundation for a new venture. They show a managerial shortsightedness.[11] Also, they do not understand the life cycle that must be considered when introducing a new product or service.

No product is instantaneously profitable, nor does its success endure indefinitely. Entrepreneurs must not only project the life cycle of the new product but also recognize that introducing the product at the right time is important to its success. Timing is critical. Action taken too soon or too late will often result in failure.

6-2c Inadequate Understanding of Technical Requirements

The development of a new product often involves new techniques. Failure to anticipate the technical difficulties related to developing or producing a product can sink a new venture. Entrepreneurs cannot be too thorough when studying the project before initiating it. Encountering unexpected technical difficulties frequently poses time-consuming and costly problems.

6-2d Poor Financial Understanding

A common difficulty with the development of a new product is an overly optimistic estimate of the funds required to carry the project to completion. Sometimes entrepreneurs are ignorant of costs or are victims of inadequate research and planning. Quite often, they tend to underestimate development costs by wide margins. It is not unusual for estimates to be less than half of what is eventually required.

6-2e Lack of Venture Uniqueness

A new venture should be unique. **Uniqueness** refers to the special characteristics and design concepts that draw the customer to the venture, which should provide performance or service that is superior to that of competitive offerings. The best way to ensure customer awareness of differences between the company's product and competitors' products is through product differentiation. Pricing becomes less of a problem when the customer sees the product as superior to its competitors. A product that is unique in a significant way can gain the advantage of differentiation.

6-2f Ignorance of Legal Issues

Business is subject to many legal requirements. One is the need to make the workplace safe for employees. A second is to provide reliable and safe products and services. A third is the necessity for patents, trademarks, and copyrights to protect one's inventions and products. When these legal issues are overlooked, major problems can result.

6-3 Critical Factors for New-Venture Development

LO6.3 Present critical factors involved in new-venture development

A number of **critical factors** are important for new-venture assessment. One way to identify and evaluate them is with a checklist (see Table 6.1). In most cases, however, such a questionnaire approach is too general. The assessment must be tailor-made for the specific venture.

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Table 6.1 A New-Venture Idea Checklist

Venture Feasibility
1. Is the concept possible?
2. Is the concept legal?
Value Proposition
1. Identify the specific competitive advantages of the concept?
2. What is unique about this venture idea?
3. Are the unique advantages sustainable?
Potential Market
1. What is the market niche?
2. Who would be the specific customers targeted?
3. Is this a reachable and reasonable customer market?
Marketing the Venture
1. What is the estimated share of market will the venture capture?
2. How will sales be accomplished?
3. Pricing? How does the price compare to competitors?
4. What are the distribution channels—retail, online, social media?
Operations of the Venture
1. What personnel are needed?
2. Describe the operational procedures.
3. What is the preferred location?
Venture Management
1. What is the background and experience of the lead entrepreneur?
2. Explain the qualifications of each key person on the management team?
3. How will each person be compensated?
Venture Financing
1. How much funding will be needed?
2. What sources of funding will be pursued?
Competition & Risks
1. What is the nature of the competition?
2. Are there specific risks inherent in this venture?

Source: Karl H. Vesper, New Venture Strategies, (Revised Edition), 1st Edition, © 1990. Reprinted by permission of Pearson Education, Inc., Upper Saddle River, NJ.

LO6.4 Study certain factors that underlie venture success

A new venture goes through three specific phases: pre–start-up, start-up, and post–start-up. The pre–start-up phase begins with an idea for the venture and ends when the doors are opened for business. The start-up phase commences with the initiation of sales activity and the delivery of products and services and ends when the business is firmly established and beyond short-term threats to survival. The post–start-up phase lasts until the venture is terminated or the surviving organizational entity is no longer controlled by an entrepreneur.

The major focus in this chapter is on the pre–start-up and start-up phases because these are the critical segments for entrepreneurs. During these two phases, five factors are critical: (1) the relative uniqueness of the venture, (2) the relative investment size at start-up, (3) the expected growth

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of sales and/or profits as the venture moves through its start-up phase, (4) the availability of products during the pre–start-up and start-up phases, and (5) the availability of customers during the pre–start-up and start-up phases.

6-3a Uniqueness

A new venture's range of uniqueness can be considerable, extending from fairly routine to highly nonroutine. What separates the routine from the nonroutine venture is the amount of innovation required during pre–start-up. This distinction is based on the need for new process technology to produce services or products and on the need to service new market segments. Venture uniqueness is further characterized by the length of time a nonroutine venture will remain nonroutine. For example, will new products, new technology, and new markets be required on a continuing basis? Or will the venture be able to "settle down" after the start-up period and use existing products, technologies, and markets?

6-3b Investment Size

The capital investment required to start a new venture can vary considerably. In some industries, less than $100,000 may be required, whereas in other industries, millions of dollars are necessary. Moreover, in some industries, only large-scale start-ups are feasible. For example, in the publishing industry, one can start a small venture that can remain small or grow into a larger venture. By contrast, an entrepreneur attempting to break into the airline industry will need a considerable up-front investment.

Another finance-related critical issue is the extent and timing of funds needed to move through the venture process. To determine the amount of needed investment, entrepreneurs must answer questions such as these: Will industry growth be sufficient to maintain break-even sales to cover a high fixed-cost structure during the start-up period? Do the principal entrepreneurs have access to substantial financial reserves to protect a large initial investment? Do the entrepreneurs have the appropriate contacts to take advantage of various environmental opportunities? Do the entrepreneurs have both industry and entrepreneurial track records that justify the financial risk of a large-scale start-up?[12]

6-3c Growth of Sales

The **growth of sales** through the start-up phase is another critical factor. Key questions are as follows: What is the growth pattern anticipated for new-venture sales and profits? Are sales and profits expected to grow slowly or level off shortly after start-up? Are large profits expected at some point, with only small or moderate sales growth? Or are both high sales growth and high profit growth likely? Or will initial profits be limited, with eventual high profit growth over a multiyear period? In answering these questions, it is important to remember that most ventures fit into one of the three following classifications:

- **Lifestyle ventures** appear to have independence, autonomy, and control as their primary driving forces. Neither large sales nor profits are deemed important beyond providing a sufficient and comfortable living for the entrepreneur.
- In **small profitable ventures**, financial considerations play a major role. Autonomy and control also are important in the sense that the entrepreneur does not want venture sales (and employment) to become so large that they must relinquish equity or an ownership position and thus give up control over cash flow and profits—which, it is hoped, will be substantial.
- In **high-growth ventures**, significant sales and profit growth are expected to the extent that it may be possible to attract venture capital money and funds raised through public or private placements.[13]

6-3d Product Availability

Essential to the success of any venture is **product availability**, the availability of a salable good or service at the time the venture opens its doors. Some ventures have problems in this regard because the product or service is still in development and needs further modification or testing. Other ventures find that, because they bring their product to market too soon, it must be recalled for further work. A typical example is the software firm that rushes the development of its product and is then besieged by customers who find "bugs" in the program. Lack of product availability in finished form can affect the company's image and its bottom line.

6-3e Customer Availability

If the product is available before the venture is started, the likelihood of venture success is considerably better than it would be otherwise. Similarly, venture risk is affected by **customer availability** for start-up. At one end of the risk continuum is the situation where customers are willing to pay cash for products or services before delivery. At the other end of the continuum is the enterprise that gets started without knowing exactly who will buy its product. A critical consideration is how long it will take to determine who the customers are as well as their buying habits. As one researcher noted,

> The decision to ignore the market is an extremely risky one. There are, after all, two fundamental criteria for entrepreneurial success. The first is having a customer who is willing to pay you a profitable price for a product or a service. The second is that you must actually produce and deliver the product or service. The farther a venture removes itself from certainty about these two rules, the greater the risk and the greater the time required to offset this risk as the venture moves through the prestart-up and start-up periods.[14]

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6-4 Developing an Effective Entrepreneurial Team

LO6.5 Explain the critical need for an effective entrepreneurial team

While much of entrepreneurship in the past has been associated largely with a solo entrepreneur, the more current state of entrepreneurship embraces the effective entrepreneurial team. Why? Because an entrepreneur's idea alone is never enough to actually execute on the venture. In other words, no matter what your new-venture concept is, you need key people to make it a reality. Keep in mind that it not easy to get the right people for an effective entrepreneurial team, but the development of that team is essential in today's world.

Research has shown that venture capitalists consider the **entrepreneurial team** to be most important when it's time to make the investment decision on a new venture. Entrepreneurial teams are defined as "two or more individuals who pursue a new business idea, are involved in its subsequent management, and share.[15] Over the past two decades, research has grown substantially to understand what constitutes effective entrepreneurial teams. This stream of research has considerably advanced our understanding of how entrepreneurial teams' characteristics and processes generate entrepreneurial outcomes at the individual, team, and venture levels.[16] How entrepreneurial teams are formed is essential for successful new-venture formation, as they influence team processes (e.g., decision making, coordinating, and venture development) and team outcomes (e.g., access to resources, legitimacy, and financial capital). The formation of an effective entrepreneurial team can generate advantages by synergizing skills, knowledge, and resources while helping to foster different strategic views and opinions on the direction of the new venture.

Once an entrepreneurial team has formed, the importance of collaboration cannot be overemphasized. Researchers Holger Patzelt, Rebecca Preller, and Nicola Breugst show that during the collaboration phase, "entrepreneurial team members' key tasks include, for example, finding customers, attracting investors, and building relationships with other important stakeholders. Thus, it is important for team members to coordinate and monitor their activities, establish effective and efficient decision-making processes, and develop and update their team thinking and feelings toward the team itself."[17]

In one research study involving 166 creators and managers of new innovative businesses, only 12 percent of start-ups were run with just one person making all of the strategic decisions, whereas in 72 percent of cases, two or three partners made these types of decisions.[18] The old African proverb "If you want to go fast, go alone. If you want to go far, go together" clearly applies to entrepreneurs. Creating an innovative new venture usually goes beyond the work of one person because of the diverse set of tasks and the skills required for success.

An entrepreneurial team should be viewed as a dynamic entity that should always be reevaluated. One of the main reasons for continuous evaluation of the team itself has been pointed out by researchers Jeffery S. McMullen, Alexander S. Kier, and Donald F. Kuratko in a study demonstrating the dangers of team recommendations on the escalation of commitment (undue persistence) by the entrepreneur toward a failing venture concept.[19] So, while teams are an effective and needed element in new-venture formation, it is imperative for the entrepreneur to balance the advice and counsel of the team with the realistic strategies being encouraged.

6-5 Why New Ventures Fail

LO6.6 Examine why new ventures fail

Every year, many millions of dollars are spent on starting new enterprises. Many of these newly established businesses vanish within a year or two; only a small percentage succeeds. Most studies have found that the factors underlying the failure of new ventures are, in most cases, within the control of the entrepreneur. Some of the major reasons for the failure of new ventures follow.

One research study examined 250 high-tech firms and found three major categories of causes for failure: product/market problems, financial difficulties, and managerial problems.[20] Product/market problems involved the following factors:

- *Poor timing*. A premature entry into the marketplace contributed to failure in 40 percent of the cases studied.
- *Product design problems*. Although these may be related to timing, product design and development became key factors at earlier stages of the venture; when the essential makeup of the product or service changed, failure resulted.
- *Inappropriate distribution strategy*. Whether it was based on commissioned sales, representatives, or direct sales at trade shows, the distribution strategy had to be geared toward the product and customer.
- *Unclear business definition*. Uncertainty about the "exact" business they were in caused these firms to undergo constant change and to lack stabilization.
- *Overreliance on one customer*. This resulted in a failure to diversify and brought about the eventual demise of some of the firms.

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The financial difficulties category involved the following factors:

- *Initial undercapitalization*. Undercapitalization contributed to failure in 30 percent of the case studies.
- *Assuming debt too early*. Some of the firms attempted to obtain debt financing too soon and in too large an amount. This led to debt service problems.
- *Venture capital relationship problems*. Differing goals, visions, and motivations of the entrepreneur and the venture capitalist resulted in problems for the enterprise.

Managerial problems involved two important factors:

- *Concept of a team approach*. The following problems associated with the managerial team were found: (1) hirings and promotions on the basis of nepotism rather than qualifications, (2) poor relationships with parent companies and venture capitalists, (3) founders who focused on their weaknesses rather than on their strengths (although weakening the company, they supposedly were building their skills), and (4) incompetent support professionals (e.g., attorneys who were unable to read contracts or collect on court judgments that already had been made).
- *Human resource problems*. Inflated owner ego, employee-related concerns, and control factors were all problems that led to business failure. The study also revealed such interpersonal problems as (1) kickbacks and subsequent firings that resulted in an almost total loss of customers, (2) deceit on the part of a venture capitalist in one case and on the part of a company president in another, (3) verbal agreements between the entrepreneur and the venture capitalists that were not honored, and (4) protracted lawsuits around the time of discontinuance.

In a study of successful ventures (firms listed in the Inc. 500 group of fastest-growing privately held companies), the most significant problems encountered at start-up were researched in order to systematically sort them into a schematic. Table 6.2 lists the types and classes of problems identified during the first year of operation. The researcher also surveyed the current problems that the owners of these successful firms encountered in order to explore the possible changes in problem patterns of new firms. It was found that dominant problems at start-up related to sales/marketing (38 percent), obtaining external financing (17 percent), and internal financial management (16 percent). General management problems were also frequently cited in the start-up stage (11 percent). Sales/marketing remained the most dominant problem (22 percent) in the **growth stage**, but it was less important than in the start-up stage. Internal financial management (21 percent) continued to be a dominant problem, as were human resource management (17 percent) and general management (14 percent). Additionally, more regulatory environment problems occurred in the growth stage (8 percent) than were mentioned in the start-up stage (1 percent). Finally, organizational structure/design (6 percent) emerged as a problem in the growth stage.[21] It is important for entrepreneurs to recognize these problem areas at the outset because they remain challenges to the venture as it grows.

Another study of 645 entrepreneurs focused on the classification of start-up and growth problems experienced internally versus externally.[22] The percentages were calculated for each of the problems. **Internal problems** involved adequate capital (15.9 percent), cash flow (14.9 percent), facilities/equipment (12.6 percent), inventory control (12.3 percent), human resources (12.0 percent), leadership (11.1 percent), organizational structure (10.8 percent), and accounting systems (10.4 percent). **External problems** were related to customer contact (27.3 percent), market knowledge (19.3 percent), marketing planning (14.4 percent), location (11.1 percent), pricing (8.4 percent), product considerations (7.6 percent), competitors (6.3 percent), and expansion (5.5 percent). The researchers found that the "intensity of competition" rather than life cycle stages was crucial in changing the relative importance of the problem areas. Thus, entrepreneurs need to recognize not only that **start-up problems** remain with the venture but also that the increasing competition will adjust the relative importance of the problems.

The differing perceptions of new-venture failure were examined in another study conducted by researchers Andrew Zacharakis, G. Dale Meyer, and Julio DeCastro. Internal and external factors were identified and ranked by a sample of venture capitalists as well as a sample of entrepreneurs. Entrepreneurs, who attributed new-venture failure, in general, to *internal* factors 89 percent of the time, ranked the highest contributing internal factors as lack of management skill, poor management strategy, lack of capitalization, and lack of vision. Venture capitalists overwhelmingly attributed the failure of most new ventures to *internal* causes as well (84 percent), similarly attributing failure most often to these three internal factors: lack of management skill, poor management strategy, and lack of capitalization. An external factor, poor external market conditions, ranked fourth on the venture capitalists' list.[23]

A fourth "failure" or problem study dealt with a proposed **failure prediction model** based on financial data from newly founded ventures. The study assumed that the financial failure process was characterized by too much initial indebtedness and too little revenue financing. As shown by the failure process schematic in Table 6.3, the risk of failure can be reduced by using less debt as initial financing and by generating enough revenue in the initial

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Table 6.2 Types and Classes of First-Year Problems

1. *Obtaining external financing* Obtaining financing for growth Other or general financing problems
2. *Internal financial management* Inadequate working capital Cash-flow problems Other or general financial management problems
3. *Sales/marketing* Low sales Dependence on one or few clients/customers Marketing or distribution channels Promotion/public relations/advertising Other or general marketing problems
4. *Product development* Developing products/services Other or general product development problems
5. *Production/operations management* Establishing or maintaining quality control Raw materials/resources/supplies Other or general production/operations management problems
6. *General management* Lack of management experience Only one person/no time Managing/controlling growth Administrative problems Other or general management problems
7. *Human resource management* Recruitment/selection Turnover/retention Satisfaction/morale Employee development Other or general human resource management problems
8. *Economic environment* Poor economy/recession Other or general economic environment problems
9. *Regulatory environment* Insurance

Source: David E. Terpstra and Philip D. Olson, "Entrepreneurial Start-Up and Growth: A Classification of Problems," *Entrepreneurship Theory and Practice* 17, no. 3 (Spring 1993): 19.

stages. Furthermore, the study recognized the risk associated with the initial size of the venture being developed. Specific applications of the model included the following:[24]

1. *Role of profitability and cash flows*. The entrepreneur and manager should ensure that the products are able to yield positive profitability and cash flows in the first years.
2. *Role of debt*. The entrepreneur and manager should ensure that enough stockholders' capital is in the initial balance sheet to buffer future losses.
3. *Combination of both*. The entrepreneur and manager should not start a business if the share of stockholders' capital in the initial balance sheet is low and if negative cash flows in the first years are probable.
4. *Role of initial size*. The entrepreneur and manager should understand that the more probable the negative cash flows and the larger the debt share in the initial balance sheet, the smaller the initial size of the business should be.

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Table 6.3 The Failure Process of a Newly Founded Firm

1. Extremely high indebtedness (poor static solidity) and small size
2. Too slow velocity of capital, too fast growth, too poor profitability (as compared to the budget), or some combination of these
3. Unexpected lack of revenue financing (poor dynamic liquidity)
4. Poor static liquidity and debt service ability (dynamic solidity)
A. Profitability
1. Return on investment ratio defined on end-of-the-year basis $= \frac{\text{Net Profit} + \text{Interest Expenses}}{\text{Total Capital at the End of the Year}} \times 100$
B. Liquidity
Dynamic 2. Cash flow to net sales $= \frac{\text{Net Profit} + \text{Depreciations}}{\text{Net Sales}} \times 100$
Static 3. Quick ratio $= \frac{\text{Financial Assets}}{\text{Current Debt}}$
C. Solidity
Static 4. Stockholders' capital to total capital $= \frac{\text{Total Capital} - \text{Debt Capital}}{\text{Total Capital}} \times 100$
Dynamic 5. Cash flow to total debt $= \frac{\text{Net Profit} + \text{Depreciations}}{\text{Total Debt}} \times 100$
D. Other Factors
Growth or Dynamic Size 6. Rate of annual growth in net sales $= \frac{\text{Net Sales in Year } t}{\text{Net Sales in Year } t-1} \times 100$
Size 7. Logarithmic net sales = ln (Net Sales)
Velocity of Capital 8. Net sales to total capital $= \frac{\text{Net Sales}}{\text{Total Capital at the End of the year}} \times 100$

Source: Erkki K. Laitinen, "Prediction of Failure of a Newly Founded Firm," *Journal of Business Venturing* 7, no. 4 (1992): 326–28.

5. *Role of velocity of capital.* The entrepreneur and manager should not budget for fast velocity of capital in the initial years if the risk of negative cash flows is high. More sales in comparison to capital results in more negative cash flows and poorer profitability.
6. *Role of control.* The entrepreneur and manager should monitor financial ratios from the first year, especially the cash-flow-to-total-debt ratio. Risky combinations of ratios—especially negative cash flows, a low stockholders' capital-to-total-capital ratio, and a high velocity of capital—should be monitored and compared with industrial standards. The entrepreneur should try to identify the reasons for poor ratios and pay special attention to keeping profitability at the planned level (with control ratios).

6-6 The Traditional Venture Evaluation Processes

A critical task in starting a new business is conducting a solid analysis of the feasibility of the product/service in getting off the ground. Entrepreneurs must put ideas through feasibility analyses to discover if their proposals

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The Entrepreneurial Process

New-Venture Failure and Investor Rejection

It is impossible to look at why investors turn down start-ups without looking at the reasons that most start-ups fail. From an investor's standpoint, if they are giving their time and money, they want to see a return on their money quickly. Investors are not going to invest in something where they do not see the potential for growth and profit. However, this does not mean that entrepreneurs should give up if investors are not interested; rather, it is important to keep trying.

Before looking at why investors might turn down a new venture, it is necessary for entrepreneurs to consider why most ventures fail to ensure that their concept does not check any of those boxes and thus are more attractive to venture capitalists.

Here are some of the most common causes of new-venture failures:

- No real value proposition for the venture
- Failure to connect with a target market
- Unable to pivot the concept for the right market
- Lack of transparency and trust by the entrepreneur
- Poor strategic leadership as indicated by lack of mentors
- Weak execution strategy for the concept
- High "burn rate"—inability to control expenses
- Lack of a positive culture for employees
- Ineffective business systems

In addition to these reasons that businesses fail, entrepreneurs need to be aware of the reasons that investors turn down start-ups. Here are some of the key reasons:

- The venture is not in the right geographic location for the potential investor.
- The industry segment is wrong for the particular investor.
- The funding stage of the venture is incorrect for the potential investor.
- Major growth potential (ability to scale) of the venture is lacking.
- The venture would take too much investment to reach positive cash flow.
- No barriers to entry exist for other competitors.

Understanding the reasons for new-venture failure and the reasons that investors reject new start-ups may help an entrepreneur better prepare their venture for an effective launch. Also, if turned down by an investor, always seek the reasons why as well as any advice the investor could offer. That advice could vault the entrepreneur into a more appropriate position in the future.

Source: Adapted from R. L. Adams, "10 Reasons Why 7 Out of 10 Businesses Fail within 10 Years," *Entrepreneur*, September 26, 2017, Quora, "7 Reasons Why Investors Turn Down Startups," *Inc.*, January 23, 2018; and author's experiences.

contain any fatal flaws. The following sections provide an explanation of the more traditional approaches to venture assessment.

6-6a Profile Analysis Approach

LO6.7 Analyze the traditional venture evaluation process methods: profile analysis, the feasibility criteria approach, and the comprehensive feasibility method

A *profile analysis* is a tool that enables entrepreneurs to judge a business venture's potential by sizing up the venture's strengths and weaknesses along a number of key dimensions or variables. A single strategic variable seldom shapes the ultimate success or failure of a new venture. In most situations, a combination of variables influences the outcome. It is important, therefore, to identify and investigate these variables before committing resources to launch a new venture.

The internal profile analysis in the experiential exercise found at the end of this chapter presents a framework, in checklist format, for determining the relative strengths and weaknesses of the financial, marketing, organizational, and human resources available to a new venture. Through careful profile analysis, entrepreneurs can mitigate possible weaknesses that may inhibit the growth of their ventures, avoiding many of the mistakes cited earlier in this chapter that can lead to venture failures.

6-6b Feasibility Criteria Approach

Another evaluation method, the feasibility criteria approach, is a criteria selection list based on the following questions, from which entrepreneurs can gain insights into the viability of their venture:

- *Is it proprietary?* The product does not have to be patented, but it should be sufficiently proprietary to permit a long head start against competitors and a period of extraordinary profits early in the venture to offset start-up costs.
- *Are initial production costs realistic?* Most estimates are too low. A careful, detailed analysis should be made so that no large unexpected expenses arise.

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- *Are the initial marketing costs realistic?* This answer requires the venture to identify target markets, market channels, and promotional strategy.
- *Does the product have potential for very high margins?* This is almost a necessity for a fledgling company. Gross margins are one thing the financial community understands. Without them, funding can be difficult.
- *Is the time required to get to market and to reach the break-even point realistic?* In most cases, the faster, the better. In all cases, the venture plan will be tied to this answer, and an error here can spell trouble later on.
- *Is the potential market large?* In determining the potential market, entrepreneurs must look three to five years into the future because some markets take this long to emerge. The cellular telephone, for example, had an annual demand of approximately 400,000 units in 1982; today, the number of smartphones sold in any given quarter is many times higher than that.
- *Is the product the first of a growing family?* If it is, the venture is more attractive to investors. If they do not realize a large return on the first product, they might on the second, third, or fourth.
- *Does an initial customer exist?* It is certainly impressive to financial backers when a venture can list its first 10 customers by name. Pent-up demand signals that the first quarter's results are likely to be good, and the focus of attention can be directed to later quarters.
- *Are the development costs and calendar times realistic?* Preferably, they are zero. A ready-to-go product gives the venture a big advantage over competitors. If costs exist, they should be complete, detailed, and tied to a month-by-month schedule.
- *Is this a growing industry?* Industry growth is not absolutely essential if profits and company growth can be substantiated, but it means less room for mistakes. In a growing industry, good companies do even better.
- *Can the product—and the need for it—be understood by the financial community?* If financiers can grasp the concept and its value, the chances for funding will increase. For example, a portable heart-monitoring system for postcoronary monitoring is a product many can understand. Undoubtedly, some of those hearing a presentation for such a device will already have had coronaries or heart problems of some sort.[25]

The criteria selection approach provides a means of analyzing the internal strengths and weaknesses that exist in a new venture by focusing on the marketing and industry potential critical to assessment. If the new venture meets fewer than six of these criteria, it typically lacks feasibility for funding. If the new venture meets seven or more of the criteria, it may stand a good chance of being funded.

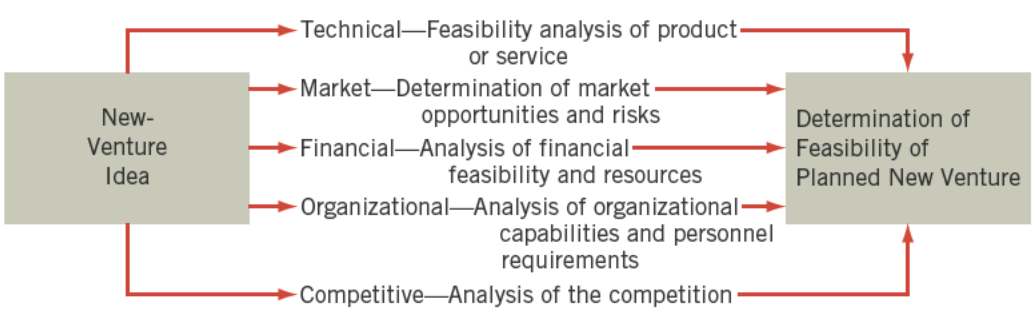
6-6c Comprehensive Feasibility Approach

A more comprehensive and systematic feasibility analysis, a comprehensive feasibility approach, incorporates external factors in addition to those included in the criteria questions cited above. Figure 6.2 presents a breakdown of the factors involved in a comprehensive feasibility study of a new venture: technical, market, financial, organizational, and competitive. Although all five of the areas presented in Figure 6.2 are important, two merit special attention: technical and market.

Technical Feasibility

The evaluation of a new-venture idea should start with identifying the technical requirements—the technical feasibility—for producing a product or service that will

Figure 6.2 Key Areas for Assessing the Feasibility of a New Venture



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The Entrepreneurial Process

Facing Your Fears!

The inner journey to the creation of an entrepreneurial venture can be even more fearful than the external process of developing a business plan and searching for capital. Building up the courage to quit a job and start a new venture can sound easy and yet pose enormous emotional challenges when the actual events are about to unfold. One consultant, Suzanne Mulvehill—author of *Employee to Entrepreneur* and host of her own radio talk show—suggests particular strategies to follow when confronting the emotional challenges of entrepreneurial start-ups. She coined the term *emotional endurance* to signify the inner strength that is needed to make the jump from job to venture. Following are a few of the more significant strategies that may help entrepreneurs move through the emotional journey.

1. *Say yes to your yearning*. In other words, acknowledge the desire you are experiencing to venture out on your own. It all begins with accepting the possibility that it could happen.
2. *Visualize your success*. Creating a vision of what *could* be may be a powerful motivator to what *will* be. It is important to write down this vision so that it has tangible reality in this early stage.
3. *Evaluate your beliefs*. On a sheet of paper, list all of your beliefs about money, business, and yourself. Then, in a similar column, write down how you would *like* to view money, business, and yourself. Compare these beliefs and decide how far apart they are and why.
4. *Do what you love*. There is no replacement for passion. What you love is what will drive you to succeed, even in the tough times. Develop your business ideas around the types of things that you absolutely love to do.
5. *Get educated*. Avoid the myth that education saps out any desire to be an entrepreneur. That may have been true 20 years ago, but we have come a long way in our approaches to business education. Entrepreneurship education is the hottest subject in universities worldwide. Remember, knowledge is power.
6. *Eliminate excuses*. Whenever you hear yourself make an excuse for not doing something, write it down and examine it later. Become aware of common excuses you may be using that have no real foundation. Turn your "I can'ts" into open-ended questions that allow you to explore the possibilities rather than shut the door.
7. *Know that here is no "right time."* Waiting for the proverbial perfect time is a trap that many people fall into, only to find later that time passed them by. The only guarantee we have about time is that it continues on, with or without us. Rather than wait, you need to proactively move on your idea.
8. *Start small*. It is always better to be realistic and reach for what you can accomplish in the near future. The longer-term future may hold greater things for the venture, but at the beginning, you need to avoid being overwhelmed.
9. *Answer the "what-ifs."* Stop for a moment and write down all of the "what-ifs" that you question yourself with. See if you can begin to logically answer the questions. It's amazing how much courage will be gained by analyzing these contingencies.
10. *Ask for help*. Reach out and find help. The maverick entrepreneur is a myth of the past. Today, there is so much assistance available if you are willing to seek it out. Ignorance is not asking questions; rather, ignorance is being arrogant enough to think you have all the answers.

Source: Adapted from Suzanne Mulvehill, "Fear Factor," *Entrepreneur*, April 2005, 104–11.

satisfy the expectations of potential customers. The most important of these are the following:

- Functional design of the product and attractiveness in appearance
- Flexibility, permitting ready modification of the external features of the product to meet customer demands or technological and competitive changes
- Durability of the materials from which the product is made
- Reliability, ensuring performance as expected under normal operating conditions
- Product safety, posing no potential dangers under normal operating conditions
- Reasonable utility, an acceptable rate of obsolescence
- Ease and low cost of maintenance
- Standardization through elimination of unnecessary variety among potentially interchangeable parts
- Ease of processing or manufacture
- Ease in handling and use[26]

The results of this investigation provide a basis for deciding whether a new venture is feasible from a technical point of view.

Marketability

Assembling and analyzing relevant information about the marketability of a new venture are vital for judging its

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potential success. Three major areas in this type of analysis are (1) investigating the full market potential and identifying customers (or users) for the goods or service, (2) analyzing the extent to which the enterprise might exploit this potential market, and (3) using market analysis to determine the opportunities and risks associated with the venture. To address these areas, a variety of informational sources must be found and used. For a market feasibility analysis, general sources would include the following:

- *General economic trends*. various economic indicators, such as new orders, housing starts, inventories, and consumer spending
- *Market data*. Customers and customer demand patterns (e.g., seasonal variations in demand and governmental regulations affecting demand)
- *Pricing data*. Range of prices for the same, complementary, and substitute products; base prices; and discount structures
- *Competitive data*. Major competitors and their competitive strength

More attention is given to marketing issues in Chapter 10. At this point, it is important to note the value of marketing research in the overall assessment and evaluation of a new venture.[27]

The comprehensive feasibility analysis approach is closely related to the preparation of a thorough business plan (covered in detail in Chapter 12). The approach clearly illustrates the need to evaluate each segment of the venture *before* initiating the business or presenting it to capital sources.

To assist in understanding feasibility analysis, Appendix 6A includes a template used for a complete feasibility plan. This template has a question-and-answer format that allows entrepreneurs to consider important segments before moving forward with an idea. Venture capitalists generally agree that the risks in any entrepreneurial venture are you, your management team, and any apparent fundamental flaws in your venture idea. Therefore, you need to make a reasonable evaluation of these risks.

6-7 The Contemporary Methodologies for Venture Evaluation

LO6.8 Highlight the contemporary venture evaluation methods: design methodology and the Lean Startup methodology

With newer movements taking shape in the ever-changing entrepreneurial world, the following sections highlight some of the more contemporary methodologies being utilized for concept assessment and new-venture evaluation. From design methods to lean start-up procedures, the fast-paced entrepreneurial environment is demonstrating newer methods to enhance venture concepts though development.

6-7a The Design Methodology

Design is now a hot topic in the business world. The demand is becoming so great that universities are now building programs that take a general approach to design rather than concentrating it in just technical schools like architecture and engineering. Mirroring the general design approach of companies like IDEO that tackle problems in industries ranging from medicine to consumer products, Stanford University has founded its Institute of Design, and the Rotman School of Management at the University of Toronto has built a curriculum based on the power of design in business. The goal of such programs is to train future business leaders to incorporate design thinking into their general practices much like Procter & Gamble and Microsoft, which have embraced design methods. This methodology can be a vital source of assessment for entrepreneurs and their early-stage venture concepts.

Design and Learn

Design is a learning process that shapes and converts ideas into form, whether that is a plan of action, an experience, or a physical thing.[28] Designers often begin the search for viable solutions through the iterative process of learning the language, issues, critical success factors, and constraints inherent in the domains of interest. Mistakes and failures along the way are to be seen as opportunities to learn and adapt. As a result, knowledge of and credibility within the venture's domain are increased. Researchers Michael G. Goldsby, Donald F. Kuratko, and Thomas Nelson believe that design methodology provides specific learning mechanisms important for converting ideas into form:

- *Learning from qualitative research*. This includes impartial observations of stakeholders related to the problem, participatory involvement with said stakeholders regarding the problem, and immersion in available secondary research.
- *Learning from prototyping*. **Prototyping** (the physical representation of the venture) captures the essence of an idea in a form that can be shared with others for communication and feedback that closes the gap between concept and reality.
- *Learning from feedback*. This feedback is on the efficacy of the venture idea and need not be complicated. First impressions and instincts provide honest observations that can be used in shaping future versions of the venture concept.[29]

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The Entrepreneurial Process

The Power of Design Thinking

The viability of a business fundamentally comes down to providing value to an audience that is willing to pay for it. The days of telling customers what they should buy are gone, as consumers now expect to participate in not only the marketing but also the development of the products they purchase. As reflected in A. G. Lafley's groundbreaking work at Procter & Gamble[i] wherein he infused the company with design to transform the way his employees engaged their customers, the impact of applying design principles to frame problems and develop a solution, commonly known as design thinking, to areas not usually considered within the purview of design has resulted in the wide adoption of design thinking to address myriad problems.

Popularized by Tim Brown in his book *Change by Design*,[ii] design thinking is essentially the process of applying the techniques and strategies used by designers, such as observation and rapid prototyping, to draw out insights regarding what customers want and need. Through their training, designers come to appreciate the difficulty that people have in articulating their latent needs, meaning those they do not realize they have, which, in turn, requires a more nuanced approach than simply having those they are endeavoring to serve complete a questionnaire in order to understand them. Design thinking empowers non-designers to make use of the designer's tool kit to better understand a problem space through more qualitative research. The outcome is a more intimate, truer understanding of what people are actually thinking and the drivers that influence their behavior—in the case of business, what drives their willingness to purchase a product or service.

Beyond problem framing, design thinking encourages an iterative approach to problem solving, which includes soliciting feedback from the target audience early and often. In addition, design thinking encourages a rapid ideation and prototyping process that demands a willingness to make mistakes and present solutions that are just good enough to evoke meaningful feedback from the target audience. Roger Martin emphasized the importance of design thinking for business professionals in his book *The Design of Business*,[iii] throughout which he explored how the traditional approach to problem solving based on the premises as presented, either inductively defining general rules based on specific cases or deductively applying general rules to arrive at a conclusion, often results in misreading the market and, subsequently, business failure. The key is to employ abductive reasoning, which involves considering all possible solutions regardless of the existing premises. It requires thinking beyond the available data when drawing conclusions, and it is the process by which designers are trained to take on challenging problems.

While there is no definitive design process, an often-cited one is the Institute of Design at Stanford framework,[iv] which entails empathizing through direct interaction with your target audience, defining what you have learned and what insights are going to guide your development process, ideating as many concepts as possible without focusing on perfection, prototyping them in order to get them in front of your target audience in order to solicit feedback, and then testing them with your target audience. Even though the process appears linear, it is not intended to be applied in a stepwise fashion. Instead, design thinking requires a willingness to revisit each step as needed, refining as you learn through user research. It also requires a willingness to think beyond the data available by abducting what might be rather than what is.

Design thinking has been embraced by businesses as a way to better understand their customers, both internal and external, and it has proven that design goes beyond aesthetics. When it comes to entrepreneurship and start-up development, design thinking is a powerful tool that enables entrepreneurs to ensure that they are solving the right problem before investing in the wrong solution. It also empowers entrepreneurs to keep tabs on their market so that they do not find themselves investing in the refinement of a product that no longer serves their market. The fluidity of consumer demand and the rapid dissemination of information in an increasingly connected world demands agility in order to stay nimble and responsive to customers' expectations, and the mindset that design thinking facilitates is critical to staying ahead of where the market is headed.

[i] Jennifer Reingold, "What P&G Knows about the Power of Design," *Fast Company*, 2005, https://www.fastcompany.com/53103/what-pg-knows-about-power-design.

[ii] Tim Brown, *Change by Design: How Design Thinking Transforms Organizations and Inspires Innovation* (New York: Harper Business, 2009).

[iii] Roger L. Martin, *The Design of Business: Why Design Thinking Is the Next Competitive Advantage* (Cambridge, MA: Harvard Business Press, 2009).

[iv] "The Virtual Crash Course Playbook," https://dschool.stanford.edu/s/crashcourseplaybookfinal3-1-120302015105-phpapp02.pdf.

Source: Contribution from Travis J. Brown, PhD, 2018.

Design Development

The design development methodology utilizes skills we all possess but are generally ignored due to more conventional problem-solving practices. Traditional methods have relied on rational and analytical techniques, while design relies on intuition, recognition, and emotion. While most businesses tend to focus on traditional dimensions of product, performance, or price, latent needs are where the design methodology focuses. Latent needs are often found in the areas

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of safety, reuse, sustainability, personalization, or convenience.

Design methodology takes an initial concept idea and develops a proof of concept that elicits feedback from relevant stakeholders. To accomplish this, several criteria must be met, including concept feasibility, concept desirability, and concept viability.[30] The design method converts ideas into form by integrating what is desirable from a user's point of view with what is technically and economically viable:

- *Proof of concept feasibility*. This focuses on whether a potential venture concept can be produced or is functionally possible.
- *Proof of concept desirability*. This focuses on whether a potential venture concept is desirable to customers—form, function, aesthetics, and user behavior are considered.
- *Proof of concept viability*. This focuses on whether the venture concept can produce viable financial outcomes.[31]

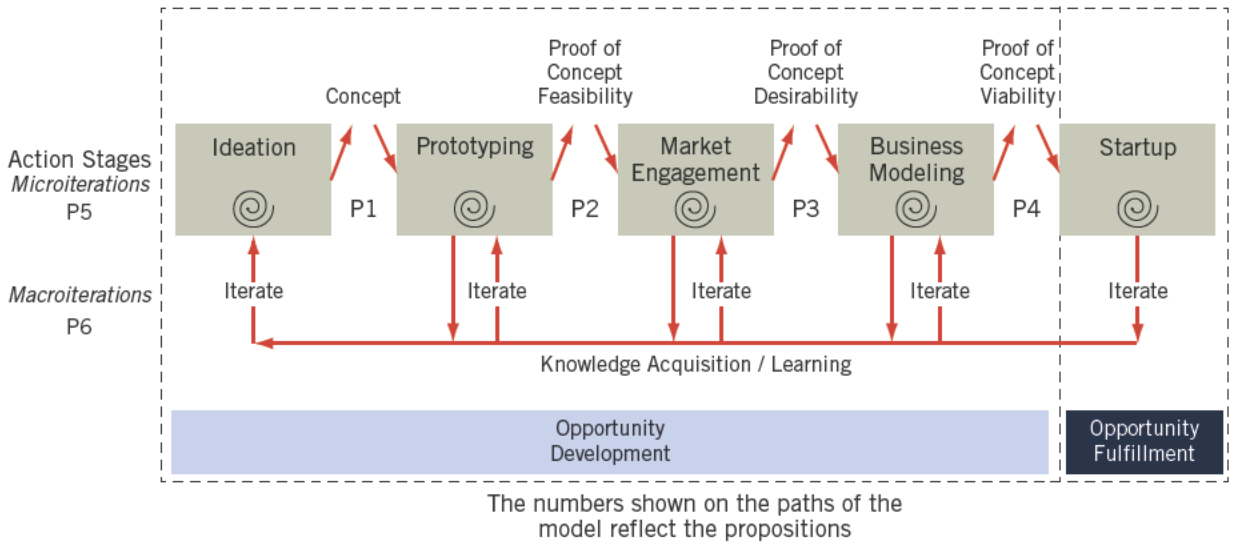
Simply put, a successful design process is made evident by a proof of concept that provides evidence that a product or solution can be made, that it is desirable to customers, and that it makes financial sense. It is largely up to the discretion of designers as to what feedback, learning, and suggestions they choose to use in iterative versions of solutions. Consequently, designers make judgment calls as to when good, better, or best solutions are reached. Gestalt moments of insight and understanding affect the process and indicate when a concept is ready for implementation.[32]

6-7b Design-Centered Entrepreneurship

Researchers Michael G. Goldsby, Donald F. Kuratko, Matthew R. Marvel, and Thomas Nelson have introduced the concept of design-centered entrepreneurship with a conceptual model. (See Figure 6.3.) In essence, the entrepreneur applies design methods in four action stages of developing an opportunity. Ideation involves taking action and learning that culminates in a venture concept for further development. The prototyping stage addresses the technical issues of the concept and ensures that a feasible product or service can be made and delivered. The market engagement action stage refines the concept for the customer as well as contributing to the acquisition of knowledge, or learning, from early users. The business model action stage completes the development of the opportunity by identifying the varying components of the model that will need to be in place for the concept to be financially viable. Once the entrepreneur has developed a business concept that appears feasible, desirable, and viable, start-up activities bring about the fulfillment of the opportunity.[33]

Utilizing design methodology within each action stage aids in creating a distinctive proof of concept that assists in developing a venture idea. Design-centered entrepreneurship includes two types: microiterations (within each action stage to improve the outcome) and macroiterations (moving from one particular action stage back to a previous stage for further development). Both microiterations and macroiterations involve taking action, learning, and refinement, all of which are beneficial to the process.

Figure 6.3 Design-Centered Entrepreneurship



Source: Michael G. Goldsby, Donald F. Kuratko, Matthew R. Marvel, and Thomas Nelson, "Design-Centered Entrepreneurship: A Four Stage Iterative Process for Opportunity Development," *Journal of Small Business and Entrepreneurship* 29, no. 6 (2017): 5.

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6-7c The Lean Start-Up Methodology

Similar to design methodology, the Lean Startup methodology provides a scientific approach to creating early venture concepts and delivers a desired product to customers' hands faster. Its philosophy originates from the Japanese concept of *lean manufacturing*, which seeks to increase value-creating practices and eliminate wasteful practices. The Lean Startup methodology begins with the premise that every new venture is a grand experiment that attempts to answer questions such as "Should this venture be created?" and "Will it be a sustainable business?"[34]

The Lean Startup methodology was first developed in 2011 by Eric Ries, founder of IMVU Inc. as a way to prevent waste in start-ups and ensure that the business plan remains a living document. The hard truth is that no matter how much research is conducted, how many surveys are developed, and how great you create your financial predictions, your new-venture concept will still be based on certain assumptions. It is critical that these assumptions be either validated or discarded as soon as possible. Reducing waste, in the Lean Startup methodology, is minimizing the time and effort that goes into an incorrect hypothesis by putting a lean-focused process on the development of your product or service. As Ries states in his best-selling book, "Work smarter, not harder."[35] Today, Steve Blank, who is recognized for developing the Customer Development methodology, which launched the Lean Startup movement, along with Jerry Engel at the University of California, Berkeley, have created an entire course for educators known as the Lean Launchpad.[36]

The Lean Startup methodology is hypothesis driven, and entrepreneurs must work to gather and *incorporate* customer feedback early and often. While it is impossible to condense the entire book and methodology, here are a few key points and concepts through which you can understand the basics of the Lean Startup methodology.

Key Lean Startup Terminology

Minimum Viable Product

The goal of producing a minimum viable product (MVP) is to get started learning as soon as possible. This is the version of the product that enables a full turn on the feedback loop with a minimum of effort.

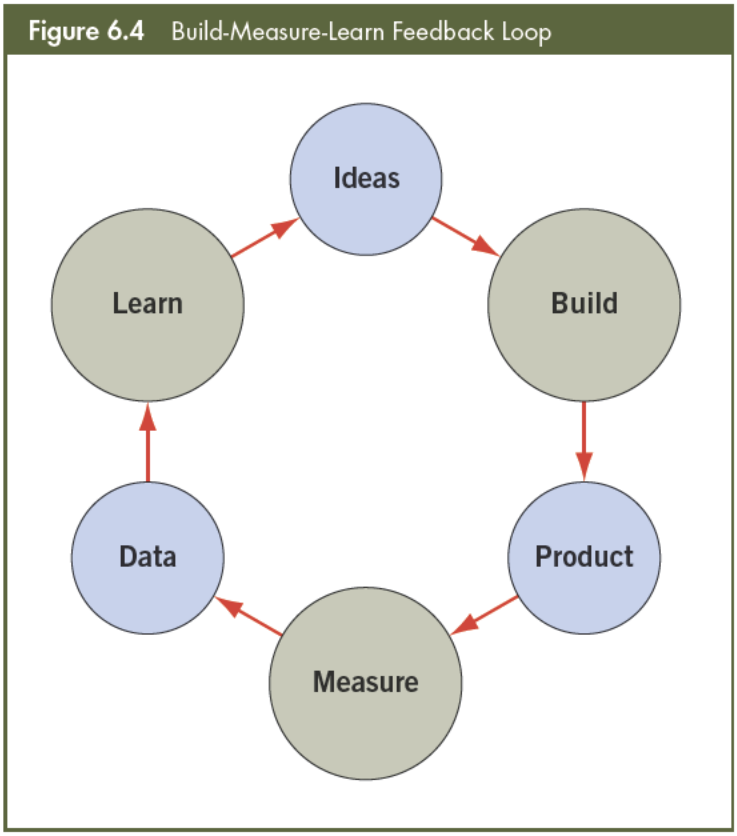
The Three As of Metrics:

- *Actionable*. A report must demonstrate clear cause and effect.
- *Accessible*. A report must be clear to entrepreneurs who are supposed to use them to guide their decision making.
- *Auditable*. Entrepreneurs need the ability to spot-check the data with real customers, and the report mechanisms should not be too complex.

Pivot:

A pivot is a structured course correction designed to test a new fundamental hypothesis about the product, strategy, and engine of growth. The decision whether to pivot or persevere should be evaluated after each build–measure–learn feedback loop for the hypotheses tested during that cycle. The key is when to learn more about the value of the venture. Research on the value of the pivot as well as whether to pivot early or later has been increasing. Researchers broadly distinguish between (1) prelaunch learning in the form of market research and technology development prior to launching a venture and (2) postlaunch learning in the form of pivots in response to market reactions and customer feedback after entering the market.[37] Some scholars and practitioners emphasize that entrepreneurs may mitigate risk and uncertainty by investing in learning before launching a venture. This approach increases an entrepreneur's preparedness and builds venture legitimacy (see the next section on legitimacy) so as to alleviate learning later in the venture life cycle. Conversely, other scholars and practitioners emphasize that entrepreneurs are best served if they launch a venture as soon as possible so that they might learn from market reactions and customer feedback after the launch. The emphasis of this type of learning is on the creative

Figure 6.4 Build-Measure-Learn Feedback Loop



Source: Eric Ries, *The Lean Startup: How Today's Entrepreneurs Use Continuous Innovation to Create Radically Successful Businesses* (New York: Crown Business, 2011).

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revision process,[38] whereby feedback providers and recipients engage in efforts to improve the novelty and usefulness of an idea.

Build–Measure–Learn Feedback Loop:
Think of this as applying the scientific method to your start-up. To begin, identify which hypotheses to test (the value hypothesis and the growth hypothesis are always a good place to start). The build stage consists of developing the MVP for this cycle. The most critical section of the loop is ensuring that you are measuring the correct thing. Do the development efforts lead to *real* progress? This is where the three As of metrics come in handy. The final stage in the cycle, learn, requires the entrepreneur to take a hard look at their results and determine whether a pivot is required. (See Figure 6.4.)

Validated Learning:
Validated learning is defined as a process in which one learns by trying out an initial idea and then measuring it to *validate* the effect. Each test of an idea is a single *iteration* in a larger process of many iterations whereby something is learned and then applied to succeeding tests.

6-8 The Challenge of New-Venture Legitimacy

LO6.9 Examine the importance of new-venture legitimacy and the unique strategies for the differing audiences

New-venture legitimacy is a major challenge for every entrepreneurial start-up. Legitimacy is a resource that enables new ventures to overcome the "liability of newness," thereby allowing for the acquisition of other resources, such as financial capital, human resources, and strategic relationships.[39] Prior research indicates that successful legitimation of new ventures partially explains many positive entrepreneurial outcomes, including organizational emergence,[40] venture survival,[41] access to venture capital,[42] and firm valuation.[43]

A lack of legitimacy is a crippling problem, particularly for new ventures within an entrepreneurial ecosystem that develop a radical new technology or seek to disrupt a market by creating a new category.[44] Since the activities of such a venture are not widely known or well understood, external audiences are less likely to accept and support what they are doing. Because of the challenge that entrepreneurs confront in fostering legitimacy for a new venture, some scholars have proposed strategies that can be employed to foster new-venture legitimacy. For example, one study suggested four basic legitimation strategies available to new ventures: (1) **conformance**, where a new venture that conforms does not question, change, or violate the social structure but rather "follows the rules"; (2) **selection**, which is locating in a favorable environment; (3) **manipulation**, where an entrepreneur attempts to make changes in the external environment to achieve consistency between an organization and its environment; and (4) **creation**, requiring an entrepreneur to create a new social context by creating new rules, norms, values, scripts beliefs, models, and so on.[45]

While those are potential general strategies for legitimacy, entrepreneurs depend on marshaling resources and support from a diverse array of external actors. Success in garnering such inputs can have a significant impact on the survival and sustainability of a new venture. For members of an external audience to provide a new venture with resources and support, they need to perceive the venture as legitimate. A venture is perceived as legitimate if others view it as proper or appropriate within some socially constructed system of norms, values, beliefs, and definitions. Perceptions of legitimacy enable new ventures to overcome their liability of newness and to access inputs that increase their otherwise limited chances of survive. Entrepreneurial ventures depend on resources and support from a diverse range of audiences, including individual supporters, venture capitalists, government agencies, and corporations. Different audiences have differing norms, beliefs, rules, and procedures for assessing a venture.[46] Since legitimacy assessments represent social judgments that reside in the eye of the beholder, such assessments are audience dependent. Therefore, researchers Greg Fisher, Donald F. Kuratko, James Bloodgood, and Jeffrey S. Hornsby distinguished the legitimacy judgments of the different audience types that a new ventures face.[47] Because there are contrasting **institutional logics** (defined as socially constructed, historical patterns of practices, assumptions, values, beliefs, and rules by which individuals will provide meaning),[48] different groupings of people will judge the legitimacy of a new venture through their own lens because of their different environmental context. These audiences and their logics are (1) government agencies dominated by a *state logic*, (2) venture capitalists dominated by a *professional logic*, (3) corporate venture capitalists dominated by a *corporate logic*, (4) crowdfunding platforms dominated by a *community logic*, and (5) angel investors dominated by a *market logic*.

This means that the legitimacy of a new venture may be judged differently by crowdfunding backers dominated by a community logic, compared to government agents dominated by a state logic, compared to angel investors dominated by a market logic, compared to venture capitalists dominated by a professional logic and compared to corporate venture capitalists dominated by a corporate logic. To account for these differences, entrepreneurs must adapt their new-venture legitimation mechanisms to align with the expectations and criteria of different audience groups operating with contrasting institutional logics.

The researchers posed three primary mechanisms available to entrepreneurs to establish legitimacy for their new ventures: (1) identity mechanisms that

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Table 6.4 The New-Venture Legitimation Framework

Audience (Resources) / *Institutional Logic* / Legitimacy Mechanisms	Crowdfunding Backers (Crowdfunding)	Grant Administrators (Research grants or awards)	Venture Capitalists (Venture capital investment)	Corporate Venture Capitalists (Corporate investment)
	Community Logic	*State Logic*	*Professional Logic*	*Corporate Logic*
Cultural Mechanisms How a venture is portrayed in its identity claims?	**Contribution claims** Claims an identity providing value directly to community members and contributing to community wellbeing.	**Technical claims** Claims an identity of contributing to knowledge advancement and providing technological breakthroughs.	**Competitive claims** Claims an identity of being as competitively superior to others.	**Complementary claims** Claims an identity that supports and enhances the corporation's strategy.
Associative Mechanisms With whom is the venture connected?	**Ties with prominent community members or associations** Venture forms and signals ties with community members or associations—tied to the community ecosystem.	**Ties with research institutions** Venture forms and signals ties with research institutions—tied to the academic ecosystem.	**Ties with other investors** Venture forms and signals associations with other investors—tied to investor ecosystem.	**Ties with other corporations** Venture forms and signals associations with other corporations—tied to the corporate ecosystem.
Organizational Mechanisms How a venture is organized? Including two factors: • Leadership • Success measures	**Community membership of the leader(s)** Venture has a leader in place with strong links to, and membership in, the community **Demonstrating prototype** Developing and demonstrating a product prototype.	**Academic experience and reputation of leader(s)** Venture has a leader in place with recognized academic qualifications and reputation. **Scientific achievements and recognition** Achieving technical and research milestones, achievements and recognition.	**Entrepreneurial experience and reputation of leader(s)** Venture has a leader in place with recognized entrepreneurial experience and reputation. **Achieving growth milestones** Achieving specified venture growth milestones.	**Managerial experience and reputation of leader(s)** Venture has a leader in place with recognized managerial experience and reputation. **Level of professionalization** Instituting a familiar organizational structure and managerial roles.

Source: Adapted from Greg Fisher, Donald F. Kuratko, James Bloodgood, and Jeffrey S. Hornsby, "Legitimate to Whom? Audience Diversity and Individual-Level New Venture Legitimacy Judgments," *Journal of Business Venturing* 32, no. 1 (2017): 57.

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account for how a venture is portrayed in its identity claims and espoused symbols and images, (2) associative mechanisms that reflect which organizations and individuals a new ventures is tied with, and (3) organizational mechanisms that account for the attributes of organizational leaders and espoused organizational achievements and success measures. Using these mechanisms, specific strategies were proposed for each audience that a new venture may interact with to gain legitimacy.[49] Table 6.4 outlines the highlights of those strategies.

Understanding the importance of legitimacy for new ventures is critical to their overall acceptance and eventual survival. It may be one of the most important facets of assessing new ventures due to the different audiences that venture may confront.

Diversity in Entrepreneurship

A Trusting Environment for Diversity

Despite the increasing prominence of diversity and inclusion initiatives, women and people of color remain underrepresented in senior leadership positions, whether in large organizations, franchises, or start-ups. The lack of progress raises questions as to whether the business case for diversity is really compelling or whether we need to rethink our approach to diversity initiatives. If current initiatives are not moving the needle, then what will? A new stream of thought argues that increasing diversity does not by itself create change. To make real progress, organizations must be willing to reshape their power structure and learn how to harness diversity. Unfortunately, companies took an easy way out with limited approaches that do not create meaningful change.

What does it mean to change the power structure of a business? It means going beyond hiring underrepresented individuals and making them feel included. It means giving them the power to help set the agenda and influence how work is done. It involves accounting for their needs and interests. Finally, it includes recognizing their contributions and rewarding them with further opportunities to contribute and advance in the workplace. In order to make this shift in power, the organizations will need to build trust, actively work against discrimination and subordination, embrace a wide range of styles and voices, and use cultural differences as a resource for learning.

Building trust is the most important and likely the most challenging task for a business to do, especially because there is no clear manual on how to create a trusting environment. At the same time, the clue seems to lie in the vagueness of the term itself. A trusting workplace is a safe workplace that supports self-expression, vulnerability, and honest dialogue even on the most difficult topics. It does not require robust solutions. Business leaders often get preoccupied with the notion that they must provide solutions or always say the right thing, but trust is built on a much more basic level: by initiating open dialogues, acknowledging the situations of others, and listening compassionately. Rather than worrying about using the right words or performing the right actions, business leaders should work on becoming more open to change and receiving feedback.

Establishing trust serves as a great base for actively working against discrimination and subordination. This action involves a systemic change that starts with the leaders of organizations. Leaders need to learn about systems of privilege and oppression and how they operate in the wider culture to relieve the minorities facing these oppressive systems from the burden of educating the majority employees. They need to use this knowledge to investigate how these systems of oppression are integrated in their organization's culture and to understand the biases that they hold due to stereotypes and assumptions. They need to recognize patterns in who received coaching, whose mistakes were forgiven, or who got a second or third chance to prove themselves. Critically, leaders then need to use their firsthand experiences to spur change with a collective process of continuous reflection and consciousness raising, experimentation, and action, followed by monitoring and continuous adjustments.

After leaders dismantle the oppressive systems, stereotypes, and assumptions, the third necessary step is to embrace a wide range of styles and voices. Asking a White woman to be "nicer," a Latina to "dial it down," or a large Black man to smile more sends messages that they are being compared to a stereotypical image of their group and makes it harder for them to bring their talents and perspectives to the table. There is no one "ideal" employee behavior style, and performance management systems need to reflect that.

Finally, the last action builds on previous steps by using these cultural differences as a resource for learning. Leaders should encourage open discussions about employees' experiences inside and outside the organization and draw on these differences, shaped by a variety of identities, as a source of ideas to enhance the organization's work and culture. If a business is able to get through these steps, it will be in a much better place to harness the power of diversity. In a world where customers are becoming more distrustful and impatient for real change, cosmetic changes to "business as usual" will no longer pass as acceptable diversity and inclusion initiatives.

Source: Adapted from Lily Zheng, "The Business Case for Diversity Is a Sinking Ship," *Medium*, July 2019, and Robin J. Ely and David A. Thomas, "Getting Serious about Diversity: Enough Already with the Business Case," *Harvard Business Review*, December 2020.

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Summary

The complexity of factors involved in new-venture start-up (as shown in Figure 6.1) makes it difficult to clearly assess and evaluate each one. In addition, the difficulty of obtaining reliable data on failed firms adds to this dilemma. Improvements are being made, however, and new-venture assessment is becoming a stronger process.

A number of pitfalls may occur in the selection of a new venture: lack of an objective evaluation of the venture, lack of insight into the market, inadequate understanding of technical requirements, poor financial understanding, lack of venture uniqueness, and failure to be aware of legal issues.

When assessing a new venture, an entrepreneur needs to consider several critical factors: the uniqueness of the good or service, the amount of capital investment required to start the venture, the growth of sales, and the availability of the product.

Some major reasons for new-venture failures are inadequate knowledge of the market, faulty product performance, ineffective marketing and sales effort, inadequate awareness of competitive pressures, rapid product obsolescence, poor timing, and undercapitalization. In drawing together these and other reasons, recent research reveals three major categories of causes for failure: product/market problems, financial difficulties, and managerial problems. In addition, entrepreneurs face internal and external problems.

The feasibility of the entrepreneur's product or service can be assessed by asking the right questions, by making a profile analysis of the venture, and by carrying out a comprehensive feasibility study.

Finally, establishing the legitimacy of a new venture is critical to its overall survival and success. Understanding the differing audiences that entrepreneurs confront and the specific strategies to employ with each audience is a valuable tool for establishing legitimacy.

Key Terms

comprehensive feasibility approach
conformance creation
critical factors
customer availability
design-centered entrepreneurship
design methodology
entrepreneurial team
external problems
failure prediction model
feasibility criteria approach
growth of sales
growth stage
high-growth venture
institutional logics
internal problems
Lean Startup methodology
legitimacy
lifestyle venture
macroiteration
manipulation
marketability
microiteration
minimum viable product (MVP)
pivot
product availability
prototyping
selection
small profitable venture
start-up problems
technical feasibility
uniqueness
validated learning

Review and Discussion Questions

1. Explain the challenges involved in new-venture development.
2. Describe some of the key factors involved in new-venture performance (use Figure 6.1).
3. Many entrepreneurs lack objectivity and have no real insight into the market. Why are these characteristics considered pitfalls of selecting new ventures?
4. Many entrepreneurs have a poor understanding of the finances associated with their new venture and/or have a venture that lacks uniqueness. Why are these characteristics considered pitfalls of selecting new ventures?
5. Describe each of the five critical factors involved in the pre–start-up and start-up phases of a new venture.
6. Explain why the development of an effective entrepreneurial team is critical for today's entrepreneurs.
7. Identify and discuss three examples of product/market problems that can cause a venture to fail.
8. Identify and discuss two examples of financial difficulties that can cause a venture to fail.
9. Identify and discuss two examples of managerial problems that can cause a venture to fail.
10. List four major types of problems that new ventures confront.
11. How can asking the right questions help an entrepreneur evaluate a new venture? What types of questions are involved?
12. Explain the traditional methods of new-venture evaluation: profile analysis, the feasibility criteria approach, and the comprehensive feasibility method.
13. Describe the contemporary methods of new-venture evaluation: design methodology and the Lean Startup methodology.
14. Explain a pivot and discuss the new research trends on its value.
15. Explain the importance of establishing the legitimacy of a new venture.
16. Identify the specific legitimacy strategies to use with each different audience that a new venture may confront.

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Appendix 6A: Feasibility Plan Outline

This outline provides a framework to help entrepreneurs recognize the actual feasibility of proposed ventures and clarify their thinking before considering potential funding. It focuses on the viability of the idea, asking whether there is a market for the concept and if the concept can be produced and sold at a profit.

Title Page

Name of proposed company: _____

Names and titles of the founding team members:

_____

_____

_____

_____

_____

Relevant contact information (name, title, address, phone, e-mail):

_____

_____

_____

_____

_____

Table of Contents

Make sure that all of the contents in the feasibility plan have page numbers and are listed carefully in the table of contents.

I. Executive Summary
II. Business Concept
III. Industry/Market Analysis
IV. Management Team
V. Product/Service Development Plan
VI. Financial Plan
VII. Time Line
VIII. Bibliography

6A-1 The Sections of a Feasibility Plan

6A-1a Executive Summary

Explanation: Include the most important highlights from each section of the feasibility study. Be sure to include a clear and concise description of the venture, whatever proprietary aspects it may possess, the target market, the amount of financing needed, and the type of financing that is being requested.

_____

_____

_____

_____

6A-1b Business Concept

Explanation: Using the following directions, articulate a compelling story that explains why this is an excellent concept. This section allows the reader to understand what concept is being proposed and why it has true potential in the marketplace. It also provides an opportunity for the entrepreneur to prove that they can articulate this concept in clear and comprehensible terms to people outside their circle of friends and close associates.

Key Concepts

Describe whether the proposed concept is a retail, wholesale, manufacturing, or service business. Identify the current stage of development for the venture (concept stage, start-up, initial operations, or expansion).

_____

_____

_____

Include a clear description of the targeted customer, the value proposition (in terms of benefits gained) for that customer, and the potential growth opportunities.

_____

_____

_____

_____

Summarize any proprietary rights associated with this concept, whether those be patents, copyrights, licenses, royalties, distribution rights, or franchise agreements.

_____

_____

_____

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6A-1c Industry/Market Analysis

Explanation: The industry/market analysis is critical. Is there a market for the product or service resulting from the venture? What are the current trends in this industry? What are the predicted trends for this industry? Can any of this be substantiated? The market for the product/service may be obvious, yet the feasibility analysis must validate its existence. In the venture feasibility analysis, it may be enough to prove that a sufficient market exists for the venture and that no further in-depth research is warranted. However, entrepreneurs should always study their competitors in the marketplace. Lessons learned from competitors provide opportunities for entrepreneurs to find the unique distinctions in their own concept.

Key Concepts

Explain the industry that this concept focuses on as well as whatever trends may exist in that particular industry today.

Discuss the target market analysis that has been used and what specific market niche that has produced. In addition, identify the market size, its growth potential, and your plan for market penetration based on research.

Explain the customer profile in terms of who the specific customer is and—again—what value proposition (in terms of benefits) is being offered the customer.

Finally, be sure to include a competitor analysis that describes thoroughly the competition existing today and how specifically your concept will match up or exceed the competition and why.

6A-1d Management Team

Explanation: Keep in mind that all new ventures must stand the scrutiny of whether the founding team can really move this idea to market. The experience of the management team may end up being one of the most critical factors to outside investors. Many times, venture capitalists have expressed their belief that they prefer a "B" idea with an "A" team as opposed to an "A" idea with a "B" team. In other words, there is a real concern about the implementation phase of a proposed concept. Does this founding team have the background, experience, skills, and networks to make the concept operationally successful?

Key Concepts

Identify the founding team members and the key personnel in place to guide the proposed company.

Explain the team's qualifications and how the critical tasks are being assigned. Also include any board of directors/advisers that are in place.

Finally, outline any "gaps" in the management team (in terms of skills and abilities) and explain how those will be addressed.

6A-1e Product/Service Development Analysis

Explanation: Before going any further with a conceptual idea, the entrepreneur must determine whether the concept has any practical feasibility. One of the most important questions in this section of the feasibility analysis would be, "What unique features distinguish your product/service?" The more unique the features of a product or service, the better chance the business concept has of being successful.

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Key Concepts

Provide a detailed description of the proposed concept, including any unique features that make it distinctive.

Explain the current status of the project and include a clear time line of the key tasks to complete.

Identify any intellectual property involved with this potential venture and discuss the proprietary protection that exists. Any proposed or completed prototype testing should be described here as well.

Finally, identify any anticipated critical risks in terms of potential product liability, governmental regulations, or raw material issues that may hinder this project at any stage.

6A-1f Financial Analysis

Explanation: Summarize the critical assumptions upon which the financial information is based; in other words, show how the numbers have been derived. A pro forma income statement and a statement of cash flows are the two most critical financial documents to add here—even though they may include preliminary outside sources needed to get some idea of the generation of revenue and the cash position of the venture during the first three years. If possible, provide a break-even analysis to demonstrate where the venture moves from survival to growth.

Key Concepts

Assumptions:

Pro Forma Income Statement:

Pro Forma Cash-Flow Statement:

Break-Even Analysis:

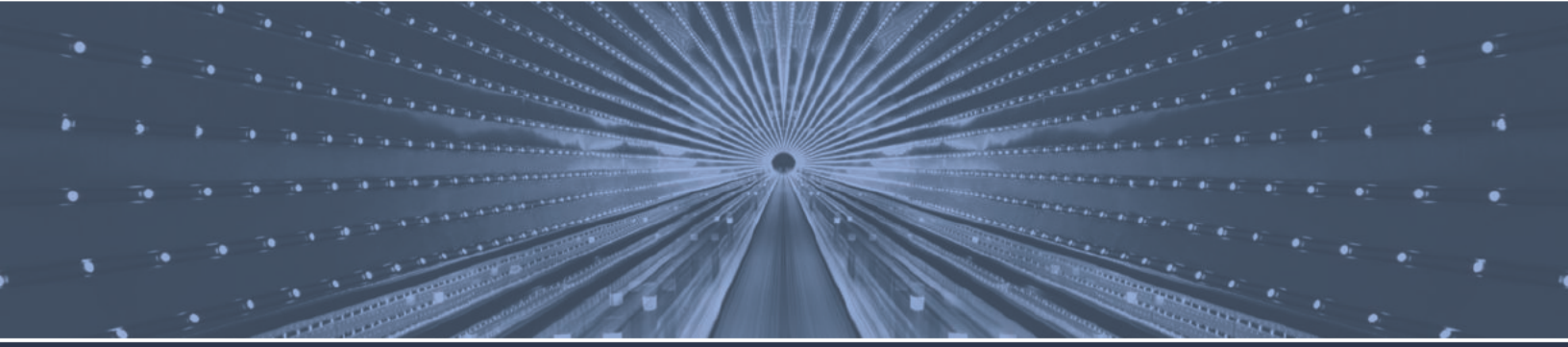
6A-1g Time Line

Explanation: Use a graphic representation of the dates and the related tasks in order of their completion until actual concept launch.

6A-1h Bibliography

Explanation: Provide any key endnotes, footnotes, sources, or extra information that would be critical for a funding source to see in relation to the work you performed in creating this feasibility study.

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Chapter 7

Pathways to Entrepreneurial Ventures

Learning Objectives

7.1. Describe the major pathways and structures for entrepreneurial ventures
7.2. Explain the newness dimensions involved in creating a "new venture"
7.3. Discuss the elements involved in acquiring an established venture
7.4. Outline 10 key questions to ask when buying an ongoing venture
7.5. Describe the underlying issues involved in the acquisition process
7.6. Define a franchise and outline its structure
7.7. Outline the benefits and drawbacks of franchising
7.8. Explain the franchise disclosure document (FDD) as a key item in franchises
7.9. Describe the elements involved with incubators, accelerators, and entrepreneurial ecosystems

---

Entrepreneurial Thought

Every large and successful company was once a start-up struggling to survive. Some of these successful companies were conceived in a flash of inspiration and planned on the back of a napkin in a coffee shop. Others took shape painstakingly over time in a basement or a garage. Some start-ups were created and then flourished overnight, while others achieved success only through a long series of painful fits and starts. The point is, every company that exists today began rather small.

—Joel Kurtzman, ***Start-Ups That Work***

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LO7.1 Describe the major pathways and structures for entrepreneurial ventures

Every prospective entrepreneur wants to know the best methods for getting a business started. They ask themselves, "What are the ideal pathways to starting a venture?" In this chapter, we examine the three most common methods: creating a new venture, acquiring an existing venture, or obtaining a franchise. Each pathway represents a particular form of entry and has its own particular advantages and disadvantages.[1] This chapter outlines some of the particular issues associated with each form.

7-1 Creating New Ventures

LO7.2 Explain the newness dimensions involved in creating a "new venture"

The most effective way to start a new business is to create a new and unique product or service. The next best way is to adapt an existing product or service or to extend an offering into an area where it is not presently available. The first approach is often referred to as *new-new* and the second as *new-old*. Peter Thiel, cofounder of Paypal and Palantir, would refer to these approaches as "0 to 1" for creating the new and "1 to n" for copying an already existing model.[2] It is then important to understand the dimensions of newness and where the created venture fits within a framework.

7-1a New-New Approach to Creating New Ventures

New products or services frequently enter the market. Typical examples include smartphones, MP3 players, plasma televisions, and global positioning systems (GPS). All of these products and more were introduced as the result of research and development efforts by major corporations (see Table 7.1 for a list of emerging ideas). What we must realize, however, is that unique ideas are not the sole province of large companies. Individuals create, too.

How does one discover or invent new products? As discussed earlier in Chapter 5, one of the ways to uncover new-product concepts is through close observation of the world around you. Making lists of annoying everyday experiences or of problems in using known products or services has led to innovative business ventures. Objects that fall out of one's hand, household chores that are difficult to do, and items that are hard to store are examples of everyday annoyances that have led to new-venture creations. An engineer once observed the mechanism for recording the revolutions of a ship's propeller. As he watched the device tally the propeller's cycles, he realized that the idea could be adapted to the recording of sales transactions—a problem he had been trying to solve for some time. The result led eventually to the development, in 1879, of the mechanical cash register.

Most business ideas tend to come from people's experiences. In general, the main sources for most entrepreneurs are prior jobs, hobbies or interests, and personally identified problems. The **new-new approach** indicates the importance of people's awareness of their daily lives (work and free time) for developing new business ideas.

Facebook was founded by Harvard University student Mark Zuckerberg, who was frustrated by the lack of networking facilities on campus—a simple annoyance that has led to a spectacularly successful technological juggernaut. Now one of the most trafficked sites on the Internet, Facebook has, only 18 years after its inception, more than 2 billion monthly users and revenues exceeding $27 billion.[3] In addition, Facebook's initial public offering in 2012 rivaled the largest ever accomplished.[4]

7-1b New-Old Approach to Creating New Ventures

Most small ventures do not start with a totally unique idea. Instead, an individual "piggybacks" on someone else's idea by either improving a product or offering a service in an area in which it is not currently available—hence the term **new-old approach**. Some of the most common examples are setting up restaurants, clothing stores, or similar outlets in sprawling suburban areas that do not have an abundance of these stores. Of course, these kinds of operations can be risky because competitors can move in easily. Potential owners considering this kind of enterprise should try to offer a product or service that is difficult to copy. For example, a computerized billing and accounting service for medical doctors can be successful if the business serves a sufficient number of doctors to cover the cost of computer operators and administrative expenses in order to turn an adequate profit. Or perhaps another type of enterprise is likely to be overlooked by other would-be entrepreneurs.

7-1c A Newness Framework for New Ventures

Researchers Donald F. Kuratko, Greg Fisher, James M. Bloodgood, and Jeffrey S. Hornsby developed a "Newness Framework" to help depict the differing dimensions of newness that ventures could exhibit.[5] Shown in Figure 7.1, entrepreneurs have the option to exploit opportunities by leveraging *incremental* or *radical* technological advances to provide a good or service with *incremental* or *radical* market disruption.

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Table 7.1 Trends in Creating Business Opportunities

Emerging Opportunities	Emerging Internet Opportunities
Social and Environmental Responsibility	*Mobile Advertising*
Gender-neutral products	Micro-influencers
Ethical products	Influencer marketing platforms
Diversity and minority groups	Podcast advertising platforms
Locally made or locally sourced products	Affiliate marketing platforms
Organic food delivery	Content marketing
Reducing food waste	*e-Commerce*
Health Care	Mobile commerce
Mental health	Social commerce
Biopharma	Groceries
Telehealth	Personal care
Niche Markets	Home workout equipment
Plant based	Seasonal
Vegetarian and vegan	*Financial Services*
LGBTQ+	Digital credit cards
Gamers	Mobile banks
Remote workers	Cryptocurrency
Environmentally conscious	*Data Processing and Storage*
Automation	Real-time analytics
Supply chains	Edge computing
Autonomous vehicles	Cloud computing
Customer service chatbots	Artificial intelligence
Internet of Things	*Cybersecurity*
Voice-powered technologies	*Virtual Environments*
Real estate	Metaverse
Smart cities	Virtual and augmented realities
Inventory management	Virtual gaming/simulation platforms
Supply chain management	*Human Resources*
Patient health monitoring	Work-management platforms
Senior care	

Source: Adapted from J. R. Ridlinger, "2021 E-Commerce Trends Entrepreneurs Would Be Foolish to Ignore," *Entrepreneur,* April 21, 2021; Forbes Council Member, "11 Emerging Business Opportunities in the Internet of Things Sector," *Forbes*, July 23, 2021; Kevin Sneader and Shubham Singhal, "The Next Normal Arrives: Trends That Will Define 2021—And Beyond," *McKinsey Quarterly*, January 2021; Cayleigh Parrish, "The World's Most Innovative Companies 2021," *Fast Company*, 2021, https://www.fastcompany.com/90603436/the-worlds-most-innovative-companies-2021; Eira Astrid, "16 Entrepreneurship Trends for 2022/2023: New Forecasts and a Look into What's Ahead," *FinancesOnline*, 2022, https://financesonline.com/entrepreneurship-trends; and Annette Rippert, Kathleen O'Reilly, Rachael Bartels, Koen Deryckere, Eva Sage-Gavin, and Paul Nunes, "Business Futures 2021: Signals of Change," Accenture, 2021, https://www.accenture.com/_acnmedia/Thought-Leadership-Assets/PDF-5/Accenture-Signals-Of-Change-Business-Futures-2021-Report.pdf.

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Linking the different *dimensions* of innovation newness—technology newness and/or market newness—with the *level* of innovation newness—incremental versus radical innovations—provides a framework for broadly classifying the overall "newness" of an innovation within an entrepreneurial venture.

According to the researchers, at the one extreme, entrepreneurs can exploit a radical new technology to provide a product or service intended to radically disrupt the market through the creation of a new product market space. This would embrace the highest level of innovation "newness" relative to other alternatives. Furthermore, because they are exploiting a radical technology, they confront high levels of technological uncertainty, and they need to help the market understand, accept, and embrace a new technological advance (quadrant D in Figure 7.1). At the other extreme, entrepreneurs who create an organization to exploit or incrementally improve on an existing technology and seek to operate within an established market category confront the lowest levels of innovation "newness" relative to other alternatives (quadrant A in Figure 7.1).

Between these two extremes, some entrepreneurs may create and exploit a radical new technology to establish a venture to compete in an existing market category (quadrant C in Figure 7.1). Also between the two extremes, a new venture may exploit and incrementally improve on an existing technology but participate in the establishment of a new market category (quadrant B in Figure 7.1).

The dimensions of newness (technological and market) and the levels of newness (radical and incremental) provide a basis for understanding how a firm's market orientation is related to successful breakthrough innovation. Thus, the dimensions and levels of newness can be useful in understanding how new an entrepreneur's venture stands within the market and /or technology domains.

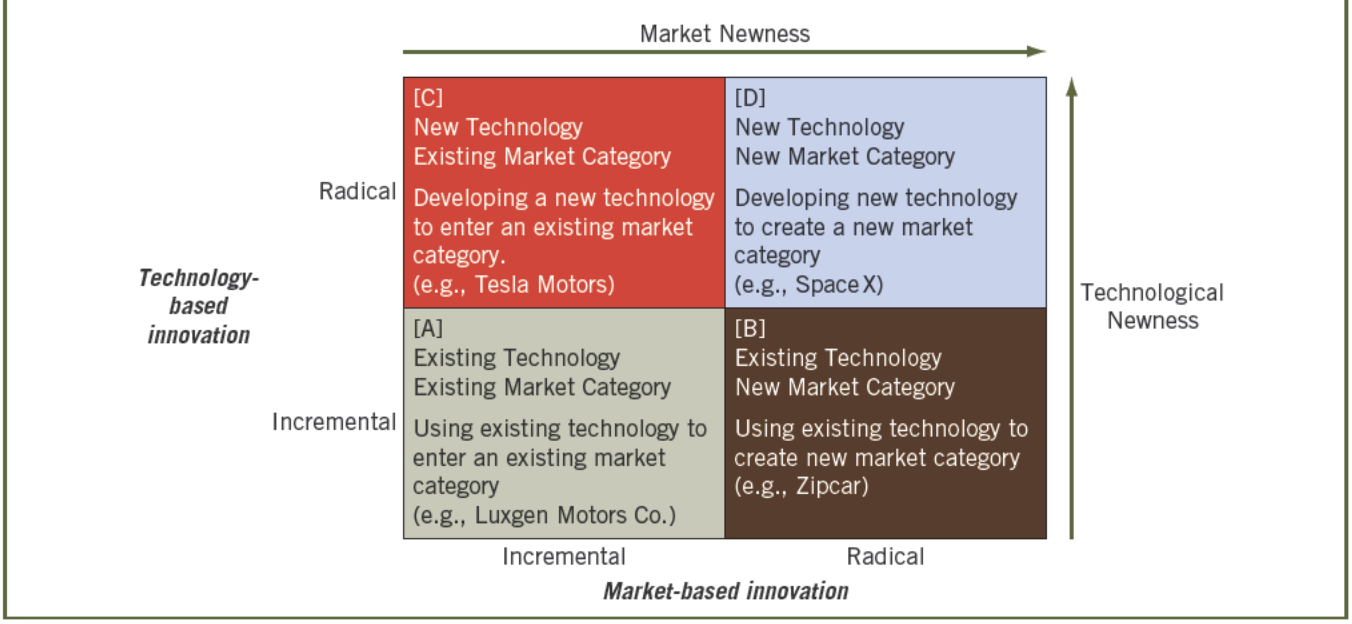
Regardless of whether the business is based on a new-new or a new-old idea, the prospective owner cannot rely exclusively on gut feeling or intuition to get started. As we demonstrate in Part III of this book, proper planning and analysis are the keys to any successful venture.

7-1d Examining the Financial Picture When Creating New Ventures

If, through a thorough feasibility analysis and business plan (covered in detail in Chapter 12) a prospective entrepreneur decides that creating a new venture is a wise option, it is imperative to remember that the plan may not work perfectly. Some modification may be necessary, and flexibility is key. A contingency or backup plan should be available because the worst thing an entrepreneur can do is adopt an all-or-nothing strategy.

As we know, prospective entrepreneurs of new ventures must evaluate an enterprise's financial picture. How much will it cost to stay in business for the first year? How much revenue will the firm generate during

Figure 7.1 Entrepreneurial Newness Framework



Source: Donald F. Kuratko, Greg Fisher, James M. Bloodgood, and Jeffrey S. Hornsby, "The Paradox of New Venture Legitimation within an Entrepreneurial Ecosystem," *Small Business Economics* 49, no. 1 (2017): 124.

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this time period? If the outflow of cash is greater than the inflow, how long will it take before the business turns the corner? It is time to look at these questions in more detail.

Answering these questions requires consideration of two kinds of expenses: start-up and monthly. Table 7.2 illustrates a typical worksheet for making the necessary calculations of start-up expenses. Notice that this worksheet is based on the assumption that no money will flow in for about three months. Also, all start-up costs are totally covered. If the firm is in the manufacturing business, however, it will be three to four months before any goods are produced and sold, so the factors in column 3 have to be doubled, and the amount of cash needed for start-up will be greater. Much of the information needed to fill in this worksheet already should have been gathered and at least partially analyzed. Now, however, it can be put into a format that allows the owner to look at the overall financial picture.

At this point, the individual should be concerned with what is called **upside gain and downside loss**. This term refers to the profits the business can make and the losses it can suffer. How much money will the enterprise take in if everything goes well? How much will it gross if operations run as expected? How much will it lose if operations do not work out well? Answers to these questions provide a composite picture of the most optimistic, the most likely, and the most pessimistic results. The owner has to keep in mind that the upside gain may be minimal, whereas the downside loss may be great.

It is necessary to examine overall gains and losses. This kind of analysis is referred to as **risk versus reward** analysis and points out the importance of getting an adequate return on the amount of money risked.

Table 7.2 Checklist for Estimating Start-Up Expenses

Monthly	Expenses	Cash Needed to Start the Business	What to Put in Column 2
Item	Estimate based on sales of $___ per year	(see column 3)	(These figures are estimates. The owner/manager decides how many months to allow, depending on the type of business.)
	Column 1	Column 2	Column 3
Salary of owner/manager	$	$	3 times column 1
Other salaries and wages			3 times column 1
Rent			3 times column 1
Advertising			3 times column 1
Delivery expenses			3 times column 1
Supplies			3 times column 1
Telephone and telegraph			3 times column 1
Other utilities			3 times column 1
Insurance			6 times column 1
Taxes, Social Security			4 times column 1
Interest			3 times column 1
Maintenance			3 times column 1
Legal and other professional assistance			3 times column 1
Miscellaneous			3 times column 1

(*Continued*)

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Start-Up Costs		
Item	**Estimate**	**To Arrive at Estimate**
Fixtures and equipment	$	Determine what is typical for this kind of business; talk to suppliers.
Decorating and remodeling		Talk to a contractor.
Installation of fixtures, equipment	t	Talk to suppliers.
Starting inventory		Talk to suppliers.
Deposits with public utilities		Talk to utility companies.
Legal and other professional fees		Talk to a lawyer, accountant, or other professional.
Licenses and permits		Contact appropriate city offices.
Advertising and promotion		Decide what will be used; talk to media.
Accounts receivable		Estimate how much will be tied up in receivables by credit customers and for how long.
Cash		Allow for unexpected expenses and losses, special purchases, and other expenditures.
Other Expenses		List them and estimate costs.
Total cash needed to start	$_____	Add all estimated amounts.

Source: U.S. Small Business Administration, "Management Aids," MA. 2.025 (Washington, DC: U.S. Government Printing Office).

7-2 Acquiring an Established Entrepreneurial Venture

LO7.3 Discuss the elements involved in acquiring an established venture

A prospective entrepreneur may seek to purchase a business venture rather than start an enterprise. This can be a successful method of getting into business, but numerous factors need to be analyzed. Purchasing a business venture is a complex transaction, and the advice of professionals always should be sought. However, a few basic steps that can be easily understood are presented here, including the entrepreneur's personal preferences, examination of opportunities, evaluation of the selected venture, and key questions to ask.

7-2a Personal Preferences

Entrepreneurs need to recognize certain personal factors and to limit their choices of ventures accordingly. An entrepreneur's background, skills, interests, and experience are all important factors in selecting the type of business to buy. In addition, personal preferences for the location and size of a business should guide the selection process. If an entrepreneur always has desired to own a business in the South or West, then that is exactly where the search should begin.

7-2b Examination of Opportunities

Entrepreneurs in search of a possible venture to buy need to examine the available opportunities through various sources:

- *Business brokers*. Professionals specializing in business opportunities, or **business brokers**, often can provide leads and assistance in finding a venture for sale. However, the buyer should evaluate the broker's reputation, services, and contacts. The entrepreneur also should remember that the broker usually represents—and gets a commission on the sale from—the seller.
- *Newspaper ads*. "Business Opportunity" classified ads are another source. Because an ad often will appear in one paper and not another, it may be necessary to check the classified sections of all the papers in the area.
- *Trade sources*. Suppliers, distributors, manufacturers, trade publications, trade associations, and trade schools may have information about businesses for sale.
- *Professional sources*. Professionals such as management consultants, attorneys, and accountants often know of businesses available for purchase.

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7-2c Advantages of Acquiring an Ongoing Venture

Of the numerous advantages to buying an ongoing venture, three of the most important are as follows:

1. Because the enterprise is already in operation, its successful future operation is likely.
2. The time and effort associated with starting a new enterprise are eliminated.
3. It sometimes is possible to buy an ongoing business at a bargain price. Each of these three advantages is discussed next.

Less Fear about Successful Future Operation

A new business faces two great dangers: the possibility that it will not find a market for its goods or services and the chance that it will not be able to control its costs. If either event occurs, the new business will go bankrupt.

Buying an existing company, however, alleviates most of these fears. A successful business already has demonstrated the ability to attract customers, control costs, and make a profit. Additionally, many of the problems a newly formed firm faces are sidestepped: Where should the company be located? How should it advertise? What type of plant or merchandise layout will be the most effective? How much should be reordered every three months? What types of customers will this business attract? What pricing strategy should the firm use? Questions such as these already have been asked and answered. Thus, when a new owner buys an ongoing operation, that person is often purchasing a known quantity. Of course, it is important to check whether hidden problems exist in the operation. Barring something of this nature, however, the purchase of an existing successful operating venture can be a wise investment.

Reduced Time and Effort

An ongoing enterprise already has assembled the inventory, equipment, personnel, and facilities necessary to run it. In many cases, this has taken the owners a long time to do. They have spent countless hours "working out the bugs" so that the business is as efficient as possible. Likewise, they probably have gone through a fair number of employees before getting the right type of personnel. Except for the top management in an operating venture, the personnel usually stay with the sale. Therefore, if the new owners treat the workers fairly, they should not have to worry about hiring, placing, and training personnel.

In addition, the previous owners undoubtedly have established relations with suppliers, bankers, and other businesspeople. These individuals often can be relied on to provide assistance to the new owners. The suppliers know the type of merchandise the business orders and how often it needs to be replenished. They can be a source of advice about managing the operation, as can the bankers with whom the enterprise has been doing business. These individuals know the enterprise's capital needs and often provide new owners with the same credit line and assistance they gave the previous owners. The same holds true for the accountant, the lawyer, and any other professionals who served the business in an advisory capacity. Naturally, the new owners may have their own bankers, accountant, or lawyer, but these old relationships are there if the new owners need them.

A Good Price

Sometimes it is possible to buy an ongoing operating venture at a very good price. The owner may want to sell quickly because of a retirement decision or illness. Or the owner may be forced to sell the business to raise money for some emergency that has occurred. Or the owner may seek a greater opportunity in another type of business and therefore be willing to sell at a low price in order to take advantage of the new opportunity.

Ideally, when one is looking to buy an ongoing, successful operating venture, one of these three advantages (especially the last one) is present. However, seldom does someone in business sell a successful firm at an extraordinarily low price. The owner of a successful small venture built the enterprise through skillful business practices, knows how to deal with people, and has a good idea of the operation's fair market value. That person will rarely sell for much below the fair market value. Therefore, the prospective owner must avoid bidding high on a poor investment or walking away from a good bargain because "it smells fishy." The way to prevent making the wrong decision is to evaluate the existing operation in a logical manner.

7-2d Evaluation of the Selected Venture

After the entrepreneur considers personal preferences and examines information sources, the next step is to evaluate specific factors of the venture being offered for sale:

- *The business environment*. The local environment for business should be analyzed to establish the potential of the venture in its present location.
- *Profits, sales, and operating ratios*. The business's profit potential is a key factor in evaluating the venture's attractiveness and in later determining a reasonable price for it. To estimate the potential earning power of the business, the buyer should review past profits, sales, and operating ratios and project sales and profits for the next one to two years. Valuation will be further discussed later in the chapter.

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- *The business assets*. The tangible (physical) and intangible (e.g., reputation) assets of the business need to be assessed. The following assets should be examined:
  - Inventory (age, quality, salability, condition)
  - Furniture, equipment, and fixtures (value, condition, leased or owned)
  - Accounts receivable (age of outstanding debts, past collection periods, credit standing of customers)
  - Trademarks, patents, copyrights, and business name (value, role in the business's success, degree of competitive edge)
  - Goodwill (reputation, established clientele, trusted name)

A lot of headaches can be avoided by taking the approach of purchasing an existing venture. For example, start-up problems will have been taken care of by previous owners. Additionally, the business has a track record the buyer can examine to determine the types of products to sell, the prices to charge, and so on. But buying an existing business also has potential pitfalls. Examples include buying a company whose success has been due to the personality and charisma of the owner/manager, buying a company when the market for its product has peaked, and paying too much for a company.

7-2e Key Questions to Ask

LO7.4 Outline 10 key questions to ask when buying an ongoing venture

When deciding whether to buy, the astute prospective owner needs to ask and answer a series of "right questions."[6] The following section discusses questions and provides insights into the types of actions to take for each response.

Why Is the Business Being Sold?

LO7.5 Describe the underlying issues involved in the acquisition process

One of the first questions that should be asked is *why* the owner is selling the business.[7] Quite often, a difference exists between the reason given to prospective buyers and the real reason. Typical responses include "I'm thinking about retiring," "I've proven to myself that I can be successful in this line of business, so now I'm moving to another operation that will provide me with new challenges," and "I want to move to California and go into business with my brother-in-law there."

Any of these statements may be accurate, and—if they can be substantiated—the buyer may find that the business is indeed worth purchasing. However, because it is difficult to substantiate this sort of personal information, the next best thing to do is to check around and gather business-related information. Is the owner in trouble with the suppliers? Is the lease on the building due for renewal and the landlord planning to triple the rent? Worse yet, is the building about to be torn down? Other site-location problems may relate to competition in the nearby area or zoning changes. Is a new shopping mall about to be built nearby that will take much of the business away from this location? Has the city council passed a new ordinance that calls for the closing of business on Sunday, the day of the week when this store does 25 percent of its business?

Financially, what is the owner going to do after selling the business? Is the seller planning to stay in town? What employment opportunities do they have? The reason for asking these questions is that the new owner's worst nightmare is to find that the previous owner has set up a similar business a block away and is drawing back all of the customers. One way to prevent this from happening is to have an attorney write into the contract an agreement that the previous owner will refrain from conducting the same business within a reasonable distance for a period of at least five years. This is known as a **legal restraint of trade**—a covenant not to compete, or a **noncompete agreement**. Doing this helps the new owner retain the business's customers.

What Is the Current Physical Condition of the Business?

Even if the asking price for the operation appears to be fair, it is necessary to examine the *physical condition of the assets*. Does the company own the building? If it does, how much repair work needs to be done? If the building is leased, does the lease provide for the kinds of repairs that will enhance the successful operation of the business? For example, if a flower shop has a somewhat large refrigerator for keeping flowers cool, who has to pay to expand the size of the refrigerator? If the landlord agrees to do so and to recover the investment through an increase in the lease price, the total cost of the additional refrigerated space must be compared to the expected increase in business. Meanwhile, if the landlord does not want to make this type of investment, the new owners must realize that any *permanent additions to the property remain with the property*. This means that if something simply cannot be carried out of the building, it stays. Pictures on the walls, chairs, and desks that the previous business owner purchased can be removed. However, new bookshelves nailed to the wall, carpeting attached to the floor, a new acoustic ceiling installed to cut down on noise in the shop, and the new refrigerated area all become permanent property of the building owner. Therefore, the overriding question while

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examining the physical facilities is, "How much will it cost to get things in order?"

What Is the Condition of the Inventory?

How much inventory does the current owner show on the books? Does a physical check show that inventory actually exists? Additionally, is inventory salable, or is it out of date or badly deteriorated?

What Is the State of the Company's Other Assets?

Most operating ventures have assets in addition to the physical facilities and the inventory. A machine shop, for example, may have various types of presses and other machinery. An office may have computers, copiers, and other technology that belong to the business. The question to ask about all of this equipment is, "Is it still useful, or has it been replaced by more modern technology?" In short, are these assets obsolete?

Another often overlooked asset is the firm's records. If the business has kept careful records, it may be possible to determine who is a good credit risk and who is not. Additionally, these records make it easy for a new owner to decide how much credit to extend to the prior customers. Likewise, sales records can be very important because they show seasonal demands and peak periods. This can provide the new owner with information for inventory-control purposes and can greatly reduce the risks of over- or understocking.

Still another commonly overlooked asset is past contracts. What type of lease does the current owner have on the building? If the lease was signed three years ago and is a seven-year lease with a fixed rent, it may have been somewhat high when it came into effect but could be somewhat on the low side for comparable facilities today. Furthermore, over the next four years, the rent should prove to be quite low considering what competitors will be paying. Of course, if the lease is about to expire, this is a different story. Then the prospective owner has to talk to the landlord to find out what the terms of the lease will be. Additionally, a prospective owner's lawyer should look at the old lease to determine if it can be passed on to a new owner and, regardless of the rent, how difficult it is to break the lease if the business should start to fail.

Finally, the prospective buyer must look at an intangible asset called **goodwill**. Goodwill is often defined as the value of the company beyond what is shown on the books. For example, if a software company has a reputation for quick and accurate service, the company has built up goodwill among its customers. If the owners were to sell the business, the buyer would have to pay not only for the physical assets in the software company (office furniture, computers, and so on) but also for the goodwill the firm has accumulated over the years. The reputation of the business has a value.[8]

How Many of the Employees Will Remain?

It is often difficult to give customers the good service they have come to expect if seasoned employees decide they do not want to remain with the new owner. The owner is certainly an important asset of the firm, but so are the employees; they play a role in making the business a success. Therefore, one question the prospective buyer must ask is, "If some people will be leaving, will enough be left to maintain the type of service the customer is used to getting?" In particular, the new owner must be concerned about key people who are not staying. Key employees are part of the value of the business. If it is evident that these people will not be staying, the prospective buyer must subtract something from the purchase price by making some allowance for the decline in sales and the accompanying expense associated with replacing key personnel.

When purchasing an existing business, the prospective owner should conduct an assessment of the current group of employees. They should review existing performance evaluations and talk with the current owners about the quality of each employee and their value to the business. It may be easier to retain valuable employees by seeking them out before the purchase to ensure their feelings of security. The incoming owner should interview all of the current employees and make decisions about whom to keep and whom to let go before actually taking over the enterprise.

What Type of Competition Does the Business Face?

No matter what goods or service the business provides, the number of people who will want it and the total amount of money they will spend for it is limited. Thus, the greater the competition, the less the business's chance of earning large profits. As the number of competitors increases, the cost of fighting them usually goes up. More money must be spent on advertising. Price competition must be met with accompanying reductions in overall revenue. Simply too many companies are pursuing the same market.

Additionally, the quality of competition must be considered. If nine competitors exist, a new owner could estimate a market share of 10 percent. However, some of these competitors undoubtedly will be more effective than others. One or two may have very good advertising and know how to use it to capture 25 percent of the market. A few others may offer outstanding service and use this advantage to capture 20 percent of the market. Meanwhile, the remaining six fight for what is left.

Then the location of the competition must be considered. In many instances, a new venture does not offer anything unique, so people buy on the basis of convenience. A service located on the corner may get most of the business of local residents. One located across town

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will get virtually none. Because the product is the same at each location, no one is going to drive across town for it. This analogy holds true for groceries, notions, drugs, and hardware. If competitors are located near one another, each will take some of the business the others could have expected, but none is going to maximize its income. But if the merchandise is an item that people shop for very carefully, such as furniture, a competitor in the immediate area can be a distinct advantage. For example, two furniture stores located near each other tend to draw a greater number of customers than they would if located 10 blocks apart. When people shop for furniture, they go where a large selection is available. With adjacent stores, customers will reason that if the furniture they are looking for is not in one, it might be in the other. Additionally, since they can step from one store to the next, they can easily compare prices and the sale terms.

Finally, any analysis of competition should look for **unscrupulous practices**. How cutthroat are the competitors? If they are very cutthroat, the prospective buyer will have to be continually on alert for practices such as price fixing and kickbacks to suppliers for special services. Usually, if the company has been around for a couple of years, it has been successful dealing with these types of practices. However, if some competitors are getting bad reputations, the new owner will want to know this. After all, over time, the customers are likely to form a stereotyped impression of enterprises in a given geographic area and will simply refuse to do business with any of them. In this case, the customers retaliate against unethical business practices by boycotting the entire area in which these firms are located. In short, an unethical business competitor can drag down other firms as well.

What Does the Firm's Financial Picture Look Like?

It may be necessary for a prospective buyer to hire an accountant to look over the company's books. It is important to get an idea of how well the firm is doing financially. One of the primary areas of interest should be the **company's profitability**.[9] Is the business doing anything wrong that can be spotted from the statements? If so, can the prospective buyer eliminate these problems?

Individuals who are skilled in buying companies that are in trouble, straightening them out, and reselling them at a profit know what to look for when examining the books. So do good accountants. Both also know that the seller's books alone should not be taken as proof of sales or profits. One should insist on seeing records of bank deposits for the past two to three years. If the current owner has held the firm for only a short time, the records of the previous owner also should be examined. In fact, it is not out of line to ask for the owner's income tax return. The astute buyer knows that the firm's records reflect its condition.

Another area of interest is the firm's **profit trend**. Is it making more money year after year? More important, are profits going up as fast as sales, or is more and more revenue necessary to attain the same profit? If the latter is true, this means the business may have to increase sales 5 to 10 percent annually to net as much as it did the previous year. This spells trouble and is often a sign that the owner is selling because "there are easier ways to make a living."

Finally, even if the company is making money, the prospective buyer should compare the firm's performance to that of similar companies. For example, if a small retail shop is making a 22 percent return in investment this year in contrast to 16 percent two years ago, is this good or bad? It certainly appears to be good, but what if competing stores are making a 32 percent return on investment? Given this information, the firm is not doing as well.

One way to compare a company to the competition is to obtain comparative information put out by firms such as Dun & Bradstreet that gather data on retail and wholesale firms in various fields and provide businesspeople with an overall view of many key financial ratios. For example, one of the most important is the comparison of current assets (cash or items that can be turned into cash in the short run) to current liabilities (debts that will come due in the short run). This key ratio reflects a business's ability to meet its current obligations. A second key ratio is the comparison of net profits to net sales (net profit margin). How much profit is the owner making for every dollar in sales? A third key ratio is net profit to net worth (return on net worth). How much profit is the individual making for every dollar invested in the firm?

By comparing the accounting information obtained from a business's books to external financial comparison data (industry ratios, industry multiples used for valuation, and so on), it is possible to determine how well the business is doing. If the facts look good, then the prospective buyer can turn to the question of how much to offer the seller.

7-2f Negotiating the Deal

The potential buyer must negotiate the final deal.[10] This negotiation process involves a number of factors. Four critical elements should be recognized: information, time, pressure, and alternatives.

Information may be the most critical element during negotiations. The performance of the company, the nature of its competition, the condition of the market, and clear answers to all of the key questions presented earlier are all vital components in the determination of the business's real potential. Without reliable

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information, the buyer is at a costly disadvantage. The seller never should be relied on as the sole information source. Although the seller may not falsify any information, they are likely to make available only the information that presents the business in the most favorable light. Therefore, the buyer should develop as many sources as possible. The rule should be to investigate every possible source.

Time is also a critical element. If the seller already has purchased another business and a potential buyer is the only prospect to buy the existing firm, then that buyer has the power to win some important concessions from the seller. If, however, the owner has no such deadline but simply is headed to retirement, or if the buyer's financial sources wish to invest in the project quickly, then the buyer is at a serious disadvantage. In short, having more time than the other party can be very beneficial.

Pressure from others also will affect the negotiation process. If the company is owned by several partners, then the individual who is selling the company may not have complete autonomy. If one of the owners is in favor of accepting an offer, the negotiator for the company must decide whether to accept the bid on behalf of all owners or attempt to hold out for more money. This causes a distraction during the negotiation process.

Finally, the alternatives available to each party become important factors. The party with no other alternatives has a great deal of interest in concluding negotiations quickly. Additional considerations that a person should keep in mind when purchasing a business include the following:

1. Request that the seller retain a minority interest in the business or establish the final purchase price dependent on the performance of the business over a three- to five-year span to keep the seller concerned about the immediate future performance of the business.
2. Buyers should be wary of any promises made without written corroboration.
3. Spend time with the seller's books. Reconstructing financial statements to determine how much cash is actually available is an absolute.
4. Investigations should be thorough and wide ranging, encompassing interviews not only with the owner but with vendors, competitors, customers, and employees as well.[11]

For the seller, alternatives include finding another buyer in the near future or not selling at all. The seller may continue to run the business, hire a manager to do so, or sell off parts of the company. Likewise, the buyer may choose not to purchase the business or may have alternative investment opportunities available. In any event, the negotiating parties' alternatives should be recognized because they impact the ability to reach an agreement.

7-3 Franchising: The Hybrid

LO7.6 Define a franchise and outline its structure

One form of business that incorporates some of the independence of an entrepreneur with the larger umbrella of a corporation is the franchise. Thus, it is a "hybrid" form of entering business. Today, more than one-third of all retail sales and an increasing part of gross domestic product are generated by private franchises. A **franchise** is any arrangement in which the owner of a trademark, trade name, or copyright has licensed others to use it in selling goods or services. A **franchisee** (a purchaser of a franchise) generally is legally independent but economically dependent on the integrated business system of the **franchisor** (the seller of the franchise). In other words, a franchisee can operate as an independent businessperson but still realize the advantages of a regional or national organization.[12]

7-3a How Franchising Works

Business franchise systems for goods and services generally work the same way. The franchisee, an independent businessperson, contracts for a complete business package. This usually requires the individual to do one or more of the following:

1. Make a financial investment in the operation
2. Obtain and maintain a standardized inventory and/or equipment package usually purchased from the franchisor
3. Maintain a specified quality of performance
4. Follow a **franchise fee** as well as a percentage of the gross revenues
5. Engage in a continuing business relationship

In turn, the franchisor provides the following types of benefits and assistance:

1. The company name. For example, if someone bought a Burger King franchise, this would provide the business with drawing power. A well-known name, such as Burger King, ensures higher sales than an unknown name, such as Ralph's Big Burgers.
2. Identifying symbols, logos, designs, and facilities. For example, all McDonald's units have the same identifying golden arches on the premises. Likewise, the facilities are similar inside.
3. Professional management training for each independent unit's staff.
4. Sale of specific merchandise necessary for the unit's operation at wholesale prices. Usually provided is all of the equipment to run the operation and the food or materials needed for the final product.

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5. Financial assistance, if needed, to help the unit in any way possible.
6. Continuing aid and guidance to ensure that everything is done in accordance with the contract.[13]

7-3b Advantages of Franchising

LO7.7 Outline the benefits and drawbacks of franchising

A number of advantages are associated with franchising. In the following section, we describe four of the most well-known advantages: training and guidance, brand-name appeal, a proven track record, and financial assistance.

Training and Guidance

Perhaps the greatest advantage of buying a franchise as compared to starting a new business or buying an existing one is that the franchisor usually will provide both training and guidance to the franchisee. As a result, the likelihood of success is much greater for national franchisees who receive this assistance than for small-business owners in general. For example, it has been reported that the ratio of failure for small enterprises in general to franchised businesses may be as high as four to one or five to one.

Brand-Name Appeal

An individual who buys a well-known national franchise, especially a big-name one, has a good chance to succeed. The franchisor's name is a drawing card for the establishment. People are often more aware of the product or service offered by a national franchise and prefer it to those offered by lesser-known outlets. See Table 7.3 for some examples of well-known franchise names.

A Proven Track Record

Another benefit of buying a franchise is that the franchisor has already proved that the operation can be successful. Of course, if someone is the first individual to buy a franchise, this is not the case. However, if the organization has been around for 5 to 10 years and has 50 or more units, it should not be difficult to see how successful the operations have been. If all of the units are still in operation and the owners report they are doing well financially, one can be certain the franchisor has proved that the layout and location of the store, the pricing policy, the quality of the goods or service, and the overall management system are successful.

Financial Assistance

Another reason a franchise can be a good investment is that the franchisor may be able to help the new owner secure the financial assistance needed to run the operation. In fact, some franchisors have personally helped the franchisee get started by lending money and not requiring any repayment until the operation is running smoothly. In short, buying a franchise is often an ideal way to ensure assistance from the financial community.

Table 7.3 Some of the Most Recognized Franchises

• Burger King
• Dairy Queen
• Days Inn
• Denny's
• Dunkin' Donuts
• H&R Block (tax preparation)
• McDonald's
• Meineke Car Care Centers
• Papa John's Pizza
• 7-Eleven
• Snap-on Tools
• Sports Clips (hair salons)
• Subway
• UPS Store (previously Mailboxes, etc.)

7-3c Disadvantages of Franchising

The prospective franchisee must weigh the advantages of franchising against the accompanying disadvantages. Some of the most important drawbacks are franchise fees, the control exercised by the franchisor, and unfulfilled promises by some franchisors. The following sections examine each of these disadvantages.

Franchise Fees

In business, no one gets something for nothing. The larger and more successful the franchisor, the greater the franchise fee. For a franchise from a national chain, it is not uncommon for a buyer to be faced with a fee that could range from $50,000 to $1,000,000. Smaller franchisors or those who have not had great success charge less. Nevertheless, entrepreneurs deciding whether to take the franchise route into small business should weigh the fee against the return they could get putting the money into another type of business. Also, remember that this fee covers only the benefits

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discussed in the previous section. The prospective franchisee also must pay to build the unit and stock it, although the franchisor may provide assistance in securing a bank loan. Additionally, a fee is usually tied to gross sales. The franchise buyer typically pays an initial franchise fee, spends their own money to build a store, buys the equipment and inventory, and then pays a continuing royalty based on sales (usually between 5 and 12 percent). Most franchisors require buyers to have 25 to 50 percent of the initial costs in cash. The rest can be borrowed—in some cases, from the franchising organization itself.[14] Table 7.4 presents a list of the costs involved in buying a franchise.

Franchisor Control

In a large corporation, the company controls the employee's activities. If an individual has a personal business, they control their own activities. A franchise operator is somewhere between these extremes. The franchisor generally exercises a fair amount of franchisor control over the operation in order to achieve a degree of uniformity. If entrepreneurs do not follow franchisor directions, they may not have their franchise license renewed when the contract expires.

Unfulfilled Promises

In some cases, especially among lesser-known franchisors, the franchisees have not received all they were promised.[15] For example, many franchisees have found themselves with trade names that have no drawing power. Also, many franchisees have found that the promised assistance from the franchisor has not been forthcoming. For example, instead of being able to purchase supplies more cheaply through the franchisor, many operators have found themselves paying exorbitant prices for supplies. If franchisees complain, they risk having their agreement with the franchisor terminated or not renewed.

Table 7.4 The Cost of Franchising

Don't let the advantages of franchising cloud the significant costs involved. Although the franchise fee may be $75,000, the actual cost of "opening your doors for business" can be more than $200,000! Depending on the type of franchise, the following expenditures are possible:

1. *Basic franchising fee*. For this, you may receive a wide range of services: personnel training, licenses, operations manuals, training materials, site selection and location preparation assistance, and more. Or you may receive none of these.
2. *Insurance*. You will need coverage for a variety of items, such as plate glass, office contents, vehicles, and others. You also should obtain so-called umbrella insurance. It is inexpensive and is meant to help out in the event of crippling million- or multi-million-dollar lawsuits.
3. *Opening product inventory*. If initial inventory is not included in your franchise fee, you will have to obtain enough to open your franchise.
4. *Remodeling and leasehold improvements*. Under most commercial leases, you are responsible for these costs.
5. *Utility charges*. Deposits to cover the first month or two are usually required for electricity, gas, oil, telephone, and water.
6. *Payroll*. This should include the costs of training employees before the store opens. You should include a reasonable salary for yourself.
7. *Debt service*. This includes principal and interest payments.
8. *Bookkeeping and accounting fees*. In addition to the services the franchisor may supply in this area, it is always wise to use your own accountant.
9. *Legal and professional fees*. The cost of hiring an attorney to review the franchise contract, to file for and obtain any necessary zoning or planning ordinances, and to handle any unforeseen conflicts must be factored into your opening costs projections.
10. *State and local licenses, permits, and certificates*. These run the gamut from liquor licenses to building permits for renovations.

Source: Donald F. Kuratko, "Achieving the American Dream as a Franchise," *Small Business Network* 3 (July 1987): 2 (updated by author April 2012).

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The Entrepreneurial Process

To Franchise or Not to Franchise: That Is the Question

Franchises are vehicles for those individuals with entrepreneurial tendencies but without the desire to base a business on their own idea. Given this fact, franchising would seem a logical fit for young entrepreneurs fresh from college. Experts differ on the merits of such an approach. Following are reasons for and against becoming a franchisee straight out of college:

For

- *Students learn best in structured learning environments as provided by franchising.* The support structure provided by franchisors makes franchising an ideal option for students looking to experience entrepreneurship with a proven formula. The educational materials provided to new franchisees extend the classroom environment to a real-world application.
- *Students are experienced customers and, in many cases, employees of franchises.* Because fewer families have stay-at-home parents, today's students have experienced active childhoods, which often involved relying on "fast" food between appointments. Many students also have taken part-time positions with these franchises, which has given them a behind-the-scenes look at how they are run.
- *So-called helicopter parents often continue to provide support beyond college.* The support that students require when starting their first business extends beyond financial needs. Having parents who are actively involved can give students the boost they need to venture out on their own, knowing that there is a safety net in the event that they fail. Although some would argue that the limited financial contribution of the students inevitably leads to a lack of accountability, others argue that having the investments from family and friends on the line further motivates the students to succeed.
- *Students are accustomed to being visionary, which fuels innovation.* The Internet has given students a venue for self-expression on a grand scale. The immediacy of results from the digitization of society has taught students how to generate an idea, implement it, and assess the results. This enthusiasm often translates to ambition that franchisors look for in their franchisees.

Against

- *Few college students have the financial wherewithal to start a franchise.* Although the costs associated with starting a franchise in the long run can be less than those for developing a new concept, the up-front franchising fees can cost several hundred thousand dollars, making the financial requirements a significant hurdle for individuals without the credit history to acquire a bank loan without a cosigner.
- *Students usually find staying motivated difficult when the business struggles.* Business concepts that initially were exciting can quickly lose their luster when they lose momentum. Given that most students will have had financial assistance from family or friends, they have little to no financial commitment to the business, which can lead to a lack of ownership when problems arise.
- *Lack of management experience makes dealing with employees a challenge.* Franchisors will provide marketing materials, supplier connections, and operational plans, but the responsibility for managing employees falls squarely on the shoulders of the franchisees. The recruitment, management, and retention of employees can be stressful for even the most seasoned manager, so students with no experience in management find it difficult to keep employees motivated and committed. Gaining experience through trial and error as a manager in a large corporation is unlikely to lead to the collapse of the entire organization, whereas franchises are far more susceptible to management mistakes.

In the end, students have to determine what makes the most sense for their career aspirations as well as for their management style. Although there is more risk inherent with a new concept, franchising is not for everyone. Some entrepreneurs have concluded that franchisor agreements are too restrictive, relegating them to what they consider to be mere employees; however, all franchisors stipulate different policies and procedures. Deciding whether to purchase a franchise is only the beginning of the process. The real work begins when an entrepreneur decides what franchise to purchase.

Source: Adapted from Jeff Elgin and Jennifer Kushell, "He Said, She Said," Entrepreneur, January 2008, http://www.entrepreneur.com/magazine/entrepreneur/2008/January/187674.html, accessed March 16, 2008.

7-3d Franchise Law

The growth in franchise operations has outdistanced laws about franchising. A solid body of appellate decisions under federal or state laws that relate to franchises has yet to be developed.[16] In the absence of case law that precisely addresses franchising, the courts tend to apply general common-law principles and appropriate federal or state statutory definitions and rules. Characteristics associated with a franchising relationship are similar in some respects to those of principal/agent, employer/employee, and employer/independent

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contractor relationships, yet a franchising relationship does not truly fit into any of these traditional classifications. So, the Federal Trade Commission (FTC) enacted the Franchise Rule in an attempt to provide disclosure requirements from franchisors. (See "Entrepreneurship in Practice: The Franchise Disclosure Document.") However, that is most valuable in the purchase of a franchise rather than any ongoing legal issues that arise. Much franchise litigation has arisen over termination provisions. Because the franchise agreement is normally a form contract that the franchisor draws and prepares and because the bargaining power of the franchisee is rarely equal to that of the franchisor, the termination provisions of contracts are generally more favorable to the franchisor. This means that the franchisee, who normally invests a substantial amount of time and money in the franchise operation to make it successful, may receive little or nothing for the business on termination. The franchisor owns the trademark and hence the business.[17]

7-3e Evaluating Franchising Opportunities

How can the average entrepreneur evaluate a franchise operation and decide if it is a good deal? Unfortunately, no mathematical formula exists (although the best valuation methods are presented in Chapter 14). Nor is it possible simply to ask a friend because the most popular franchises, which are probably the only ones the individual is familiar with, do not give franchises to people seeking to enter the field. This leaves only the smaller, lesser-known, and more risky franchise operations.[18]

One research study examined the relationship between the base fees and royalties paid to the franchise's overall value. The findings indicated that the age of a franchise, number of retail units, concentration in the state, and national representation are all reflected in the size of base fees and royalties. However, the key to examining the value of a prospective franchise is a proper information search.[19] In addition, to ensure an adequately protected investment, an evaluation of all franchise opportunities must be undertaken. Figure 7.2 illustrates a complete process model for analyzing the purchase of a franchise.

Learning of Franchising Opportunities

One of the first things a prospective franchisee must do is to find a reliable source of information about franchising opportunities. Some of the most readily available sources are newspapers, trade publications, and the Internet (see Table 7.5 for a list of useful websites). *Entrepreneur* magazine carries advertisements of franchise opportunities, and exhibitions and trade shows are held by franchisors from time to time in various cities. Entrepreneur.com annually lists the top franchises and the fastest-growing franchises.

Finally, franchisors themselves offer information on specific opportunities—although, in this case, one needs to beware of promises that exceed what may be delivered.

Investigating the Franchisor

The prospective investor should get as much information as possible on the franchisor. So many people have lost their life savings in franchise schemes that, except when dealing with a long-established franchisor, one is best advised to enter the investigation prepared for the worst. In particular, if the franchisor seems too eager to sell dealerships or units, it is cause for alarm. Likewise, if the franchisor does not make a vigorous effort to check out prospective investors, it is usually a sign that the seller does not think the operation will last long and probably is interested in just taking the franchise fees and absconding with them.

LO7.8 Explain the franchise disclosure document (FDD) as a key item in franchises

Remember: No reputable franchisor will sell a franchise without ensuring that the buyer is capable of operating it successfully. McDonald's—one of the most cautious of all franchisors—carefully screens all applicants, and it claims it has never had a unit go bankrupt.

Seeking Professional Help

If the franchisor passes the initial investigation and offers a franchise contract, the prospective franchisee should first take it to a qualified attorney. The attorney will understand the terms of the agreement and can explain any penalties or restrictive clauses that limit what the franchisee can do.

Of major importance are contract provisions related to cancellation and renewal of the franchise. Can the franchisor take away the franchise for some minor rule infraction? More important, if the agreement is canceled, how much of the initial franchise fee will be refunded to the individual? If the franchise can be purchased back by the franchisor at 20 percent of the initial fee, the lawyer will need to examine carefully how easily the franchisor can terminate the agreement.

Other considerations include the franchise fee, the percentage of gross revenues to be paid to the franchisor, the type and extent of training to be provided, the territorial limits of the franchise, and the provisions for supplying materials to the unit. In addition, the lawyer needs to examine the degree of control

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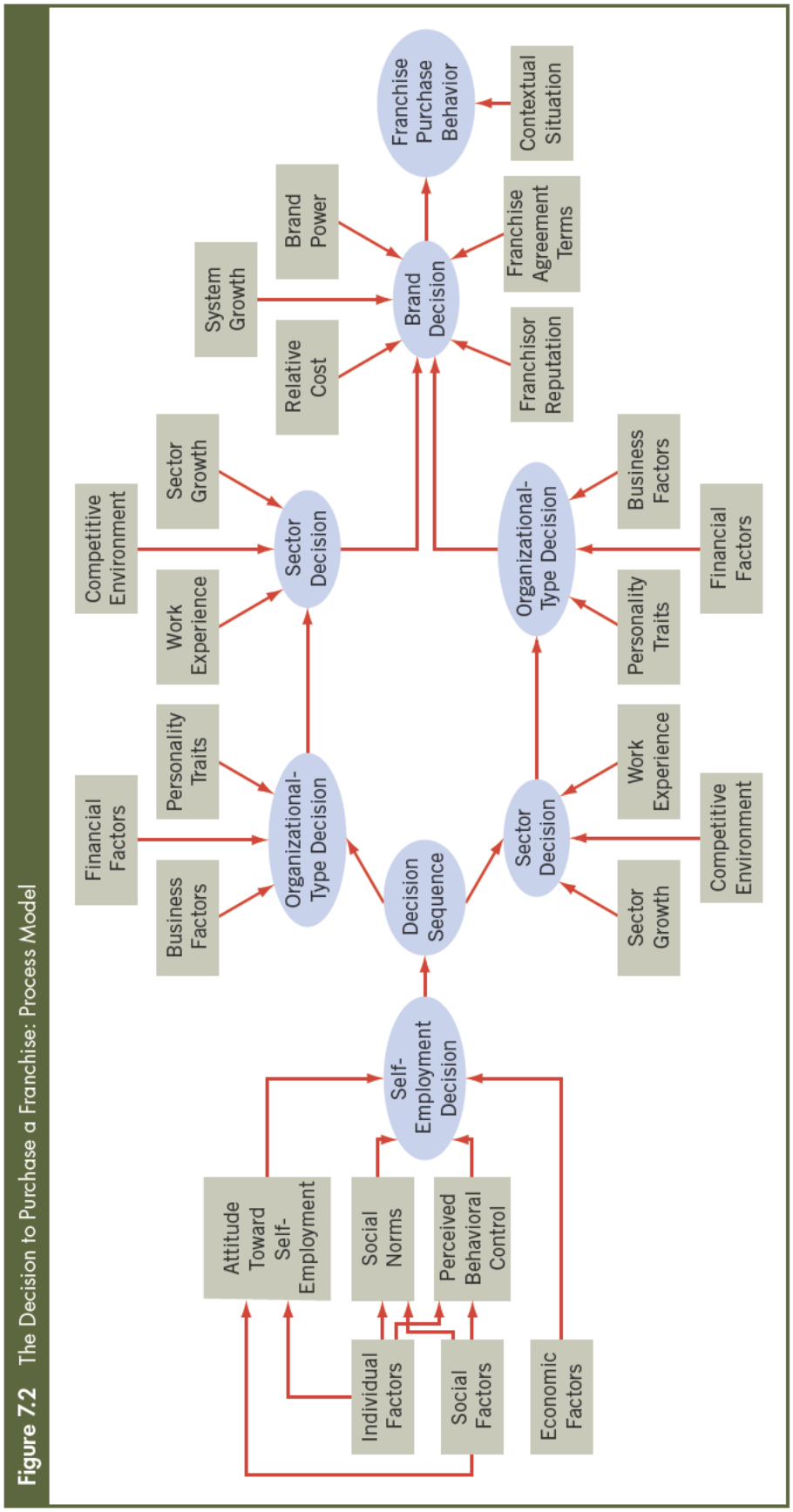


Figure 7.2 The Decision to Purchase a Franchise: Process Model

Source: Patrick J. Kaufmann, "Franchising and the Choice of Self Employment," *Journal of Business Venturing* 14, no. 4 (1999): 348.

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Table 7.5 World Wide Web Franchise Sites

The Internet has become the foremost source of information for people of all ages, trades, and interests. Short of handing over the funds, the prospective franchisee can find everything they need to ensure the successful research, selecting, and planning of a franchise business in the comfort of their own home.

You can search for the perfect match by location, category, investment, and actual franchise at http://www.franchiseexpo.com. This site allows you to obtain pertinent information about certain franchises via "showcases" that provide histories, business summaries, frequently asked questions, and investment requirements. Basic franchise information, including interactive financial worksheets, ways to select the right franchise, expo information, and links to other valuable Web resources, is also available.

The International Franchise Association is a premier source for industry data. Browse http://www.franchise.org to stay on top of the latest government developments and hot topics that affect franchisees and franchisors worldwide.

Franchise Direct (https://www.franchisedirect.com) is a top franchise portal for those exploring franchises to buy. It produces free franchise industry–sector reports to dive deeply into the world of franchising and hosts a lot of helpful content.

The franchise section of the Entrepreneur website, found at https://www.entrepreneur.com/franchises, is provided by *Entrepreneur* magazine and hosts the latest content on franchise news. Start investigating franchises with their Franchise 500 list or view their resource center for tips on starting a franchise.

Other Valuable Sites:	
American Bar Association Forum on Franchising	https://www.americanbar.org/groups/franchising.html
U.S. Small Business Administration	https://www.sba.gov
Minority Business Entrepreneur magazine	https://mbemag.com
Franchise Times	https://www.franchisetimes.com
Franchising.com	https://www.franchising.com
National Restaurant Association	https://restaurant.org
Federal Trade Commission	https://www.ftc.gov/tips-advice/business-center/selected-industries/franchises%2C-business-opportunities%2C-and-investments
Franchise.com	https://www.franchise.com
Franchise Solutions	https://www.franchisesolutions.com
Franchise Opportunities Network	https://www.franchiseopportunities.com
Franchise Mall	http://www.thefranchisemall.com
FranchiseWire America's Best Franchises All USA Franchises Franchise Chatter	https://www.franchisewire.com https://americasbestfranchises.com https://www.allusafranchises.com https://www.franchisechatter.com

the franchisor will have over operations, including price requirements, performance standards, and the required days and hours of operation. The individual also should seek financial counsel. A good banker should be able to look over the franchisor's prospectus and give an opinion regarding its feasibility. Is the projected revenue too high for a new unit? Is the return on investment overly optimistic? Would the bank be prepared to advance a loan on this type of business undertaking?

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The Entrepreneurial Process

The Franchise Disclosure Document

In 1979, the Federal Trade Commission (FTC) established a Franchise Disclosure Rule that required franchisors to make full presale disclosure nationwide. This was amended in 2007 by the FTC to enact greater disclosure requirements from franchisors. From that amendment, a legal disclosure document titled the **franchise disclosure document (FDD)** must now be presented to prospective buyers of franchises in the presale disclosure process in the United States. It was originally known as the Uniform Franchise Offering Circular.

The FDD underlies the franchise agreement (the formal sales contract) between the parties at the time the contract is formally signed. This franchise sales contract governs the long-term relationship and contains the *only* promises and obligations of the parties to each other that will remain in effect over the stated time term of the contracts—the terms of which generally range from 5 to 20 years. The contracts cannot be changed unless there is agreement of both parties.

Under the Franchise Rule, which is enforced by the FTC, a prospective franchisee must receive the franchisor's FDD at least 10 days before they are asked to sign any contract or pay any money to the franchisor or an affiliate of the franchisor. The prospective franchisee has the right to ask for (and get) a copy of the sample FDD once the franchisor has received the prospective franchisee's application and agreed to consider it. The franchisor may provide a copy of its FDDs on paper, via e-mail, over the Web, or on a disc.

There are 23 categories of information that must be provided by the franchisor to the prospective franchisee prior to the execution of the franchise agreement. These categories include the following:

1. The franchisor, its predecessors, and affiliates
2. Business experience of key persons
3. Litigation history
4. Bankruptcy
5. Initial franchise fee
6. Other fees
7. Initial investment
8. Restrictions on sources of products
9. Franchisee's obligations
10. Financing arrangements
11. Franchisor's obligations
12. Territory
13. Trademarks
14. Patents, copyrights, and proprietary information
15. Obligation to participate in the actual operation of the franchised business
16. Restrictions on what the franchisee may sell
17. Renewal, termination, transfer, and dispute resolution
18. Public figures
19. Financial performance representations: sales, profits, and earnings claims
20. List of franchise outlets
21. Financial statements
22. Contracts
23. Acknowledgment of receipt

Source: Adapted from the Federal Trade Commission (2015).

Finally, the investor should talk to a certified public accountant (CPA), who can review the data and construct a projected income statement for the first few years. Does the investment look promising? What might go wrong and jeopardize the investment? How likely are those developments? Is this the type of investment that constitutes an acceptable risk for the prospective buyer, or should the individual walk away from the deal?

Legal and financial professionals will help the prospective franchisee answer some very important questions. In particular, they will force the individual to face the risks inherent in a franchise and answer the question, "Am I willing to take this type of risk?"

Making the Decision: It's Up to the Entrepreneur

After the prospective entrepreneur has gathered all of the necessary information, it is up to them to make the final decision on the matter. As with buying an ongoing business, however, the series of "right questions" outlined previously can help.

7-4 Incubators, Accelerators, and Entrepreneurial Ecosystems

LO7.9 Describe the elements involved with incubators, accelerators, and entrepreneurial ecosystems

When examining the pathways to entrepreneurial ventures, it is important to understand the rise of incubators, accelerators, and entrepreneurial ecosystems

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because they may be an important pathway for an entrepreneur to pursue.

Incubators

A **business incubator** is an entity that helps new ventures develop by providing services such as management training and office space. Entrepreneurs enjoy a collaborative work environment with invaluable mentoring and networking opportunities, funding support, and shared equipment. Most top incubators tend to be industry specific. The International Business Innovation Association (InBIA) defines business incubators as a catalyst tool for either regional or national economic development. The InBIA categorizes their members' incubators by the following five incubator types: academic institutions, nonprofit development corporations, for-profit property development ventures, venture capital firms, and combinations thereof. While each incubator is different, the vast majority provide new ventures with marketing assistance, market research tools, access to professionals (accounting and legal), and access to loan facilities or grant programs. Because many incubators are affiliated with colleges and universities, entrepreneurs may be able to access higher-education resources, such as student consultants and library access. Usually, incubators do not require equity in the new venture in return for access to the resources. Access to funding, mentors, skill development programs, and a collaborative work environment can make a world of difference to an entrepreneur's success.

Accelerators

A **business accelerator** is an organization that offers a range of support services and funding opportunities for new ventures. Typically, entrepreneurs are enrolled in months-long programs that offer mentorship, coaching, office space, and other resources. As discussed in Chapter 2, the "coachability" of an entrepreneur is critical for achieving success with a new venture.[20] One of the most important elements of accelerators is their ability to offer access to capital and investment in return for start-up equity. New ventures will spend on average about four months in the program and then must "graduate," so it is very intensive for the entrepreneur.

Accelerators appear very similar to incubators, but there are key differences. Incubators operate as nonprofits, so, as mentioned above, they do not require equity in a company in return for access to their resources in the way that accelerators do. As a result, new ventures generally receive far less access to capital by joining an incubator than they could expect to receive from an accelerator. The number of accelerators operating across the globe has expanded exponentially. From only a handful in the early 2000s, there are well over 7,000 in existence today according to the InBIA.[21] The popularity has been fueled because accelerators have stringent review policies for the new ventures that apply, so investors can simply invest in accelerators that take on shares in the new ventures themselves. The only potential drawback of joining a business accelerator is that the entrepreneur usually gives up equity in the venture.[22]

Entrepreneurial Ecosystems

Amidst the energy and excitement of the entrepreneurial movement has been the rise of entrepreneurial ecosystems as areas that attempt to establish environments that are conducive to the probabilities of success for a new venture following its launch. The metaphor of an entrepreneurial "ecosystem" is from biology and represents a set of interdependent actors and factors that are governed in such a way that they enable productive entrepreneurship. An **entrepreneurial ecosystem** has been defined as "a dynamic community of inter-dependent actors (entrepreneurs, suppliers, buyer, government, etc.) and system-level institutional, informational and socioeconomic contexts."[23] This ecosystem metaphor has moved researchers to conceptualize entrepreneurship more holistically as part of larger ecosystems with interactions between actors, such as institutions, firms, and individuals, engaging in innovative and entrepreneurial activity.

These ecosystems consist of six general domains: a conducive culture, enabling policies and leadership, the availability of appropriate finance, quality human capital, venture-friendly markets for products, and a range of institutional and infrastructural supports.[24]

It has become popular to refer to entrepreneurial ecosystems within communities or geographic regions.[25] An ecosystem in this context is defined as an agglomeration of interconnected individuals, entities, and regulatory bodies in a given geographic area. Examples include venture start-ups, banks, venture capitalists, incubators, accelerators, universities, professional service providers, and government agencies that support entrepreneurial activity. The very idea of an ecosystem is predicated on the dependence of these elements on one another. Ecosystems, however, are inherently complex, and little is known about how the different components interact with each other, making it challenging for new ventures seeking legitimacy within that ecosystem.

Several research studies have shown that an effective entrepreneurial ecosystem enables entrepreneurship and subsequent value creation at the regional level.[26] For example, a study by Elizabeth Mack and Heike Mayer in 2016 showed how a strong entrepreneurial ecosystem contributed to entrepreneurial successes in Phoenix,

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Arizona. Another study in Waterloo and Calgary, Canada, found that the presence of strong entrepreneurial ecosystems helped to create a cohesive social and economic system that supported the creation and growth of entrepreneurial ventures. Other work on regions such as Silicon Valley, Route 128, and Washington, DC, has demonstrated the increased value of entrepreneurial ecosystems.[27] Thus, accelerators, incubators, business plan competitions, start-up awards, and public funding schemes create synergies that play an important role for the foundation and growth of new enterprises.

Researchers Michael H. Morris, Xaver Neumeyer, and Donald F. Kuratko point out that there is a divergence of financial, social, and human capital resources

Diversity in Entrepreneurship

Franchises Moving into the Diversity Challenge

Taco Bell, an iconic Mexican-style fast-food chain with locations across the globe, is starting a Taco Bell Business School in 2022—a six-week boot camp to teach future managers and franchisee owners the ins and outs of fast-food management and to increase diversity among Taco Bell franchisees. The initiative started when Taco Bell's parent company Yum! Brands created the Yum! Center for Global Franchise Excellence, which partnered with the University of Louisville in 2021. "Franchising is one of the best paths to entrepreneurship, creating an opportunity to build generational wealth," said Kathleen Gosser, PhD, executive-in-residence at the University of Louisville College of Business. However, this approach to become an entrepreneur and carve an independent financial path is rarely taken by people of color and women, which is what Taco Bell is hoping to change. "Our goal is to uncover and reduce barriers to franchise ownership, starting with education," explained Gosser. Participants will receive accredited training with classes ranging from finances to human resources, marketing, and entrepreneurship.

Another franchise giant, McDonald's, is going even further to address the diversity in the franchise community, believing that limiting its focus on nurturing an inclusive environment to just one time will not create a permanent change. McDonald's believes that cultures need to be nurtured on an ongoing basis, which is why they put together a long-term investment to address its multipronged Diversity, Equity, and Inclusion Initiative announced in 2020. Ninety-three percent of McDonald's restaurants are owned and operated by franchisees, making them a crucial part of McDonald's business that serves diverse and vibrant communities all over the world. Yet franchisee owners do not currently reflect that same diversity. Indeed, starting a franchise is often a great financial burden. McDonald's found that up-front entry costs are a barrier for many entrepreneurs with limited access to capital, especially for entrepreneurs from historically underrepresented groups. The company committed $250 million over five years to provide alternative financing options in the hopes of tackling this challenge.

Besides tackling the barriers to entry into franchise ownership, McDonald's is also significantly expanding its recruiting and training efforts and implementing a mentorship program from experienced owners for new franchisees. This increased interconnectedness should facilitate knowledge sharing and improve the chances of success for all franchisees with the ambition of running their own McDonald's business regardless of their background. It is not enough to just enable more underrepresented groups to enter into franchise community; it is equally important to support them in the running of their business, as they may not by themselves have access to this type of network and knowledge, which can be crucial for the success of a business.

What is even more significant is that McDonald's is tackling diversity challenges throughout its value chain. The company has committed to a 10 percent increase in spending with underrepresented suppliers, which will bring the total number to $3.5 billion in annual spending by 2025. In marketing, it aims to increase its marketing spending with diverse-owned media from 4 to 10 percent and with Black-owned media from 2 to 5 percent of the total national advertising budget by 2024. McDonald's is also tackling diverse representation in leadership roles by linking these targets to executive compensation. Finally, with the implementation of the new Global Brand Standards in all 40,000 restaurants and corporate offices around the world, it seeks to further a culture of physical and psychological safety through the prevention of violence, harassment, and discrimination.

It is certainly exciting to see big franchise names get on board with diversity, equity, and inclusion in a more meaningful way. They need to take ownership of the diversity issue and take proactive steps in order to make an impactful difference. To do nothing equals contributing to the existing problem that has, throughout history, become ingrained into our daily lives and that will require a systemic change. Only time will tell how effective these initiatives will be in truly diversifying the franchise community.

Source: Adapted from Michael Gonda, "What McDonald's Is Doing to Promote Minority-Owned Franchisees," *Inc.*, January 2022, and Lauren David, "The Real Reason Taco Bell Just Launched Its Own Business School," *Mashed*, January 2022.

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that entrepreneurs have access to in different ecosystems. Comparing entrepreneurial ventures in Silicon Valley to those in Detroit, Michigan, there is quite a difference in which set of entrepreneurs has more adverse conditions that limit their overall economic productivity. The entrepreneurs in microenterprises, smaller ventures, or managed growth ventures are often critical to the functioning of lower-performing economic systems, demonstrating ingenuity and resourcefulness, while high-growth ventures (known as "gazelles") seem to gravitate to the higher-performing economic systems. However, as we have seen in this chapter, all types of new ventures confront the initial challenge of newness.[28]

Summary

The easiest and best way to approach a new business venture is to design a unique product or service. Sometimes this involves what is called a new-new approach—that is, the development of an entirely new idea for a product or service (as was the case with Zynga and Google). In most instances, however, the prospective owner/manager must be content to use a new-old approach by "piggybacking" on someone else's ideas. This involves either expanding on what the competition is doing or offering a product or service in an area in which it is not presently available.

Another opportunity is the purchase of an existing successful firm, which has a number of advantages. Three of the most important are that its successful future operation is likely, the time and effort associated with starting a new enterprise are eliminated, and a bargain price may be possible.

Before deciding whether to buy, however, the prospective owner needs to ask and answer a series of "right questions." These include the following: Why is the business being sold? What is the physical condition of the business? What is the condition of the inventory? What is the state of the company's other assets? How many of the employees will remain? What competition does the business face? What is the firm's financial picture? After all questions have been answered satisfactorily, the prospective buyer must negotiate for the business. In the final analysis, however, the prospective owner should be concerned with buying the company's assets at *market value* and then paying something for *goodwill* if it is deemed an asset.

Another popular pathway to an entrepreneurial venture is a franchise, which incorporates some of the independence of an entrepreneur into the larger umbrella of a corporation. Thus, it is a "hybrid" form of entering business. Today, more than one-third of all retail sales and an increasing part of gross domestic product are generated by private franchises. A franchise is any arrangement in which the owner of a trademark, trade name, or copyright has licensed others to use it in selling goods or services.

Finally, when examining the pathways to entrepreneurial ventures, it is important to understand the rise of incubators, accelerators, and entrepreneurial ecosystems because they may be important pathways for an entrepreneur to pursue. Incubators provide space and management training, while accelerators offer a range of support services, including mentorship, coaching, and funding opportunities. Entrepreneurial ecosystems are areas that attempt to establish environments that are conducive to the probabilities of success for a new venture following its launch.

Key Terms

business accelerator
business broker
business incubator
company's profitability
entrepreneurial ecosystem
franchise
franchise disclosure document (FDD)
franchisee
franchise fee
franchisor
franchisor control
goodwill
legal restraint of trade
new-new approach
new-old approach
noncompete agreement
profit trend
risk versus reward
unscrupulous practices
upside gain and downside loss

Review and Discussion Questions

1. Identify the three main pathways to entering business for a prospective entrepreneur.
2. What is the new-new approach to starting a new venture? How does this approach differ from a new-old approach?
3. Describe what dimensions the "Newness Framework" is based on.
4. How can an individual who is thinking of going into business evaluate the financial picture of the enterprise? Use the methodology of Table 7.2 to prepare your answer.

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5. In addition to personal and financial issues, what other factors should the prospective owner be concerned with? Describe at least four.
6. What are the advantages of buying an ongoing business? Explain them.
7. What "right questions" need to be answered when deciding whether to buy a business?
8. How should a prospective buyer examine the assets of a company? Explain.
9. What is meant by the term *franchise*?
10. In a franchising agreement, what is the franchisee often called on to do? What responsibility does the franchisor assume?
11. What are some of the major advantages of franchising? Cite and explain three.
12. What are some of the major disadvantages of franchising? Cite and explain at least two.
13. How can a prospective franchisee evaluate a franchise opportunity? Explain.
14. In evaluating whether to buy a franchise operation, the potential investor should ask a series of questions. What questions should the potential investor ask about the franchisor, the franchise, the market, and the potential investor themselves?
15. Identify the Franchise Disclosure Document. Explain why it is important in franchising.
16. Describe the critical elements involved in incubators, accelerators, and entrepreneurial ecosystems.

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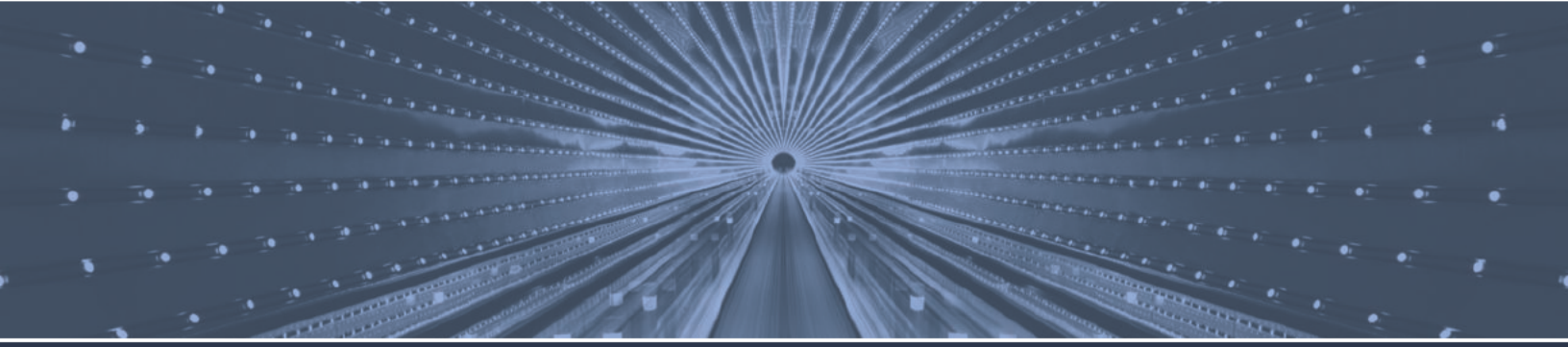
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Chapter 8

Sources of Capital for Entrepreneurs

Learning Objectives

8.1 Explain the advantages and disadvantages of bootstrapping
8.2 Differentiate between debt and equity as methods of financing
8.3 Discuss commercial loans and social lending as sources of capital
8.4 Explain initial public offerings (IPOs) as a source of capital
8.5 Describe special purpose acquisition companies (SPACs)
8.6 Discuss private placements as an opportunity for equity capital
8.7 Describe the rise of crowdfunding as an increasingly popular source of funding
8.8 Explain the market for venture capital
8.9 Describe venture capitalists' evaluation criteria for new ventures
8.10 Explain the importance of evaluating venture capitalists for a proper selection
8.11 Describe the existing informal risk-capital market ("angel capital")

Entrepreneurial Thought

Money is like a sixth sense without which you cannot make a complete use of the other five.

—**William Somerset Maugham, *Of Human Bondage***

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The Search for Capital

Every entrepreneur planning a new venture confronts the same dilemma: where to find start-up capital. But every entrepreneur may not be aware that numerous possibilities for funding exist or that combinations of financial packages, rather than a single source, may be appropriate. It is important, therefore, to understand not only various sources of capital but also the expectations and requirements of each.

Bootstrapping, commercial loans, public offerings, private placements, convertible debentures, venture capital, crowdfunding, and informal risk capital are some of the major types of financing encountered in the search for capital. But what exactly are they, and what is expected of an entrepreneur applying for these funds?

Studies have investigated the various sources of capital preferred by entrepreneurs.[1] These sources range from debt to equity, depending on the type of financing that is arranged. As illustrated in Figure 8.1, entrepreneurs have a number of sources of capital as their ventures develop. Notice that the level of risk and the stage of the firm's development impact the appropriate source financing for the entrepreneurial ventures.

In this chapter, we examine the various sources of capital available to new ventures, along with some insights into the processes expected of the entrepreneur. We begin with an examination of bootstrapping as a way that many entrepreneurs begin their ventures.

8-1 Bootstrapping

Bootstrapping allows an entrepreneur to found and build a venture from personal finances or the operating revenues of the new company. Examples of techniques employed because of the decision to bootstrap include using credit cards, drawing on home equity, sweat equity, taking loans from family, and investing salary from one's regular job. The term *bootstrapping* likely emerged from the American cowboy. To pull oneself up by the bootstraps was to rise from seating to standing by grasping one's bootstraps, thereby utilizing only what was on one's person—without external assistance—to accomplish the task at hand.

A "strategic bootstrapping" approach classifies bootstrapping as (1) delaying payments, (2) private-owner financed, (3) minimizing, (4) relationship oriented, and (5) subsidy oriented.[2] Essentially, there are different ways to bootstrap. Why would an entrepreneur consider bootstrapping? First, there exists the unwillingness of equity investors (venture capitalists and angels) to invest in new ventures. Second, because entrepreneurs are driven by a need for autonomy, they can often have a disdain for external forms of funding because entrepreneurs fear losing control to their investors. Third, many new venture founders are less knowledgeable about options that may be available to them; this is evidenced by the fact that most entrepreneurs never ask for outside funding.[3] All of these reasons show that start-up entrepreneurs have a tendency to avoid external forms of funding and embrace bootstrapping.

LO8.1 Explain the advantages and disadvantages of bootstrapping

Advantages and Disadvantages of Bootstrapping

Advantages:

- *Cost*. Bootstrapping is inexpensive because working with your own money means that super-efficiency is necessary. Entrepreneurs start operating their venture on a lean business model.
- *Control*. Without any external investors (as only founders are investing in the business), the founders' control over the company is not diluted. The entrepreneurs are their own bosses and are responsible for all crucial decisions in operating and growing the company.
- *Concentration*. Raising external finance is not an issue and allows for full concentration on the core aspects of the business, such as sales and product development. Eventually, investors will be much more confident funding businesses that are already backed and that show promise and commitment by their owners.

Disadvantages:

- *Cash*. Because of the lack of capital and cash flow, problems can arise if a company doesn't generate the capital it needs to develop products and grow.
- *Equity*. Equity issues can become a problem when there's more than one founder. This could cause disharmony as well as adverse tax consequences if there's an imbalance between founders when it comes to the amount of invested capital, experience, or time.
- *Risk*. Bootstrapping involves much more risk where losses and failures may be experienced. One reason some bootstrapped companies are unsuccessful is due to the lack of revenue.
- *Stress*. Stressful situations occur when entrepreneurs accept funds from family members and friends. Proper expectations and communications are keys to coping with the stress of these situations.[4]

Keep in mind that many of the successful companies that we see today had their humble beginnings as bootstrapped enterprises. Examples of these include Dell Computers, Meta (formerly Facebook), Apple, Hewlett-Packard, Microsoft, Oracle, eBay, Cisco Systems, and SAP.

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8-2 Debt versus Equity Financing

LO8.2 Differentiate between debt and equity as methods of financing

The use of *debt* to finance a new venture involves a payback of the funds plus a fee (interest) for the use of the money. *Equity* financing involves the sale of some of the ownership in the venture. Debt places a burden on the entrepreneur of loan repayment with interest, whereas equity financing forces the entrepreneur to relinquish some degree of control. In short, the choice is this: (1) take on debt without giving up ownership in the venture or (2) relinquish a percentage of ownership in order to avoid having to borrow. In most cases, a combination of debt and equity proves most appropriate.

Debt Financing

LO8.3 Discuss commercial loans and social lending as sources of capital

Many new ventures find that debt financing is not a choice but a necessity. Short-term borrowing (one year or less) often is required to obtain working capital and is repaid out of proceeds from sales. Long-term debt (term loans of one to five years or long-term loans maturing in more than five years) is used to finance the purchase of property or equipment, with the purchased asset serving as collateral for the loans. The most common sources of debt financing are commercial banks.[5]

8-3 Commercial Loans

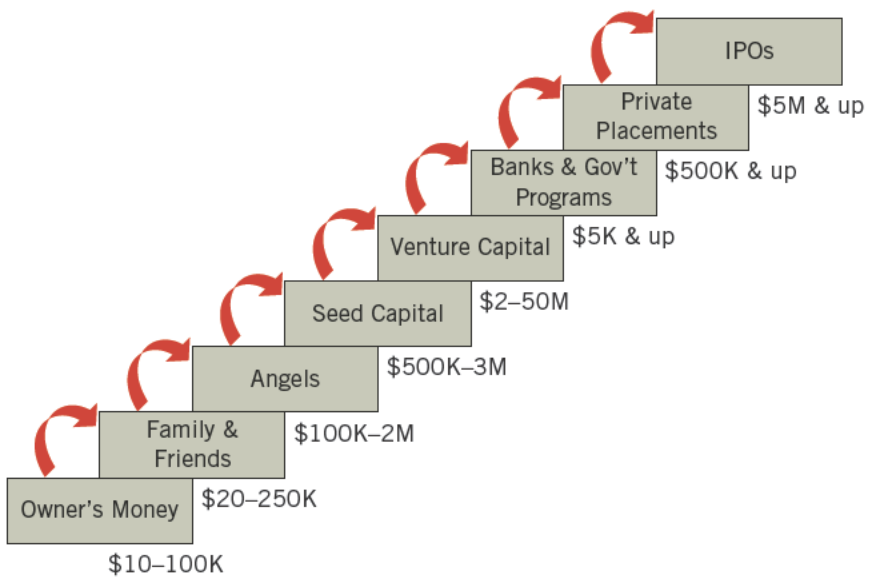
About 5,000 commercial banks operate in the United States today, although that number, since the 2008 economic downturn, keeps decreasing. It has been predicted that by 2030, there will be continued emergence of new disruptors in the financial sector, such as financial technology firms (fintechs), digital giants, players from other industries, and even new entrants, each of which has distinct beliefs, strengths, and weaknesses. Innovative business models and alliance ecosystems will be required for incumbents to respond to these dynamics, create new revenue streams, and establish strategic advantage.[6]

Although some banks make unsecured short-term loans, most bank loans are secured by receivables, inventories, or other assets. Commercial banks also make a large number of intermediate term loans with maturities of one to five years. In about 90 percent of these cases, the banks require collateral, which generally consists of stocks, machinery, equipment, and real estate, and systematic repayment over the life of the loan is required. Apart from real estate mortgages and loans guaranteed

Figure 8.1 Who Is Funding Entrepreneurial Start-Up Companies?

Financing Continuum

The following diagram depicts the typical financing for start-up companies.



Source: Indiana Venture Center, "Successful Angel Investing," March 2008.

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by the Small Business Administration (SBA) or a similar organization, commercial banks make few loans with maturities greater than five years. Banks also may offer a number of services to a new venture, including computerized payroll preparation, letters of credit, international services, lease financing, and money market accounts.

To secure a bank loan, entrepreneurs typically have to answer a number of questions. Five of the most common questions, together with descriptive commentaries, follow:

1. *What do you plan to do with the money?* Do not plan on using bank loans for high-risk ventures. Banks typically lend only to the surest of all possible ventures.
2. *How much do you need?* Some entrepreneurs go to their bank with no clear idea of how much money they need. All they know is that they need cash. The more precisely an entrepreneur can answer this question, the more likely the loan will be granted.
3. *When do you need it?* Never rush to a bank with immediate requests for money. Poor planners never attract lenders.
4. *How long will you need it?* The shorter the period of time entrepreneurs need the money, the more likely they are to get loans. The time at which the loan will be repaid should correspond to some important milestone in the business plan.
5. *How will you repay the loan?* This is the most important question. What if plans go awry? Can other income be diverted to pay off the loan? Does collateral exist? Even if a quantity of fixed assets exists, the bank may be unimpressed. Experience dictates that assets sold at liquidation command only a fraction—5 to 10 cents on the dollar—of their value.[7]

Banks are not the only source of debt financing. Sometimes long-term financing for a particular piece of equipment is obtainable from manufacturers who take a portion of the purchase price in the form of a long-term note. Manufacturers are willing to finance purchases especially when an active market exists for their used equipment, thus allowing machinery to be resold if it is repossessed. Also, new ventures sometimes can obtain short-term debt financing by negotiating extended credit terms with suppliers. However, this kind of trade credit restricts the venture's flexibility in selecting suppliers and may reduce its ability to negotiate supplier prices.

Advantages of Debt Financing Not surprisingly, debt financing has both advantages and disadvantages. The advantages of debt financing can be characterized as follows:

- No relinquishment of ownership is required.
- More borrowing, potentially, allows for greater return on equity.
- Low interest rates reduce the opportunity cost of borrowing.

Disadvantages of Debt Financing Financing with debt has its downside:

- Regular (monthly) interest payments are required.
- Cash-flow problems can intensify because of payback responsibilities.
- Heavy use of debt can inhibit growth and development.

Peer-to-Peer Lending

Peer-to-peer (P2P) lending is the practice of lending money to unrelated individuals, or "peers," without going through a bank or other traditional financial institution. Also known as "debt-based crowdfunding" or "crowdlending," this lending takes place online on P2P lending companies' websites using various lending platforms. This form of financing is a twenty-first-century phenomenon.

P2P lenders are Internet-based sites that pool money from investors willing to lend capital at agreed-on rates. P2P lenders charge fees for brokering and servicing loans and collect penalties for late payments as well. The average size of social loans is around $25,000, with maximums predicted to increase to a potential of $250,000. P2P lending is one of the fastest-growing areas of finance with 100 percent increases each year. The interest rates range from 5.9 to 29.9 percent, depending on the loan term and borrower rating. The default rates vary from about 1.5 to 10 percent for the more risky borrowers. Lending Club, a well-known social lending company, has the largest loan volume among social lending sites in the United States, matching borrowers and lenders based on loan size, risk tolerance, and social familiarity (e.g., coworkers, fellow alumni, hometown residents, and so on).

Once thought of as an alternative funding option only for entrepreneurs unable to qualify for commercial loans, P2P lending is beginning to attract borrowers among established entrepreneurs seeking quick capital without the administrative overhead of traditional lenders. The first P2P lending sites appeared in 2005, bringing scale to the age-old idea of borrowing from friends. They multiplied in the latest economic downturn as traditional pools of credit dried up. When word got out in 2008 that some lenders were getting burned by defaulters, the U.S. Securities and Exchange Commission (SEC) stepped in to regulate the industry. P2P lending has gained increased popularity. P2P lending platforms based in the United States provided more than $48 billion in consumer loans from 2006 to 2018, and they're expected to originate $150 billion per year by 2026.

Social lending sites are different from so-called microlending sites like Kiva.org, a nonprofit organization that allows donors to make zero-interest loans to specific causes around the globe. Kiva collects the money and gives it to a micro-finance institution that disburses the funds and works with borrowers to ensure repayment.

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P2P lending is very similar to other social networking phenomena in that it is largely dependent on the site providers' ability to provide a forum in which an open, trusting community can be built. As the P2P lending movement continues, entrepreneurs will have an effective weapon in their arsenal to combat the cash-flow issues inherent in running a business. As with all lenders, entrepreneurs need to carefully review the policies and procedures as well as the reputation for any P2P lender they are considering taking a loan through. For those individuals who have been putting their entrepreneurial aspirations on hold due to financial fears, P2P lending could provide the peace of mind needed for them to dust off their ideas and put them into action. Recently, there have been signs of P2P lending becoming more mainstream as executives from traditional financial institutions are joining P2P companies as board members, lenders, and investors. While the use of P2P lending provides many immediate advantages for entrepreneurs in start-up mode, potential dangers include the following:

- *Funding success rate*. Most loans are difficult to complete, so the funding success rate could be questionable.
- *Business plan disclosure*. The entrepreneur's business plan is now released to the public domain.
- *No ongoing counseling relationship*. The entrepreneur does not receive any advice or gain experience from the lender, and there are no future rounds of lending or investment.
- *Potential tax liability*. There are tax implications for the borrower and the lender.
- *Uncertain regulatory environment*. The SEC continues to review these sites for potential regulatory policies.[8]

Other Debt-Financing Sources

In addition to commercial banks and social lenders, other debt-financing sources include trade credit, accounts receivable factoring, finance companies, leasing companies, mutual savings banks, savings and loan associations, and insurance companies. Table 8.1 provides a summary of these sources, the business types they often finance, and their financing terms.

Trade credit is credit given by suppliers who sell goods on account. This credit is reflected on the entrepreneur's balance sheet as accounts payable, and in most cases, it must be paid in 30 to 90 days. Many small, new businesses obtain this credit when no other form of financing is available to them. Suppliers typically offer this credit as a way to attract new customers.

Accounts receivable financing is short-term financing that involves either the pledge of receivables as collateral for a loan or the sale of receivables (factoring). Accounts receivable loans are made by commercial banks, whereas factoring is done primarily by commercial finance companies and factoring concerns.

Accounts receivable bank loans are made on a discounted value of the receivables pledged. A bank may make receivable loans on a notification or nonnotification plan. Under the notification plan, purchasers of goods are informed that their accounts have been assigned to the bank. They then make payments directly to the bank, which credits them to the borrower's account. Under the nonnotification plan, borrowers collect their accounts as usual and then pay off the bank loan.

Factoring is the sale of accounts receivable. Under this arrangement, the receivables are sold, at a discounted value, to a factoring company. Some commercial finance companies also do factoring. Under a standard arrangement, the factor will buy the client's receivables outright,

Table 8.1 Common Debt Sources

Business Type Financed				Financing Term	
Source	**Start-Up Firm**	**Existing Firm**	**Short Term**	**Intermediate Term**	**Long Term**
Trade credit	Yes	Yes	Yes	No	No
Commercial banks	Sometimes, but only if strong capital or collateral exists	Yes	Frequently	Sometimes	Seldom
Peer-to-peer (P2P)	Yes	Yes	Yes	Sometimes	No
Finance companies	Seldom	Yes	Most frequent	Yes	Seldom
Factors	Seldom	Yes	Most frequent	Seldom	No
Leasing companies	Seldom	Yes	No	Most frequent	Occasionally
Mutual savings banks and savings and loan associations	Seldom	Real estate ventures only	No	No	Real estate ventures only
Insurance companies	Rarely	Yes	No	No	Yes

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without recourse, as soon as the client creates them by its shipment of goods to customers. Factoring fits some businesses better than others, and it has become almost traditional in industries such as textiles, furniture manufacturing, clothing manufacturing, toys, shoes, and plastics.

Finance companies are asset-based lenders that lend money against assets such as receivables, inventory, and equipment. The advantage of dealing with a commercial finance company is that it often will make loans that banks will not. The interest rate varies from 2 to 6 percent over that charged by a bank. New ventures that are unable to raise money from banks and factors often turn to finance companies.

8-4 Equity Financing

Equity financing is money invested in the venture with no legal obligation for entrepreneurs to repay the principal amount or pay interest on it. The use of equity funding thus requires no repayment in the form of debt. It does, however, require sharing the ownership and profits with the funding source. Because no repayment is required, equity capital can be much safer for new ventures than debt financing. However, the entrepreneur must consciously decide to give up part of the ownership in return for this funding.[9] Financial equity instruments, which give investors a share of the ownership, may include the following:

- *Loan with warrants* provides the investor with the right to buy stock at a fixed price at some future date. Terms on the warrants are negotiable. The warrant customarily provides for the purchase of additional stock, such as up to 10 percent of the total issue at 130 percent of the original offering price within a five-year period following the offering date.
- *Convertible debentures* are unsecured loans that can be converted into stock. The conversion price, the interest rate, and the provisions of the loan agreement are all areas for negotiation.
- *Preferred stock* is equity that gives investors a preferred place among the creditors in the event the venture is dissolved. The stock also pays a dividend and can increase in price, thus giving investors an even greater return. Some preferred stock issues are convertible to common stock, a feature that can make them even more attractive.
- *Common stock* is the most basic form of ownership. This stock usually carries the right to vote for the board of directors. If a new venture does well, common-stock investors often make a large return on their investment. These stock issues often are sold through public or private offerings.

During the past 50 years, a tremendous boom has taken place in the private equity industry. The pool of U.S. private equity funds—partnerships that specialize in venture capital, leveraged buyouts, mezzanine investments, buildups, distressed debt, and related investments—has grown significantly in recent years. By mid-2022, the sector had amassed a record $3.3 trillion of unspent capital, including $1 trillion held by buyout funds, giving it significant power for fresh acquisitions.[10]

Equity capital can be raised through two major sources: public stock offerings and private placements. In both cases, entrepreneurs must follow the state laws pertaining to the raising of such funds and must meet the requirements set forth by the SEC. This entire process can be difficult, expensive, and time consuming. The laws and regulations are complex and often vary from state to state. On the other hand, successful stock offerings can help a fledgling enterprise raise a great deal of money.

Public Offerings

Going public is a term used to refer to a corporation's raising capital through the sale of securities on the public markets. Following are some of the advantages to this approach:

- *Size of capital amount*. Selling securities is one of the fastest ways to raise large sums of capital in a short period of time.
- *Liquidity*. The public market provides liquidity for owners since they can readily sell their stock.
- *Value*. The marketplace puts a value on the company's stock, which in turn allows value to be placed on the corporation.
- *Image*. The image of a publicly traded corporation often is stronger in the eyes of suppliers, financiers, and customers.[11]

LO8.4 Explain initial public offerings (IPOs) as a source of capital

During the past three decades, many new ventures have sought capital through the public markets. The term **initial public offering (IPO)** is used to represent the registered public offering of a company's securities for the first time. Many times, the number of companies "going public" does not vary much, but the amount of financing raised certainly does. In addition, the economy has a major effect on the IPO markets—as evidenced by the huge upswing in IPOs from 1995 to 1999, when 2,994 companies went public during an economic period of continual growth and prosperity. The year 2000 introduced a correction on the economy, and everything began to constrict, including the IPO market. In 2001, only 91 firms went public, raising $37.1 billion—quite a slump from the all-time high of 868 IPOs in 1996. From 2003 to 2007, there was much more stable and conservative activity among the IPO markets as evidenced by an approximate average of 220 IPOs. Then 2008 brought the economic downturn

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globally, and IPOs fell to an all-time low of 37 with only $27 billion raised. However, since that time, the markets have slowly crept back, with 2010 and 2011 demonstrating a significant increase with averages of about 180 IPOs and the amounts approaching $45 billion. By 2015, the IPO markets gained their greatest amounts since 2000 with numbers reaching 288 IPOs and raising $94 billion. Some of that growth was fueled by the recent IPOs that included some of the largest in history, including Alibaba ($25 billion), Visa ($19.7 billion), and Facebook ($16 billion).[12] In 2016, the IPO market fell to only 119 filings which was the lowest since the global downturn in 2008. However, with steady increases over the next four years, 2020 produced 471 IPOs in the United States, raising a record $168 billion.[13] As mentioned above, the economy has a major effect on the IPO market. For example, the high inflation rates in 2022 and 2023 caused a severe drop in the IPO market. However, as indicated by the numbers over the years, the IPO markets always rebound.

8-5 The Rise of Special Purpose Acquisition Companies

LO8.5 Describe special purpose acquisition companies (SPACs)

A **special purpose acquisition company** (**SPAC**) is a company that has no commercial operations and is formed strictly to raise capital through an IPO for the purpose of acquiring or merging with an existing company. Also known as "blank-check companies," SPACs have been around for decades, but their popularity has soared in recent years. In 2020, 247 SPACs were created with $80 billion invested, and in just the first quarter of 2021, a record $96 billion was raised from 295 newly formed SPACs. By comparison, only two SPACs came to market in 2010.

SPACs are generally formed by investors or sponsors with expertise in a particular industry or business sector to pursue deals in that area. In creating a SPAC, the founders sometimes have at least one acquisition target in mind, but they don't identify that target to avoid extensive disclosures during the IPO process. (This is why they are called blank-check companies. IPO investors typically have no idea about the company in which they will ultimately be investing.) SPACs seek underwriters and institutional investors before offering shares to the public.

The funds that SPACs raise in an IPO are placed in an interest-bearing trust account. These funds cannot be disbursed except to complete an acquisition or to return the money to investors if the SPAC is liquidated. A SPAC generally has two years to complete a deal or else face liquidation. In some cases, some of the interest earned from the trust can serve as the SPAC's working capital. After an acquisition, a SPAC is usually listed on one of the major stock exchanges.[14]

All of these figures and changes reflect the tremendous *volatility* that exists within the stock market over the years, and thus entrepreneurs should be aware of the concerns that confront them when they pursue the IPO market. In addition, many new ventures have begun to recognize some other disadvantages of going public. Several of these follow:

- *Costs*. The expenses involved with a public offering are significantly higher than for other sources of capital. Accounting fees, legal fees, and prospectus printing and distribution, as well as the cost of underwriting the stock, can result in high costs.
- *Disclosure*. Detailed disclosures of the company's affairs must be made public. New-venture firms often prefer to keep such information private.
- *Requirements*. The paperwork involved with SEC regulations, as well as continuing performance information, drains large amounts of time, energy, and money from management. Many new ventures consider these elements better invested in helping the company grow.
- *Shareholder pressure*. Management decisions are sometimes short term in nature to maintain a good performance record for earnings and dividends to the shareholders. This pressure can lead to a failure to give adequate consideration to the company's long-term growth and improvement.[15]

The advantages and disadvantages of going public must be weighed carefully. If the decision is to undertake a public offering, it is important that the entrepreneur understand the process involved. Chapter 15 presents some of the complex requirements involved in the IPO process. Here, we summarize by saying that entrepreneurs who pursue the public securities route should be prepared for reporting requirements, disclosure statements, and the shared control and ownership with outside shareholders.

8-6 Private Placements

LO8.6 Discuss private placements as an opportunity for equity capital

Another method of raising capital is through the **private placement** of securities. Small ventures often use this approach.

The SEC provides **Regulation D**, which allows smaller firms to sell stock through what is referred to as **direct public offerings** (**DPOs**). It eases the regulations for the reports and statements required for selling stock to private parties—friends, employees, customers, relatives, and

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local professionals. The most common type of DPO is the Small Corporate Offering Registration, or SCOR (which is included in Rule 504), which provides an exemption to private companies that raise no more than $1 million in any 12-month period through the sale of stock. There are no restrictions on the number or types of investors, and the stock may be freely traded. The SCOR process is easy enough for a small-business owner to complete with the assistance of a knowledgeable accountant and attorney. Regulation D defines three separate exemptions that are based on the amount of money being raised. Along with their accompanying rule, these exemptions follow:

1. *Rule 504—placements up to $1 million.* No specific disclosure/information requirements and no limits on the kind or type of purchasers exist. This makes marketing offerings of this size easier than it was heretofore.
2. *Rule 505—placements of up to $5 million.* The criteria for a public offering exemption are somewhat more difficult to meet than those for smaller offerings. Sales of securities can be made to not more than 35 nonaccredited purchasers and to an unlimited number of accredited purchasers. If purchasers are nonaccredited as well as accredited, then the company must follow specified information disclosure requirements. Investors must have the opportunity to obtain additional information about the company and its management.
3. *Rule 506—placements in excess of $5 million.* Sales can be made to no more than 35 nonaccredited purchasers and an unlimited number of accredited purchasers. However, the nonaccredited purchasers must be "sophisticated" in investment matters. Also, the specific disclosure requirements are more detailed than those for offerings between $500,000 and $5 million. Investors must have the opportunity to obtain additional information about the company and its management.[16]

As noted in Rules 505 and 506, Regulation D uses the term **accredited purchaser**. Included in this category are institutional investors such as banks, insurance companies, venture capital firms, registered investment companies, small-business investment companies, wealthy individuals, and certain tax-exempt organizations with more than $5 million in assets. Everyone not covered in these descriptions is regarded as a nonaccredited purchaser.

Sophisticated investors are wealthy individuals who invest more or less regularly in new and early- and late-stage ventures. They are knowledgeable about the technical and commercial opportunities and risks of the businesses in which they invest. They know the kind of information they want about their prospective investment, and they have the experience and ability needed to obtain and analyze the data provided.

The objective of Regulation D is to make it easier and less expensive for small ventures to sell stock. However, many states have not kept pace with these rules. Consequently, many new ventures still find it costly and time consuming to try to clear their offerings in some states. In addition, many are discouraged by the disclosure requirements for offerings of $1,000,000 and over, which are cited under Rules 505 and 506. Despite these difficulties, Regulation D does a lot to simplify small-company financing.[17]

Another set of exemptions brought forth in the 2012 JOBS Act is Regulation A and Regulation A+. Regulation A was intended to provide a middle ground between a purely private financing transaction exempt from registration but often inaccessible to small businesses and the fulsome registration and reporting obligations of a public securities offering. For example, Regulation A limited the amount of money a company could raise to up to $5 million but did not limit the offering to accredited investors or require the company to provide audited financials, an S-1 registration statement, or ongoing reporting. Both Regulation A+ and old Regulation A provide an exemption from the extensive public registration requirements for smaller issuances of securities by certain types of issuers. Elements of the old Regulation A that would remain the same for offerings under proposed Regulation A+ are that the securities issued may be sold publicly by means of a general solicitation, the securities issued will be freely tradable subject to certain restrictions, under the civil liability provisions of the Securities Act. You must identify which of the two tiers applies to the offering:

- Regulation A Tier 1 (offerings up to $20 million in a 12-month period, with no more than $6 million in offers by selling security holders that are affiliates of the issuer)
- Regulation A Tier 2 (offerings up to $50 million in a 12-month period, with no more than $15 million in offers by selling security holders that are affiliates of the issuer)

Again, the objective of Regulation A and Regulation A+ was to make it easier, less expensive, and simpler for small ventures to sell stock.

8-7 Crowdfunding

LO8.7 Describe the rise of crowdfunding as an increasingly popular source of funding

A financial phenomenon of the twenty-first century has been the creation of a funding vehicle for ventures through the use of the general public. Known as **crowdfunding**, this practice seeks funding for a venture by raising monetary contributions from a large number of

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people, typically via the Internet. In the United States, legislation that is mentioned in the 2012 JOBS Act allowed for a wider pool of small investors with fewer restrictions following the implementation of the act. The crowdfunding model has three principal parts: the entrepreneur who proposes the idea and/or venture to be funded, individuals or groups who support the idea, and a moderating organization (the "platform") that brings the parties together to launch the idea.[18]

There are two distinct forms of crowdfunding. In one form, known as rewards crowdfunding, the entrepreneur will seek a target amount of funding to launch a business concept without incurring debt or sacrificing equity. In return for a donation from those interested in the venture, the entrepreneur provides some type of gift or incentive for participating (e.g., a T-shirt or gift card). The other form (and now growing in popularity) is equity crowdfunding, where the entrepreneur will share equity in the venture, usually in its early stages, in exchange for the money pledged.[19]

In 2021, there were over 1,478 crowdfunding platforms (Kickstarter and Indiegogo are the most well known) as the industry grew to be over $17.2 billion with 6,455,080 crowdfunding campaigns worldwide. It is now estimated that crowdfunding raises over $2 million per day with some predictions of 100 percent growth each year. According to the World Bank, crowdfunding is predicted to account for over $300 billion in cumulative transactions by 2030.[20]

In spite of these promising numbers and predictions, there are numerous critics of crowdfunding. One skeptic warns that equity crowdfunding may be just hype and that it will fail to significantly improve the supply of investment capital or improve the investment return of investors. The fear of future regulations is still a reality to some. In comparison to the SEC's Regulation D, crowdfunding appears to be a much tougher approach because Regulation D's disclosure requirement is relatively easier and lets a venture raise an unlimited amount of capital from an unlimited number of investors provided that those investors are "accredited." So, the types of ventures seeking nonaccredited investors through crowdfunding may be only the desperate ones.[21] Therefore, it is wise for any entrepreneur to be aware of the potential concerns that still exist with crowdfunding, such as the following:

- *Reputation*. Reaching financial goals and successfully gathering substantial public support but being unable to deliver on the venture could have a negative impact.
- *IP protection*. Concerns exist about idea theft and protecting intellectual property.
- *Donor dilution*. If the same network of supporters is reached out to multiple times, they will eventually tire of the necessary support.
- *Investor management*. Investors must be managed, which is time consuming.
- *Public fear*. Without a proper regulatory framework, the likelihood of a scam or an abuse of funds is high.[22]

As with any potential funding mechanism, entrepreneurs must be diligent in their pursuit of a complete understanding of the regulations and drawbacks involved with the investments. On the other hand, this new form of equity financing is here to stay and with predictions of huge growth. Crowdfunding may serve as a viable vehicle for raising those early seed-stage dollars. Crowdfunding campaigns provide entrepreneurs with a number of benefits, including the following:

- *Funding*. Access to smaller amounts of funding that major investors usually ignore
- *Profile*. Increases the new venture's reputation
- *Marketing*. Demonstrates that there is an interested market for the venture
- *Engagement*. Creates a forum to engage with the audiences
- *Feedback*. Offers an opportunity to beta-test with access to market feedback

Researchers Regan M. Stevenson, Donald F. Kuratko, and Jared Eutsler conducted an assessment of venture capital and crowdfunding in the United States at the federal, state, regional, and sector levels by combining and aggregating data from two distinct sources: the population of venture capital deals and the population of Kickstarter deals from inception over a 13-quarter period. Across 8,471 deals during the pre-crowdfunding era, the data revealed that venture capital firms were highly focused on a small number of regions (e.g., Silicon Valley and Boston). In contrast, crowdfunding during the inception period was widely dispersed geographically and was nondiscriminatory in terms of state or region.[23] This has potential implications for the "rise of the rest." As Steve Case, AOL's founder, explained, "I am a big believer in crowdfunding. You saw the benefit of it with some of the project crowdfunding sites like Kickstarter that have unleashed thousands of products and companies just through people essentially prepaying for a product."[24] In addition, historically, venture capitalists have focused on a small number of sectors (e.g., technology and health care), whereas crowdfunding has focused on leisure, retail, and consumer products. Indeed, recent forecasts highlight that crowdfunding is on pace to surpass venture capital as the leading source of new-venture funding within a decade.[25] Moreover, recent legislation now allows new ventures to raise up to $50 million in crowdfunding annually,[26] dwarfing earlier legislation that capped annual equity deals to $1 million per company on equity crowdfunding platforms. Could this signal a downward trend in venture

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capital funding? Alternatively, will experienced venture capitalists find new ways to conduct business in a world where crowdfunding becomes the dominant early-stage funding form? This potential shift also sets the stage for some interesting future possibilities.

8-8 The Venture Capital Market

LO8.8 Explain the market for venture capital

Venture capitalists are professional investors who invest in business ventures, providing capital for start-up, early stage, or expansion. Venture capitalists are looking for a higher rate of return than would be given by more traditional investments. They are a valuable and powerful source of equity funding for new ventures. These experienced professionals provide a full range of financial services for new or growing ventures, including the following:

- Capital for start-ups and expansion
- Market research and strategy for businesses that do not have their own marketing departments
- Management-consulting functions and management audit and evaluation
- Contacts with prospective customers, suppliers, and other important businesspeople
- Assistance in negotiating technical agreements
- Help in establishing management and accounting controls
- Help in employee recruitment and development of employee agreements
- Help in risk management and the establishment of an effective insurance program
- Counseling and guidance in complying with myriad government regulations

8-8a Recent Developments in Venture Capital

Following a five-year upward trend from 2004 to 2008, when venture capital grew from investing $22.4 billion in 3,178 deals to investing $30.6 billion in 4,111 deals, the global economic downturn in 2008 caused a major constriction in activity. Venture capitalists invested only $19 billion in 3,065 deals in 2009. However, a slow climb back was witnessed in the following years with 3,526 deals drawing $23.2 billion in 2010 and $28.5 billion in 3,673 deals in 2011. By 2015, venture capital deals grew to well over 4,300 with an excess of $58 billion invested.[27] In 2017, deals had leveled off at 4,259 but with over $73 billion invested.[28] In the United States, the sectors with the most investments were Internet, health care, mobile/telecommunications, and software. The three subsectors on the rise were artificial intelligence, cybersecurity, and genomics. In 2017, $5 billion was invested in artificial intelligence companies, $3.6 billion in cybersecurity, and $2.5 billion in genomics companies. In 2020, $12.9 billion across 3,093 deals was invested in companies raising equity financing for the first time. By comparison, $13.1 billion across 3,328 deals was committed to first-time financings in 2019. The U.S. venture capital ecosystem ended 2020 with more than 10,800 companies across the country receiving venture funding and approximately 1,965 venture capital firms managing 3,680 venture funds with $548 billion in assets under management. Total capital invested in the United States reached $164 billion and buoyed global total venture capital investment to $321 billion. Pharma and biotech's strong results buoyed a record year for life sciences because of investor interest in vaccines, antivirals, and companies engaged in the fight against COVID-19; $36 billion in capital was invested in life sciences companies in 2020, 41 percent more than the previous annual record of $26 billion invested in 2018. Investment in drug discovery nearly doubled from $8.8 billion in 2019 to $16.2 billion in 2020.[29]

The top-line figures for the U.S. venture capital industry in 2021 show that a staggering $329.9 billion was invested across an estimated 17,054 deals, a record for deal count and roughly double 2020's previous high in deal value. A record number of start-ups received first financings in 2021, collectively raising $23.8 billion and exceeding 4,000 investments for the first time. Seed funding grew 56 percent year over year and totaled $29.4 billion in 2021, with more than 17,000 start-ups around the world raising funding at seed. Investors raised an unprecedented $128.3 billion, passing the $100 billion mark for the first time. In addition, $774.1 billion in annual exit value was created by venture capital–backed companies going public or being acquired. Overall, the venture ecosystem observed a sharp uptick in valuations across all stages of the investment cycle.[30] In 2022 and 2023, venture capital investments dropped dramatically due to the inflationary economy and the over-valuations that were prevalent in the earlier years.

However, it should be understood that the venture capitalists normally raise their investments in later-stage companies and not start-ups. Recently, however, venture capitalists have increased investments in early-stage funding due to a number of reasons, including the following:

- The ease and efficiency to launch a venture, get the product to market, and reach larger markets than ever before
- The huge increase in incubators and accelerators that work with the ventures to increase their value
- Sharp reductions in infrastructure costs because of cloud-based computing

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- Shorter product cycles and iterative development processes
- Selling to global consumers becoming feasible for start-up entrepreneurs who can access much larger markets through the Internet
- The dramatic impact that equity crowdfunding has had on early stage investing
- College graduates having more sophisticated knowledge about some of the most important technological developments, such as mobile, social, and cloud[31]

Even with this recent surge in early-stage funding, it must be understood that today's venture capitalists are far less inclined to finance a start-up firm as opposed to a firm in its more mature stages of early development.

In addition to these developments, a number of major trends have occurred in venture capital over the past few years.

First, the dominant investor class is changing from individuals, foundations, and families to pension institutions. Therefore, sources of capital commitments will continue to shift away from the less experienced venture capital firm (less than three years) to the more experienced firm (greater than three years).

Second, innovation has become more global and is no longer the exclusive domain of Silicon Valley and Route 128 in Boston. Therefore, many venture capitalists have opened offices in China, India, Israel, and Vietnam.[32]

Third, funds are becoming more specialized and less homogeneous. The industry has become more diverse, more specialized, and less uniform than is generally thought. Sharp differences are apparent in terms of investing objectives and criteria, strategy, and focusing on particular stages, sizes, and market technology niches. Some of the tech sectors that have funds focused exclusively on them are life sciences, biotech, clean technology (cleantech), and digital media.[33]

Fourth, syndicated deals are emerging. Accompanying this specialization is a new "farm team" system. Large, established venture capital firms have crafted both formal and informal relationships with new funds as feeder funds. Often, one general partner of the established fund will provide time and know-how to the new fund. The team may share deal flow and coinvest in a syndicated deal. More often than not, these new funds focus on seed-stage or start-up deals that can feed later deals to the more conventional, mainstream venture capital firm with which they are associated.[34]

Fifth, small start-up investments have weakened over the past decade. Many venture capital firms have experienced challenges with some of the high-risk ventures in today's technological environment in their portfolios. As a result, general partners—who are often the most experienced and skillful at finding and nurturing innovative technological ventures—are allocating premium time to salvaging or turning around problem ventures. In addition, because start-up and first-stage investing demands the greatest intensity of involvement by venture capital investors, this type of venture has felt the greatest effects. Finally, other venture capital funds lack professionals who have experience with start-ups and first-stage ventures. Consequently, the level of seed and start-up financing is much lower in comparison to the financing available for early stages, expansion, and acquisition.[35]

Sixth, the industry has become more efficient and more responsive to the needs of the entrepreneur as a result of greater professionalism and greater competition. Now most venture capitalists view themselves as service providers whose job is to provide advice and counsel, which adds more value to the enterprise than just cash. Many venture capitalists today were successful entrepreneurs themselves and can therefore relate to the challenges faced by entrepreneurs and can help with strategies to finance and build a successful enterprise. Entrepreneurs should look for a venture capitalist that not only is a source of capital but also has deep industry knowledge and a broad network.[36]

Seventh, the trend is toward a stronger legal environment. The heated competition for venture capital in recent years has resulted in a more sophisticated legal and contractual environment. The frequency and extent of litigation are rising. As an example, the final document governing the investor–entrepreneur relationship—called the investment agreement—can be a few inches thick and can make up two volumes. In this regard, legal experts recommend that the following provisions be carefully considered in the investment agreement: choice of securities (preferred stock, common stock, convertible debt, and so on), control issues (who maintains voting power), evaluation issues and financial covenants (ability to proceed with mergers and acquisitions), and remedies for breach of contract (rescission of the contract or monetary damages).[37]

Finally, corporate venture capital (CVC) is on the rise among major corporations. The advantages are clear for entrepreneurs because the parent companies can offer strategic and tactical advice, an operating budget, credibility and validation of having a well-known investor name, access to the parent company's information technology talent, and potential sales to the parent company. These give venture capitalists more confidence for follow-on funding and the ability to tap into global connections and the in-house expertise of the parent company and provide a potential exit path for the venture. In 2020, global CVC-backed deals fell for the first time in more than five years. CVC-backed deals declined from a record high of 3,416 in 2019 to 3,359 in 2020. CVC-backed funding soared to an all-time high of $73.1 billion in 2020, increasing 24 percent from 2019 despite the overall decline in CVC-backed deals.[38]

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8-8b Dispelling Venture Capital Myths

Because many people have mistaken ideas about the role and function of venture capitalists, a number of myths have sprung up about them. Some of these, along with their rebuttals, follow.

Myth 1: Venture Capital Firms Want to Own Control of Your Company and Tell You How to Run the Business

No venture capital firm intentionally sets out to own control of a small business. Venture capitalists have no desire to run the business. They do not want to tell entrepreneurs how to make day-to-day decisions and have the owner report to them daily. They want the entrepreneur and the management team to run the company profitably. They do want to be consulted on any major decision, but they want no say in daily business operations.[39]

Myth 2: Venture Capitalists Are Satisfied with a Reasonable Return on Investments

Venture capitalists expect very high, exorbitant, unreasonable returns. They can obtain reasonable returns from hundreds of publicly traded companies. They can obtain reasonable returns from many types of investments that do not have the degree of risk involved in financing a small business. Because every venture capital investment involves a high degree of risk, it must have a correspondingly high return on investment.[40]

Myth 3: Venture Capitalists Are Quick to Invest

It takes a long time to raise venture capital. On the average, it will take six to eight weeks from the initial contact to raise venture capital. If the entrepreneur has a well-prepared business plan, the investor will be able to raise money in that time frame. A venture capitalist will see from 50 to 100 proposals a month; of that number, 10 will be of some interest. Of those, two or three will receive a fair amount of analysis, negotiation, and investigation. Of the two or three, just one may be funded. This funneling process of selecting 1 out of a 100 takes a great deal of time. Once the venture capitalist has found that one, they will spend a significant amount of time investigating possible outcomes before funding it.

Myth 4: Venture Capitalists Are Interested in Backing New Ideas or High-Technology Inventions—Management Is a Secondary Consideration

Execution is the operative word in the venture capitalist world. So, venture capitalists back only good management. If an entrepreneur has a bright idea but a poor managerial background and no experience in the industry, the individual should try to find someone in the

The Entrepreneurial Process

Venture Capitalists' Due Diligence "Deal Killers"

When venture capitalists examine a business plan and then conduct their own due diligence on a proposed venture, certain areas stand out immediately as negative. These are referred to as "deal killers" because it is sometime impossible to get a deal done if any one of these items is identified:

An arrogant management team. This is a team that will not listen or one that has displayed a lack of integrity or is preoccupied with complete control.

No defendable market position. This occurs when there is no identified intellectual property to defend or any specific market niche to occupy.

Excessive founder salaries. If the focus seems to be on the founders' distributing the proceeds to themselves quickly (or bonuses), then there is a problem of commitment to the venture.

Vulnerability of the founder. Whenever there is overdependence on one person (a particular founder) for their skills or persona, there could be a major issue.

Yesterday's news. If a business plan is perceived as "overshopped" or simply presented too much over a short period of time, then it may be perceived as an "old idea."

Ignorance of the competitive landscape. Whenever the team lacks the understanding of the real strengths and weaknesses of the competition, a major red flag goes up for the venture capitalist.

Unrealistic expectations. A typical problem of entrepreneurs is their lack of understanding of the valuation of their venture and the deal terms involved in the venture capital investment proposal. Usually, the entrepreneurs think that their venture is worth far more than the venture capitalist does.

Source: Adapted from Andrew J. Sherman, *Raising Capital*, 3rd ed. (New York: AMACOM Books, 2012), 196.

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industry to bring onto the team. The venture capitalist will have a hard time believing that an entrepreneur with no experience in that industry and no managerial ability in their background can follow through on a business plan. A good idea is important, but a good management team is even more important.[41]

Myth 5: Venture Capitalists Need Only Basic Summary Information before They Make an Investment

A detailed and well-organized business plan is the only way to gain a venture capital investor's attention and obtain funding. Every venture capitalist, before becoming involved, wants the entrepreneur to have thought out the entire business plan and to have written it down in detail.[42]

8-8c Venture Capitalists' Objectives

LO8.9 Describe venture capitalists' evaluation criteria for new ventures

Venture capitalists have different objectives from most others who provide capital to new ventures. Lenders, for example, are interested in security and payback. However, as partial owners of the companies they invest in, venture capitalists are most concerned with return on investment. As a result, they put a great deal of time into weighing the risk of a venture against the potential return. They carefully measure both the product/service and the management. Figure 8.2 illustrates an evaluation system for measuring these two critical factors—status of product/service and

Figure 8.2 Venture Capitalist System of Evaluating Product/Service and Management

Status of Product/Service	Level 1	Level 2	Level 3	Level 4
Level 4 Fully developed product/service Established market Satisfied users	4/1	4/2	4/3	4/4
Level 3 Fully developed product/service Few users as of yet Market assumed	3/1	3/2	3/3	3/4
Level 2 Operable pilot or prototype Not yet developed for production Market assumed	2/1	2/2	2/3	2/4
Level 1 Product/service idea Not yet operable Market assumed	1/1	1/2	1/3	1/4
	Level 1 Individual founder/ entrepreneur	**Level 2** Two founders Other personnel not yet identified	**Level 3** Partial management team Members identified to join company when funding is received	**Level 4** Fully staffed, experienced management team

Riskiest (Status of Product/Service)

Riskiest

Status of Management

Source: Stanley Rich and David Gumpert, *Business Plans That Win $$$* (New York: Harper & Row, 1985), 169.

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Table 8.2 Returns on Investment Typically Sought by Venture Capitalists

Stage of Business	Expected Annual Return on Investment	Expected Increase on Initial Investment
Start-up business (idea stage)	60% +	10 to 15× investment
First-stage financing (new business)	40% to 60%	6 to 12× investment
Second-stage financing (development stage)	30% to 50%	4 to 8× investment
Third-stage financing (expansion stage)	25% to 40%	3 to 6× investment
Turnaround situation	50% +	8 to 15× investment

Source: Adapted from W. Keith Schilit, "How to Obtain Venture Capital," *Business Horizons*, May/June 1987, 78. Copyright © 1987 by the Foundation for the School of Business at Indiana University.

status of management—on four levels. The figure demonstrates that ideas as well as entrepreneurs are evaluated when the viability of a venture proposal is determined.

Venture capitalists are particularly interested in making a large return on investment. Table 8.2 provides some commonly sought targets. Of course, these targets are flexible. They would be reduced, for example, in cases where a company has a strong market potential and is able to generate good cash flow or the management has invested a sizable portion of its own funds in the venture. However, an annual goal of a 20 to 30 percent return on investment would not be considered too high regardless of the risks involved.

8-8d Criteria for Evaluating New-Venture Proposals

In addition to the evaluation of product ideas and management strength, numerous criteria are used to evaluate new-venture proposals. Researcher Dean A. Shepherd developed a list of eight critical factors that venture capitalists use in the evaluation of new ventures:

1. Timing of entry
2. Key success factor stability
3. Educational capability
4. Lead time
5. Competitive rivalry
6. Entry wedge imitation
7. Scope
8. Industry-related competence.[43]

Each factor was defined from the high/low perspective (see Table 8.3 for definitions).

Another set of researchers developed 28 of these criteria grouped into six major categories:

1. Entrepreneur's personality
2. Entrepreneur's experience
3. Product or service characteristics
4. Market characteristics
5. Financial considerations
6. Nature of the venture team[44]

Other researchers have uncovered similar results. For example, one study examined the criteria venture that capitalists use during a proposal screening and evaluation. Table 8.4 outlines the factors used in the study.[45] Their results showed that venture capitalists reached a "go/no-go" decision in an average of six minutes on the initial screening and in less than 21 minutes on the overall proposal evaluation. They found that the venture capital firm's requirements and the long-term growth and profitability of the proposed venture's industry were the critical factors for initial screening. In the more detailed evaluation, the background of the entrepreneurs as well as the characteristics of the proposal itself were important.

In a study that examined the "demand side" of venture capital, researchers surveyed 318 private entrepreneurs who sought out venture capital in amounts of $100,000 or more. The study found that entrepreneurs' success with acquiring funding is related to four general, variable categories: (1) characteristics of the entrepreneurs, including education, experience, and age; (2) characteristics of the enterprise, including stage, industry type, and location (e.g., rural or urban); (3) characteristics of the request, including amount, business plan, and prospective capital source; and (4) sources of advice, including technology, preparation of the business plan, and places to seek funding.[46]

The business plan is a critical element in a new-venture proposal and should be complete, clear, and well presented. Venture capitalists generally will analyze five major aspects of the plan: (1) the proposal size, (2) financial projections, (3) investment recovery, (4) competitive advantage, and (5) company management.

The evaluation process typically takes place in stages. The four most common stages follow.

Stage 1: Initial Screening

This is a quick review of the basic venture to see if it meets the venture capitalist's particular interests.

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Table 8.3 Factors in Venture Capitalists' Evaluation Process

Attribute	Level	Definition
Timing of entry	Pioneer	Enters a new industry first
	Late follower	Enters an industry late in the industry's stage of development
Key success factor stability	High	Requirements necessary for success will not change radically during industry development
	Low	Requirements necessary for success will change radically during industry development
Educational capability	High	Considerable resources and skills available to overcome market ignorance through education
	Low	Few resources or skills available to overcome market ignorance through education
Lead time	Long	An extended period of monopoly for the first entrant prior to competitors entering the industry
	Short	A minimal period of monopoly for the first entrant prior to competitors entering this industry
Competitive rivalry	High	Intense competition among industry members during industry development
	Low	Little competition among industry members during industry development
Entry wedge mimicry	High	Considerable imitation of the mechanisms used by other firms to enter this, or any other, industry—e.g., a franchisee
	Low	Minimal imitation of the mechanisms used by other firms to enter this, or any other, industry—e.g., introducing a new product
Scope	Broad	A firm that spreads its resources across a wide spectrum of the market—e.g., many segments of the market
	Narrow	A firm that concentrates on intensively exploiting a small segment of the market—e.g., targeting a niche
Industry-related competence	High	Venturer has considerable experience and knowledge with the industry being entered or a related industry
	Low	Venturer has minimal experience and knowledge with the industry being entered or a related industry

Source: Dean A. Shepherd, "Venture Capitalists' Introspection: A Comparison of 'In Use' and 'Espoused' Decision Policies," *Journal of Small Business Management* (April 1999): 76–87; Dean A. Shepherd, "Venture Capitalists' Assessment of New Venture Survival," *Management Science*, May 1999, 621–32. Reprinted by permission. Copyright © 1999, the Institute for Operation Research and the Management Sciences (INFORMS), 7240 Parkway Drive, Suite 310, Hanover, MD 21076 USA.

Stage 2: Evaluation of the Business Plan

A detailed reading of the plan is done to evaluate the factors mentioned earlier.

Stage 3: Oral Presentation

The entrepreneur verbally presents the plan to the venture capitalist. See Table 8.5 for a thorough understanding of the key elements necessary in presenting to a venture capitalist.

Stage 4: Final Evaluation

After analyzing the plan and visiting with suppliers, customers, consultants, and others, the venture capitalist makes a final decision.

This four-step process screens out approximately 98 percent of all venture plans. The rest receive some degree of financial backing.

8-8e Evaluating the Venture Capitalist

LO8.10 Explain the importance of evaluating venture capitalists for a proper selection

The venture capitalist will evaluate the entrepreneur's proposal carefully, and the entrepreneur should not hesitate to evaluate the venture capitalist. Does the venture capitalist understand the proposal? Is the individual familiar with the business? Is the person someone with

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Table 8.4 Venture Capitalists' Screening Criteria

Venture Capital Firm Requirements
Must fit within lending guidelines of venture firm for stage and size of investment
Proposed business must be within geographic area of interest
Prefer proposals recommended by someone known to venture capitalist
Proposed industry must be kind of industry invested in by venture firm
Nature of the Proposed Business
Projected growth should be relatively large within five years of investment
Economic Environment of Proposed Industry
Industry must be capable of long-term growth and profitability
Economic environment should be favorable to a new entrant
Proposed Business Strategy
Selection of distribution channel(s) must be feasible
Product must demonstrate defendable competitive position
Financial Information on the Proposed Business
Financial projections should be realistic
Proposal Characteristics
Must have full information
Should be a reasonable length, be easy to scan, have an executive summary, and be professionally presented
Must contain a balanced presentation
Use graphics and large print to emphasize key points
Entrepreneur/Team Characteristics
Must have relevant experience
Should have a balanced management team in place
Management must be willing to work with venture partners
Entrepreneur who has successfully started previous business given special consideration

Source: John Hall and Charles W. Hofer, "Venture Capitalists' Decision Criteria in New Venture Evaluation," *Journal of Business Venturing*, January 1993, 37.

Table 8.5 Essential Elements for a Successful Presentation to a Venture Capitalist

Team Must: • Be able to adapt • Know the competition • Be able to manage rapid growth • Be able to manage an industry leader • Have relevant background and industry experience • Show financial commitment to company, not just sweat equity • Be strong with a proven track record in the industry unless the company is a start-up or seed investment
Product Must: • Be real and work • Be unique • Be proprietary • Meet a well-defined need in the marketplace • Demonstrate potential for product expansion to avoid being a one-product company; emphasize usability • Solve a problem or improve a process significantly • Be for mass production with potential for cost reduction
Market Must: • Have current customers and the potential for many more • Grow rapidly (25% to 45% per year) • Have a potential for market size in excess of $250 million • Show where and how you are competing in the marketplace • Have potential to become a market leader • Outline any barriers to entry
Business Plan Must: • Tell the full story, not just one chapter • Promote a company, not just a product • Be compelling • Show the potential for rapid growth and knowledge of your industry, especially competition and market vision; include milestones for measuring performance • Show how you plan to beat or exceed those milestones • Address all of the key areas • Detail projections and assumptions; be realistic • Serve as a sales document • Include a strong and well-written executive summary • Show excitement and color • Show superior rate of return (a minimum of 30% to 40% per year) with a clear exit strategy

Source: Andrew J. Sherman, *Raising Capital*, 3rd ed. (New York: AMACOM Books, 2012), 190.

whom the entrepreneur can work? If the answers reveal a poor fit, it is best for the entrepreneur to look for a different venture capitalist.

One researcher found that venture capitalists do add value to an entrepreneurial firm beyond the money they supply, especially in high-innovation ventures. Because of this finding, entrepreneurs need to choose the appropriate venture capitalist at the outset, and, most important, they must keep the communication channels open as the firm grows.[47]

On the other hand, it is important to realize that the choice of a venture capitalist can be limited. Although funds are available today, they tend to be controlled by fewer groups, and the quality of the venture must be promising. Even though two and a half times more money is available today for seed financing than was available 10 years ago,

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The Entrepreneurial Process

The Discovery of Search Funds by MBAs

There are two breeds of entrepreneurs. Some love the challenge of building a business from scratch and are passionate about bringing their idea or product to life. Others are less concerned about the kind of product or service; instead, they love the idea of growing a small business to its full potential. If you are in the second group, entrepreneurship can still be a viable path for you. The search-fund model has been gaining momentum as an alternative way to becoming a business owner. This trend is spreading primarily within the MBA programs at schools of business with student entrepreneurs skipping the traditional start-up path and pitching themselves as the investment. These MBAs are known as "searchers" who, lacking in personal capital, start a search fund and use that money to acquire a privately held, under-the-radar business. The MBA graduate then runs the company as the new CEO and gains a share of ownership in the business. If the business grows successfully, investors and the MBA graduate can enjoy attractive returns. While this model has been a part of the business school scheme for decades, it has taken off only in the last couple of years during the pandemic, as cash-rich investors have been on the lookout for promising opportunities to invest their capital. Fifty-one new search funds were started in 2019, while in 2020, that number rose to at least 70.

The excitement behind these search funds has not been unwarranted. A Stanford study performed on 400 search funds through 2019 found that 75 percent of search-funded businesses yielded a positive return for investors, of which 69 percent delivered at least double returns. From the point of view of a student entrepreneur, they have a 75 percent chance of finding and acquiring a business within two years, followed by a 67 percent chance of successfully growing the business and making it financially profitable for themselves and their investors. Considering this, you have a greater than 50 percent chance of becoming a successful CEO, with meaningful experience and financial outcome. Comparing this to a more traditional "boom and bust" start-up path, the search-fund model may be an attractive alternative.

Nevertheless, the search-fund model is not without its challenges. Searching requires numerous calls to potential sellers and many rejections: about one-third of searchers do end up without an acquisition. It is your job to find, acquire, and then grow the business. MBA searchers forgo their opportunity of recruiting with the high-profile names of Silicon Valley, Wall Street, or the Fortune 500. They must forget about the prestige of consulting, investment, or private equity industries. The companies that searchers target are not flashy start-ups or well-known brands. They could be anything from a family-owned printing business without a succession plan to a small wireless service provider. However, search funds are not about exciting products and innovative ideas. Instead, they provide an opportunity to become an early leader, grow a company, and create a significant financial upside.

It is important to consider the upsides and downsides when deciding whether search funds are right for you. Do you like to go from 0 to 10 or from 100 to 1,000? Are you willing to forgo a lucrative consulting job at a large firm? Are you willing to accept the uncertainty of not knowing the type of business that you will have to run? Are you willing to move across the country to grow the acquired business? Is this something that you would like to do for the next 7 to 10 years? Despite all the benefits, search-funded companies require a large commitment, hard work, and a tenacious character who can accept their inexperience and is willing to grow and listen. A typical search fund CEO is 32 years old, which is a noticeably young CEO. They tend to be motivated and talented individuals, surrounded by experienced investors and former operators who help the MBA graduate avoid a lot of basic mistakes and improve the odds of success. An average holding period from the time of acquisition is seven years, though highly successful cases can last much longer.

If, after considering the downsides, you still believe that becoming a young CEO at a start-up firm sounds like a great idea and you are willing to put in the time and effort that it takes to build a company, then a search-fund method can be a viable option for you.

Source: Adapted from Lindsay Ellis, "M.B.A.s' Latest Pitch to Investors: Skip the Startup, Invest in Me," *Wall Street Journal*, March 20, 2022; Kim Girard, "How Search Funds Turn MBA 'Searchers' into Young CEOs," *Berkeley Haas News*, June 10, 2021; and Theresa Johnston, "What It Takes to Be a Search Fund Entrepreneur," *Stanford Business News*, September 25, 2015.

the number of venture capital firms is not increasing. In addition, the trend toward concentration of venture capital under the control of a few firms is increasing.[48]

Nevertheless, the entrepreneur should not be deterred from evaluating prospective venture capitalists.

There are a number of important questions that entrepreneurs should ask of venture capitalists. Following are seven of the most important, along with their rationales.

Key Questions for Evaluating a Venture Capital Firm

1. Does the venture capital firm in fact invest in your industry? How many deals has the firm actually done in your field?
2. What is it like to work with this venture capital firm? Get references. (An unscreened list of referrals, including CEOs of companies that the firm has been

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successful with—as well as those it has not—can be very helpful.)

3. What experience does the partner doing your deal have, and what is their clout within the firm? Check out the experiences of other entrepreneurs.
4. How much time will the partner spend with your company if you run into trouble? A seed-stage company should ask, "You guys are a big fund, and you say you can seed me a quarter of a million dollars. How often will you be able to see me?" The answer should be at least once a week.
5. How healthy is the venture capital fund, and how much has been invested? A venture firm with a lot of troubled investments will not have much time to spare. If most of the fund is invested, there may not be much money available for your follow-on rounds.
6. Are the investment goals of the venture capitalists consistent with your own?
7. Have the venture firm and the partner championing your deal been through any economic downturns? A good venture capitalist won't panic when things get bad.[49]

Evaluating and even negotiating with the venture capitalist are critical to establishing the best equity funding. You may worry that if you rock the boat by demanding too much, the venture capital firm will lose interest. That's an understandable attitude; venture capital is hard to get, and if you've gotten as far as the negotiating process, you're already among the lucky few.

But that doesn't mean you have to roll over and play dead. A venture capital investment is a business deal that you may have to live with for a long time. Although you'll have to give ground on many issues when you come to the bargaining table, there is always a point beyond which the deal no longer makes sense for you. You must draw a line and fight for the points that really count.[50]

8-9 Informal Risk Capital: Angel Financing

LO8.11 Describe the existing informal risk-capital market ("angel capital")

Not all venture capital is raised through formal sources such as public and private placements. Many wealthy people in the United States are looking for investment opportunities; they are referred to as **business angels** or **informal risk capitalists**. These individuals constitute a huge potential investment pool, as the following calculations show. Using the recent *Forbes* "Richest 400" list,[51] a few interesting and creative assumptions could be made to demonstrate the power of individuals' ability to finance new ventures:

- The aggregate net worth of the *Forbes* "Richest 400" Americans was $4.5 trillion ($11.25 billion per person).
- Forty-four new members made the list in 2021.
- Thirteen of the top 18 are entrepreneurs, including Elon Musk (Tesla, SpaceX), Mark Zuckerberg (Facebook), Bill Gates (Microsoft), Larry Page and Sergey Brin (Google), Warren Buffett (Berkshire Hathaway), Larry Ellison (Oracle), Charles Ballmer (Microsoft), Phil Knight (Nike), Charles Koch (Koch Industries), Michael Bloomberg (Bloomberg), Jeff Bezos (Amazon), and Michael Dell (Dell Computers). Their total worth is $1.25 trillion.
- If 1 percent of those entrepreneurs' wealth were available for venture financing, the pool of funds would amount to over $10 billion.
- Ninety-five billionaires did not even make the list. If 1 percent of their funds were available for venture financing, the pool of funds would be at least $1 billion
- If both amounts could be available for venture deals, there would be a total of $15 billion.
- If the average venture deal took $500,000, there would be the potential of 30,000 deals!

William E. Wetzel Jr., considered to be the pioneer researcher in the field of informal risk capital, defined this type of investor as someone who has already made their money and now seeks out promising young ventures to support financially. "Angels are typically entrepreneurs, retired corporate executives, or professionals who have a net worth of more than $1 million and an income of more than $100,000 a year. They're self-starters. And they're trying to perpetuate the system that made them successful."[52] If entrepreneurs are looking for such an angel, Wetzel would advise, "Don't look very far away—within 50 miles or within a day's drive at most. And that's because this is not a full-time profession for them."[53]

Why would individuals be interested in investing in a new venture from which professional venture capitalists see no powerful payoff? It may be, of course, that the reduced investment amount reduces the total risk involved in the investment. However, informal investors seek other, nonfinancial returns—among them the creation of jobs in areas of high unemployment, development of technology for social needs (e.g., medical or energy), urban revitalization, minority or disadvantaged assistance, and personal satisfaction from assisting entrepreneurs.[54]

How do informal investors find projects? Research studies indicate that they use a network of friends. Additionally, many states are formulating venture capital networks, which attempt to link informal investors with entrepreneurs and their new or growing ventures.

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8-9a Types of Angel Investors

Angel investors can be classified into five basic groups:

- *Corporate angels.* Typically, so-called corporate angels are senior managers at *Fortune* 1000 corporations who have been laid off with generous severances or have taken early retirement. In addition to receiving the cash, an entrepreneur may persuade the corporate angel to occupy a senior management position.
- *Entrepreneurial angels.* The most prevalent type of investors, most of these individuals own and operate highly successful businesses. Because these investors have other sources of income and perhaps significant wealth from IPOs or partial buyouts, they will take bigger risks and invest more capital. Therefore, the best way to market your deal to these angels is as a synergistic opportunity. Reflecting this orientation, entrepreneurial angels seldom look at companies outside of their own area of expertise and will participate in no more than a handful of investments at any one time. These investors almost always take a seat on the board of directors but rarely assume management duties. They will make fair-sized investments—typically $200,000 to $500,000—and invest more as the company progresses.
- *Enthusiast angels.* Whereas entrepreneurial angels tend to be somewhat calculating, enthusiasts simply like to be involved in deals. Most enthusiast angels are age 65 or older, are independently wealthy from success in a business they started, and have abbreviated work schedules. For them, investing is a hobby. As a result, they typically play no role in management and rarely seek to be placed on a board. Because they spread themselves across so many companies, the size of their investments tends to be small—ranging from as little as $10,000 to perhaps a few hundred thousand dollars.
- *Micromanagement angels.* Micromanagers are very serious investors. Some of them were born wealthy, but the vast majority attained wealth through their own efforts. Unfortunately, this heritage makes them dangerous. Because most have successfully built a company, micromanagers attempt to impose the tactics that worked for them on their portfolio companies. Although they do not seek an active management role, micromanagers usually demand a seat on the board of directors. If business is not going well, they will try to bring in new managers.
- *Professional angels.* The term *professional* in this context refers to the investor's occupation, such as doctor, lawyer, and, in some very rare instances, accountant. Professional angels like to invest in companies that offer a product or service with which they have some experience. They rarely seek a board seat, but they can be unpleasant to deal with when the going gets rough and may believe that a company is in trouble before it actually is. Professional angels will invest in several companies at one time, and their capital contributions range from $25,000 to $250,000.[55]

The importance of understanding the role of informal risk capital is illustrated by the fact that the pool of today's angel capital is five times the amount in the institutional venture capital market, providing money to 20 to 30 times as many companies. Angels invest more than $25 billion a year in 60,000 to 70,000 companies nationwide, twice the amount of money and twice the number of companies as 10 years ago.[56]

Recent research by Jeffrey Sohl, who worked with William E. Wetzel Jr. on **angel capital** and who is now the director of the Center for Venture Research at the University of New Hampshire, shows a marked increase in angel investing activity over the past few years. In 2020, a total of $25.3 billion was invested in 64,480 entrepreneurial ventures. This accounted for 334,680 active angel investors with an average of $392,025 per investment. Health care services/medical devices and equipment held the top sector position with 30 percent of total angel investments, followed by software (23 percent), energy/cleantech (9 percent), financial services (9 percent), retail (8 percent), and biotech (6 percent). Angels provided their investments in the seed and start-up stage at 39 percent, while early-stage investing was at 32 percent. Angel investments continue to be a significant contributor to job growth with the creation of 3.9 jobs per angel investment. Also, in 2020, women angels represented 29.5 percent of the angel market, unchanged from 2019 (29.0 percent). In 2020, women-owned ventures accounted for 33.6 percent of the entrepreneurs who were seeking angel capital (27.6 percent in 2019), and 28.1 percent of these women entrepreneurs received an angel investment in 2020 (21.4 percent in 2019).[57]

Another important consideration for angel capital is that a larger percentage of informal investment is devoted to seed a start-up business as opposed to venture capital. The median size of an informal investment is $350,000, which indicates the importance of informal risk capital to entrepreneurs seeking smaller amounts of start-up financing.[58] (See Table 8.6 for some "angel stats.") Obviously, informal networks are a major potential capital source for entrepreneurs. However, every entrepreneur should be careful and thorough in their approach to business angels—there are advantages and disadvantages associated with angel financing. Table 8.7 outlines some of the critical pros and cons of dealing with business angels. Only through recognition of these issues will entrepreneurs be able to establish the best relationship with a business angel.

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Table 8.6 "Angel Stats"	
Typical deal size	$250,000 to $600,000
Typical recipient	Start-up firms
Cash-out time frame	5 to 7 years
Expected return	35% to 50% a year
Ownership stake	Less than 50%

Source: Jeffrey Sohl, University of New Hampshire's Center for Venture Research, 2011; Angel Resource Institute, Halo Report, 2011, https://angelresourceinstitute.org/research/report.php?report=75&name=2011%20Annual%20Halo%20Report.

Table 8.7 Pros and Cons of Dealing with Angel Investors

Pros:
1. Angels engage in smaller financial deals.
2. Angels prefer seed stage or start-up stage.
3. Angels invest in various industry sectors.
4. Angels are located in local geographic areas.
5. Angels are genuinely interested in the entrepreneur.

Cons:
1. Angels offer no additional investment money.
2. Angels cannot offer any national image.
3. Angels lack important contacts for future leverage.
4. Angels may want some decision making with the entrepreneur.
5. Angels are getting more sophisticated in their investment decisions.

Diversity in Entrepreneurship

Improving Gender Diversity in Venture Capital

The gender imbalance in venture capital (VC) is no longer a surprising fact. Yet, despite an increased awareness of the issue, the numbers remain grim. While the amount of capital invested in start-ups continues to reach new records, female founders in the United States received only 1.9 percent of VC, down from 2.2 percent in 2020. In Europe, the amount received was only 0.7 percent of the total funding, also down from 2.2 percent in 2020. A number of new reports have shown that a major barrier to such funding disparity is a lack of female representation in decision-making positions in VC firms. Seeing the majority of funding go to all-male founding teams and watching them be featured in media coverage about initial public offerings and unicorn status creates a subconscious bias toward assuming that male entrepreneurs are more likely to reap success and higher returns. With more female investors, such biases would be less likely to happen. However, in 2021, only 3.4 percent of assets under management were held by women-founded VC firms in the United States. In Europe, only 10 percent of VC firms had a gender-mixed general partnership team.

With an increased emphasis on diversity and inclusion in the corporate world, why have VC firms not made any progress? Research by Atomico shows that 36 percent of VCs and 70 percent of corporate VCs have not introduced quantifiable targets on diversity. While diversity is considered to be important, without concrete targets, we cannot hope to create meaningful progress. In fact, the conversations around improving diversity in VC firms revolve mostly around generic steps that any firm could take, such as adopting standardized interview questionnaires, scorecards, and metrics. Removing biases in the recruitment process is definitely important; however, that is not where decision making and cash allocation happen. In order to attack the issue of diversity at the core—at the point of the investment decision—we need more robust data. A 2021 report by European Women in VC recommends an implementation of a diversity index to show the gender composition of investment teams, a tracking platform on gender composition in the upper ranks of start-up teams, and data showing the types of government funding that supports female-led VC firms and start-ups.

With the right data, we can then invest in the right solutions and monitor the impact of our actions. To combat unconscious bias, research finds that firms should create environments, initiatives, metrics, and guidelines that limit the potential of such biases to manifest themselves. This includes two main ways: by investing in the solutions that limit biases and by equipping decision makers with tools to notice and act on biases and to understand the contexts and processes that are more prone to them. A project based on Harvard's Kennedy School research on advancing gender equality in VC identified three focus areas where VC firms can take actions to close the gender opportunity gap:

- *Career opportunities*. Foster interest in becoming a part of VC investment team by offering internships, venture scouts, or rotation programs.
- *Career experience*. Improve the experience of women in existing VC investment teams by offering mentorship and networking opportunities.
- *Leadership opportunities*. Facilitate leadership opportunities for women in investment teams with executive sponsorship, transparency on roles and opportunities, and training.

By targeting key stages of the corporate world—entry, experience, and leadership—VC firms will have better chances of recruiting, retaining, and promoting women. There has been plenty of research pointing to the benefits of diverse leadership teams in both start-ups and VC firms. It is time for VC firms to start taking proactive actions that can effect meaningful change.

Source: Adapted from Leah Hodgson, "Senior Female VCs Call Out Major Funding Disparity in Europe," *PitchBook*, July 27, 2021, and Ram Jambunathan and Joanna Maryewska, "Two Ways Corporates Can Support Women Entrepreneurs," *World Economic Forum*, January 20, 2022.

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Summary

This chapter examined the various forms of capital formation for entrepreneurs. Initial consideration was given to bootstrapping, debt and equity financing in the form of commercial banks, trade credit, accounts receivable financing, factoring and finance companies, and various forms of equity instruments.

IPOs have advantages and disadvantages as a source of equity capital. Although large amounts of money can be raised in short periods of time, the entrepreneur must sacrifice a degree of control and ownership. In addition, the SEC has myriad requirements and regulations that must be followed.

Private placements are an alternative means of raising equity capital for new ventures. This source is often available to entrepreneurs who seek venture capital in amounts of less than $500,000, although it is possible that up to $5 million could be raised with no more than 35 nonaccredited purchasers. The SEC's Regulation D clearly outlines the exemptions and requirements involved in a private placement. This placement's greatest advantage to the entrepreneur is limited company disclosure and only a small number of shareholders.

In recent years, the venture capital market has grown dramatically. Billions of dollars are now invested annually to seed new ventures or help fledgling enterprises grow. The individuals who invest these funds are known as venture capitalists. A number of myths that have sprung up about these capitalists were discussed and refuted.

Venture capitalists use a number of different criteria when evaluating new-venture proposals. In the main, these criteria focus on two areas: the entrepreneur and the investment potential of the venture. The evaluation process typically involves four stages: initial screening, business plan evaluation, oral presentation, and final evaluation.

A financial phenomenon of the twenty-first century has been the creation of a funding vehicle for ventures through the use of the general public. Known as crowdfunding, this practice seeks funding for a venture by raising monetary contributions from a large number of people, typically via the Internet. In the United States, legislation that is mentioned in the 2012 JOBS Act allowed for a wider pool of small investors with fewer restrictions following the implementation of the act.

Over the years, informal risk capital (angel financing) has begun to play an important role in new-venture financing. Everyone with money to invest in new ventures can be considered a source for this type of capital. Some estimates put the informal risk capital pool at more than $25 billion. Entrepreneurs who are unable to secure financing through banks or through public or private stock offerings typically will turn to the informal risk capital market by seeking out friends, associates, and other contacts who may have (or know of someone who has) money to invest in a new venture.

Key Terms

accounts receivable financing
accredited purchaser
angel capital
bootstrapping
business angel
crowdfunding
debt financing
direct public offering (DPO)
equity financing
factoring
finance companies
informal risk capitalist
initial public offering (IPO)
peer-to-peer (P2P) lending
private placement
Regulation D
sophisticated investor
special purpose acquisition companies (SPACs)
trade credit
venture capitalist

Review and Discussion Questions

1. Using Figure 8.1, describe some of the sources of capital available to entrepreneurs and discuss how they correlate to the varying levels of risk involved with each stage of the venture.
2. Explain bootstrapping with its advantages and disadvantages.
3. What are the benefits and drawbacks of equity and of debt financing? Briefly discuss both.
4. If a new venture has its choice between long-term debt and equity financing, which would you recommend? Why?
5. Why would a venture capitalist be more interested in buying a convertible debenture for $500,000 than in lending the new business $500,000 at a 4 percent interest rate?
6. What are some of the advantages of going public? What are some of the disadvantages?
7. What is the objective of Regulation D?
8. If a person inherited $100,000 and decided to buy stock in a new venture through a private placement, how would Regulation D affect this investor?
9. How has crowdfunding changed the landscape of new-venture financing?
10. Is it easier or more difficult to get new-venture financing today? Why?
11. Some entrepreneurs do not like to seek new-venture financing because they feel that venture capitalists are greedy. In your opinion, is this true? Do these capitalists want too much?
12. Identify and describe three objectives of venture capitalists.
13. How would a venture capitalist use Figure 8.2 to evaluate an investment? Use an illustration in your answer.
14. Identify and describe four of the most common criteria that venture capitalists use to evaluate a proposal.

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15. In a new-venture evaluation, what are the four stages through which a proposal typically goes? Describe each in detail.
16. An entrepreneur is in the process of contacting three different venture capitalists and asking each to evaluate her new business proposal. What questions should she be able to answer about each of the three?
17. An entrepreneur of a new venture has had no success in getting financing from formal venture capitalists. He now has decided to turn to the informal risk capital market. Who is in this market? How would you recommend that the entrepreneur contact these individuals?

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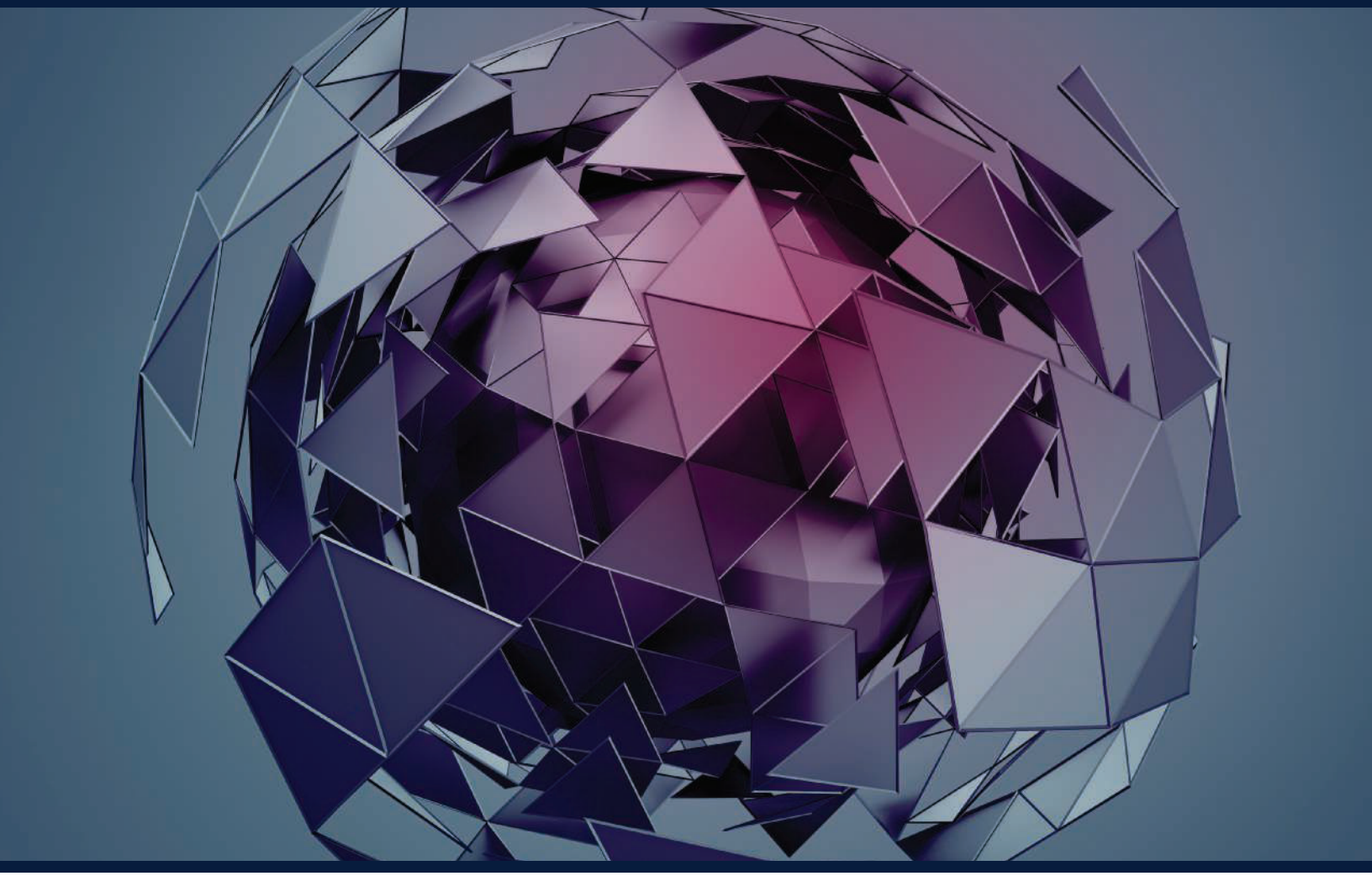
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Part 3 | Developing the Entrepreneurial Plan



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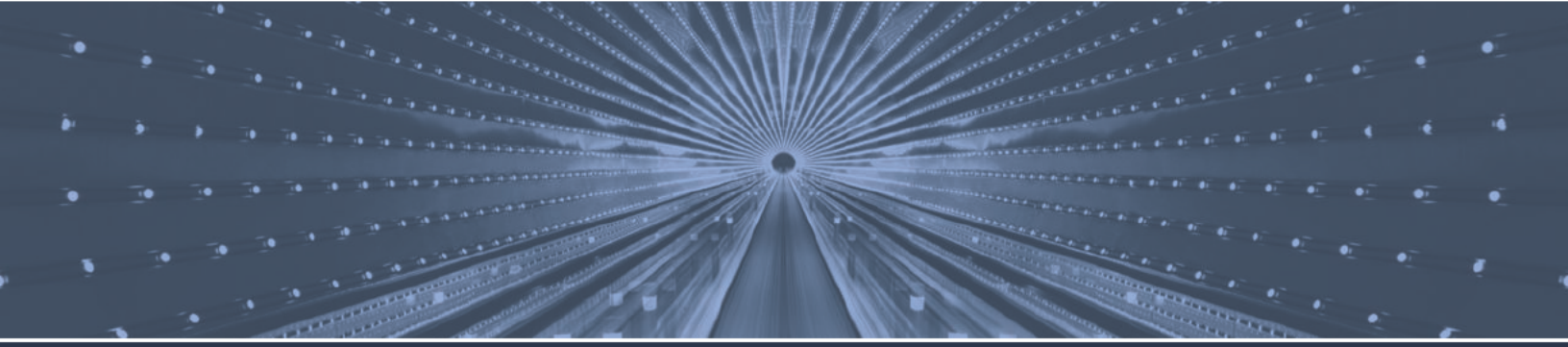
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Chapter 9

Legal Challenges for Entrepreneurial Ventures

Learning Objectives

9.1. Explain the importance of legal issues for entrepreneurs
9.2. Identify patent protection, including definitions and preparation
9.3. Discuss copyrights and their relevance to entrepreneurs
9.4. Explain trademarks and their impact on new ventures
9.5. Identify the legal forms of organization: sole proprietorship, partnership, and corporation
9.6. List the advantages and disadvantages of each of these three legal forms
9.7. Explain the nature of the limited partnership and limited liability partnerships
9.8. Discuss how an S corporation works
9.9. Define the additional classifications of corporations, including limited liability companies (LLCs), B corporations, and low-profit, limited liability companies (L3Cs)
9.10. Identify the major segments of the bankruptcy law that apply to entrepreneurs

Entrepreneurial Thought

A major difficulty for the inexperienced entrepreneur is the host of strange terms and phrases which are scattered throughout most legal documents. The novice in this kind of reading should have some understanding not only of what is contained in such documents, but also why these provisions have been included. If an entrepreneur cannot find the time or take the interest to read and understand the major contracts into which his company will enter, he should be very cautious about being an entrepreneur at all.

—**Patrick R. Liles, *Harvard Business School***

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Importance of Legal Issues

LO9.1 Explain the importance of legal issues for entrepreneurs

Entrepreneurs cannot hope to have the legal expertise or background of an attorney, of course, but they should be sufficiently knowledgeable about certain legal concepts that have implications for the business venture.[1]

Table 9.1 sets forth some of the major legal concepts that can affect entrepreneurial ventures. These concepts can be divided into three groups: (1) those that relate to the inception of the venture, (2) those that relate to the ongoing venture, and (3) those that relate to the growth and continuity of the venture. The focus of this chapter is on the legal concepts related to the first and third groups.

Table 9.1 Major Legal Concepts and Entrepreneurial Ventures

I. Inception of an Entrepreneurial Venture
- A. Laws governing intellectual property
  1. Patents
  2. Copyrights
  3. Trademarks
- B. Forms of business organization
  1. Sole proprietorship
  2. Partnership
  3. Corporation
  4. Franchise
- C. Tax considerations
- D. Capital formation
- E. Liability questions

II. An Ongoing Venture: Business Development and Transactions
- A. Personnel law
  1. Hiring and firing policies
  2. Equal Employment Opportunity Commission
  3. Collective bargaining
- B. Contract law
  1. Legal contracts
  2. Sales contracts
  3. Leases

III. Growth and Continuity of a Successful Entrepreneurial Venture
- A. Tax considerations
  1. Federal, state, local
  2. Payroll
  3. Incentives
- B. Governmental regulations
  1. Zoning (property)
  2. Administrative agencies (regulatory)
  3. Consumer law
- C. Continuity of ownership rights
  1. Property laws and ownership
  2. Wills, trusts, estates
  3. Bankruptcy

Specifically, we examine intellectual property protection (patents, copyrights, trademarks), the legal forms of organization, and bankruptcy law.

9-1 Intellectual Property Protection: Patents

LO9.2 Identify patent protection, including definitions and preparation

A patent provides the owner with exclusive rights to hold, transfer, and license the production and sale of the patented product or process. Design patents last for 15 years (before May 2015, it was 14 years), while all others last for 20 years. The objective of a patent is to provide the holder with a temporary monopoly on their innovation and thus to encourage the creation and disclosure of new ideas and innovations in the marketplace. Securing a patent, however, is not always an easy process.

A patent is an intellectual property right. It is the result of a unique discovery, and patent holders are provided protection against infringement by others. In general, a number of items can qualify for patent protection, among them processes, machines, products, plants, compositions of elements (chemical compounds), and improvements on already existing items.[2]

9-1a Securing a Patent: Basic Rules

Because quite often the patent process is complex (see Figure 9.1), careful planning is required. For pursuing a patent, the following basic rules are recommended by the experts:

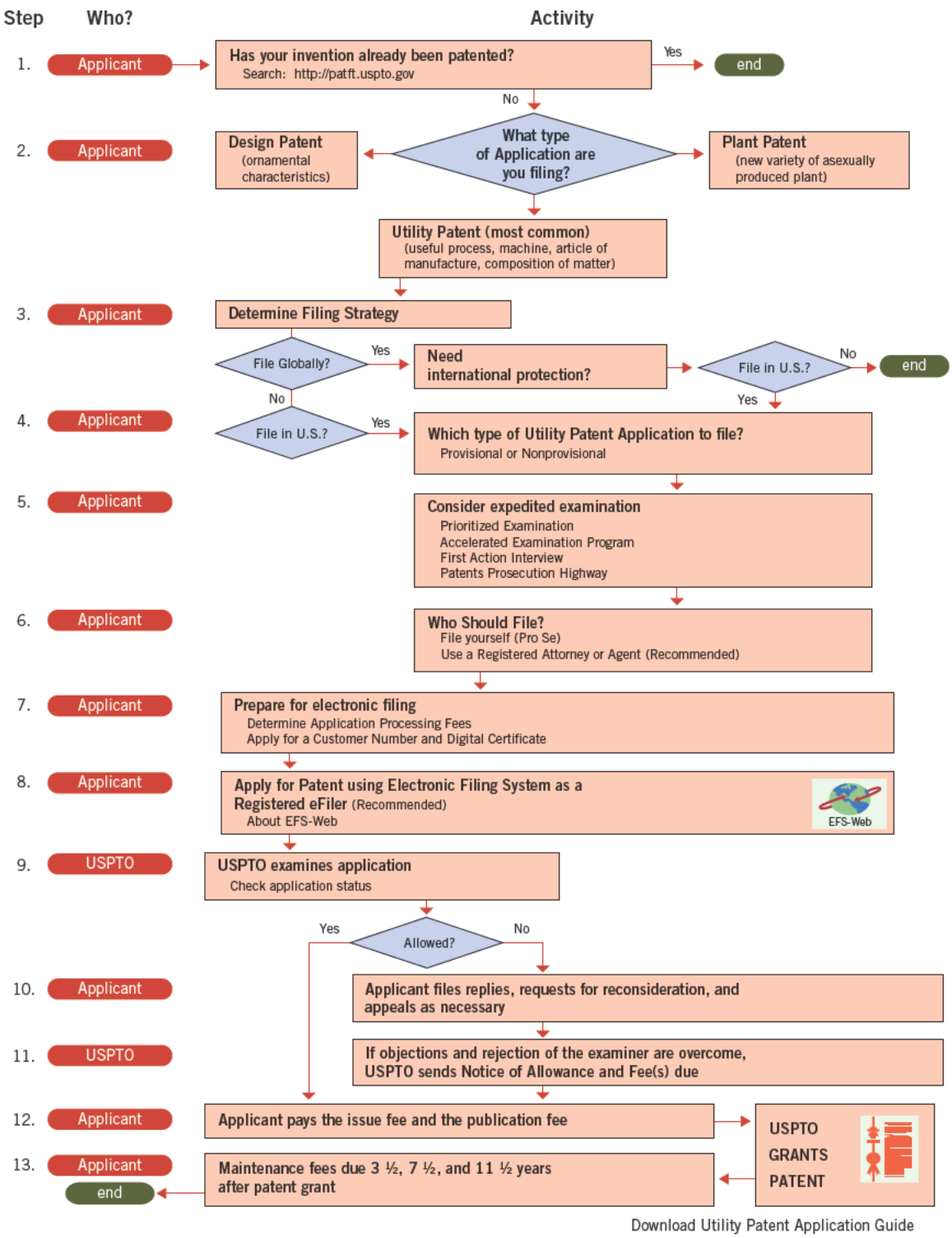
Rule 1: Pursue patents that are broad, are commercially significant, and offer a strong position. This means that relevant patent law must be researched to obtain the widest coverage possible on the idea or concept. In addition, there must be something significantly novel or proprietary about the innovation. Record all steps or processes in a notebook and have them witnessed so that documentation secures a strong proprietary position.

Rule 2: Prepare a patent plan in detail. This plan should outline the costs to develop and market the innovation as well as analyze the competition and technological similarities to your idea. Attempt to detail the precise value of the innovation.

Rule 3: Have your actions relate to your original patent plan. This does not mean that a plan cannot be changed. However, it is wise to remain close to the plan during the early stages of establishing the patent. Later, the path that is prepared may change—for example, licensing out the patent versus keeping it for yourself.

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Figure 9.1 Process for Obtaining a Patent



Source: U.S. Patent Office, 2015.

Rule 4: Establish an infringement budget. Patent rights are effective only if potential infringers fear legal damages. Thus, it is important to prepare a realistic budget for prosecuting violations of the patent.

Rule 5: Evaluate the patent plan strategically. The typical patent process takes three years. This should be compared to the actual life cycle of the proposed innovation or technology. Will the patent be worth

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defending in three years, or will enforcement cost more than the damages collected?[3]

These rules about proper definition, preparation, planning, and evaluation can help entrepreneurs establish effective patent protection. In addition, they can help the patent attorney conduct the search process.

9-1b Securing a Patent: The Application

Patent applications must include detailed specifications of the innovation that any skilled person in the specific area can understand. A patent application has two parts:

1. The **specification** is the text of a patent and may include any accompanying illustrations. Because its purpose is to teach those who are fluent in this area of technology all they need to understand, duplicate, and use the invention, it may be quite long. The specification typically includes the following:
   a. An introduction explaining why the invention will be useful.
   b. A description of all prior art that you are aware of and that could be considered similar to the invention. The specification usually lists other patents by number—with a brief description of each—but you can cite and describe unpatented technology as well.
   c. A summary of the invention that describes the essence of the new technology and emphasizes its difference from prior art while including all its requisite features, whether novel or not.
   d. A detailed description of the invention, including anything that could be remotely relevant, reference to all reasonable variations, and number bounds. Take as much space as you like. Use as many numbers as necessary, including close or tight limits based on experience as well as loose ones based on what might be possible. This section should be detailed enough to really teach a skilled practitioner.
   e. Examples and/or experimental results, in full detail.
   The specification is inherently broad because its intent is to teach and also, as a practical matter, to allow some flexibility in the claims that are based on it.
2. **Claims** are a series of short paragraphs, each of which identifies a particular feature or combination of features that is protected by the patent. The entire claims section, at the end of the patent, is typically about one page long or less.

Claims define and limit the patented invention. The invention can be broad (e.g., a process requiring an "inorganic, nonmetal solid" would cover a lot of possibilities) but sharply limited not to cover anything in prior art (other existing processes that use organics or metals).[4]

Once the application is filed with the **Patent and Trademark Office** of the Department of Commerce, an examiner will determine whether the innovation qualifies for patentability. The examiner will do this by researching technical data in journals as well as previously issued patents. Based on the individual's findings, the application will be rejected or accepted.

Only a small percentage of issued patents are commercially valuable. Consequently, the entrepreneur must weigh the value of the innovation against the time and money spent to obtain the patent. Also, it is important to remember that many patents granted by the Patent and Trademark Office have been declared invalid after being challenged in court. This occurs for several reasons. One is that the patent holder waited an unreasonable length of time before asserting their rights. A second is that those bringing suit against the patent holder are able to prove that the individual misused the patent rights—for example, by requiring certain purchases of other goods or services as part of the patent-use arrangement. A third is that other parties are able to prove that the patent itself fails to meet tests of patentability and is therefore invalid.[5]

If, after careful review, an entrepreneur concludes that the innovation will withstand any legal challenge and is commercially worthwhile, a patent should be pursued. If a challenge is mounted, legal fees may be sizable, but a successful defense can result in damages sufficient to compensate for the infringement plus court costs and interest. In fact, the court may award damages of up to three times the actual amount. In addition, a patent infringer can be liable for all profits resulting from the infringement as well as for legal fees.[6]

9-2 Intellectual Property Protection: Copyrights

LO9.3 Discuss copyrights and their relevance to entrepreneurs

A **copyright** provides exclusive rights to creative individuals for the protection of their literary or artistic productions. It is not possible to copyright an idea, but the particular mode for expression of that idea often can be copyrighted. This expression can take many forms, including books, periodicals, dramatic or musical compositions, art, motion pictures, lectures, sound recordings, and computer programs.

Any works created after January 1, 1978, and receiving a copyright are protected for the life of the author plus 70 years. The owner of this copyright may (1) reproduce the work, (2) prepare derivative works based on it (e.g., a condensation or movie version of a novel), (3) distribute copies of the work by sale or otherwise, (4) perform the work publicly, and (5) display the work publicly. Each of these rights (or a portion of each) also may be transferred.[7]

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9-2a Understanding Copyright Protection

For the author of creative material to obtain copyright protection, the material must be in a tangible form so it can be communicated or reproduced. It also must be the author's own work and thus the product of their skill or judgment. Concepts, principles, processes, systems, or discoveries are not valid for copyright protection until they are put in tangible form—written or recorded.

Formal registration of a copyright with the Copyright Office of the Library of Congress is a requirement before an author can begin a lawsuit for infringement. In addition, an author can find their copyright invalidated if proper notice isn't provided.

Anyone who violates an author's exclusive rights under a copyright is liable for infringement. However, because of the **fair use doctrine**, it is sometimes difficult to establish infringement. Fair use is described as the reproduction of a copyrighted work for purposes such as criticism, comment, news reporting, teaching (including multiple copies for classroom use), scholarship, or research. These uses may be good candidates for the fair use defense, as they may be deemed not an infringement of copyright. In determining whether the use made of a work in any particular case is a fair use, the factors to be considered include (1) the purpose and character of the use, including whether such use is of a commercial nature or is for nonprofit educational purposes; (2) the nature of the copyrighted work; (3) the amount and substantiality of the portion used in relation to the copyrighted work as a whole; and (4) the effect of the use on the potential market for a value of the copyrighted work.[8]

If, however, an author substantiates a copyright infringement, the normal remedy is recovery of actual damages plus any profits the violator receives. Keep in mind that there is absolutely no cost or risk involved in protecting material that you generate by copyright. Therefore, as a matter of course, any writing that you prepare and spend a lot of time on should be copyrighted by putting the copyright notice (©) on it. Also, it is not necessary to register copyrights with the Copyright Office unless and until you want to sue somebody for infringement. In the overwhelming majority of cases—assuming you are not in the publishing business—you can simply use the copyright notice and do not need to spend the time and effort necessary to register copyrights with the Copyright Office.

9-2b Protecting Ideas?

The Copyright Act specifically excludes copyright protection for any "idea, procedure, process, system, method of operation, concept, principle, or discovery, regardless of the form in which it is described, explained, illustrated, or embodied." Note that it is not possible to copyright an *idea*—the underlying ideas embodied in a work may be used freely by others. What is copyrightable is the particular way an idea is expressed. Whenever an idea and an expression are inseparable, the expression cannot be copyrighted.

Generally, anything that is not an original expression will not qualify for copyright protection. Facts widely known to the public are not copyrightable. Page numbers are not copyrightable because they follow a sequence known to everyone. Mathematical calculations are not copyrightable. Compilations of facts, however, are copyrightable. The Copyright Act defines a compilation as "a work formed by the collection and assembling of preexisting materials of data that are selected, coordinated, or arranged in such a way that the resulting work as a whole constitutes an original work of authorship."[9]

9-3 Intellectual Property Protection: Trademarks

LO9.4 Explain trademarks and their impact on new ventures

A **trademark** is a distinctive name, mark, symbol, or motto identified with a company's product(s) and registered at the Patent and Trademark Office. Thanks to trademark law, no confusion should result from one venture's using the symbol or name of another.

Specific legal terms differentiate the exact types of marks. For example, trademarks identify and distinguish goods. Service marks identify and distinguish services. Certification marks denote the quality, materials, or other aspects of goods and services and are used by someone other than the mark's owner. Collective marks are trademarks or service marks that members of groups or organizations use to identify themselves as the source of goods or services.[10]

Usually, personal names or words that are considered generic or descriptive are not trademarked unless the words are in some way suggestive or fanciful or the personal name is accompanied by a specific design. For example, "English Leather" may not be trademarked to describe a leather processed in England; however, English Leather is trademarked as a name for aftershave lotion because this constitutes a fanciful use of the words. Consider also that even the common name of an individual may be trademarked if that name is accompanied by a picture or some fanciful design that allows easy identification of the product, such as Smith Brothers Cough Drops.

In most cases, the Patent and Trademark Office will reject an application for marks, symbols, or names that are flags or insignias of governments, portraits or signatures of living persons, immoral or deceptive, or items likely to cause problems because of resemblance to a previously registered mark. Once issued, the trademark is listed in the Principal Register of the Patent and Trademark Office.

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This listing offers several advantages: (1) nationwide constructive notice of the owner's right to use the mark (thus eliminating the need to show that the defendant in an infringement suit had notice of the mark), (2) Bureau of Customs protection against importers using the mark, and (3) incontestability of the mark after five years.[11]

In 1995, Congress amended the Trademark Act by passing the Federal Trademark Dilution Act, which extended the protection available to trademark owners by creating a federal cause of action for trademark dilution. Until the passage of this amendment, federal trademark law prohibited only the unauthorized use of the same mark on competing—or on noncompeting but "related"—goods or services when such use would likely confuse consumers as to the origin of those goods and services. In 2006, Congress enacted a further amendment known as the Trademark Dilution Revision Act to protect "distinctive" or "famous" trademarks (such as McDonald's, Google, Nike, and Apple) from certain unauthorized uses of the marks *regardless* of a showing of competition or a likelihood of confusion.[12]

Historically, a trademark registration lasted 20 years; however, the current registrations are good for only 10 years, with the possibility for continuous renewal every 10 years. It is most important to understand that a trademark may be invalidated in four specific ways:

1. *Cancellation proceedings*. **Cancellation proceedings** constitute a third party's challenge to the mark's distinctiveness within five years of its issuance.
2. *Cleaning-out procedure*. The **cleaning-out procedure** is the failure of a trademark owner to file an affidavit stating it is in use or justifying its lack of use within six years of registration.
3. *Abandonment*. The nonuse of a trademark for two consecutive years without justification or a statement regarding the trademark's **abandonment**.
4. *Generic meaning*. **Generic meaning** refers to the allowance of a trademark to represent a general grouping of products or services. For example, cellophane has come to represent plastic wrap, and Scotch tape has come to represent adhesive tape. Xerox is currently seeking, through national advertising, to avoid having its name used to represent copier machines.

If a trademark is properly registered, used, and protected, the owner can obtain an injunction against any uses of the mark that are likely to cause confusion. Moreover, if infringement and damages can be proven in court, a monetary award may be given to the trademark holder.

9-3a Avoiding Trademark Pitfalls

Trademark registration and search can be costly, sometimes ranging into the thousands of dollars. Trademark infringement can be even more expensive. To avoid these pitfalls, one author has noted five basic rules that entrepreneurs should follow when selecting trademarks for their new ventures:

- Never select a corporate name or a mark without first doing a trademark search.
- If your attorney says you have a potential problem with a mark, trust their judgment.
- Seek a coined or fanciful name or mark before you settle for a descriptive or highly suggestive one.
- Whenever marketing or other considerations dictate the use of a name or mark that is highly suggestive of the product, select a distinctive logotype for the descriptive or suggestive words.
- Avoid abbreviations and acronyms wherever possible, and when no alternative is acceptable, select a distinctive logotype in which the abbreviation or acronym appears.[13]

9-3b Trade Secrets

Certain business processes and information cannot be patented, copyrighted, or trademarked. Yet they may be protected as **trade secrets**. Customer lists, plans, research and development, pricing information, marketing techniques, and production techniques are examples of potential trade secrets. Generally, anything that makes an individual company unique and has value to a competitor could be a trade secret.[14]

Protection of trade secrets extends both to ideas and to their expression. For this reason and because a trade secret involves no registration or filing requirements, trade-secret protection is ideal for software. Of course, the secret formula, method, or other information must be disclosed to key employees. Businesses generally attempt to protect their trade secrets by having all employees who use the process or information agree in their contracts never to divulge it. Theft of confidential business data by industrial espionage—such as stealing a competitor's documents—is a theft of trade secrets without any contractual violation and is actionable in itself.

The law clearly outlines the area of trade secrets: Information is a trade secret if (1) it is not known by the competition, (2) the business would lose its advantage if the competition were to obtain it, and (3) the owner has taken reasonable steps to protect the secret from disclosure.[15] Keep in mind that prosecution is still difficult in many of these cases.

9-3c Trademark Protection on the Internet

Because of the unique nature of the Internet, its use creates unique legal questions and issues—particularly with respect

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The Entrepreneurial Process

Parody or Trademark Infringement?

Parody is sometimes used as a defense against trademark infringement. A parody must convey two simultaneous and contradictory messages: not only that it is the original but also that it is not the original and is instead a parody. According to the Patent and Trademark Office, a true parody actually decreases the likelihood of confusion because the effect of the parody is to create a distinction in the viewer's mind between the actual product and the joke. The customer must be amused, not confused.

Haute Diggity Dog is a company that sells pet toys. They have made a number of parody products, including Chewnel No. 5, Jimmy Chew, and Dog Perignon. However, their parody pet toy called *Chewy Vuiton* enraged the Louis Vuitton company and their brand with a stylized LV monogram that represented to consumers an image of quality and exclusivity with products retailing from $995 to $4,500. *Chewy Vuiton* did mimic the shape, design, and color of Louis Vuitton's handbags, but instead of LV, the toy's pattern included a CV with a flower, cross, and diamond pattern that resembled but was not identical to the Vuitton pattern. The chew toy sold for less than $20 in pet stores.

The court ruled this to be a parody. The *Chewy Vuiton* toy was found to be similar, indicating that the toy is an imitation, but also was found to be different from the original handbags, being a small dog toy, not an expensive, luxury handbag. After finding that the *Chewy Vuiton* toy was a parody, the court still had to examine for infringement (i.e., whether the use created a likelihood of confusion).

To assess whether a trademark infringement has occurred, the courts consider seven factors: (1) the degree of similarity between the trademarks, (2) the similarity of the products for which the name is used, (3) the area and manner of concurrent use, (4) the degree of care likely to be exercised by consumers, (5) the strength of the complainant's trademark, (6) whether actual product confusion exists among buyers, and (7) an intent on the part of the alleged infringer to palm off their products as those of another.

The *Chewy Vuiton* parody was sufficiently similar to invoke the famous trademark in the minds of consumers yet still distinguish the products. The dissimilarity of the products was in Haute Diggity Dog's favor, as one product is a chew toy and the other a designer purse. Haute Diggity Dog's products generally were sold at pet stores with other pet products, including other parody products, while Louis Vuitton handbags generally are sold in Louis Vuitton boutiques or department stores.

Having found no trademark infringement, the court turned to the issue of dilution (Trademark Dilution Revision Act of 2006): whether Haute Diggity Dog's use of *Chewy Vuiton* was likely to impair the distinctiveness or harm the reputation of the Louis Vu tton marks. In doing this, courts examine a number of factors, including (1) the degree of similarity between the mark or trade name and the famous mark, (2) the degree of inherent or acquired distinctiveness of the famous mark, (3) the extent to which the owner of the famous mark is engaging in substantially exclusive use of the mark, (4) the degree of recognition of the famous mark, (5) whether the user of the mark or trade name intended to create an association with the famous mark, and (6) any actual association between the mark or trade name and the famous mark. Because the product was a parody, the court supported Haute Diggity Dog and found no violation against Louis Vuitton.

The *Chewy Vuiton* case brings to mind several questions that every entrepreneurial company should consider whenever attempting parody:

> *Is the parody humorous?* If it doesn't make you laugh, be concerned. In order to be an effective parody, it must communicate the necessary element of satire, ridicule, joking, or amusement.
>
> *Is the proposed trademark similar enough and different enough from the mark being parodied?* Haute Diggity Dog escaped liability as a trademark parody because each element of its mark and design were similar but not identical to the Louis Vuitton marks and design.
>
> *Is the proposed parody mark in a product line that is too close to those offered by the target?* In Chewy Vuiton, the products were dissimilar, and the court found it unlikely that Louis Vuitton would sell pet chew toys. Beware that courts have been very strict where the mark is used on a competing product.
>
> *Are you prepared for legal action?* Despite the fact that it was ultimately successful, Haute Diggity Dog spent several hundreds of thousands of dollars defending itself, lost distributors, and had merchandise sent back as a result of the lawsuit. Is it worth a legal battle with companies like Microsoft, Hard Rock Cafe, McDonald's, Coca-Cola, or Nike? Companies are getting more aggressive about protecting their trademarks, and an infringement suit filed by a well-funded company can mean years of legal issues and huge legal bills.
>
> Examples of other court rulings include the following:

- Hard Rain Cafe was likely to confuse consumers regarding the Hard Rock Cafe.
- Enjoy Cocaine was not a valid parody of Enjoy Coca-Cola, where both used the familiar red-and-white logo.
- Lardash was considered a valid parody of Jordache.
- Mutant of Omaha and the subtitle Nuclear Holocaust Insurance were not valid parodies of Mutual of Omaha.
- Bagzilla was a permissible pun of Godzilla and would not confuse consumers.
- Spy Notes was a valid parody of CliffsNotes.

Source: Adapted from Maxine S. Lans, "Parody as a Marketing Strategy," *Marketing News*, January 3, 1994, 20; Diane E. Burke, "Trademark Parody: Taking a Bite Out of Owner's Rights," 2009, http://www.steptoejohnson.com/publications/publicationstory/TrademarkParodyTakingaBiteOutof,249.aspx, accessed January 15, 2012; and Jane P. Mallor, A. James Barnes, Thomas Bowers, and Arlen W. Langvardt, *Business Law: The Ethical, Global, and E-Commerce Environment*, 15th ed. (New York: McGraw-Hill Irwin, 2013), 288–92.

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to intellectual property rights. The emerging body of law governing cyberspace is often referred to as *cyberlaw*.

One of the initial trademark issues involving intellectual property in cyberspace has been whether domain names (Internet addresses) should be treated as trademarks or simply as a means of access, similar to street addresses in the physical world. Increasingly, the courts are holding that the principles of trademark law should apply to domain names. One problem in applying trademark law to Internet domain names, however, is that trademark law allows multiple parties to use the same mark—as long as the mark is used for different goods or services and will not cause customer confusion. On the Internet as it is currently structured, only one party can use a particular domain name regardless of the type of goods or services offered. In other words, although two or more businesses can own the trademark Entrevision, only one business can operate on the Internet with the domain name Entrevision.com. Because of this restrictive feature of domain names, a question has arisen as to whether domain names should function as trademarks. To date, the courts that have considered this question have held that the unauthorized use of another's mark in a domain name may constitute trademark infringement.[16]

Table 9.2 provides a comprehensive outline of the forms of intellectual property protection.

9-4 Legal Forms for Entrepreneurial Ventures

LO9.5 Identify the legal forms of organization: sole proprietorship, partnership, and corporation

Prospective entrepreneurs need to identify the legal form or structure that will best suit the demands of the venture. The necessity for this derives from changing tax laws, liability situations, the availability of capital, and the complexity of business formation.[17] When examining these legal forms of organizations, entrepreneurs need to consider a few important factors:

- How easily the form of business organization can be implemented
- The amount of capital required to implement the form of business organization
- Legal considerations that might limit the options available to the entrepreneur

The Entrepreneurial Process

Internet Intellectual Property Information Sources

http://www.uspto.gov

The Patent and Trademark Office website provides a wealth of valuable information for entrepreneurs. Users can locate patent and trademark information, such as registration forms, international patents, legal issues, and frequently asked questions. Users can also check the status of a trademark or patent application on this site.

http://www.copyright.gov

The Copyright Office at the Library of Congress website provides information on copyright protecting works, licensing, and legal issues. Users also can search copyright records on the site.

http://www.law.cornell.edu

The website for the Legal Information Institute at the Cornell School of Law provides legal documentation and a history of copyright law. It also offers information on international copyrights and links to other copyright information resources.

http://www.findlaw.com

This site allows the user to search for any topic and yield returns of the actual written law, court precedents, and current cases and interpretations. The site also provides topical searches that aid the user in getting started as well as a business section to help put the laws into more practical applications.

https://www.cengage.com/s?q=business%20law&searchbtn=Search

Cengage Learning offers numerous business law textbooks. This website offers an overview of each book with updates that allow surfers to check contents before purchasing.

https://patentscope.wipo.int

Patentscope is the World Intellectual Property Organization's major international database where users can search through 101 million patent documents and gain access to patent statistics.

https://patents.google.com

Google Patents indexes granted and published patents from the Patent and Trademark Office, European Patent Office, and World Intellectual Property Organization databases.

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Table 9.2 Forms of Intellectual Property

	Patent	Copyright	Trademarks (Service Marks and Trade Dress)	Trade Secrets
Definition	A grant from the government that gives an inventor exclusive rights to an invention.	An intangible property right granted to authors and originators of a literary work or artistic production that falls within specified categories.	Any distinctive word, name, symbol, or device (image or appearance), or combination thereof, that an entity uses to identify and distinguish its goods or services from those of others.	Any information (including formulas, patterns, programs, devices, techniques, and processes) that a business possesses and that gives the business an advantage over competitors who do not know the information or process.
Requirements	An invention must be: 1. Novel. 2. Not obvious. 3. Useful.	Literary or artistic works must be: 1. Original. 2. Fixed in a durable medium that can be perceived, reproduced, or communicated. 3. Within a copyrightable category.	Trademarks, service marks, and trade dresses must be sufficiently distinctive (or must have acquired a secondary meaning) to enable consumers and others to distinguish the manufacturer's, seller's, or business user's products or services from those of competitors.	Information and processes that have commercial value, that are not known or easily ascertainable by the general public or others, and that are reasonably protected from disclosure.
Types or categories	1. Utility (general). 2. Design. 3. Plant (flowers, vegetables, and so on).	1. Literary works (including computer programs). 2. Musical works. 3. Dramatic works. 4. Pantomime and choreographic works. 5. Pictorial, graphic, and sculptural works. 6. Films and audiovisual works. 7. Sound recordings.	1. Strong, distinctive marks (such as fanciful, arbitrary, or suggestive marks). 2. Marks that have acquired a secondary meaning by use. 3. Other types of marks, including certification marks and collective marks. 4. Trade dress (such as a distinctive decor, menu, style, or type of service).	1. Customer lists. 2. Research and development. 3. Plans and programs. 4. Pricing information. 5. Production techniques. 6. Marketing techniques. 7. Formulas. 8. Compilations.
How acquired	By filing a patent application with the U.S. Patent and Trademark Office and receiving that office's approval.	Automatic (once in tangible form); to recover for infringement, the copyright must be registered with the U.S. Copyright Office.	1. At common law, ownership is created by use of mark. 2. Registration (either with the U.S. Patent and Trademark Office or with the appropriate state office) gives constructive notice of date of use. 3. Federal registration is permitted if the mark is currently in use or if the applicant intends use within six months (period can be extended to three years). 4. Federal registration can be renewed between the fifth and sixth years and, thereafter, every ten years.	Through the originality and development of information and processes that are unique to a business, that are unknown by others, and that would be valuable to competitors if they knew of the information and processes.

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Rights	An inventor has the right to make, use, sell, assign, or license the invention during the duration of the patent's term. The first to invent has patent rights.	The author or originator has the exclusive right to reproduce, distribute, display, license, or transfer a copyrighted work.	The owner has the right to use the mark or trade dress and to exclude others from using it. The right of use can be licensed or sold (assigned) to another	The owner has the right to sole and exclusive use of the trade secrets and the right to use legal means to protect against misappropriation of the trade secrets by others. The owner can license or assign a trade secret.
Duration	20 years from the date of application; for design patents, 14 years.	1. For authors: the life of the author, plus 70 years. 2. For publishers: 95 years after the date of publication or 120 years after creation.	Unlimited, as long as it is in use. To continue notice by registration, the registration must be renewed by filing.	Unlimited, as long as not revealed to others.
Civil remedies for infringement	Monetary damages, which include reasonable royalties and lost profits, plus attorneys' fees. (Treble damages are available for intentional infringement.)	Actual damages, plus profits received by the infringer; or statutory damages of not less than $500 and not more than $20,000 ($100,000, if infringement is willful); plus costs and attorneys' fees.	1. Injunction prohibiting future use of mark. 2. Actual damages, plus profits received by the infringer (can be increased to three times the actual damages under the Lanham Act). 3. Impoundment and destruction of infringing articles. 4. Plus costs and attorneys' fees.	Monetary damages for misappropriation (the Uniform Trade Secrets Act permits punitive damages up to twice the amount of actual damages for willful and malicious misappropriation); plus costs and attorneys' fees.

Source: Frank B. Cross and Roger LeRoy Miller, *West's Legal Environment of Business*, 4th ed. © 2001 Cengage Learning; see also Roger LeRoy Miller, *The Legal Environment Today*, 10th ed. (Mason, OH: Cengage, 2022).

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- The tax effects of the form of organization selected
- The potential liability to the owner of the form of organization selected

Three primary legal forms of organization are the sole proprietorship, the partnership, and the corporation. Because each form has specific advantages and disadvantages, it is impossible to recommend one form over the other. The entrepreneur's specific situation, concerns, and desires will dictate this choice.[18]

9-4a Sole Proprietorships

A **sole proprietorship** is a business that is owned and operated by one person. The enterprise has no existence apart from its owner. This individual has a right to all of the profits and bears all of the liability for the debts and obligations of the business. The individual also has **unlimited liability**, which means that their business and personal assets stand behind the operation. If the company cannot meet its financial obligations, the owner may be forced to sell the family car, house, and whatever assets would satisfy the creditors.

To establish a sole proprietorship, a person merely needs to obtain whatever local and state licenses are necessary to begin operations. If the proprietor chooses a fictitious or assumed name, they also must file a *certificate of assumed business name* with the county. Because of its ease of formation, the sole proprietorship is the most widely used legal form of organization.[19]

Advantages of Sole Proprietorships

LO9.6 List the advantages and disadvantages of each of these three legal forms

Some of the advantages associated with sole proprietorships are as follows:

- *Ease of formation.* Less formality and fewer restrictions are associated with establishing a sole proprietorship than with any other legal form. The proprietorship needs little or no governmental approval, and it usually is less expensive than a partnership or corporation.
- *Sole ownership of profits.* The proprietor is not required to share profits with anyone.
- *Decision making and control vested in one owner.* No co-owners or partners must be consulted in the running of the operation.
- *Flexibility.* Management is able to respond quickly to business needs in the form of day-to-day management decisions as governed by various laws and good sense.
- *Relative freedom from governmental control.* Except for requiring the necessary licenses, very little governmental interference occurs in the operation.
- *Freedom from corporate business taxes.* Proprietors are taxed as individual taxpayers and not as businesses.

Disadvantages of Sole Proprietorships

Sole proprietorships also have disadvantages. Some of these are as follows:

- *Unlimited liability.* The individual proprietor is personally responsible for all business debts. This liability extends to *all* of the proprietor's assets.
- *Lack of continuity.* The enterprise may be crippled or terminated if the owner becomes ill or dies.
- *Less available capital.* Ordinarily, proprietorships have less available capital than other types of business organizations, such as partnerships and corporations.
- *Relative difficulty obtaining long-term financing.* Because the enterprise rests exclusively on one person, it often has difficulty raising long-term capital.
- *Relatively limited viewpoint and experience.* The operation depends on one person, and this individual's ability, training, and expertise will limit its direction and scope.

9-4b Partnerships

A **partnership**, as defined by the **Revised Uniform Partnership Act (RUPA),** is an association of two or more persons who act as co-owners of a business for profit. Each partner contributes money, property, labor, or skills, and each shares in the profits (as well as the losses) of the business.[20] Although not specifically required, written articles of partnership are usually executed and are always recommended. This is because, unless otherwise agreed to in writing, the courts assume equal partnership—that is, equal sharing of profits, losses, assets, management, and other aspects of the business.

The articles of partnership clearly outline the financial and managerial contributions of the partners and carefully delineate the roles in the partnership relationship, including such items as duration of agreement, character of partners (general or limited, active or silent), division of profits and losses, salaries, death of a partner (dissolution and windup), authority (individual partner's authority on business conduct), settlement of disputes, and additions, alterations, or modifications of partnership.

In addition to the written articles, entrepreneurs must consider a number of different types of partnership arrangements. Depending on the needs of the enterprise, one or more of these may be used. Examples include the percentage of financial investment of each partner, the amount of managerial control

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of each partner, and the actual duties assigned to each partner. It is important to remember that in a typical partnership arrangement, at least one partner must be a general partner who is responsible for the debts of the enterprise and who has unlimited liability.[21]

Advantages of Partnerships

The advantages associated with the partnership form of organization are as follows:

- *Ease of formation*. Legal formalities and expenses are few compared with those for creating a more complex enterprise, such as a corporation.
- *Direct rewards*. Partners are motivated to put forth their best efforts by direct sharing of the profits.
- *Growth and performance facilitated*. It often is possible to obtain more capital and a better range of skills in a partnership than in a sole proprietorship.
- *Flexibility*. A partnership often is able to respond quickly to business needs in the form of day-to-day decisions.
- *Relative freedom from governmental control and regulation*. Very little governmental interference occurs in the operation of a partnership.
- *Possible tax advantage*. Most partnerships pay taxes as individuals, thus escaping the higher rate assessed against corporations.

Disadvantages of Partnerships

Partnerships also have disadvantages. Some of these are as follows:

- *Unlimited liability of at least one partner*. Although some partners can have limited liability, at least one must be a general partner who assumes unlimited liability.
- *Lack of continuity*. If any partner dies, is adjudged insane, or simply withdraws from the business, the partnership arrangement ceases. However, operation of the business can continue based on the right of survivorship and the possible creation of a new partnership by the remaining members or by the addition of new members.
- *Relative difficulty obtaining large sums of capital*. Most partnerships have some problems raising a great deal of capital, especially when long-term financing is involved. Usually, the collective wealth of the partners dictates the amount of total capital the partnership can raise, especially when first starting out.
- *Bound by the acts of just one partner*. A general partner can commit the enterprise to contracts and obligations that may prove disastrous to the enterprise in general and to the other partners in particular.
- *Difficulty of disposing of partnership interest*. The buyout of a partner may be difficult unless specifically arranged for in the written agreement.

9-4c Corporations

According to Supreme Court Justice John Marshall (1819), a **corporation** is "an artificial being, invisible, intangible, and existing only in contemplation of the law." As such, a corporation is a separate legal entity apart from the individuals who own it. A corporation is created by the authority of state laws and usually is formed when a transfer of money or property by prospective shareholders (owners) takes place in exchange for capital stock (ownership certificates) in the corporation.[22] The procedures ordinarily required to form a corporation are (1) that subscriptions for capital stock must be taken and a tentative organization created and (2) that approval must be obtained from the secretary of state in the state in which the corporation is to be formed. This approval is in the form of a charter for the corporation that states the powers and limitations of the particular enterprise. Corporations that do business in more than one state must comply with federal laws regarding interstate commerce and with the varying state laws that cover foreign (out-of-state) corporations.

Advantages of Corporations

Some of the advantages associated with corporations are as follows:

- *Limited liability*. The stockholder's liability is limited to the individual's investment. This is the most money the person can lose.
- *Transfer of ownership*. Ownership can be transferred through the sale of stock to interested buyers.
- *Unlimited life*. The company has a life separate and distinct from that of its owners and can continue for an indefinite period of time.
- *Relative ease of securing capital in large amounts*. Capital can be acquired through the issuance of bonds and shares of stock and through short-term loans made against the assets of the business or personal guarantees of the major stockholders.
- *Increased ability and expertise*. The corporation is able to draw on the expertise and skills of a number of individuals, ranging from the major stockholders to the professional managers who are brought on board.

Corporations also have disadvantages. Some of these are as follows:

- *Activity restrictions*. Corporate activities are limited by the charter and by various laws.
- *Lack of representation*. Stockholders with a minority share of stock are sometimes outvoted by

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The Entrepreneurial Process

Incorporating on the Web

Today, forming a corporation is easier than ever. Individuals who wish to form a corporation can simply access the services of one of the many companies that provide online incorporation services. Although one has always been able to incorporate in states outside of their residence, online incorporation service providers have made this process much more simple. Delaware has been the favorite of many out-of-state incorporations over the past several years. This is due, in large part, to the state's limited restrictions on the formation and operation of corporations.

Web Incorporation Firms

Hundreds of firms offer online incorporation services, and most of these firms offer a very simple process for incorporation in any state. Most of these sites also offer valuable information, such as the various forms of corporation and the positives and negatives of the different options, frequently asked questions on incorporation, the cost of incorporation and maintenance of a corporation, and advantages and disadvantages of incorporation. Harvard Business Services (http://www.delawareinc.com), The Company Corporation (http://www.incorporate.com), and American Incorporators Ltd (http://www.ailcorp.com) are a few examples of these online incorporation firms. Entrepreneurs also can simply search using a search engine by typing in the word "incorporation" to locate other online incorporation firms.

Considerations for the Entrepreneur

The entrepreneur must consider the future of the business that they wish to incorporate. In most cases, online incorporation is fine for individuals who are interested in starting smaller businesses with limited growth potential, but other avenues are recommended for entrepreneurs who plan to start a business with higher growth potential. If high growth is possible and a large amount of funding is likely necessary, then entrepreneurs are recommended to seek legal counsel through the process of incorporation.

How to Incorporate on the Web

In most cases, filing for incorporation on the Web is as simple as filling out an online incorporation form on one of these firms' websites. The firms then take this information and file the necessary forms at the state office in which the entrepreneur wishes to incorporate. The given state will then issue a certificate of incorporation.

those with a majority of the stock and force their will on the others.

- *Regulation.* Extensive governmental regulations and reports required by local, state, and federal agencies often result in a great deal of paperwork and red tape.
- *Organizing expenses.* A multitude of expenses are involved in forming a corporation.
- *Double taxation.* Income taxes are levied both on corporate profits and on individual salaries and dividends.

Table 9.3 compares the characteristics of sole proprietorships, partnerships, and corporations.

9-5 Partnerships and Corporations: Specific Forms

A number of specific forms of partnerships and corporations warrant special attention. The following sections examine these.

9-5a Limited Partnerships

LO9.7 Explain the nature of the limited partnership and limited liability partnerships

Limited partnerships are used in situations where a form of organization is needed that permits capital investment without responsibility for management *and* without liability for losses beyond the initial investment. Such an organization allows the right to share in the profits with limited liability for the losses.

Limited partnerships are governed by the Revised Uniform Limited Partnership Act.[23] The act contains 11 articles and 64 sections of guidelines covering areas such as (1) general provisions, (2) formation, (3) limited partners, (4) general partners, (5) finance, (6) distributions and withdrawals, (7) assignment of partnership interest, (8) dissolution, (9) foreign limited partnerships, (10) derivative actions, and (11) miscellaneous. If a limited partnership appears to be the desired legal form of organization, the prospective partners must examine this act's guidelines.

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Table 9.3 General Characteristics of Forms of Business

	Sole Proprietorship	Partnership	Limited Liability Partnership	Limited Partnership	Limited Liability Limited Partnership	Corporation	S Corporation	Limited Liability Company
Formation	When one person owns a business without forming a corporation or LLC	By agreement of owners or by default when two or more owners conduct business together without forming a limited partnership, an LLC, or a corporation	By agreement of owners; must comply with limited liability partnership statute	By agreement of owners; must comply with limited partnership statute	By agreement of owners; must comply with limited liability limited partnership statute	By agreement of owners; must comply with corporation statute	By agreement of owners; must comply with corporation state; must elect S Corporation status under Subchapter S of Internal Revenue Code	By agreement of owners; must comply with limited liability company statute
Duration	Terminates on death or withdrawal of sole proprietor	Usually unaffected by death or withdrawal of partner	Unaffected by death or withdrawal of partner	Unaffected by death or withdrawal of partner, unless sole general partner dissociates	Unaffected by death or withdrawal of partner, unless sole general partner dissociates	Unaffected by death or withdrawal of shareholder	Unaffected by death or withdrawal of shareholder	Usually unaffected by death or withdrawal of member
Management	By sole proprietor	By partners	By partners	By general partners	By general partners	By board of directors	By board of directors	By managers or members
Owner liability	Unlimited	Unlimited	Mostly limited to capital contribution	Unlimited for general partners; limited to capital contribution for limited partners	Limited to capital contribution	Limited to capital contribution	Limited to capital contribution	Limited to capital contribution
Transferability of owners' interest	None	None	None	None, unless agreed otherwise	None, unless agreed otherwise	Freely transferable, although shareholders may agree otherwise	Freely transferable, although shareholders usually agree otherwise	None, unless agreed otherwise
Federal income taxation	Only sole proprietor taxed	Only partners taxed	Usually only partners taxed; may elect to be taxed like a corporation	Usually only partners taxed; may elect to be taxed like a corporation	Usually only partners taxed; may elect to be taxed like a corporation	Corporation taxed; shareholders taxed on dividends (double tax)	Only shareholders taxed	Usually only members taxed; may elect to be taxed like a corporation

Source: Jamie D. Prenkert, A. James Barnes, Joshua E. Perry, Todd Haugh, and Abbey Stemler, *Business Law: The Ethical, Global, and Digital Environment*, 18th ed. (New York: McGraw-Hill, 2022), 37-B. © The McGraw-Hill Companies, Inc.

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9-5b Limited Liability Partnerships

The **limited liability partnership (LLP)** is a relatively new form of partnership that allows professionals the tax benefits of a partnership while avoiding personal liability for the malpractice of other partners. If a professional group organizes as an LLP, innocent partners are not personally liable for the wrongdoing of the other partners.

The LLP is similar to the *limited liability company* discussed later. The difference is that LLPs are designed more for professionals who normally do business as a partnership. As with limited liability companies, LLPs must be formed and operated in compliance with state statutes.

One of the reasons why LLPs are becoming so popular among professionals is that most statutes make it relatively easy to establish an LLP. This is particularly true for an already formal partnership.

Converting from a partnership to an LLP also is easy because the firm's basic organizational structure remains the same. Additionally, all of the statutory and common-law rules governing partnerships still apply (apart from those modified by the LLP statute). Normally, LLP statutes are simply amendments to a state's already existing partnership law.[24]

The **limited liability limited partnership (LLLP)** is a relatively new variant of the limited partnership. An LLLP has elected limited liability status for all of its partners, including general partners. Except for this liability status of general partners, limited partnerships and LLLPs are identical (see Table 9.4 for characteristics of limited partnerships and LLLPs).

9-5c S Corporations

LO9.8 Discuss how an S corporation works

Formerly termed a Subchapter S corporation, the **S corporation** takes its name from Subchapter S of the Internal Revenue Code, under which a business can seek to avoid the imposition of income taxes at the corporate level yet retain some of the benefits of a corporate form (especially the limited liability).

Commonly known as a "tax option corporation," an S corporation is taxed similarly to a partnership. Only an information form is filed with the Internal Revenue Service to indicate the shareholders' income. In this manner, the double-taxation problem of corporations is avoided. Corporate income is not taxed but instead flows to the personal income of shareholders of businesses and is taxable at that point.

Although this is very useful for small businesses, strict guidelines must be followed:

1. The corporation must be a domestic corporation.
2. The corporation must not be a member of an affiliated group of corporations.
3. The shareholders of the corporation must be individuals, estates, or certain trusts. Corporations,

Table 9.4 Principal Characteristics of Limited Partnerships and LLPs

1. A limited partnership or LLLP may be *created only in accordance with a statute.*
2. A limited partnership or LLLP has two types of partners: *general partners* and *limited partners*. It must have one or more of each type.
3. All partners, limited and general, *share the profits* of the business.
4. Each limited partner has liability *limited to their capital contribution* to the business. Each general partner of a limited partnership has *unlimited liability* for the obligations of the business. A general partner in an LLLP, however, has liability *limited to their capital contribution.*
5. Each general partner has a *right to manage* the business, and they are agents of the limited partnership or LLLP. A limited partner has *no right to manage* the business or to act as its agent, but they do have the right to vote on fundamental matters. A limited partner may manage the business yet retain limited liability for partnership obligations.
6. General partners, as agents, are *fiduciaries* of the business. Limited partners are not fiduciaries.
7. A partner's rights in a limited partnership or LLLP *are not freely transferable.* A transferee of a general or limited partnership interest in not a partner but is entitled only to the transferring partner's share of capital and profits.
8. The death or other withdrawal of a partner does not dissolve a limited partnership or LLLP, unless there is no surviving general partner.
9. Usually, a limited partnership or LLLP is taxed like a partnership.

Source: Adapted from Jamie D. Prenkert, A. James Barnes, Joshua E. Perry, Todd Haugh, and Abbey Stemler, *Business Law: The Ethical, Global, and Digital Environment*, 18th ed. (New York: McGraw-Hill, 2022), 40-10.

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partnerships, and nonqualifying trusts cannot be shareholders.

4. The corporation must have 100 or fewer shareholders.
5. The corporation must have only one class of stock, although not all shareholders need have the same voting rights.
6. No shareholder of the corporation may be a nonresident alien.

The S corporation offers a number of benefits. For example, when the corporation has losses, Subchapter S allows the shareholders to use these losses to offset taxable income. Also, when the stockholders are in a tax bracket lower than that of the corporation, Subchapter S causes the company's entire income to be taxed in the shareholders' bracket whether or not it is distributed. This is particularly attractive when the corporation wants to accumulate earnings for future business purposes.

The taxable income of an S corporation is taxable only to those who are shareholders at the end of the corporate year when that income is distributed. The S corporation can choose a fiscal year that will permit it to defer some of its shareholders' taxes. This is important because undistributed earnings are not taxed to the shareholders until after the corporation's (not the shareholders') fiscal year. In addition, the shareholder in an S corporation can give some of their stock to other members of the family who are in a lower tax bracket. Additionally, up to six generations of one family may elect to be treated as one shareholder. Finally, an S corporation can offer some tax-free corporate benefits. These benefits typically mean federal tax savings to the shareholders.

9-5d Limited Liability Companies

Since 1977, an increasing number of states have authorized a new form of business organization called the **limited liability company** (**LLC**). The LLC is a hybrid form of business enterprise that offers the limited liability of a corporation but the tax advantages of a partnership.

LO9.9 Define the additional classifications of corporations, including limited liability companies (LLCs), B corporations, and low-profit, limited liability companies (L3Cs)

A major advantage of the LLC is that it does not pay taxes on an entity; rather, profits are "passed through" the LLC and paid personally by company members. Another advantage is that the liability of members is limited to the amount of their investments. In an LLC, members are allowed to participate fully in management activities, and—under at least one state's statute—the firm's managers need not even be LLC members. Yet another advantage is that corporations and partnerships, as well as foreign investors, can be LLC members. Also, no limit exists on the number of LLC shareholder members.

The disadvantages of the LLC are relatively few. Perhaps the greatest disadvantage is that LLC statutes differ from state to state, and thus any firm engaged in multistate operations may face difficulties. In an attempt to promote some uniformity among the states in respect to LLC statutes, the National Conference of Commissioners on Uniform State Laws adopted the Revised Uniform Limited Liability Company Act in 2006. However, as of 2023, only 20 states had adopted it. Until all of the states have adopted the uniform law, an LLC in one state will have to check the rules in the other states in which the firm does business to ensure that it retains its limited liability.[25]

9-5e B Corporations

As discussed in Chapter 4, there is a new legal form of a socially responsible corporation being introduced across the United States—the **B corporation**. Certified B corporations are a new way for businesses to solve social and environmental problems. B Lab, a nonprofit organization, certifies B corporations. B corporations address two critical problems:

1. Corporate laws make it difficult for businesses to consider employee, community, and environmental interests in their decision making.
2. The lack of transparent standards makes it difficult to tell the difference between a socially proactive company and just good marketing.

To address these issues, B corporations' legal structure expands corporate accountability so that they are required to make decisions that are good for society, not just their shareholders. B corporations' performance standards enable consumers to support businesses that align with their values, investors to drive capital to higher-impact investments, and governments and multinational corporations to implement sustainable procurement policies.

B corporations have specific requirements, including the following:

1. Comprehensive and transparent social and environmental performance standards
2. Higher legal accountability standards
3. Expected relations with constituencies established for public policies that support sustainable business

There are over 4,000 certified B corporations across 150 different industries (from food and apparel to attorneys and office supplies). B corporations may be quite diverse, but they share one unifying goal: *to redefine success in business*. Through a company's public B Impact Report, anyone can access performance data about the social and environmental practices that stand behind their products.[26]

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9-5f L3C

A low-profit, limited liability company, known as the **L3C**, can provide a structure that facilitates investments in socially beneficial, for-profit ventures. In 2008, Vermont became the first state to recognize the L3C as a legal corporate structure; however, similar legislation has been introduced in Georgia, Michigan, Montana, and North Carolina. Currently, the L3C is legal for activity all across the United States because it is designed to attract private investments and philanthropic capital in ventures designed to provide a social benefit. Unlike a standard LLC, the L3C has an explicit primary charitable mission and only a secondary profit concern. But unlike a charity, the L3C is free to distribute the profits, after taxes, to owners or investors. A principal advantage of the L3C is its qualification as a "program-related investment" (PRI). That means it is an investment with a socially beneficial purpose that is consistent with a foundation's mission. Because foundations can directly invest only in for-profit ventures qualified as PRIs, the L3C's operating agreement specifically outlines its respective PRI-qualified purpose in being formed, making it easier for foundations to identify social-purpose businesses as well as helping to ensure that their tax exemptions remain secure. L3Cs could attract a greater amount of private capital from various sources in order to serve their charitable or education goals. As of 2020, there were 1,700 L3Cs operating in the United States.

Similar to the standard LLC, the L3C is able to form flexible partnerships where ownership rights are set to meet the requirements of each partner. This flexibility permits a tiered ownership structure. Because a foundation can invest through PRIs at less than the market rate while embracing higher risk levels, this lowers the risk to other investors and increases their potential rate of return. So the remaining L3C memberships can then be marketed at risk/return profiles necessary to attract market-driven investors. The end result: the L3C is able to leverage PRIs to access a wide range of investment dollars. Like the standard LLC, profits and losses flow through the L3C to its members and are taxed according to each investor's particular tax situation.[27]

9-6 Final Thoughts on Legal Forms

As mentioned earlier, an entrepreneur always should seek professional legal advice to avoid misunderstandings, mistakes, and, of course, added expenses. The average entrepreneur encounters many diverse problems and stumbling blocks in venture formation. Because many entrepreneurs do not have a thorough knowledge of law, accounting, real estate, taxes, and governmental regulations, an understanding of certain basic concepts in these areas is imperative.

The material in this chapter is a good start toward understanding the legal forms of organizations. It can provide entrepreneurs with guidelines for seeking further and more specific advice on the legal form that appears most applicable to their situation.

9-7 Bankruptcy

LO9.10 Identify the major segments of the bankruptcy law that apply to entrepreneurs

Bankruptcy occurs when a venture's financial obligations are greater than its assets. No entrepreneur intentionally seeks bankruptcy. Although problems occasionally can arise out of the blue, following are several ways to foresee impending failure: (1) new competition enters the market, (2) other firms seem to be selling products that are a generation ahead, (3) the research and development budget is proportionately less than the competition's, and (4) retailers always seem to be overstocked.[28]

9-7a The Bankruptcy Act

The **Bankruptcy Act** is a federal law that provides for specific procedures to handle **insolvent debtors**—those who are unable to pay debts as they become due. The initial act of 1912 was completely revised in 1978; significant amendments were added in 1984, 1986, and 1994 and the most substantial revision in 2005. The purposes of the Bankruptcy Act are (1) to ensure that the property of the debtor is distributed fairly to the creditors, (2) to protect creditors from having debtors unreasonably diminish their assets, and (3) to protect debtors from extreme demands by creditors. The law was set up to provide assistance to both debtors and creditors.

Each of the various types of bankruptcy proceedings has its own particular provisions. For purposes of business ventures, the three major sections are called straight bankruptcy (Chapter 7), reorganization (Chapter 11), and adjustment of debts (Chapter 13). Table 9.5 provides a comparison of these three types of bankruptcies. The following sections examine each type.

9-7b Chapter 7: Straight Bankruptcy

Chapter 7 bankruptcy, sometimes referred to as **liquidation**, requires the debtor to surrender all property to a trustee appointed by the court. The trustee then sells the assets and turns the proceeds over to the creditors. The remaining debts (with certain exceptions) are then discharged, and the debtor is relieved of their obligations.

A liquidation proceeding may be voluntary or involuntary. In a voluntary bankruptcy, the debtor files a petition with a bankruptcy court that provides a list of all creditors, a statement of financial affairs, a list of all owned property, and a list of current income and expenses. In

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Table 9.5 Bankruptcy: A Comparison of Chapters 7, 11, and 13

	Chapter 7	Chapter 11	Chapter 13
Purpose	Liquidation	Reorganization	Adjustment
Who can petition	Debtor (voluntary) or creditors (involuntary)	Debtor (voluntary) or creditors (involuntary)	Debtor (voluntary) only
Who can be a debtor	Any "person" (including partnerships and corporations) except railroads, insurance companies, banks, savings and loan institutions, and credit unions. Farmers and charitable institutions cannot be involuntarily petitioned.	Any debtor eligible for Chapter 7 relief.	Any individual (not partnerships or corporations) with regular income who owes fixed unsecured debt of less than $360,475 or secured debt of less than $1,081,400.
Basic procedure	Nonexempt property is sold with proceeds to be distributed (in order) to priority groups. Dischargeable debts are terminated.	A plan is submitted and, if it is approved and followed, debts are discharged.	A plan is submitted in which unsecured creditors must receive at least liquidation value. If it is approved and followed, debts are discharged.
Advantages	On liquidation and distribution, most debts are discharged, and the debtor has an opportunity for a fresh start.	The debtor continues in business. The plan allows for a reorganization and liquidation of debts over the plan period.	The debtor continues in business or keeps possession of assets. If the plan is approved, most debts are discharged after a three-to five-year period.

Source: Adapted from Jamie D. Prenkert, A. James Barnes, Joshua E. Perry, Todd Haugh, and Abbey Stemler, *Business Law: The Ethical, Global, and Digital Environment*, 18th ed. (New York: McGraw-Hill, 2022), 30–32; see also Kenneth W. Clarkson and Roger LeRoy Miller, *Business Law,* 15th ed. (Mason, OH: Cengage, 2021).

an involuntary bankruptcy, the creditors force the debtor into bankruptcy. For this to occur, 12 or more creditors (of which at least three have a total of $16,750 of claims) must exist; if fewer than 12 exist, one or more creditors must have a claim of $16,750 against the debtor.[29]

9-7c Chapter 11: Reorganization

Reorganization is the most common form of bankruptcy. Under this format, a debtor attempts to formulate a plan to pay a portion of the debts, have the remaining sum discharged, and continue to stay in operation. The plan is essentially a contract between the debtor and creditors. In addition to being viewed as "fair and equitable," the plan must (1) divide the creditors into classes, (2) set forth how each creditor will be satisfied, (3) state which claims or classes of claims are impaired or adversely affected by the plan, and (4) provide the same treatment to each creditor in a particular class.

The same basic principles that govern Chapter 7 bankruptcy petitions also govern the Chapter 11 petitions. The proceedings may be either voluntary or involuntary, and the provisions for protection and discharge are similar to the Chapter 7 regulations.

Once an order for relief (the petition) is filed, the debtor in a Chapter 11 proceeding continues to operate the business as a **debtor-in-possession**, which means that the court appoints a trustee to oversee the management of the business. The plan is then submitted to the creditors for approval. Approval generally requires that creditors holding two-thirds of the amount and one-half of the number of each class of claims impaired by the plan must accept it. Once approved, the plan goes before the court for confirmation. If the plan is confirmed, the debtor is responsible for carrying it out.[30]

Once the plan is confirmed by the creditors, it is binding for the debtor. This type of bankruptcy provides an alternative to liquidating the entire business and thus extends to the creditors and debtor the benefits of keeping the enterprise in operation.

9-7d Chapter 13: Adjustment of Debts

Under this arrangement, individuals are allowed to (1) avoid a declaration of bankruptcy, (2) pay their debts in installments, and (3) be protected by the federal court. Individuals or sole proprietors with unsecured debts of less than $465,275 and secured debts of less than $1,395,875 are eligible to file under a Chapter 13 procedure. This petition must be voluntary only; creditors are not allowed to file a Chapter 13 proceeding. In the petition, the debtor declares an inability to pay their debts and requests some form of extension through future

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Diversity in Entrepreneurship

Remote Work's Impact on Diversity, Equity, and Inclusion

The COVID-19 pandemic has shaken many parts of our lives, including work. The number of remote jobs has exploded, and so has the desire to work remotely. According to one survey, fewer than 20 percent of employees who currently work remotely report wanting to return to daily commuting. The shift to remote work may have had a positive effect on productivity for many employees; however, we need to acknowledge that this shift has also had important implications on diversity, equity, and inclusion initiatives.

Remote work has the potential to open the company doors to a diverse pool of candidates and enable more inclusive environments. This is especially true for those employees who might otherwise be excluded from many job opportunities due to disabilities, lack of daily commuting options, or caregiving responsibilities. For example, a person with chronic health issues no longer needs to navigate workplace accommodations and is able to perform the duties from home, where the person feels most comfortable. However, the company needs to be careful about how it treats in-person, hybrid, and remote workers. As much as remote work enables many equity-enhancing opportunities, it also possesses equity-reducing threats. It is easy to imagine how a mixture of an in-person and remote workforce could enable people with a wider variety of backgrounds and abilities to work for the company yet how those who work remotely all or most of the time could potentially be disadvantaged when it comes to career advancement opportunities and promotions.

One of the key aspects that leaders should consider when creating an inclusive workplace is the use of collaborative technology that connects remote or hybrid employees with those working in person. While having the same access to the same tools and benefits across the board is paramount, so is the way that the technology is used. Leaders have the potential to use collaboration tools and online skills training initiatives to encourage participation of the voices that might otherwise not have been heard in a traditional office setting. Many of us have experienced the disconnect in conversations between those who were attending a meeting in person and those who connected online. The remote employees would try to contribute to the conversation, while in-person employees would have difficulties hearing them speak and might misinterpret their inputs. These conversations would end with discussions among in-person employees, while remote employees were often forgotten.

It is important not only that these tools are accessible but also that they are used to promote inclusion, education, and a sense of open community to foster a culture of equality. A recent survey found that employees of color, caregivers, and women are most likely to prefer remote or hybrid work, which makes it that much more important to create a workplace of inclusivity and equal opportunity so as to not risk marginalizing specific demographic groups, which would counteract any positive efforts in hiring a diverse workforce.

While remote work can connect a more diverse group of people, it can also cause some candidates to feel disconnected and unproductive. Many people do enjoy connecting with other employees during lunch or stopping by each other's desk in between tasks. Because an individual has chosen a remote type of work does not mean that the person does not care for casual office conversations or forming connections with coworkers. This is especially true for those individuals who consider remote work not an option but a necessity. Companies should offer employees tools and resources to build spaces where they can feel supported and connected to others, such as with Employee Resource Groups (ERGs). Google, for example, has created ERGs that bring together employees with shared interests, experiences, or backgrounds to provide them with a sense of community and belonging that supports them while they try to navigate the changing work landscape. Google's ERGs build a community by hosting virtual yoga sessions, career development sessions, global summits, or dedicated "office hours" for employees to sign up to talk to a peer about anything that is on their mind. Another popular tool for maintaining a virtual company culture is Slack. In Slack, work happens in channels—dedicated spaces for all the right people to have focused discussions on a specific topic. In lieu of working in the same location together, channels allow everyone to see the same conversations and stay up to date with the latest files and decisions, keeping your team naturally aligned from anywhere.

Even as the COVID-19 pandemic becomes a thing of the past, remote and hybrid work is likely to be a key part of how we conduct business globally. The pandemic has thrown many businesses into the uncharted world of fully remote work, surfacing both good and bad aspects. As businesses transition into a new normal, taking thoughtful actions and learnings from these experiences can create more inclusive cultures that can realize the full potential of its employees whether they are in person or remote.

Source: Adapted from Steven T. Hunt, "How Hybrid Remote Work Improves Diversity and Inclusion" *Forbes*, May 2021; Melonie Parker "Google's Chief Diversity Officer Reflects on Being Inclusive in Year 3 of Remote Work," *Fast Company*, March 2022; Diana Ellsworth, Ruth Imose, Stephanie Madner, and Rens van den Broek, "Sustaining and Strengthening Inclusion in Our New Remote Environment," *McKinsey & Company*, July 2020; and "An Introduction to the Slack Platform," https://api.slack.com/start/overview.

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earnings (longer period of time to pay) or a composition of debt (reduction in the amount owed).

The individual debtor then files a plan providing the details for treatment of the debts. A Chapter 13 plan must provide for (1) the turnover of such future earnings or income of the debtor to the trustee as is necessary for execution of the plan, (2) full payment in deferred cash payments of all claims entitled to priority, and (3) the same treatment of each claim within a particular class.[31] The plan must provide for payment within three years unless the court specifically grants an extension to five years.

Once the debtor has completed all scheduled payments, the court will issue a discharge of all other debts provided for in the plan. As always, some exceptions to the discharge exist, such as child support and certain long-term debts. In addition, the debtor can be discharged even when they do not complete the payments within the three years if the court is satisfied that the failure is due to circumstances for which the debtor cannot justly be held accountable. During a Chapter 13 proceeding, no other bankruptcy petition (Chapter 7 or 11) may be filed against the debtor. Thus, an individual has an opportunity to relieve a debt situation without liquidation or the stigma of bankruptcy. In addition, the creditors may benefit by recovering a larger percentage than they would through a liquidation.

9-8 Minimizing Legal Expenses

Throughout any legal proceedings, the entrepreneur can run up large legal bills. Following are some suggestions for minimizing these expenses:

- Establish a clear fee structure with an attorney before any legal matters are handled. This structure may be based on an hourly charge, a flat fee (straight contract fee), or a contingent fee (percentage of negotiated settlement).
- Attorneys also operate in a competitive environment; thus, fee structures are negotiable.
- Establish clear written agreements on all critical matters that affect business operations, including agreements between principals, employment agreements, confidentiality agreements, and noncompete agreements.
- Always attempt to settle any dispute rather than litigate.
- Have your attorney share forms in electronic format that you can use in routine transactions.
- Use a less expensive attorney for smaller transactions.
- Suggest cost-saving methods to your attorney for ordinary business matters.
- Always check with your attorney during normal business hours.
- Client inefficiency rewards attorneys: consult with your attorney on several matters at one time.
- Keep abreast of legal developments in your field.
- Handle matters within your "comfort zone" yourself.
- Involve attorneys early on when it is feasible: an ounce of prevention is worth a pound of cure.
- Shop around but don't attorney-hop. Once you find a good attorney, stick with that person. An attorney who is familiar with your business can handle your affairs much more efficiently than a succession of attorneys, each of whom must research your case from scratch.[32]

Summary

A patent is an intellectual property right that is a result of a unique discovery. Patent holders are provided protection against infringement by others. This protection lasts for 14 years in the case of design patents and for 20 years in all other cases.

Securing a patent can be a complex process, and careful planning is required. Some of the useful rules to follow in acquiring a patent were set forth in this chapter.

A patent may be declared invalid for several reasons: failure to assert the property right for an unreasonable length of time, misuse of the patent, and inability to prove that the patent meets patentability tests. On the other hand, if a patent is valid, the owner can prevent others from infringing on it; if they do infringe on it, the owner can bring legal action to prevent the infringement and, in some cases, obtain financial damages.

A copyright provides exclusive rights to creative individuals for the protection of their literary or artistic productions. This protection lasts for the life of the author plus 70 years. In case of infringement, the author (or whoever holds the copyright) can initiate a lawsuit for infringement. This action can result in an end to the infringement and, in some cases, the awarding of financial damages.

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A trademark is a distinctive name, mark, symbol, or motto identified with a company's product(s). When an organization registers a trademark, it has the exclusive right to use that mark. Registration acquired before 1989 lasts for 20 years. However, after 1989, registration lasts for 10 years and is renewable every 10 years thereafter. In case of infringement, the trademark holder can seek legal action and damages.

This chapter examined the three major forms of legal organization: sole proprietorship, partnership, and corporation. The advantages and disadvantages of each form were highlighted and compared. In addition, the characteristics and tax considerations of partnerships were compared with those of corporations.

The specific forms of partnerships and corporations were examined. In particular, the requirements and benefits of limited partnerships, LLLPs, S corporations, LLCs, B corporations, and L3Cs were presented.

During the past two decades, numerous business failures have occurred. Three major sections of the Bankruptcy Act are of importance to entrepreneurs. Chapter 7 deals with straight bankruptcy and calls for a liquidation of all assets to satisfy outstanding debts. Chapter 11 deals with reorganization, a format wherein a business continues operating and attempts to formulate a plan to pay a portion of the debts, to have the remaining sum discharged, and to continue to pay the debt in installments. Chapter 13 deals with individual debtors who file a plan for adjustment of their debts. This would apply to sole proprietorships because they are individually owned. More business bankruptcies are handled under Chapter 11 than under the other two sections.

Key Terms

abandonment
bankruptcy
Bankruptcy Act
B corporation
cancellation proceedings
claims
cleaning-out procedure
copyright
corporation
debtor-in-possession
fair use doctrine
generic meaning
infringement budget
insolvent debtor
intellectual property right
L3C
limited liability company (LLC)
limited liability limited partnership (LLLP)
limited liability partnership (LLP)
limited partnership
liquidation
partnership
patent
Patent and Trademark Office
Revised Uniform Limited Partnership Act
Revised Uniform Partnership Act (RUPA)
S corporation
sole proprietorship
specification
trademark
trade secrets
unlimited liability

Review and Discussion Questions

1. In your own words, what is a patent? Of what value is a patent to an entrepreneur? What benefits does it provide?
2. What are four basic rules entrepreneurs should remember about securing a patent?
3. When can a patent be declared invalid? Cite two examples.
4. In your own words, what is a copyright? What benefits does a copyright provide?
5. How much protection does a copyright afford the owner? Can any of the individual's work be copied without paying a fee? Explain in detail. If an infringement of the copyright occurs, what legal recourse does the owner have?
6. In your own words, what is a trademark? Why are generic or descriptive names or words not given trademarks?
7. When may a trademark be invalidated? Explain.
8. What are three of the pitfalls individuals should avoid when seeking a trademark?
9. Identify the legal forms available for entrepreneurs structuring their ventures: sole proprietorship, partnership, and corporation.
10. What are the specific advantages and disadvantages associated with each primary legal form of organization?
11. What is the Revised Uniform Limited Partnership Act? Describe it.
12. Explain the limited liability partnership.
13. What is the nature of an S corporation? List five requirements for such a corporation.
14. What is a limited liability company?
15. Explain the value of the B corporation and the L3C as new legal forms.
16. What type of protection does Chapter 7 offer to a bankrupt entrepreneur?
17. What type of protection does Chapter 11 offer to a bankrupt entrepreneur? Why do many people prefer Chapter 11 to Chapter 7?
18. What type of protection does Chapter 13 offer to a bankrupt entrepreneur? How does Chapter 13 differ from Chapter 7 or Chapter 11?

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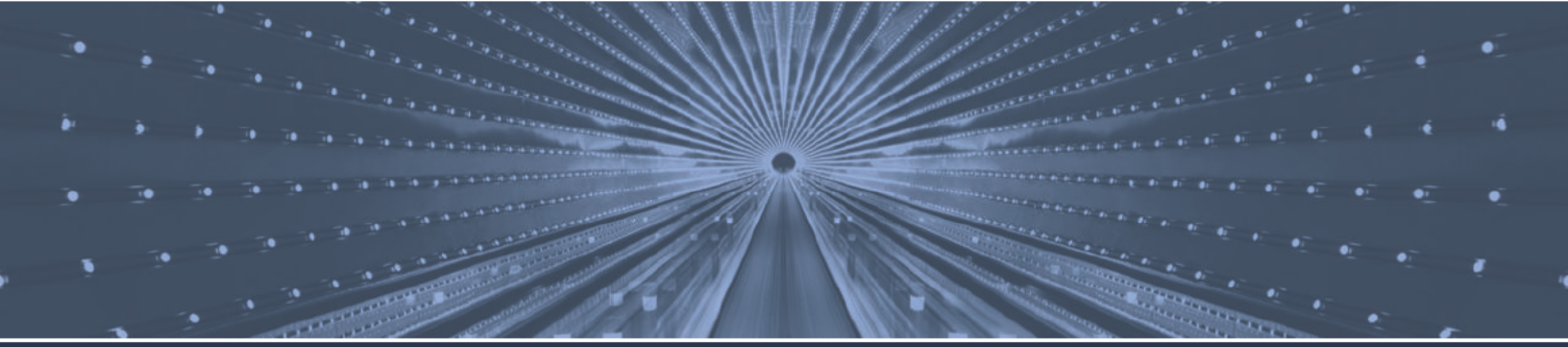
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Chapter 10

Marketing Challenges for Entrepreneurial Ventures

Learning Objectives

10.1. Explain the new marketing concept for entrepreneurs
10.2. Discuss the importance of marketing research for new ventures
10.3. Identify the key elements of an effective market survey
10.4. List the factors that inhibit the use of marketing
10.5. Explain the emerging use of social media marketing and mobile marketing
10.6. Identify the components of effective marketing
10.7. Summarize the marketing concept: philosophy, segmentation, and consumer orientation
10.8. Identify the areas vital to a marketing plan
10.9. List the key features of a pricing strategy
10.10. Discuss pricing in the social media age

Entrepreneurial Thought

Master the topic, the message, and the delivery.

—Steve Jobs, Founder, Apple

Brand is just a perception, and perception will match reality over time.

—Elon Musk, Founder, SpaceX

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10-1 The New Marketing Concept for Entrepreneurs

LO10.1 Explain the new marketing concept for entrepreneurs

Marketing has been and always will be a major element of any entrepreneurial venture. The challenge today is to understand the fundamental shifts that have taken place in our world.

Researchers Minet Schindehutte, Michael H. Morris, and Leyland F. Pitt describe how the new marketing logic requires a fundamental rethinking of the old rules that applied in a world of stability and control. The speed of transactions is higher, dynamic, and happening in real time. In a demand-based economy, entrepreneurs must realize that the customer is in control and therefore drives decisions. This fact requires a reconceptualization of the marketing mix from customer-centric to customer-made. To illustrate this major rethinking in marketing, we must shift from the 4 Ps to the 4 Cs:

From **P**roduct . . . to *Cocreated*

From **P**romotion . . . to *Communities*

From **P**rice . . . to *Customizable*

From **P**lace . . . to *Choice*

This is the era of Generation C, where the C stands for *content*. This generation is connected, creative, collaborative, and contextual. Entrepreneurs must realize that the customer is now at the center of all effective marketing activity.[1]

The new *marketing concept* for entrepreneurs includes knowing what a market consists of, the understanding of marketing research, the development of a marketing plan, the proper understanding and application of social media marketing, and the proper approach to a pricing strategy. In this chapter, we examine each of these key components.

A **market** is a group of consumers (potential customers) who have purchasing power and unsatisfied needs.[2] A new venture will survive only if a market exists for its product or service.[3] This is so obvious that it would seem that every entrepreneur would prepare thoroughly the market analysis needed to establish a target market. However, many entrepreneurs know very little about their market, and some even attempt to launch new ventures without identifying any market. (See Table 10.1 concerning the marketing skills of great entrepreneurs.)

A number of techniques and strategies can assist entrepreneurs to effectively analyze a potential market. By using them, entrepreneurs can gain in-depth knowledge about the specific market and can translate this knowledge into a well-formulated business plan. Effective marketing analysis also can help a new venture position itself and make changes that will result in increased sales.[4] The key to this process is marketing research.

Table 10.1 Common Elements in the Marketing Skills of Great Entrepreneurs

1. They possess unique environmental insight, which they use to spot opportunities that others overlook or view as problems.
2. They develop new marketing strategies that draw on their unique insights. They view the status quo and conventional wisdom as something to be challenged.
3. They take risks that others, lacking their vision, consider foolish.
4. They live in fear of being preempted in the market.
5. They are fiercely competitive.
6. They think through the implications of any proposed strategy, screening it against their knowledge of how the marketplace functions. They identify and solve problems that others do not even recognize.
7. They are meticulous about details and are always in search of new competitive advantages in quality and cost reduction, however small.
8. They lead from the front, executing their management strategies enthusiastically and autocratically. They maintain close information control when they delegate.
9. They drive themselves and their subordinates.
10. They are prepared to adapt their strategies quickly and to keep adapting them until they work. They persevere long after others have given up.
11. They have clear visions of what they want to achieve next. They can see further down the road than the average manager can see.

Source: Peter R. Dickson, *Marketing Management*, 1st ed. © 1994 Cengage Learning; see also Barry J. Babin and William G. Zikmund, *Essentials of Marketing Research*, 6th ed. (Mason, OH: Cengage/South-Western, 2016).

10-2 Marketing Research

LO10.2 Discuss the importance of marketing research for new ventures

Marketing research involves the gathering of information about a particular market, followed by analysis of that information.[5] A knowledge and understanding of the procedures involved in marketing research can be very helpful to the entrepreneur in gathering, processing, and interpreting market information.

10-2a Defining the Research Purpose and Objectives

The first step in marketing research is to define precisely the informational requirements of the decision to be made. Although this may seem too obvious to mention, the fact is that needs are too often identified without

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sufficient probing. If the problem is not defined clearly, the information gathered will be useless.

In addition, specific objectives should be established. For example, one study has suggested the following set of questions to establish objectives for general marketing research:

- Where do potential customers go to purchase the good or service in question?
- Why do they choose to go there?
- What is the size of the market? How much of it can the business capture?
- How does the business compare with competitors?
- What impact does the business's promotion have on customers?
- What types of products or services are desired by potential customers?[6]

10-2b Gathering Secondary Data

Information that has already been compiled is known as **secondary data**. Generally speaking, secondary data are less expensive to gather than are new, or primary, data. The entrepreneur should exhaust all the available sources of secondary data before going further into the research process. Marketing decisions often can be made entirely with secondary data.

Secondary data may be internal or external. Internal secondary data consist of information that exists within the venture. The records of the business, for example, may contain useful information. External secondary data are available in numerous periodicals, trade association literature, and government publications.

Unfortunately, several problems accompany the use of secondary data. One is that such data may be outdated and, therefore, less useful. Another is that the units of measure in the secondary data may not fit the current problem. Finally, the question of validity is always present. Some sources of secondary data are less valid than others.

10-2c Gathering Primary Data

If secondary data are insufficient, a search for new information, or **primary data**, is the next step. Several techniques can be used to accumulate primary data; these are often classified as observational methods or questioning methods. Observational methods avoid contact with respondents, whereas questioning methods involve respondents in varying degrees. Observation is probably the oldest form of research in existence. Observational methods can be used very economically, and they avoid a potential bias that can result from a respondent's awareness of their participation in questioning methods. A major disadvantage of observational methods, however, is that they are limited to descriptive studies.

Surveys and experimentation are two questioning methods that involve contact with respondents. *Surveys* include contact by mail, contact by telephone, and personal interviews. Mail surveys are often used when respondents are widely dispersed; however, these are characterized by low response rates. Telephone surveys and personal interview surveys involve verbal communication with respondents and provide higher response rates. Personal interview surveys, however, are more expensive than mail and telephone surveys. Moreover, individuals often are reluctant to grant personal interviews because they feel that a sales pitch is forthcoming. (Table 10.2 describes the major survey research techniques.)

Experimentation is a form of research that concentrates on investigating cause-and-effect relationships. The goal is to establish the effect that an experimental variable has on a dependent variable. For example, what effect will a price change have on sales? Here, the price is the experimental variable, and sales volume is the dependent variable. Measuring the relationship between these two variables would not be difficult were it not for the many other variables involved.[7]

Developing an Information-Gathering Instrument

LO10.3 Identify the key elements of an effective market survey

The questionnaire is the basic instrument for guiding the researcher and the respondent through a survey. The questionnaire should be developed carefully before it is used. Several major considerations for designing a questionnaire are as follows:

- Make sure each question pertains to a specific objective that is in line with the purpose of the study.
- Place simple questions first and difficult-to-answer questions later in the questionnaire.
- Avoid leading and biased questions.
- Ask yourself, "How could this question be misinterpreted?" Reword questions to reduce or eliminate the possibility that they will be misunderstood.
- Give concise but complete directions in the questionnaire. Succinctly explain the information desired and route respondents around questions that may not relate to them.
- When possible, use scaled questions rather than simple yes/no questions to measure intensity of an attitude or frequency of an experience. For example, instead of asking, "Do we have friendly sales clerks?" (yes/no), ask, "How would you evaluate the friendliness of our sales clerks?" Have respondents choose a response on a five-point scale ranging from "very unfriendly" (1) to "very friendly" (5).[8]

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Table 10.2 Comparison of Major Survey Research Techniques

	Door-to-Door Personal Interview	Mall Intercept Personal Interview	Telephone Interview	Mail Survey	Internet Survey
Speed of data collection	Moderate to fast	Fast	Very fast	Slow; researcher has no control over return of questionnaire	Instantaneous; 24/7
Geographic flexibility	Limited to moderate	Confined; possible urban bias	High	High	High (worldwide)
Respondent cooperation	Excellent	Moderate to low	Good	Moderate; poorly designed questionnaire will have low response rate	Varies depending on website; high from consumer panels
Versatility of questioning	Quite versatile	Extremely versatile	Moderate	Not versatile; requires highly standardized format	Extremely versatile
Questionnaire length	Long	Moderate to long	Moderate	Varies depending on incentive	Moderate; length customized based on answers
Item nonresponse rate	Low	Medium	Medium	High	Software can assure none
Possibility for respondent misunderstanding	Low	Low	Average	High; no interviewer present for clarification	High
Degree of interviewer influence on answer	High	High	Moderate	None; interviewer absent	None
Supervision of interviewers	Moderate	Moderate to high	High; especially with central location interviewing	Not applicable	Not applicable
Anonymity of respondent	Low	Low	Moderate	High	Respondent can be either anonymous or known
Ease of callback or follow-up	Difficult	Difficult	Easy	Easy, but takes time	Difficult, unless e-mail address is known
Cost	Highest	Moderate to high	Low to moderate	Lowest	Low
Special features	Visual materials may be shown or demonstrated; extended probing possible	Taste tests, viewing of TV commercials possible	Fieldwork and supervision of data collection are simplified; quite adaptable to computer technology	Respondent may answer questions at own convenience: has time to reflect on answers	Streaming media software allows use of graphics and animation

Source: Adapted from Peter R. Dickson, *Marketing Management*, 1st ed., © 1994 Cengage Learning; see also Barry J. Babin and William G. Zikmund, *Essentials of Marketing Research*, 6th ed. (Mason, OH: Cengage/South-Western, 2016).

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10-2d Quantitative versus Qualitative Marketing Research

Quantitative research involves empirical assessments that work from numerical measurements and analytical approaches to compare the results in some way. The researcher is an uninvolved observer so that the results are "objective." However, larger samples are needed to be able to perform the statistical analyses effectively. **Qualitative research** needs far less of a sample size, as it involves the researcher in the process and is able to delve deeper into the questions with the respondents. Since it relies less on analytical testing and the researcher is engaged in the process, the results are thus considered "subjective."[9]

10-2e Interpreting and Reporting Information

After the necessary data have been accumulated, they should be developed into usable information. Large quantities of data are merely facts. To be useful, they must be organized and molded into meaningful information. The methods of summarizing and simplifying information for users include tables, charts, and other graphic methods. Descriptive statistics—such as the mean, mode, and median—are most helpful in this step of the research procedure.

10-2f Marketing Research Questions

The need for marketing research before and during a venture will depend on the type of venture. However, typical research questions might include the following, which are divided by subject:

Sales

1. Do you know all you need to know about your competitors' sales performance by type of product and territory?
2. Do you know which accounts are profitable and how to recognize a potentially profitable one?
3. Is your sales power deployed where it can do the most good and maximize your investment in selling costs?

Distribution

1. If you are considering introducing a new product or line of products, do you know all you should about distributors' and dealers' attitudes toward it?
2. Are your distributors' and dealers' salespeople saying the right things about your products or services?
3. Has your distribution pattern changed along with the geographic shifts of your markets?

Markets

1. Do you know all that would be useful about the differences in buying habits and tastes by territory and kind of product?
2. Do you have as much information as you need on brand or manufacturer loyalty and repeat purchasing in your product category?
3. Can you now plot, from period to period, your market share of sales by products?

Advertising

1. Is your advertising reaching the right people?
2. Do you know how effective your advertising is compared to that of your competitors?
3. Is your budget allocated appropriately for greater profit—according to products, territories, and market potentials?

Products

1. Do you have a reliable quantitative method for testing the market acceptability of new products and product changes?
2. Do you have a reliable method for testing the effect on sales of new or changed packaging?
3. Do you know whether adding higher or lower quality levels would make new profitable markets for your products?

10-3 Inhibitors to Marketing Research

LO10.4 List the factors that inhibit the use of marketing

Despite the fact that most entrepreneurs would benefit from marketing research, many fail to do it. A number of reasons exist for this omission, among them cost, complexity, level of need for strategic decisions, and irrelevancy. Several articles have dealt with the lack of marketing research by entrepreneurs in the face of its obvious advantages and vital importance to the success of entrepreneurial businesses.[10]

10-3a Cost

Marketing research can be expensive, and some entrepreneurs believe that only major organizations can afford it. Indeed, some high-level marketing research is expensive, but smaller companies can also use very affordable marketing techniques.

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The Entrepreneurial Process

Omnichannel Marketing versus Multichannel Marketing

With people spending on average of over two hours a day on social media, it is no wonder that entrepreneurs have worked to create social media strategies to tap into this potential market. However, going about reaching this market must be done thoughtfully to build brand awareness and familiarity.

Previously, companies used multichannel strategies, but with the growth in social media, omnichannel strategies have become much more successful, achieving 91 percent year-on-year customer retention. What is the difference? Multichannel strategies were those where the brand was the center of the marketing strategy. The product or service was placed in front of the consumer and wasn't necessarily personalized to suit the customers' needs. The various platforms used to advertise the product were operated independently and didn't relate to one another. For example, the strategy may have been only to show the product and encourage one to buy it or to provide a coupon for buying the product at a discount. It didn't seek input from the customer to see if the product was what the customer wanted.

Omnichannel strategies use both social media platforms and non-technological platforms (like media, catalogs, and storefronts) working together to provide a more personalized journey for the customer. From the start, the customer is the center of the marketing strategy, building a long-term relationship with the customer. And from the first message to the last, each channel provides a unified message. The result is loyalty, higher engagement and higher purchase rate using an omnichannel strategy versus a multichannel strategy. An omnichannel strategy would look like this:

Understand your customer. Where does your customer shop, and what social media sites do they like? Or do they also look through catalogs, listen to the radio, and read the newspaper, and how can all the different marketing methodologies be integrated? Are they best reached on TikTok, Twitter, Instagram, SMS, e-mail, or Facebook and by what combination of social media sites? Are they motivated by influencers? Visuals? Additionally, the entire team must understand the customer and what they seek. Gathering feedback directly from the customers will help map out the customer journey to understand how they locate your brand and your site. Google Research states that 90 percent of multiple-device owners switch between an average of three per day to complete a task. The rule of seven has never meant more than it does today, meaning that one must see a brand's message seven times before purchasing. With our receiving over 5,000 messages in a day, social media is a great tool to help with this awareness. But finding the correct channels is the very reason why understanding your customer and their patterns is key.

Find your brand voice. This would be the personality of your company. Is your product serious, relatable, friendly, upscale, and eco-friendly? Whatever brand voice you determine, your company should be consistent across all advertising platforms. How do you talk about the business's products or services with a friend? This should help you find that voice.

Now that you know your voice, the various ways you wish to convey the message, and the platforms your audience frequents, does this combination make sense?

Be authentic and tell a story. Consumers like to know the people behind the business. This provides the opportunity to showcase the people who work in the business, creating an emotional connection to your customer. Dive into the past and use nostalgia, stories, problems solved using the product or service, and memories that resonate with consumers. Curate content like the sharing of recipes or articles relevant to your product. This is more likely to increase purchasing behavior than the giving of a coupon.

Be intentional about your social media posts. Every post should have intention so that they appear authentic. Find a mix of social media posts that benefit the customer where some aren't even an ask to buy at all. These posts support your brand, benefit the customer, and remind them that you are there when they are ready to spend next. It also shows that you take the business seriously. This two-way conversation is important for creating brand loyalty. If you grow too large, hire someone to do this work because many of the social posts may require daily posts, such as Instagram and Facebook. Twitter may require multiple posts per day, and LinkedIn may require several posts a week. How often you post depends on the platforms you use and the message you wish to share.

Measure and pivot if you need to. Measure your marketing goals across all marketing channels. Are they resulting in the sales you anticipated? If not, are you able to ascertain why? An experiment may include trying different strategies with different audiences and then measuring the results. This will help you understand what content or what channels you need to try next. With hundreds or thousands of customers, even a small percent increase can affect your revenue.

Source: Adapted from Wendy Dessler, "13 Social Media Strategies to Boost Your Small Business Online," November 12, 2020, https://blog.socialmediastrategiessummit.com/social-media-strategies-for-local-small-business; Ella Goldfeld, "Omnichannel Marketing: Strategy, Examples, Definition and Benefits," February 16, 2022, https://www.mayple.com/blog/omnichannel-marketing; Martha Kendall, "How to Create a Social Media Strategy for Small Businesses," February 16, 2021, https://later.com; Megan Mahoney, "The Impact of Social Media on Business in 2022," 2022, https://www.singlegrain.com/blog-posts/impact-of-social-media-in-todays-business-world; Tracy Puckett, "What Is Omnichannel Marketing? Examples and Tips for Ecommerce," November 22, 2021, https://www.omnisend.com; Nancy Rothman, "Social Media for Small Business Owners—9 Top Strategies Social Media for Small Business Owners," May 16, 2021, https://meetedgar.com; and Ted Vroutas, "How to Create the Perfect Omnichannel Marketing," July 1, 2020, https://secretsite.co.

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10-3b Complexity

A number of marketing research techniques rely on sampling, surveying, and statistical analysis. This complexity—especially the quantitative aspects—is frightening to many entrepreneurs, and they shun it. The important point to remember is that the key concern is interpretation of the data, and an entrepreneur always can obtain the advice and counsel of those skilled in statistical design and evaluation by calling on the services of marketing research specialists or university professors trained in this area.

10-3c Strategic Decisions

Some entrepreneurs feel that only major strategic decisions need to be supported through marketing research. This idea is tied to the cost and complexity issues already mentioned. The contention is that, because of the cost and statistical complexity of marketing research, it should be conducted only when the decisions to be made are major. The problem lies not only in the misunderstanding of cost and complexity but also in the belief that marketing research's value is restricted to major decisions. Much of the entrepreneur's sales efforts could be enhanced through the results of such research.[11]

10-3d Irrelevancy

Many entrepreneurs believe that marketing research data will contain either information that merely supports what they already know or irrelevant information. Although it is true that marketing research does produce a variety of data, some of which may be irrelevant, it is also a fact that much of the information is useful. In addition, even if certain data merely confirm what the entrepreneur already knows, it is knowledge that has been tested and thus allows the individual to act on it with more confidence.

As indicated by these inhibitors, most of the reasons that entrepreneurs do not use marketing research center either on a misunderstanding of its value or on a fear of its cost. However, the approach to marketing does not have to be expensive and can prove extremely valuable.

10-4 Social Media Marketing

LO10.5 Explain the emerging use of social media marketing and mobile marketing

"Mobile apps, social media, advertising networks, video streaming, broadband, Flash, optimization! These are only a few of the Internet-related terms that have entered the marketing vocabulary in recent years . . . suggesting how complex the marketing job has become in the Internet age."[12]

Today, our world is dominated by social networks, online communities, blogs, wikis, and other online collaborative media. **Social media marketing** describes the use of these tools for marketing purposes. The most common social media marketing tools include Twitter, blogs, LinkedIn, Facebook, Pinterest, Instagram, and YouTube. There are three important aspects to consider with social media marketing:

1. *Create* something of value with an event, a video, a tweet, or a blog entry that attracts attention and becomes viral in nature. This viral replication of a message through user-to-user contact is what makes social media marketing work.
2. *Enable* customers to promote a message themselves with multiple online social media venues. Fan pages in Twitter and Facebook are examples of this.
3. *Encourage* user participation and dialogue. A successful social media marketing program must fully engage and respect the customers with online conversations. Social media marketing is not controlled by the organization.[13]

As you can see in these three elements, the real goal of social media marketing is to create a conversation among customers in your market space—a type of word-of-mouth marketing that reaches a critical mass. And why is this so critical for entrepreneurs and their start-up ventures? Researchers focused on social media marketing have pointed to the following facts:

- Facebook now has over 1 billion users (larger than the populations of the United States, Canada, and Mexico combined).
- According to a social media study, three-quarters of the online population is comprised of frequent social media users.
- Google processes over 3.5 billion online searches every day (or 1.2 trillion per year).
- Forrester Research estimates that online U.S. retail spending will reach $414 billion by 2018, or 11 percent of the entire retail market.[14]

10-4a Key Distinctions of Social Media Marketing

As we pointed out earlier in the chapter, it is a complete misconception to think that social media marketing is just using online social media sites to do traditional marketing. The traditional marketing approach, emphasizing the 4 Ps (product, price, place, and promotion), still has some important lessons for marketing, but in the new terrain of social media, it has to be adapted or in some areas changed completely. That is why we

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presented the 4 Cs based on the customer focused concept in this new age of marketing.

In addition, there are several other aspects that distinguish social media marketing from traditional marketing. One distinction is referred to as *control versus contributions*. Traditional marketing seeks to control the content seen by the audience and attempts to dominate the territory by excluding their competitors' message. Social media marketing emphasizes audience contribution and relinquishes control over large parts of the content. Effective social media marketing can sometimes influence what participants say and think about a brand, but rarely can they control the conversation.

A second important distinction is *trust building*. Firms cannot fully control the content that users will create, so a venture must develop trusting relationships with the customer audience. Unlike traditional advertisements in which consumers have grown to expect some exaggeration to be applied to a product, on social media, it is important to be completely honest. Any firm that bends the truth will be held accountable and have to explain those actions.

A third distinction is in how social media messages are consumed. Traditional marketing was "one-way" from the firm to the customers. Social media involves *two-way communication* to an audience that is interested in responding. If the message being delivered is boring, inaccurate, or irrelevant, the customer will look elsewhere. Social media creates an ongoing conversation between the new venture and the customer.[15] Table 10.3 provides an excellent outline of the differences in traditional marketing versus entrepreneurial marketing.

10-4b Developing a Social Media Marketing Plan

A social media marketing plan details an organization's social media goals and the actions necessary to achieve them. Key among these actions is the creation of solid marketing strategies, without which there is little chance

Table 10.3 Traditional versus Entrepreneurial Marketing

	Conventional Marketing	Entrepreneurial Marketing
Basic premise	Facilitation of transactions and market control	Sustainable competitive advantage through value-creating innovation
Orientation	Marketing as objective, dispassionate science	Central role of passion, zeal, persistence, and creativity in marketing
Context	Established, relatively stable markets	Envisioned, emerging, and fragmented markets with high levels of turbulence
Marketer's role	Coordinator of marketing mix; builder of the brand	Internal and external change agent; creator of the category
Market approach	Reactive and adaptive approach to current market situation with incremental innovation	Proactive approach, leading the customer with dynamic innovation
Customer needs	Articulated, assumed, expressed by customers through survey research	Unarticulated, discovered, identified through lead users
Risk perspective	Risk minimization in marketing actions	Marketing as vehicle for calculated risk taking; emphasis on finding ways to mitigate, stage, or share risks
Resource management	Efficient use of existing resources, scarcity mentality	Leveraging, creative use of the resources of others; doing more with less; actions are not constrained by resources currently controlled
New product/service development	Marketing supports new product/service development activities of research and development and other technical departments	Marketing is the home of innovation; customer is coactive producer
Customer's role	External source of intelligence and feedback	Active participant in firm's marketing decision process, defining product, price, distribution, and communications approaches.

Source: Adapted from Minet Schindehutte, Michael H. Morris, and Leyland F. Pitt, *Rethinking Marketing* (Upper Saddle River, NJ: Pearson Prentice Hall, 2009), 30.

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of successfully executing the plan. Here are some critical steps to keep in mind:

Listen What people are saying about a company enables the organization to determine its current social media presence, which in turn guides the setting of social media goals and strategies to achieve them.

Identify Identify the target market (*niche*) so that marketing strategies can be organized to efficiently reach those most receptive customers and eventually advocates.

Categorize Categorize social media platforms by target market relevancy. In other words, a company should focus its efforts on the social media sites where its target audience resides in the greatest numbers, resulting in a higher return on investment.

Appraise The location, behavior, tastes, and needs of the target audience, as well as the competition, need to be appraised to determine an organization's strengths and weaknesses and the opportunities and threats (SWOT analysis covered in Chapter 13) in the environment.

Implement Choosing the right tools is accomplished by finding the social media sites where the target audience resides and then focusing the company's social media efforts on those platforms.

Collaborate Collaboration with platform members is a means of establishing a mutually beneficial relationship with the platform participants. Social media is a key way to build relationships. People who feel a personal connection with a company are apt to like and trust the associated brand or product. A faceless corporation is unlikely to inspire confidence, but seeing the people behind the brand can build customer loyalty and support.

Contribute Contribute content to build reputation and become a valued member, helping to improve the community. A brand or company can be positioned as thought leaders or experts in an industry by showcasing their unique knowledge. This positioning can develop positive equity for that brand or company; if a firm knows more about the subject area than anyone else, it signals that its product will most likely be of higher quality.

Convert Convert strategy execution into desired outcomes, such as brand building, increasing customer satisfaction, driving word-of-mouth recommendations, producing new product ideas, generating leads, handling crisis reputation management, integrating social media marketing with public relations and advertising, and increasing search engine ranking and site traffic.

Monitor Evaluate the organization's social media marketing initiatives.[16]

These key steps for a social media marketing plan are just a beginning. It is most important to develop an approach that links the specific goals of the entrepreneur with the marketing strategies. The specifics will depend on information from listening to and observing the target market.

10-4c Mobile Marketing

Mobile computing is the use of portable wireless devices to connect to the Internet. It enables people to access data and to interact on the social web while on the move as long as they are in range of a cellular or WiFi (wireless fidelity) network. Common mobile computing devices include cell phones, smartphones, tablet PCs, and netbooks. Cell phones provide wireless voice communications and Short Message Service (SMS) for sending and receiving text messages. Smartphones combine the power of cell phones and laptop computers; using mini keyboards for either mechanical or touchscreen input, they can receive and store text messages and e-mail, act as web browsers, run mobile applications to perform a growing variety of tasks, and take pictures with increasingly high-quality miniaturized digital cameras. Tablet PCs are similar to laptop computers, but they use touch screens to replace bulky key words, offering a more compact form with maximum screen size. Netbooks are basically laptop computers but on a smaller scale; they are more lightweight and about the size of a hardback book.

Mobile devices are now within everyone's reach, and thus people are connected with their social networks constantly. This means that participants in social networks are always on and always connected. As a result, people tend to post and share content on social networks more often. Authors Melissa S. Barker, Donald I. Barker, Nicholas F. Bormann, and Krista E. Neher reported that nearly one-third of Facebook's 1 billion active users are currently accessing Facebook through their mobile devices. Twitter shows similar statistics, with reports that 95 percent of Twitter users own a mobile phone and that half of the users access Twitter through their mobile device. It is the way of the future.[17]

Mobile social media marketing is a fast-paced and high-impact marketing tool that many companies have started to use very successfully as part of their overall marketing strategy. Many companies are now using mobile social media applications as their standard communication strategy to connect with consumers. It can be defined as a group of mobile marketing applications that allow the creation and exchange of user-generated content. Mobile computing provides a plethora of marketing opportunities, such as text messaging, mobile applications, and mobile advertising.

Companies using mobile social media often obtain personal data about their consumers, such as current

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geographical position in time or space. Mobile social media applications can be differentiated based on location sensitivity (does the message take account of the specific location of the user?) as well as on time sensitivity (is the message received and processed by the user instantaneously or with a time delay?). The most sophisticated forms of mobile social media applications are those that account for both time and location simultaneously.

The overall mobile social media strategy can be complicated, but researcher Andreas Kaplan recommends the following 4 Is to help grasp the overall strategy: **integrate, individualize, involve,** and **initiate.**[18]

1. *Integrate.* The best way to integrate the application into the daily life of the user is to offer incentives, prizes, or discounts to the user of the application.
2. *Individualize.* Mobile marketing allows for an even higher level of individualized company-to-consumer communication by directing customized messages to different users based on location, taste preferences, and shopping habits.
3. *Involve.* Effective mobile campaigns involve the user interactively with a type of a story or game. Mobile social media games often involve prizes for the winners, often in the form of discounts, coupons, or gift cards. Even without prizes, users are still motivated to win one of these interactive games because their social media network "friends" will see if they have won.
4. *Initiate.* Companies sometimes need to initiate the creation of user-generated content in order to start a meaningful dialogue between different consumers as they communicate online. This initiation of consumer dialogue is not straightforward, and many companies may not achieve this no matter how much effort they put into it.

Overall, the future of mobile social media marketing is very promising, and firms should try to capitalize on this type of marketing as soon as possible. The future will bring continued technology enhancements, and the integration of virtual life and real life is inevitable. **Mobile marketing** using social media will be revolutionary and potentially more important than almost any other type of marketing.

10-5 Entrepreneurial Tactics in Market Research

LO10.6 Identify the components of effective marketing

Since new start-up ventures are many times resource constrained, entrepreneurs need to sometimes become innovative with their market research. Researchers Minet Schindehutte, Michael H. Morris, and Leyland F. Pitt recommend a number of possible avenues for entrepreneurs to pursue in their marketing research process.[19] These tactics include the following:

Guerrilla Marketing The use of nonconventional tactics and unorthodox practices applied to marketing research. Realizing that there are an unlimited number of ways in which to collect information regarding a given question, the entrepreneur must thrive on tapping into unutilized sources of information and collecting information in very creative ways.

Insights in Ordinary Patterns The entrepreneur needs to understand that patterns emerge over time, so identifying and tracking them is invaluable. Here are a few of the identifiable trends:

- Potential customers buying at certain times of the year
- Questions that customers ask employees at similar stores
- Information sources that customers rely on for different types of purchases
- Patterns in the characteristics of repeat users of similar products
- Methods that potential customers rely on to reduce risk when they are purchasing

Technological Tools Today, technology can be extremely valuable to entrepreneurs and their research efforts. Tracking software to see exactly how a visitor to the firm's website behaves, what features are examined, and how long they remain on the site may be a viable tool. Technology that facilitates surveys, such as Survey Monkey, could prove helpful. The emergence of smartphones that allow customers to take pictures of things that interest them represents another research tool with rich potential. Tools to track response rates to advertisements or promotions placed in certain media, especially the Internet, are also valuable.

Customer Observation Insights can be gained from observing situations as they occur. Observational approaches can take many creative forms. They can be obtrusive, where the subject is aware that they are being observed, or unobtrusive, where they are not aware. An example of the obtrusive approach would be having potential customers use their smartphones to identify preferences and questions as they peruse their choices. An unobtrusive example would be when the entrepreneur counts cars or people that pass a given location at certain times of the day. Either method can be a systematic means of capturing market information.

Web-based Surveys As mentioned, Survey Monkey is an example of the easy-to-use tools for creating online surveys. These services help an entrepreneur design a

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The Entrepreneurial Process

Artificial Intelligence Solutions for the Entrepreneurial Firm

Artificial intelligence (AI) solutions are being applied to entrepreneurial firms in a variety of ways because AI solutions are suited to every step of the entrepreneurial process. Here are some of the most common:

Marketing, Sales, and Data Gathering

With SEO (search engine optimization), a type of AI intervention, potential customers can be reached, engaged, and even retained with a lower expense. This support mechanism can enhance the online experience, directing customers to what they are seeking and even making a sale. If the condition(s) become too complicated, the AI (chatbot) can direct the customer to a live person for more assistance or a final sale; this is differentiating users into segments.

Understanding customers' unique needs to plan future product rollout can be another application of AI. Being able to implement social algorithms to identify patterns in customer purchase behavior and predict and anticipate trends has limitless options. Using AI creates an increase in sales that people cannot do as quickly.

Social Media

AI tools can be used to understand what competitors are actively pursuing on their social media platforms, allowing entrepreneurs to reevaluate their business plans accordingly. They can understand how the competition engages with their customers, what is viewed, and what is purchased. The target audience of their competition will be their target audience as well, and AI tools and algorithms will be key to access this group of individuals.

Also, AI tools are even sophisticated enough to create social media posts for companies, being able to draft and target ads. AI can monitor trends based on its ability to gather and sort large amounts of data for decision making. Machine learning can improve predictions over time, knowing who will take action and purchase more, with the ability to target those customers specifically. AI can even predict which social media will best be suited for certain ads.

Relationship Management

Done right, AI tools can enhance a company's relationship with the end customer by delivering a personalized experience to each user. The ability of AI tools to collect and store customers' preferences to deliver a personalized experience gives the user a feeling of having a special one-on-one relationship with the firm. Many of these types of AI tools are easy to implement and customer satisfying. An example would be sending a text reminder, such as "Your product delivery has scheduled for tomorrow at 9:30 a.m. Please call our office if you have any questions or need to reschedule." These are easy to implement on the entrepreneur's end and create satisfaction on the customer end.

Process/Supply Automation

Entrepreneurs who have businesses that depend on supply orders can use AI tools for supply ordering and monitoring. There are tools that can keep track of inventory patterns for automatic reordering. This allows the entrepreneur more time for other efforts rather than keeping track of inventory levels and delivery times. This same AI can keep track of returns or issues with products for later analysis.

Hiring Employees/Fewer Employees

Some firms have tried using AI tools to hire employees using an algorithm where it screens candidates via tests to see if they match the hiring firm's behavior and culture. This may speed up the hiring process when an entrepreneur has a limited time to get a team pulled together. Also, there is some thought that AI bots can do some of the work that employees can do (such as menial tasks), resulting in hiring fewer employees. Some examples include data collection, data analysis, and, as mentioned above, initial sales screening. This AI investment saves energy for creativity and human interaction, which isn't AI applicable.

Each entrepreneur has to decide how they will use AI for their particular firm. However, keep in mind that not using this innovative technology may only leave the entrepreneur behind the competition. Most AI is scalable and with careful implementation can be an asset to any entrepreneurial firm.

Source: Adapted from Luis Jorge Rios, "3 Entrepreneurial Uses of Artificial Intelligence That Will Change Your Business," January 13, 2022; Mike Kaput, "What Is Artificial Intelligence for Social Media?," April 18, 2022, https://www.marketingaiinstitute.com; Alan Morantz, "Why AI Is the Entrepreneur's New Best Friend," August 2, 2021, Geek Culture | Medium, https://medium.com/geekculture/why-ai-is-the-entrepreneurs-new-best-friend-69bbdda47f6c; Julian Jewel Jeyaraj, "How to Leverage on Artificial Intelligence to Transform the Way Entrepreneurs Do Business," August 19, 2020, https://www.entrepreneur.com/en-in/technology/how-to-leverage-on-artificial-intelligence-to-transform-the/354973; Ketan Chavda, "8 Ways Artificial Intelligence Helps Entrepreneurs Grow Their Businesses," Prismetric, November 6, 2020, https://www.prismetric.com/artificial-intelligence-opportunities-for-entrepreneurs; James Grills, "Best 4 Ways How AI Can Help My Business Entrepreneurs," 2020, https://www.the-next-tech.com; Founder's Guide, "5 Artificial Intelligence Uses for Entrepreneurs in 2020," September 12, 2019, https://foundersguide.com; and Zeeshan Khalid, "Three Ways Entrepreneurs Can Use AI to Boost Their Business," December 14, 2018, https://www.entrepreneur.com/en-au/technology/how-entrepreneurs-can-use-ai-to-boost-their-business/324586.

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survey, drop it into an established online questionnaire format, and post it on a secure website. These web-based services will format the data and provide the statistical analysis as well. Web-based surveys are inexpensive and can reach very large numbers of people in a short period of time.

Focus Groups Gathering small groups of potential customers (usually 6 to 10) for an in-depth discussion about the new venture the entrepreneur is proposing may be a valuable source of insights. Participants elaborate on their feelings, beliefs, perceptions, and experiences with this new venture. Because they are small and less representative of entire market segments, focus groups are valuable ways for getting preliminary insights that are relevant to a particular venture decision.

Lead User Research Find lead users in the marketplace or in particular industries—people who have needs for which no solution exists and who often have ideas for effective products that have not yet been developed. They sometimes are experimenting with prototype solutions that, with modification, have the potential for addressing the lead user's needs. Lead users are often experienced in a particular field of endeavor and are driven to seek a solution to a problem they recognize. These prototype experiments do not produce satisfactory solutions, which creates the opportunity for innovation. The lead user approach would allow the entrepreneur to take pieces of information from these experts about the future and combine them in novel ways.

Blog Monitoring Blog sites have produced a new source of market research insights. A blog is a website that includes user-generated content, typically on some focused topic where anyone can post opinions or information, allowing for interactive discussions. Photos, videos, audio inputs, and links to other websites can also be posted. Through **blog monitoring,** Simple content analysis can be applied to identify prominent terms or themes that appear in blog discussions. Today, there are technologies that foster linguistic observation and social network analysis as well.

Archival Research Archives are a collection of records that have been created or accumulated over time. These records might be written documents, magazines, videos, computer files, online databases, patent records, and so on. Access to most archives is free, and the information is objective. They are a type of secondary information that can reveal important insights to the creative researcher. For example, the historical records of Country Business Patterns from the Bureau of the Census can reveal growth patterns for certain industries in different regions of the country. As we discussed in the section on secondary research, there are numerous files and data available if the entrepreneur is willing to search.

10-6 The Components of Effective Marketing

LO10.7 Summarize the marketing concept: philosophy, segmentation, and consumer orientation

Effective marketing is based on four key elements: marketing philosophy, market segmentation, consumer behavior, and channels of distribution. A new venture must integrate all four elements when developing its marketing concept and its approach to the market. This approach helps set the stage for how the firm will seek to market its goods and services.

10-6a Marketing Philosophy

Three distinct types of marketing philosophies exist among new ventures: production driven, sales driven, and consumer driven.

The **production-driven philosophy** is based on the belief you must "produce efficiently and worry about sales later." Production is the main emphasis; sales follow in the wake of production. New ventures that produce high-tech, state-of-the-art output sometimes use a production-driven philosophy. A **sales-driven philosophy** focuses on personal selling and advertising to persuade customers to buy the company's output. This philosophy often surfaces when an overabundance of supply occurs in the market. New auto dealers, for example, rely heavily on a sales-driven philosophy. A **consumer-driven philosophy** relies on research to discover consumer preferences, desires, and needs *before* production actually begins. This philosophy stresses the need for marketing research to better understand where or who a market is and to develop a strategy targeted toward that group. Of the three philosophies, a consumer-driven orientation is often most effective, although many ventures do not adopt it.

Three major factors influence the choice of a marketing philosophy:

1. *Competitive pressure.* The intensity of the competition will many times dictate a new venture's philosophy. For example, strong competition will force many entrepreneurs to develop a consumer orientation in order to gain an edge over competitors. If, on the other hand, little competition exists, the entrepreneur may remain with a production orientation in the belief that what is produced will be sold.
2. *Entrepreneur's background.* The range of skills and abilities entrepreneurs possess varies greatly. Whereas some have a sales and marketing background, others possess production and operations experience. The entrepreneur's strengths will influence the choice of a market philosophy.

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3. *Short-term focus*. Sometimes a sales-driven philosophy may be preferred due to a short-term focus on "moving the merchandise" and generating sales. Although this focus appears to increase sales (which is why many entrepreneurs pursue this philosophy), it also can develop into a hard-selling approach that soon ignores customer preferences and contributes to long-range dissatisfaction.

Any one of the three marketing philosophies can be successful for an entrepreneur's new venture. It is important to note, however, that over the long run, the consumer-driven philosophy is the most successful. This approach focuses on the needs, preferences, and satisfactions of the consumer and works to serve the end user of the product or service.

10-6b Market Segmentation

Market segmentation is the process of identifying a specific set of characteristics that differentiates one group of consumers from the rest. For example, although many people eat ice cream, the market for ice cream can be segmented based on taste and price. Some individuals prefer high-quality ice cream made with real sugar and cream because of its taste; many others cannot tell the difference between high-quality and average-quality ingredients and, based solely on taste, are indifferent between the two types. The price is higher for high-quality ice cream such as Häagen-Dazs or Ben & Jerry's, so the market niche is smaller for these offerings than it is for lower-priced competitors. This process of segmenting the market can be critical for new ventures with very limited resources.

To identify specific market segments, entrepreneurs need to analyze a number of variables. As an example, two major variables that can be focused on are *demographic* and *benefit* variables. Demographic variables include age, marital status, sex and gender identity, occupation, income, location, and the like. These characteristics are used to determine a geographic and demographic profile of the consumers and their purchasing potential. The benefit variables help to identify unsatisfied needs that exist within this market. Examples may include convenience, cost, style, trends, and the like, depending on the nature of the particular new venture. Whatever the product or service, it is extremely valuable to ascertain the benefits that a market segment is seeking in order to further differentiate a particular target group.

10-6c Consumer Behavior

Consumer behavior is defined by the many types and patterns of consumer characteristics. However, entrepreneurs can focus their attention on only two considerations: personal characteristics and psychological characteristics. Traditionally, some marketing experts have tied these characteristics to the five types of consumers: (1) innovators, (2) early adopters, (3) early majority, (4) late majority, and (5) laggards.

The differences in social class, income, occupation, education, housing, family influence, and time orientation are all possible personal characteristics, while the psychological characteristics are needs, perceptions, self-concept, aspiration groups, and reference groups. This type of breakdown can provide an entrepreneur with a visual picture of the type of consumer to target for the sales effort.

The next step is to link the characteristic makeup of potential consumers with buying trends in the marketplace. Table 10.4 shows the keys to understanding consumer behavior that could shape buying decisions. Each of these elements relates to consumer attitudes and behaviors based on education, the economy, the environment, and/or societal changes. By using some of the common consumer characteristics and combining them with Table 10.4, the entrepreneur can begin to examine consumer behavior more closely.

10-6d Channels of Distribution

Distribution channels are a key element in all the marketing strategies that revolve around the product. A distribution channel is a path or route decided by the entrepreneur to deliver its good or service to the customers. The route can be as short as a direct interaction between the venture and the customer or can include several interconnected intermediaries, such as wholesalers, distributors, retailers, and so on. The main goal of these channels is to make goods available to final consumers in sales outlets as soon as possible. Distribution channels directly impact a venture's sales, so you want to make them as efficient as possible.

Types of Distribution Channels

Direct Channels The venture is fully responsible for delivering products to consumers. Goods do not go through intermediaries before reaching their final destination. This model gives manufacturers total control over the distribution channel.

Indirect Channels Products are delivered by intermediaries, not by the sellers. Wholesalers, retailers, distributors, or brokers are examples. In this case, manufacturers do not have total control over distribution channels. The benefit is that this makes it possible to sell larger volumes and sell to a range of customers.

Hybrid Channels Hybrid channels are a mix of direct and indirect channels. The manufacturer has a partnership with intermediaries, but it still takes control when it comes to contact with customers. An example would be brands that promote products online but don't deliver them directly to customers.

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Table 10.4 Keys to Understanding Consumer Behavior

Contemporary consumers are:
Informed about your company, industry, and events
Eager for solutions
Social with other customers
Connected to various devices and channels
Opinionated and vocal
Willing to be self-sufficient
Critical of competitive customer experiences
Expecting businesses to be proactive
Contemporary consumers want:
Solutions on the Internet
To avoid excessive ads
To compare different brands
The best value for the money
To make purchases with no bureaucracy
To feel part of a community
Other people's opinion of a product
New market trends
To be influenced by people they admire
Eco-friendly products and avoid waste
Contemporary consumers' Spheres of influence:
Reciprocity. The need to return a favor or reciprocate kind gestures (free samples and discounts)
Commitment. Cultivating brand loyalty (return customers)
Consensus. Popularity across a wide customer base (increases customers)
Authority. Relevant experts on the effectiveness of a brand (convert new consumers)
Liking. Similar demographics—whether in terms of ethnicity, socioeconomic class, religious inclination, or even shared interests (persuade customers)
Scarcity. Exclusivity or short supply (increases the likelihood of purchase)

Source: Adapted from Sean Peek, "The Science of Persuasion: How to Influence Consumer Choice," *Business News Daily*, December 2, 2021, https://www.businessnewsdaily.com/10151-how-to-influence-consumer-decisions.html; Clint Fontanella, "8 Customer Characteristics Every Service Rep Should Know," Hub Spot, April 7, 2020, https://blog.hubspot.com/service/customer-characteristics; and "What Is Consumer Behavior Today Like?," Hotmart blog, April 8, 2018, https://blog.hotmart.com/en/consumer-behavior.

Types of Intermediaries in Distribution Channels

Retailers are intermediaries used frequently by companies. Examples include supermarkets, pharmacies, restaurants, and bars. *Wholesalers* are intermediaries that buy and resell products to retailers. *Distributors* sell, store, and offer technical support to retailers and wholesalers usually focused on specific regions. *Agents* are legal entities hired to sell a company's goods to final consumers and are paid a commission for their sales with a long-term relationship. *Brokers* are also hired to sell and receive a commission with a short-term relationship. For tech and software, the *Internet* itself works as the intermediary of the distribution channel. A company can also have its own *sales team* who are responsible for selling goods or services. *Resellers* are companies or people who buy from manufacturers or retailers to later sell to consumers in retail. A salesperson is connected to a company and sells its products using a magazine or *catalog*.

Selecting a Distribution Channel

Essentially, there are several questions to consider when determining a distribution channel:

- How long is the products shelf life?
- How large is the market for this product?
- How large is the company and what is its product mix?
- What is the cost of a specific channel of distribution?
- Are you in the right channels for your target customers?
- Are they stocking sufficient inventory?
- Are they giving your product proper location(s)?
- Are they supporting you with knowledgeable salespeople if point-of-purchase "selling" is needed?

When selecting a distribution channel, always keep in mind your venture's brand, profitability, and the scale of operations for your product. Choosing the right distribution channel is paramount to your venture's success and should be carefully considered. You should first understand that a distribution channel represents the relationship between the manufacturer and the user. Additionally, you need to understand your target audience and what their preferences are. Will you be selling to an audience that is technologically savvy, or is your target audience older and more traditional? Again, think of the cost of the different types of distribution channels. Consider your profit margin and desired volume when choosing a channel.

Another important aspect of selecting a distribution channel is the brand of your venture. Don't forget to think about the audience's perception of your product and if it needs to be sold in high-end designer stores or if department stores will do. Finally, opening strategic channels of distribution in local markets may or may not enhance the profitability of your products and should be considered. Before choosing a distribution channel, know that there are three things a distribution strategy influences: pricing strategy, product branding, and buyer and producer relationships.[20]

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The Entrepreneurial Process

Competitive Information

Following is a list of potential techniques to use to assess your competition and avoid paying a high-priced market research firm to collect information for you.

1. **Networking.** Speaking with people in the field will help you get a feel for what's going on in your industry. Vendors, customers, and anyone who does business with companies in your field may have information on emerging competition. Venture capitalists can be a great source of information because of the due diligence they must perform with pending venture loans. Much like what happens during the start-up phase of a business, a person can become so immersed in a project that they develop tunnel vision. Social networking also can provide a fresh view of the industry.
2. **Related products.** This market is the obvious place to look. Companies that can provide anything that complements your product or service are primed to become competition because they also know what the customers' needs are and how to fulfill them. Large companies whose customers are businesses will assess this issue very differently compared to a small business with the average person as its primary consumer. A good example of a complementary relationship is the one that exists among cameras, film, photo disks, and so on. The number and type of photographic products available have increased substantially in recent years, and different fields have capitalized on this trend.
3. **Value chain.** Whereas related products fall on the horizontal axis of an industry, exploring the value chain forces a vertical assessment of potential entrants into your competitive pool. The value chain for a given product or service offers many opportunities for expansion both for you and for the potential competition. In this situation, the potential competition is fully aware of and understands the business environment in which you operate. They already have easy access to suppliers, buyers, and services that you deal with on a daily basis.
4. **Companies with related competencies.** One of the more ignored avenues involves companies that can take their expertise and apply it to an indirectly related field. Competencies can be both technological and non-technological. Just because one company has unparalleled customer service and sales in the cellular industry doesn't mean the company couldn't use the same spectacular service in the cable business. The perfect example of expanding on technological similarities is Motorola, whose original intent was to focus on the defense industry. Surely that was not an area that cellular providers were examining when trying to anticipate potential competition!
5. **Internet.** It goes without saying that the Internet is one of the premiere sources of information available to anyone who knows how to use it. Using search engines to access millions of web pages allows a business to easily scope out anyone that offers similar products or services. Searches can be both broad and defined. Most important, they can be done cheaply and as often as desired. It is best to use words that customers might use and to avoid technological or industry jargon when surfing, but try to brainstorm all possible relations to ensure a thorough and effective search. Queries to search engines, such as Bing, Google, and Yahoo!, are logged by those search engines along with basic connectivity information, such as IP address and browser version. In the past, analysts had to rely on external companies to provide search behavior data, but increasingly, search engines are providing tools to directly mine their data. You can use search engine data with a greater degree of confidence because it comes directly from the search engine. In Google AdWords, you can use Keyword Tool, the search-based Keyword Tool, and Insights for Search.
6. **Benchmarks from web analytics vendors.** Web analytics vendors have many customers and thus a great deal of data. Many vendors now aggregate these real customer data and present them in the form of benchmarks that you can use to index your own performance. Benchmarking data are currently available from Fireclick, Coremetrics, and Google Analytics. Often, as is the case with Google Analytics, customers have to explicitly opt in their data into this benchmarking service.

Once the sufficient information has been gathered, a plan to beat the current and emerging competition should be prepared. The plan created will be analogous to the business's strengths and resources. Issues such as losing sales to another company could be addressed, a SWOT (strengths, weaknesses, opportunities, threats) analysis could be executed, or the plan to offer a new product or change price points could be outlined.

Source: Adapted from Mark Henricks, "Friendly Competition?," *Entrepreneur*, December 1999, 114–17; "The Definitive Guide to Competitive Intelligence Data Sources," February 22, 2010, http://www.kaushik.net/avinash/competitive-intelligence-data-sources-best-practices, accessed April 30, 2012; and "Gathering Competitive Information," United Technologies Corporation, http://utc.com/StaticFiles/UTC/StaticFiles/info_englishlanguage.pdf, accessed April 30, 2012.

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Drivers of Channel Support for Retail

If the venture resides in the retail space, then it's important to think of the selected channel as your customer in order to gain support from that channel. One key element to remember is the *gross margin return on inventory investment* (GMROI). This is what the channel will be examining to decide how well to support your particular product on the shelves. As shown in Figure 10.1, the GMROI equals the retail unit margin times the volume divided by the average inventory investment. With this equation, your particular retail margin versus what other competitors' margin may be will determine how much is available to discount the channel to carry your product over others. The entrepreneur will also use their marketing strategy to create greater end-user demand so that there is greater volume being sold by the channel. Thus, helping the channel with their inventory management results in greater support and sales for the entrepreneur's specific product.

The low price point provides low margins. Therefore, from an entrepreneurial standpoint, it's compelling to offer a competitive product to consumers for a much lower price than the competition. However, that strategy usually fails not because of the idea/product concept but because the entrepreneur cannot get distribution support. This is often overlooked.[21]

An analysis of the way consumers view the venture's product or service provides additional data. Entrepreneurs should be aware of five major consumer classifications:

1. *Convenience goods*. Whether staple goods (foods), impulse goods (checkout counter items), or emergency goods and services, consumers will want these goods and services but will not be willing to spend time shopping for them.
2. *Shopping goods*. These are products that consumers will take time to examine carefully and compare for quality and price.
3. *Specialty goods*. These are products or services that consumers make a special effort to find and purchase.
4. *Unsought goods*. These are items that consumers do not currently need or seek. Common examples are life insurance, encyclopedias, and cemetery plots. These products require explanation or demonstration.
5. *New products*. These are items that are unknown due to a lack of advertising or are new products that take time to be understood. When microcomputers were first introduced, for example, they fell into this category.

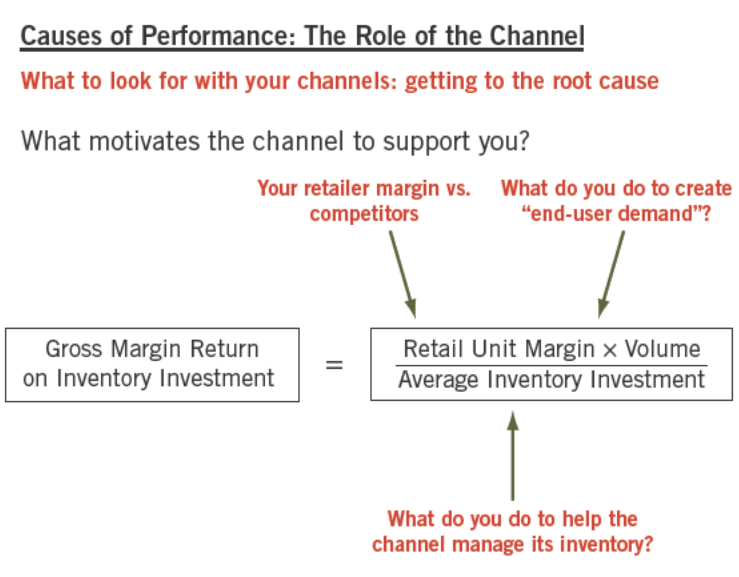
10-7 Developing a Marketing Plan

LO10.8 Identify the areas vital to a marketing plan

A *marketing plan* is the process of determining a clear, comprehensive approach to the creation of customers. The following elements are critical for developing this plan:

- *Current marketing research*. Determining who the customers are, what they want, and how they buy
- *Current sales analysis*. Promoting and distributing products according to marketing research findings

Figure 10.1 Causes of Performance: The Role of the Channel



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- *Marketing information system*. Collecting, screening, analyzing, storing, retrieving, and disseminating marketing information on which to base plans, decisions, and actions
- *Sales forecasting*. Coordinating personal judgment with reliable market information
- *Evaluation*. Identifying and assessing deviations from marketing plans[22]

10-7a Current Marketing Research

The purpose of current marketing research is to identify customers—target markets—and to fulfill their desires. For current marketing research to be effective for the growing venture, the following areas warrant consideration:

- *The company's major strengths and weaknesses*. These factors offer insights into profitable opportunities and potential problems and provide the basis for effective decision making.
- *Market profile*. A market profile helps a company identify its current market and service needs: How profitable are existing company services? Which of these services offer the most potential? Which (if any) are inappropriate? Which will customers cease to need in the future?
- *Current and best customers*. Identifying the company's current clients allows management to determine where to allocate resources. Defining the best customers enables management to segment this market niche more directly.
- *Potential customers*. By identifying potential customers—either geographically or with an industry-wide analysis of its marketing area—a company increases its ability to target this group, thus turning potential customers into current customers.
- *Competition*. By identifying the competition, a company can determine which firms are most willing to pursue the same basic market niche.
- *Outside factors*. This analysis focuses on changing trends in demographics, economics, technology, cultural attitudes, and governmental policy. These factors may have substantial impact on customer needs and, consequently, expected services.
- *Legal changes*. Marketing research performs the important task of keeping management abreast of significant changes in governmental rates, standards, and tax laws.[23]

10-7b Current Sales Analysis

An entrepreneur needs to continually review the methods employed for sales and distribution in relation to the market research that has been conducted. Matching the correct customer profile with sales priorities is a major goal in sales analysis. Following is a list of potential questions to be answered by this analysis:

- Do salespeople call on their most qualified prospects on a proper priority and time-allocation basis?
- Does the sales force contact decision makers?
- Are territories aligned according to sales potential and salespeople's abilities?
- Are sales calls coordinated with other selling efforts, such as trade publication advertising, trade shows, and direct mail?
- Do salespeople ask the right questions on sales calls? Do sales reports contain appropriate information? Does the sales force understand potential customers' needs?
- How does the growth or decline of a customer's or a prospect's business affect the company's own sales?

10-7c Marketing Information System

A marketing information system compiles and organizes data relating to cost, revenue, and profit from the customer base. This information can be useful for monitoring the strategies, decisions, and programs concerned with marketing. As with all information systems designs, the key factors that affect the value of such a system are (1) data reliability, (2) data usefulness or understandability, (3) reporting system timeliness, (4) data relevancy, and (5) system cost.

10-7d Sales Forecasting

Sales forecasting is the process of projecting future sales through historical sales figures and the application of statistical techniques. The process is limited in value due to its reliance on historical data, which many times fail to reflect current market conditions. As a segment of the comprehensive marketing-planning process, however, sales forecasting can be very valuable.

10-7e Evaluation

The final critical factor in the marketing-planning process is evaluation. Because a number of variables can affect the outcome of marketing planning, it is important to evaluate performance. Most important, reports should be generated from a customer analysis: attraction or loss of customers, with reasons for the gain or loss, as well as established customer preferences and reactions. This analysis can be measured against performance in sales volume, gross sales dollars, or market share. It is only through this type of evaluation that flexibility and adjustment can be incorporated into marketing planning.

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The Entrepreneurial Process

The Guerrilla Marketing Plan

A business plan is essential for any entrepreneur planning to start an initiative; however, by the time you include your market research results, pro forma statements, and critical risks, your business plan will become a dense packet of information to be used when guiding your entire business—a document that few will read in its entirety. Given this fact, entrepreneurs should be able to quickly articulate the key aspects of their venture in a matter of a few minutes. One tool that can be used for this purpose is what is known as a **guerrilla marketing plan**.

A guerrilla marketing plan forces an entrepreneur to specify the seven most important marketing issues that face their company. Of course, there will most certainly be more than seven key areas to address; however, by going through the exercise of consolidating the marketing topics that require the most focus, an entrepreneur will be better prepared to get to the heart of their concept both when presenting to potential investors and when managing the business.

The key is to address each area using no more than a sentence. Guerrilla marketing plans give people a quick understanding of exactly what is of the utmost concern to your business by eliminating much of the detail provided in your full business plan. Large companies make use of such plans by developing different ones for different products. For example, Procter & Gamble developed a guerrilla marketing plan for each of its products.

Although some companies choose to attach several pages of documentation to their plans, the key is to get the seven sentences right. Following are guidelines for developing a guerrilla marketing plan:

- You should begin your guerrilla marketing plan with a sentence that describes the purpose of your marketing. This sentence should be very specific and should address what impact your marketing initiative should have on a potential customer. Goals such as "to be more successful than my competitors" or "to be more profitable" are not useful. This sentence should quantify your overarching goal so that it is measurable. The point is to envision exactly what you want your customer to ideally do and then to establish a goal for ensuring that customers will act in that way.
- The next sentence is meant for you to address the competitive advantages of the enterprise; in other words, what are the characteristics of the business that make it uniquely positioned to offer value to the public? The objective with this sentence is to outline your business's strengths that are the most unique so that you can emphasize them in your marketing materials.
- You will address your target audience in the third sentence. By specifying exactly who will be exposed to a marketing campaign, you will find the process of engineering an effective plan to be much more straightforward. Companies often have more than one target audience, so guerrilla marketing plans should be written to address all potential customers in order to avoid losing sales to competitors.
- For the fourth point, a list is most appropriate. This topic addresses the marketing weapons that you will use. The important idea of this section is to include only those tools that the company can understand, afford, and use properly. Countless tools are now readily available to entrepreneurs, so filtering out those that do not meet these three criteria will help you avoid making poorly directed investments.
- You should discuss the company's market niche in the fifth sentence. Now that you have addressed the purpose, benefits, and target market, understanding your marketing niche is the next logical step. The market niche should capture what customers most readily associate with your company. It could be speed, value, variety, or any number of other characteristics. You will not be able to please everyone, so defining what your company is and what it is not will help to narrow your focus when promoting it to potential customers.
- The sixth sentence is where you will establish the identity of your company. Entrepreneurs should ensure that the marketing image they broadcast to the world is supported by the identity of their companies, which means that the companies' operating procedures need to reinforce whatever identity they establish.
- The final sentence in your guerrilla marketing plan needs to explicitly state what percentage of projected gross sales you are willing to earmark as your marketing budget. The quality of your marketing materials will clearly reflect on your business, so this step requires a significant amount of research to ensure that the amount you have allotted will be sufficient for supporting all previous steps.

When developing your guerrilla marketing plan, all subsequent steps should be framed by the first sentence you write, which is meant to define the purpose of your plan. Entrepreneurs should theoretically be able to write a plan of this nature within five minutes given its brevity. The more practice you get at articulating your business objectives, the easier you will find using tools—such as the guerrilla marketing plan—to communicate your business goals.

Source: Adapted from Jay Conrad Levinson and Jeannie Levinson, "Here's the Plan," *Entrepreneur*, February 2008, http://www.entrepreneur.com/magazine/entrepreneur/2008/february/188842.html, accessed March 20, 2008.

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10-7f Final Considerations for Entrepreneurs

Marketing plans are part of a venture's overall strategic effort.[24] To be effective, these plans must be based on the venture's specific goals. Following is an example of a five-step program designed to help entrepreneurs create a structured approach to developing a market plan:

Step 1: Appraise marketing strengths and weaknesses, emphasizing factors that will contribute to the firm's "competitive edge." Consider product design, reliability, durability, price/quality ratios, production capacities and limitations, resources, and need for specialized expertise.

Step 2: Develop marketing objectives, along with the short- and intermediate-range sales goals necessary to meet those objectives. Next, develop specific sales plans for the current fiscal period. These goals should be clearly stated, measurable, and within the company's capabilities. To be realistic, these goals should require only reasonable efforts and affordable expenditures.

Step 3: Develop product/service strategies. The product strategy begins with identifying the end users, wholesalers, and retailers as well as their needs and specifications. The product's design, features, performance, cost, and price then should be matched to these needs.

Step 4: Develop marketing strategies. Strategies are needed to achieve the company's intermediate- and long-range sales goals and long-term marketing objectives. These strategies should include advertising, sales promotion campaigns, trade shows, direct mail, and telemarketing. Strategies also may be necessary to increase the size of the sales force or market new products. Contingency plans will be needed in the event of technological changes, geographic market shifts, or inflation.

Step 5: Determine a pricing structure. A firm's pricing structure dictates which customers will be attracted as well as the type or quality of products/services that will be provided. Many firms believe that the market dictates a "competitive" pricing structure. However, this is not always the case—many companies with a high price structure are very successful. Regardless of the strategies, customers must believe that the product's price is appropriate. The price of a product or service, therefore, should not be set until marketing strategies have been developed.[25]

10-8 Pricing Strategies

LO10.9 List the key features of a pricing strategy

One final marketing issue that needs to be addressed is that of pricing strategies. Many entrepreneurs are unsure of how to price their product or service, even after marketing research is conducted. A number of factors affect this decision: the degree of competitive pressure, the availability of sufficient supply, seasonal or cyclical changes in demand, distribution costs, the product's life cycle stage, changes in production costs, prevailing economic conditions, customer services provided by the seller, the amount of promotion done, and the market's buying power. Obviously, the ultimate price decision will balance many of these factors and, usually, will not satisfy *all* conditions. However, awareness of the various factors is important.

Other considerations, sometimes overlooked, are psychological in nature:

- In some situations, the quality of a product is interpreted by customers according to the level of the item's price.
- Some customer groups shy away from purchasing a product when no printed price schedule is available.
- An emphasis on the monthly cost of purchasing an expensive item often results in greater sales than an emphasis on total selling price.
- Most buyers expect to pay even-numbered prices for prestigious items and odd-numbered prices for commonly available goods.
- The greater the number of meaningful customer benefits the seller can convey about a given product, the less the price resistance (generally).[26]

10-8a Views of Pricing

Pricing can be viewed as value, variable, variety, visible, and virtual. When seen as *value*, the amount a customer is willing to pay is, in the final analysis, a statement of the amount of value they perceive in the product or service. Pricing can be *variable*, such as varying the components of payment, what is actually being paid for, the time of payment, the form of payment, the terms of payment, and the person doing some or all of the paying. There is a *variety* of pricing because firms typically sell multiple products and services, and they may use the price of some items to influence the sales of others or price in a manner that pushes items with higher versus lower profit margins. The *visible* nature of pricing means that customers see and are aware of the prices of most things that they buy, which signals to the customer ideas about value, image, product availability, demand conditions, and exclusivity. Finally, pricing is *virtual* because it is the easiest and quickest to change in response to market conditions, especially in today's technological age.[27]

10-8b Product Life Cycle Pricing

Pricing procedures differ depending on the nature of the venture: retail, manufacturing, or service. Pricing for the product life cycle as presented in Table 10.5, however, might be applied to any type of business. The table demonstrates the basic steps of developing a pricing system and indicates how that system should relate to the desired pricing goals.

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Table 10.5 Pricing for the Product Life Cycle

Customer demand and sales volume will vary with the development of a product. Thus, pricing for products needs to be adjusted at each stage of their life cycle. The following outline provides some suggested pricing methods that relate to the different stages in the product life cycle. With this general outline in mind, potential entrepreneurs can formulate the most appropriate pricing strategy.

Product Life Cycle Stage	Pricing Strategy	Reasons/Effects
Introductory Stage		
Unique product	**Skimming**—deliberately setting a high price to maximize short-term profits	Initial price set high to establish a quality image, to provide capital to offset development costs, and to allow for future price reductions to handle competition
Nonunique product	**Penetration**—setting prices at such a low level that products are sold at a loss	Allows quick gains in market share by setting a price below competitors' prices
Growth stage	**Consumer pricing**—combining penetration and competitive pricing to gain market share; depends on consumer's perceived value of product	Depends on the number of potential competitors, size of total market, and distribution of that market
Maturity stage	**Demand-oriented pricing**—a flexible strategy that bases pricing decisions on the demand level for the product	Sales growth declines; customers are very price sensitive
Decline stage	**Loss leader pricing**—pricing the product below cost in an attempt to attract customers to other products	Product possesses little or no attraction to customers; the idea is to have low prices bring customers to newer product lines

Source: Adapted from Colleen Green, "Strategic Pricing," *Small Business Reports*, August 1989, 27–33; updated for accuracy February 2015.

10-8c Pricing in the Social Media Age

LO10.10 Discuss pricing in the social media age

Today's social media start-ups are finding unique ways of generating revenue from the very beginning. There are numerous variations of revenue models, including freemium, affiliate, subscription, virtual goods, and advertising. Let's briefly examine these.

Freemium Model The **freemium model** offers a basic service for free while charging for a premium service with advanced features to paying members. Examples of companies that have used this method include Flickr and LinkedIn. The biggest challenge for businesses using the freemium model is figuring how much to give away for free so that users will still need and want to upgrade to a paying plan. If most users can get by with the basic free plan, they won't have a need to upgrade.

Affiliate Model In the **affiliate model**, the business makes money by driving traffic, leads, or sales to another, affiliated company's website. Businesses that sell a product, meanwhile, rely on affiliated sites to send them the traffic or leads they need to make sales. Like businesses that rely on advertising, high-traffic sites have an easier time making money using affiliate links than sites that are just starting out. The biggest challenge may be reader trust and proper targeting. It's worth the time researching those in your market niche and initiate conversations with them.

Subscription Model The **subscription model** requires users to pay a fee (generally monthly or yearly) to access a product or service. If you are creating a long-term relationship with customers, then this model would be better in the long run. However, you need content and features every month that will be new and exciting. You should also recognize that monthly membership sites have a high attrition rate—after the first time they log in, they forget about it and never come back.

Virtual Goods Model In the **virtual goods model**, users pay for virtual goods, such as upgrades, points, or gifts, on a website or in a game. Virtual goods come in all shapes and sizes. The attraction of virtual goods is that margins are high since goods essentially cost only as much as the bandwidth required to serve them, which is generally almost zero.

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Diversity in Entrepreneurship

Disabilities and Diversity

Today, more and more companies are investing in workplace diversity, equity, and inclusion (DEI) efforts. Far too often, though, these efforts focus only on limited demographic factors such as race, age, ethnicity, gender, and sexual orientation. As such, they overlook one of the largest groups in the United States—people with disabilities, who, according to the Centers for Disease Control and Prevention, account for roughly 26 percent of the U.S. population. Disability is an integral part of diversity that intersects all other identifies and should thus be a critical perspective to consider at the decision-making table.

In order to understand just how much impact people with disabilities have on our daily lives, let us look at a couple of examples. We might be used to thinking about products as designed for the masses and then adapted to people with disabilities. Smartphones are an example of that. Nevertheless, several technologies that we use today exist because of people with disabilities. Many such technologies have even become an integral feature of smartphones. A Silicon Valley inventor, Ray Kurzweil, developed multiple technologies with the National Federation of the Blind. One such technology that we all recognize is the text-to-speech software that we have come to know as Siri or Alexa. Similarly, hearing aids were one of the earliest proven applications of computers chips that can now be found in everything from fighter jets to your home fridge. Even curb cuts in sidewalks were developed for people in wheelchairs, but they proved to be useful for many other people, such as parents with strollers, small children, or teenagers with rollerblades.

For working-age individuals, having a disability can prove to be a significant challenge when pursuing traditional employment. There are widespread attitudinal barriers and lack of understanding of the impact of disabilities on an individual's day-to-day work. Because a particular disability may be outside the boundaries of what managers traditionally understand, they simply cannot comprehend what the disabled person is going through. This lack of understanding makes individuals and businesses reluctant to get involved and proactively provide support.

People with disabilities do not want to be—and should not be—excluded from the workforce. As many feel unwelcome in the traditional avenues, it is not surprising to see U.S. census numbers that show workers with disabilities opting for self-employment at a rate twice that of their nondisabled peers. Disability should not make individuals contemplate whether they should apply for certain positions. As with other diversity attributes, businesses need to do more to understand people with disability and include them into their DEI efforts.

Source: Adapted from Shira Ovide, "Disability Drives Innovation," *New York Times*, October 14, 2021; Gus Alexiou, "Disabled Entrepreneurs Speak Out on the Choice to Go It Alone and Be Your Own Boss," *Forbes*, November 28, 2021; and Gus Alexiou, "New Report Unveils Shocking Attitudes amongst Employers towards Disability Hiring," *Forbes*, November 15, 2021.

Advertising Model In the advertising model, advertisements are sold against the traffic of the site. Simply put, the more traffic you have on your site, the more you can charge for ads (additional demographics about your site's visitors, such as age, gender, location, or interests, also affects the amount you can charge advertisers to place ads on your site). However, it is never easy to monetize something that sits on top of a free service. Maintaining and increasing the value proposition is a daily challenge. Free trials may be the key, as they demonstrate respect for the users as well as confidence in the value that the service provides.[28]

Summary

The new marketing logic requires a fundamental rethinking of the old rules and realizes that today's marketing is dynamic and happening in real time where the customer is in control. This new marketing for entrepreneurs includes knowing what a market consists of, the understanding of marketing research, the development of a marketing plan, the effective understanding and application of social media marketing, and the proper approach to a pricing strategy.

Marketing research involves the gathering of information about a particular market, followed by analysis of that information. The marketing research process has five steps: (1) define the purpose and objectives of the research, (2) gather secondary data, (3) gather primary data, (4) develop an information-gathering instrument (if necessary), and (5) interpret and report the information.

Four major reasons that entrepreneurs may not carry out marketing research are (1) cost, (2) complexity of the undertaking, (3) belief that only major strategic decisions need to be supported through marketing research, and (4) belief that the data will be irrelevant to company

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operations. Usually, they misunderstand the value of marketing research or fear its cost.

Social media marketing describes the use of social networks, online communities, blogs, wikis, and other online collaborative media for marketing purposes. The most common social media marketing tools include Twitter, blogs, LinkedIn, Facebook, Flickr, and YouTube. A social media marketing plan should be developed that details the venture's social media goals and the actions necessary to achieve them. Mobile devices are now within everyone's reach, and thus people are connected with their social networks constantly. Mobile social media marketing is a fast-paced and high-impact marketing tool that many companies have started to use very successfully as part of their overall marketing strategy. Many companies are now using mobile social media applications as their standard communication strategy to connect with consumers.

Because new start-up ventures are resource constrained, the chapter covered some innovative methods for entrepreneurs to conduct market research. From there, we examined the development of a marketing concept that has three important parts. The first part is the formulation of a marketing philosophy. Some entrepreneurs are production driven, others are sales driven, and still others are consumer driven. The entrepreneur's values and the market conditions will help determine this philosophy. The second part is market segmentation, which is the process of identifying a specific set of characteristics that differentiates one group of consumers from the rest. Demographic and benefit variables often are used in this process. The third part is an understanding of consumer behavior. Because many types and patterns of consumer behavior exist, entrepreneurs need to focus on the personal and psychological characteristics of their customers. In this way, they can determine a tailor-made, consumer-oriented strategy. This customer analysis focuses on such important factors as general buying trends in the marketplace, specific buying trends of targeted consumers, and the types of goods and services being sold.

A marketing plan is the process of determining a clear, comprehensive approach to the creation of customers. The following elements are critical for developing this plan: current marketing research, current sales analysis, a marketing information system, sales forecasting, and evaluation.

Pricing strategies are a reflection of marketing research and must consider such factors as marketing competitiveness, consumer demand, life cycle of the goods or services being sold, costs, and prevailing economic conditions. Today's social media start-ups are finding unique ways of generating revenue from the very beginning. In the chapter, we presented five revenue models, including freemium, affiliate, subscription, virtual goods, and advertising.

Key Terms

advertising model
affiliate model
blog monitoring
consumer-driven philosophy
consumer pricing
demand-oriented pricing
freemium model
guerrilla marketing plan
individualize
initiate
integrate
involve
loss leader pricing
mobile marketing
market
marketing research
market segmentation
penetration
primary data
production-driven philosophy
qualitative research
quantitative research
sales-driven philosophy
secondary data
skimming
social media marketing
subscription model
virtual goods model

Review and Discussion Questions

1. Describe the "new" marketing concept for entrepreneurs with the 4 Cs.
2. In your own words, what is a market? How can marketing research help an entrepreneur identify a market?
3. What are the five steps in the marketing research process? Briefly describe each.
4. Which is of greater value to the entrepreneur, primary or secondary data? Why?
5. Identify and describe three of the primary obstacles to undertaking marketing research.
6. Describe social media marketing and mobile marketing. Be specific in your answer.
7. Discuss some of the entrepreneurial tactics in market research that are accomplished with limited resources.
8. How would an entrepreneur's new-venture strategy differ under each of the following marketing philosophies: production driven, sales driven, and consumer driven? Be complete in your answer.
9. In your own words, what is market segmentation? What role do demographic and benefit variables play in the segmentation process?
10. Identify and discuss three of the psychological characteristics that help an entrepreneur identify and describe customers. Also, explain how the product life cycle will affect the purchasing behavior of these customers.
11. Identify three channels of distribution that can be used by an entrepreneur.
12. What are the five steps that are particularly helpful for developing a marketing plan? Identify and describe each.

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13. What are some of the major environmental factors that affect pricing strategies? What are some of the major psychological factors that affect pricing? Identify and discuss three of each.
14. Explain how pricing is viewed in different ways. Be specific.
15. How do pricing strategies differ based on the product life cycle?
16. Identify the five revenue models for social media start-ups.

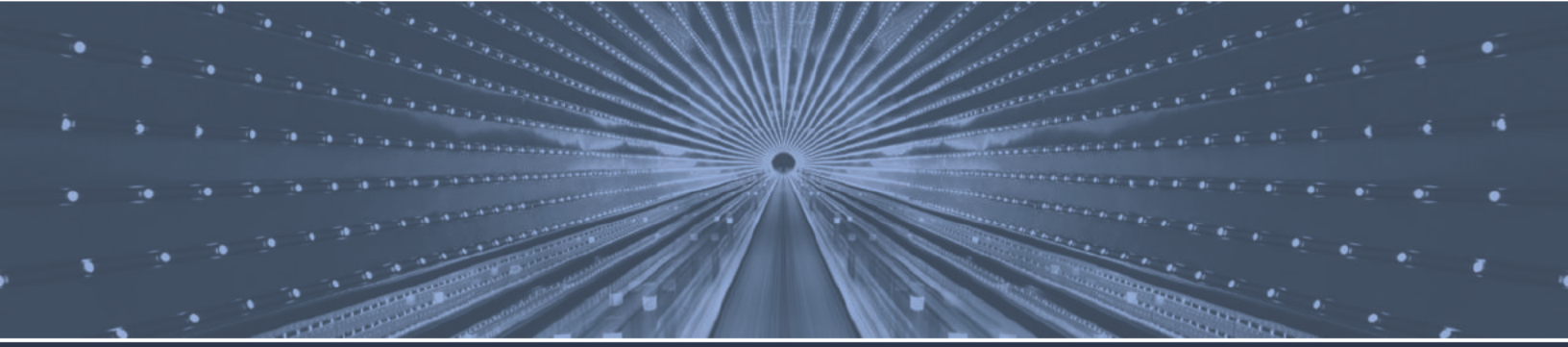
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Chapter 11

Financial Preparation for Entrepreneurial Ventures

Learning Objectives

11.1. Explain the principal financial statements needed for any entrepreneurial venture
11.2. Outline the process of preparing an operating budget
11.3. Explain how to draw up a cash-flow statement
11.4. Describe how pro forma statements are prepared
11.5. Explain how capital budgeting can be used in the decision-making process
11.6. Illustrate how to use break-even analysis
11.7. Describe ratio analysis
11.8. Illustrate the use of some of the important ratio measures and their meanings

Entrepreneurial Thought

Small company managers are too inclined to delegate to outside accountants every decision about their companies' financial statements. Indeed, it is most unfair to suppose that accountants can produce—without management's advice and counsel—the perfect statement for a company. Instead, I contend, top managers of growing small companies must work with their independent accountants in preparing company financial statements to ensure that the right message is being conveyed.

—James Mcneill Stancill, *Growing Concerns*

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11-1 The Importance of Financial Information for Entrepreneurs

Today's entrepreneur operates in a competitive environment characterized by the constraining forces of governmental regulation, competition, and resources. In regard to the latter, no firm has access to an unlimited amount of resources. So, in order to compete effectively, the entrepreneur must allocate resources efficiently. Three kinds of resources are available to the entrepreneur: human, material, and financial. This chapter focuses on financial resources in the entrepreneurial environment, beginning with a discussion of financial statements as a managerial planning tool. How the budgeting process translates into the preparation of pro forma statements is presented, and attention is also given to break-even analysis and ratio analysis as profit-planning tools.

Financial information pulls together all of the information presented in the other segments of the business: marketing, distribution, manufacturing, and management. It also quantifies all of the assumptions and historical information concerning business operations.[1]

It should be remembered that entrepreneurs make assumptions to explain how numbers are derived, and they correlate these assumptions with information presented in other parts of the business operations. The set of assumptions on which projections are based should be clearly and precisely presented; without these assumptions, numbers will have little meaning. It is only after carefully considering such assumptions that the entrepreneur can assess the validity of financial projections. Because the rest of the financial plan is an outgrowth of these assumptions, they are the most integral part of any financial segment. (See Table 11.1 for a financial glossary for entrepreneurs.)

Table 11.1 A Financial Glossary for the Entrepreneur

Accrual system of accounting A method of recording and allocating income and costs for the period in which each is involved regardless of the date of payment or collection. For example, if you were paid $100 in April for goods you sold in March, the $100 would be income for March under an accrual system. (Accrual is the opposite of the cash system of accounting.)
Asset Anything of value that is owned by you or your business.
Balance sheet An itemized statement listing the total assets and liabilities of your business at a given moment. It is also called a *statement of condition*.
Capital (1) The amount invested in a business by the proprietor(s) or stockholders. (2) The money available for investment or money invested.
Cash flow The schedule of your cash receipts and disbursements.
Cash system of accounting A method of accounting whereby revenue and expenses are recorded when received and paid, respectively, without regard for the period to which they apply.
Collateral Property you own that you pledge to the lender as security on a loan until the loan is repaid. Collateral can be a car, home, stocks, bonds, or equipment.
Cost of goods sold This is determined by subtracting the value of the ending inventory from the sum of the beginning inventory and purchases made during the period. Gross sales less cost of goods sold gives you gross profit.
Current assets Cash and assets that can be easily converted to cash, such as accounts receivable and inventory. Current assets should exceed current liabilities.
Current liabilities Debts you must pay within a year (also called short-term liabilities).
Depreciation Lost usefulness; expired utility; the diminution of service yield from a fixed asset or fixed asset group that cannot or will not be restored by repairs or by replacement of parts.
Equity An interest in property or in a business, subject to prior creditors. An owner's equity in their business is the difference between the value of the company's assets and the debt owed by the company. For example, if you borrow $30,000 to purchase assets for which you pay a total of $50,000, your equity is $20,000.
Expense An expired cost; any item or class of cost of (or loss from) carrying on an activity; a present or past expenditure defraying a present operating cost or representing an irrecoverable cost or loss; an item of capital expenditures written down or off; a term often used with some qualifying expression denoting function, organization, or time, such as a selling expense, factory expense, or monthly expense.

(*Continued*)

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Table 11.1 A Financial Glossary for the Entrepreneur (*Continued*)
Financial statement A report summarizing the financial condition of a business. It normally includes a balance sheet and an income statement.
Gross profit Sales less the cost of goods sold. For example, if you sell $100,000 worth of merchandise for which you paid $80,000, your gross profit would be $20,000. To get net profit, however, you would have to deduct other expenses incurred during the period in which the sales were made, such as rent, insurance, and sales staff salaries.
Income statement Also called *profit and loss statement*. A statement summarizing the income of a business during a specific period.
Interest The cost of borrowing money. It is paid to the lender and is usually expressed as an annual percentage of the loan. That is, if you borrow $100 at 12 percent, you pay 1 percent (0.01 × 100 × 1) interest per month. Interest is an expense of doing business.
Liability Money you owe to your creditors. Liabilities can be in the form of a bank loan, accounts payable, and so on. They represent a claim against your assets.
Loss When a business's total expenses for the period are greater than the income.
Net profit Total income for the period less total expenses for the period. (See *Gross profit*.)
Net worth The same as *equity*.
Personal financial statement A report summarizing your personal financial condition. Normally it includes a listing of your assets, liabilities, large monthly expenses, and sources of income.
Profit (See *Net profit* and *Gross profit*.) "Profit" usually refers to net profit.
Profit and loss statement Same as *income statement*.
Variable cost Costs that vary with the level of production on sales, such as direct labor, material, and sales commissions.
Working capital The excess of current assets over current liabilities.

In order for entrepreneurs to develop the key components of a financial segment, they should follow a clear process, described in the next section.

11-2 Understanding the Key Financial Statements

Financial statements are powerful tools that entrepreneurs can use to manage their ventures.[2] The basic financial statements an entrepreneur needs to be familiar with are the balance sheet, the income statement, and the cash-flow statement. The following sections examine each of these in depth, providing a foundation for understanding the books of record all ventures need.

11-2a The Balance Sheet

LO11.1 Explain the principal financial statements needed for any entrepreneurial venture

A balance sheet is a financial statement that reports a business's financial position at a specific time. Many accountants like to think of it as a picture taken at the close of business on a particular day, such as December 31. The closing date is usually the one that marks the end of the business year for the organization.

The balance sheet is divided into two parts: the financial resources owned by the firm and the claims against these resources. Traditionally, these claims against the resources come from two groups: creditors who have a claim to the firm's assets and can sue the company if these obligations are not paid and owners who have rights to anything left over after the creditors' claims have been paid.

The financial resources the firm owns are called *assets*. The claims that creditors have against the company are called *liabilities*. The residual interest of the firm's owners is known as *owner's equity*. When all three are placed on the balance sheet, the assets are listed on the left, and the liabilities and owner's equity are listed on the right.

An asset is something of value the business owns. To determine the value of an asset, the owner/manager must do the following:

1. Identify the resource.
2. Provide a monetary measurement of that resource's value.
3. Establish the degree of ownership in the resource.

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Most assets can be identified easily. They are tangible, such as cash, land, and equipment. However, *intangible assets* also exist. These are assets that cannot be seen; examples include copyrights and patents.

Liabilities are the debts of the business. These may be incurred either through normal operations or through the process of obtaining funds to finance operations. A common liability is a short-term account payable in which the business orders some merchandise, receives it, and has not yet paid for it. This often occurs when a company receives merchandise during the third week of the month and does not pay for it until it pays all of its bills on the first day of the next month. If the balance sheet was constructed as of the end of the month, the account still would be payable at that time.

Liabilities are divided into two categories: short term and long term. **Short-term liabilities** (also called **current liabilities**) are those that must be paid during the coming 12 months. **Long-term liabilities** are those that are not due and payable within the next 12 months, such as a mortgage on a building or a five-year bank loan.

Owner's equity is what remains after the firm's liabilities are subtracted from its assets—it is the claim the owners have against the firm's assets. If the business loses money, its owner's equity will decline. This concept will become clearer when we explain why a balance sheet always balances.[3]

Understanding the Balance Sheet

To fully explain the balance sheet, it is necessary to examine a typical one and determine what each entry means. Table 11.2 provides an illustration. Note that it has three sections: assets, liabilities, and owner's equity. Within each of these classifications are various types of accounts. The following sections examine each type of account presented in the table.

Current Assets Current assets consist of cash and other assets that are reasonably expected to be turned into cash, sold, or used up during a normal operating cycle. The most common types of current assets are those shown in Table 11.2.

Cash refers to coins, currency, and checks on hand. It also includes money that the business has in its checking and savings accounts.

Accounts receivable are claims of the business against its customers for unpaid balances from the sale of merchandise or the performance of services. For example, many firms sell on credit and expect their customers to pay by the end of the month. Or, in many of these cases, they send customers a bill at the end of the month and ask for payment within 10 days.

The *allowance for uncollectible accounts* refers to accounts receivable judged to be uncollectible. How does a business know when receivables are not collectible? This question can be difficult to answer, and a definitive answer is not known. However, assume that the business asks all of its customers to pay within the first 10 days of the month following the purchase. Furthermore, an aging of the accounts receivable shows that the following amounts are due the firm:

Number of Days Outstanding	Amount of Receivables
1–11	$325,000
11–20	25,000
21–30	20,000
31–60	5,000
61–90	7,500
91+	17,500

In this case, the firm might believe that anything more than 60 days old will not be paid and will write it off as uncollectible. Note that, in Table 11.2, the allowance for uncollectible accounts is $25,000, the amount that has been outstanding for more than 60 days.

Inventory is merchandise held by the company for resale to customers. Current inventory in our example is $150,000, but this is not all of the inventory the firm had on hand all year. Naturally, the company started the year with some inventory and purchased more as sales were made. This balance sheet figure is what was left at the end of the fiscal year.

Prepaid expenses are expenses that the firm already has paid but that have not yet been used. For example, insurance paid on the company car every six months is a prepaid-expense entry because it will be six months before all of the premium has been used. As a result, the accountant would reduce this prepaid amount by one-sixth each month. Sometimes supplies, services, and rent are also prepaid, in which case the same approach is followed.

Fixed assets consist of land, building, equipment, and other assets expected to remain with the firm for an extended period. They are not totally used up in the production of the firm's goods and services. Some of the most common types are shown in Table 11.2.

Land is property used in the operation of the firm. This is not land that has been purchased for expansion or speculation; that would be listed as an investment rather than a fixed asset. Land is listed on the balance sheet at cost, and its value usually is changed only periodically. For example, every five years, the value of the land might be recalculated so that its value on the balance sheet and its resale value are the same.

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Table 11.2 Kendon Corporation Balance Sheet for the Year Ended December 31, 2025

Assets		
Current Assets		
Cash		$200,000
Accounts receivable	$375,000	
Less: allowance for uncollectible accounts	$25,000	350,000
Inventory		150,000
Prepaid expenses		35,000
Total current assets		$735,000
Fixed Assets		
Land		$330,000
Building	$315,000	
Less: accumulated depreciation of building	80,000	
Equipment	410,000	
Less: accumulated depreciation of equipment	60,000	
Total fixed assets		915,000
Total assets		$1,650,000
Liabilities		
Current Liabilities		
Accounts payable	$150,000	
Notes payable	25,000	
Taxes payable	75,000	
Loan payable	50,000	
Total current liabilities		$300,000
Bank loan		200,000
Total liabilities		$500,000
Owner's Equity		
Contributed Capital		
Common stock, $10 par, 40,000 shares	$400,000	
Preferred stock, $100 par, 500 shares		
Authorized, none sold		
Retained Earnings	750,000	
Total owner's equity		1,150,000
Total liabilities and owner's equity		$1,650,000

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Building consists of the structures that house the business. If the firm has more than one building, the total cost of all the structures is listed.

Accumulated depreciation of building refers to the amount of the building that has been written off the books due to wear and tear. For example, referring to Table 11.2, the original cost of the building was $315,000, but accumulated depreciation is $80,000, leaving a net value of $235,000. The amount of depreciation charged each year is determined by the company accountant after checking with the Internal Revenue Service rules. A standard depreciation is 5 percent per year for new buildings, although an accelerated method sometimes is used. In any event, the amount written off is a tax-deductible expense. Depreciation therefore reduces the amount of taxable income to the firm and helps lower the tax liability. In this way, the business gets the opportunity to recover part of its investment.

Equipment is the machinery the business uses to produce goods. This is placed on the books at cost and then depreciated and listed as the *accumulated depreciation of equipment*. In our example, it is $60,000. The logic behind equipment depreciation and its effect on the firm's income taxes is the same as that for accumulated depreciation on the building.

Current Liabilities Current liabilities are obligations that will become due and payable during the next year or within the operating cycle. The most common current liabilities are listed in Table 11.2.

Accounts payable are liabilities incurred when goods or supplies are purchased on credit. For example, if the business buys on a basis of net 30 days, during that 30 days, the bill for the goods will constitute an account payable.

A **note payable** is a promissory note given as tangible recognition of a supplier's claim or a note given in connection with an acquisition of funds, such as for a bank loan. Some suppliers require that a note be given when a company buys merchandise and is unable to pay for it immediately.

Taxes payable are liabilities owed to the government—federal, state, and local. Most businesses pay their federal and state income taxes on a quarterly basis. Typically, payments are made on April 15, June 15, and September 15 of the current year and January 15 of the following year. Then the business closes its books, determines whether it still owes any taxes, and makes the required payments by April 15. Other taxes payable are sales taxes. For example, most states (and some cities) levy a sales tax. Each merchant must collect the taxes and remit them to the appropriate agency.

A **loan payable** is the current installment on a long-term debt that must be paid this year. As a result, it becomes a part of the current liabilities. The remainder is carried as a long-term debt. Note that, in Table 11.2, $50,000 of this debt was paid in 2025 by the Kendon Corporation.

Long-Term Liabilities As we have said, long-term liabilities consist of obligations that will not become due or payable for at least one year or not within the current operating cycle. The most common are bank loans.

A *bank loan* is a long-term liability due to a loan from a lending institution. Although it is unclear from the balance sheet in Table 11.2 how large the bank loan originally was, it is being paid down at the rate of $50,000 annually. Thus, it will take four more years to pay off the loan.

Contributed Capital The Kendon Corporation is owned by individuals who have purchased stock in the business. Various kinds of stock can be sold by a corporation, the most typical being common stock and preferred stock. Only common stock has been sold by this company.

Common stock is the most basic form of corporate ownership. This ownership gives the individual the right to vote for the board of directors. Usually, for every share of common stock held, the individual is entitled to one vote. As shown in Table 11.2, the corporation has issued 40,000 shares of $10 par common stock, raising $400,000. Although the term *par value* may have little meaning to most stockholders, it has legal implications: it determines the legal capital of the corporation. This legal capital constitutes an amount that total stockholders' equity cannot be reduced below except under certain circumstances (the most common is a series of net losses). For legal reasons, the total par value of the stock is maintained in the accounting records. However, it has no effect on the *market value* of the stock.

Preferred stock differs from common stock in that its holders have preference to the assets of the firm in case of dissolution. This means that, after the creditors are paid, preferred stockholders have the next claim on whatever assets are left. The common stockholders' claims come last. Table 11.2 shows that 500 shares of preferred stock were issued, each worth a par value of $100, but none has been sold. Therefore, it is not shown as a number on the balance sheet.

Retained Earnings **Retained earnings** are the accumulated net income over the life of the business to date. In Table 11.2, the retained earnings are shown as $750,000. Every year, this amount increases by the profit the firm makes and keeps within the company. If dividends are declared on the stock, they, of course, are paid from the total net earnings. Retained earnings are what remain after that.

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The Entrepreneurial Process

Watching Your Accounts Receivables

One of the primary issues that plagues start-up companies is poor cash flow, and one of the largest contributors to this problem is uncollected or extremely delayed accounts receivables. When the economy is in decline, the first tactic that most businesses will employ is to stretch out the payments on their accounts payables as long as they can, which presents an issue for their vendors. Most entrepreneurs offer credit to their customers to encourage business, but when those customers choose not to pay off that credit in a timely manner, businesses servicing them can face a cash deficit, making payments to their own vendors problematic. In some cases, entrepreneurs are left with no choice but to take on credit cards that charge excessive interest rates just to keep their business afloat.

Avoiding this situation takes significant forethought on the part of the management team. A good rule of thumb is to always secure funding before your company needs it. You will usually find cash when in dire straits, but the cost of that capital can be significant. Securing an operating line of credit and keeping tabs on your accounts receivable will help prevent expensive mistakes when the going gets tough.

Following are seven tips for making sure that you are paid what is coming to you:

Track your accounts receivable with software. Given the abundance of free and inexpensive invoice creating and tracking software, the only reason not to use one is if you do not have a computer or a smartphone. One example is QuickBooks, which is cost effective and user friendly. However, there are a plethora of other choices as well.

Develop a process. Customers will stretch out their payments to you if they think they can get away with it; do not let them. Being consistent when dealing with your customers will let them know that you take collecting your receivables seriously. Establish a payment due date and enforce it. If you let your customers slide, you will be sending them the message that they can pay when they want to, which might work fine when your company is flush with cash but will be a significant burden if your business hits a lull.

Make some noise. Once you have provided a product or service, you are entitled to get paid. You should not feel guilty about contacting your customers about a delinquent payment. After all, you have upheld your end of the deal. Your customers are going to pay the vendors who are the most committed to getting paid. If you choose to sit idle, you may never get your money.

Get paid up front. When in doubt, there is no better way to ensure payment than by mandating that your customers pay up front; this is especially useful when working with new clients. You can always charge a percentage so that you and your customers are sharing the burden of responsibility. In the event that you choose to issue credit to a customer, make sure to perform a credit check first.

Find an advocate. The person paying your company is most likely not the entrepreneur. Find out who is responsible for issuing payments in each of your respective customers' businesses so that you get to know them. The order in which payments are submitted will usually be at the discretion of this individual, so you stand a greater chance of being at the top of that list if they know you.

Discounts for early payment. Incentivize customers to pay as soon as possible by offering discounts. One of the more popular credit terms is 2%/10, net 30 days. This means that a customer receives a 2 percent discount if they pay within 10 days and that the total balance is due within 30 days of the date of the invoice.

Know when to walk away. Despite what traditional thinking suggests, customers are not always right, and they are not always profitable. The time spent collecting fees from a customer and the cost of carrying the credit for that customer might outweigh the margins that customer's business is generating. If that turns out to be the case, do not be afraid to discontinue the relationship. Often, the costs far outweigh what appears on your financial statements given that time spent on troublesome customers could be spent acquiring new business. To prevent such issues from burdening your company, conduct annual audits of your customers and consider eliminating those that cost you money.

Cash-flow management is a process that never ends for an entrepreneur. Liquidity is an important metric when considering the health of your business; if you are allowing your customers to postpone their payments, you risk their putting your company's life in jeopardy.

Source: Adapted from C. J. Prince, "Time Bomb," *Entrepreneur*, January 2008, http://www.entrepreneur.com/magazine/entrepreneur/2008/january/187658.html, accessed May 12, 2012, and Ronika Khanna, "Tips on Managing Your Accounts Receivable," *Toolbox.com*, November 23, 2010, http://finance.toolbox.com/blogs/montreal-financial/tips-on-managing-your-accounts-receivable-42717, accessed May 12, 2012.

Why the Balance Sheet Always Balances

By definition, the balance sheet always balances.[4] If something happens on one side of the balance sheet, it is offset by something on the other side. Hence, the balance sheet remains in balance. Before examining some illustrations, let us restate the balance sheet equation:

$$\text{Assets} = \text{Liabilities} + \text{Owner's Equity}$$

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With this in mind, let us look at some typical examples of business transactions and their effect on the balance sheet.

A Credit Transaction The Kendon Corporation calls one of its suppliers and asks for delivery of $11,000 in materials. The materials arrive the next day, and the company takes possession of them.

The bill is to be paid within 30 days. How is the balance sheet affected? *Inventory* goes up by $11,000, and *accounts payable* rise by $11,000. The increase in current assets is offset by an increase in current liabilities.

Continuing this illustration, what happens when the bill is paid? The company issues a check for $11,000, and *cash* declines by this amount. At the same time, *accounts payable* decrease by $11,000. Again, these are offsetting transactions, and the balance sheet remains in balance.

A Bank Loan Table 11.2 shows that the Kendon Corporation had an outstanding bank loan of $200,000 in 2025. Assume that the company increases this loan by $110,000 in 2026. How is the balance sheet affected? *Cash* goes up by $110,000, and *bank loan* increases by the same amount; again, balance is achieved. However, what if the firm uses this $110,000 to buy new machinery? In this case, *cash* decreases by $110,000 and *equipment* increases by a like amount. Again, a balance exists. Finally, what if Kendon decides to pay off its bank loan? In this case, the first situation is reversed; *cash* and *bank loan* (long-term liabilities) decrease in equal amounts.

A Stock Sale Suppose that the company issues and sells another 40,000 shares of $10 par *common* stock. How does this action affect the balance sheet? (This answer is rather simple.) *Common stock* increases by $400,000, and so does *cash*. Once more, a balance exists.

With these examples in mind, it should be obvious why the balance sheet always balances. Every entry has an equal and offsetting entry to maintain this equation:

$$\text{Assets} = \text{Liabilities} + \text{Owner's Equity}$$

Keep in mind that, in accounting language, the terms *debit* and *credit* denote increases and decreases in assets, liabilities, and owner's equity. The following chart relates debits and credits to increases and decreases:

Category	A Transaction Increasing the Amount	A Transaction Decreasing the Amount
Asset	Debit	Credit
Liability	Credit	Debit
Owner's equity	Credit	Debit

Applying this idea to the preceding examples results in the following:

	Debit	Credit
Credit Transaction		
Inventory	$11,000	
Accounts payable		$11,000
Bank Loan		
Cash	110,000	
Bank loan		110,000
Stock Sale		
Cash	400,000	
Common stock		400,000
	$511,000	$511,000

11-2b The Income Statement

The **income statement** is a financial statement that shows the change that has occurred in a firm's position as a result of its operations over a specific period. This is in contrast to the balance sheet, which reflects the company's position at a particular point in time.

The income statement, sometimes referred to as a "profit and loss statement" or "P&L," reports the success (or failure) of the business during the period. In essence, it shows whether revenues were greater than or less than expenses. These *revenues* are the monies the small business has received from the sale of its goods and services. The *expenses* are the costs of the resources used to obtain the revenues. These costs range from the cost of materials used in the products the firm makes to the salaries it pays its employees.

Most income statements cover a one-year interval, but it is not uncommon to find monthly, quarterly, or semiannual income statements. All of the revenues and expenses accumulated during this time are determined, and the net income for the period is identified. Many firms prepare quarterly income statements but construct a balance sheet only once a year. This is because they are interested far more in their profits and losses than in examining their asset, liability, and owner's equity positions. However, it should be noted that the income statement drawn up at the end of the year will coincide with the firm's fiscal year, just as the balance sheet does. As a result, at the end of the business year, the organization will have both a balance sheet and an income statement. In this way, they can be considered together, and the interrelationship between them can be studied. A number of different types of

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income and expenses are reported on the income statement. However, for purposes of simplicity, the income statement can be reduced to three primary categories: (1) revenues, (2) expenses, and (3) net income.

Revenues are the gross sales the business made during the particular period under review. Revenue often consists of the money actually received from sales, but this need not be the case. For example, sales made on account still are recognized as revenue, as when a furniture store sells $500 of furniture to a customer today, delivers it tomorrow, and will receive payment two weeks from now. From the moment the goods are delivered, the company can claim an increase in revenue.

Expenses are the costs associated with producing goods or services. For the furniture store in the preceding paragraph, the expenses associated with the sale would include the costs of acquiring, selling, and delivering the merchandise. Sometimes these are expenses that will be paid later. For example, the people who deliver the furniture may be paid every two weeks, so the actual outflow of expense money in the form of salaries will not occur at the same time the work is performed. Nevertheless, it is treated as an expense.

Net income is the excess of revenue over expenses during the particular period under discussion. If revenues exceed expenses, the result is a *net profit*. If the reverse is true, the firm suffers a *net loss*. At the end of the accounting period, all of the revenues and expenses associated with all of the sales of goods and services are added together, and then the expenses are subtracted from the revenues. In this way, the firm knows whether it made an overall profit or suffered an overall loss.[5]

Understanding the Income Statement

To explain the income statement fully, it is necessary to examine one and determine what each account is. Table 11.3 illustrates a typical income statement. It has five major sections: (1) sales revenue, (2) cost of goods sold, (3) operating expenses, (4) financial expense, and (5) income taxes estimated.

Revenue Every time a business sells a product or performs a service, it obtains revenue. This often is referred to as *gross revenue* or *sales revenue*. However, it is usually an overstated figure because the company finds that some of its goods are returned or some customers take advantage of prompt-payment discounts.

In Table 11.3, sales revenue is $1,750,000. However, the firm also has returns and allowances of $50,000. These returns are common for companies that operate on a "satisfaction or your money back" policy. In any event, a small business should keep tabs on these returns and allowances to see if the total is high in relation to the total sales revenue. If so, the firm will know that something is wrong with what it is selling, and it can take action to correct the situation.

Table 11.3 Kendon Corporation Income Statement for the Year Ended December 31, 2025

Sales Revenue	$1,750,000	
Less: sales returns and allowances	50,000	
Net sales		$1,700,000
Cost of Goods Sold		
Inventory, January 2000	$150,000	
Purchases	1,050,000	
Goods available for sale	$1,200,000	
Less: inventory, December 2000	200,000	
Cost of goods sold		1,000,000
Gross margin		$700,000
Operating Expenses		
Selling expenses	$150,000	
Administrative expenses	100,000	
Total operating expenses		250,000
Operating income		$450,000
Financial Expenses		$20,000
Income before income taxes		$430,000
Estimated income taxes		172,000
Net profit		$258,000

Deducting the sales returns and allowances from the sales revenue, the company finds its *net sales*. This amount must be great enough to offset the accompanying expenses in order to ensure a profit.

Cost of Goods Sold As the name implies, the cost of goods sold section reports the cost of merchandise sold during the accounting period. Simply put, the cost of goods for a given period equals the beginning inventory plus any purchases the firm makes minus the inventory on hand at the end of the period. Note that, in Table 11.3, the beginning inventory was $150,000, and the purchases totaled $1,050,000. This gave Kendon goods available for sale of $1,200,000. The ending inventory for the period was $200,000, so the cost of goods sold was $1,000,000. This is what it cost the company to buy the inventory it sold. When this cost of goods sold is subtracted from net sales, the result is the *gross*

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margin. The gross margin is the amount available to meet expenses and to provide some net income for the firm's owners.

Operating Expenses The major expenses, exclusive of costs of goods sold, are classified as **operating expenses**. These represent the resources expended, except for inventory purchases, to generate the revenue for the period. Expenses often are divided into two broad subclassifications: selling expenses and administrative expenses.

Selling expenses result from activities such as displaying, selling, delivering, and installing a product or performing a service. Expenses for displaying a product include rent for storage space, depreciation on fixtures and furniture, property insurance, and utility and tax expenses. Sales expenses, salaries, commissions, and advertising also fall into this category. Costs associated with getting the product from the store to the customer also are considered selling expenses. Finally, if the firm installs the product for the customer, all costs—including the parts used in the job—are considered in this total. Taken as a whole, these are the selling expenses.

Administrative expenses is a catchall term for operating expenses not directly related to selling or borrowing. In broad terms, these expenses include the costs associated with running the firm. They include salaries of the managers, expenses associated with operating the office, general expenses that cannot be related directly to buying or selling activities, and expenses that arise from delinquent or uncollectible accounts.

When these selling and administrative expenses are added together, the result is *total operating expenses*. Subtracting them from gross margin gives the firm its *operating income*. Note that, in Table 11.3, selling expenses are $150,000, administrative expenses are $100,000, and total operating expenses are $250,000. When subtracted from the gross margin of $700,000, the operating income is $450,000.

Financial Expense The **financial expense** is the interest expense on long-term loans. As seen in Table 11.3, this expense is $20,000. Additionally, many companies include their interest expense on short-term obligations as part of their financial expense.

Estimated Income Taxes As noted earlier, corporations pay estimated income taxes; then, at some predetermined time (e.g., December 31), the books are closed, actual taxes are determined, and any additional payments are made (or refunds claimed). When these taxes are subtracted from the income before income taxes, the result is the *net profit*. In our example, the Kendon Corporation made $258,000.

11-2c The Cash-Flow Statement

The **cash-flow statement** (also known as *statement of cash flows*) shows the effects of a company's operating, investing, and financing activities on its cash balance. The principal purpose of the statement of cash flows is to provide relevant information about a company's cash receipts and cash payments during a particular accounting period. It is useful for answering such questions as the following:

- How much cash did the firm generate from operations? How did the firm finance fixed capital expenditures?
- How much new debt did the firm add?
- Was the cash from operations sufficient to finance fixed asset purchases?

The statement of cash flows is a supplement to the balance sheet and income statements. One of the limitations of the income and balance sheet statements is that they are based on accrual accounting. In accrual accounting, revenues and expenses are recorded when incurred—not when cash changes hands. For example, if a sale is made for credit, under accrual accounting, the sale is recognized, but cash has not been received. Similarly, a tax expense may be shown in the income statement, but it may not be paid until later. The statement of cash flows reconciles the accrual-based figures in the income and balance sheet statements to the actual cash balance reported in the balance sheet.

The statement of cash flows is broken down into *operating, investing*, and *financing* activities. Table 11.4 provides an outline of a statement of cash flows. *Operating cash flows* refer to cash generated from or used in the course of business operations of the firm. The net operating cash flows will be positive for most firms because their operating inflows (primarily from revenue collections) will exceed operating cash outflows (e.g., payment for raw materials and wages).

Investing activities refer to cash-flow effects from long-term investing activities, such as purchase or sale of plant and equipment. The net cash flow from investing activities can be either positive or negative. A firm that is still in the growth phase would be building up fixed assets (installing new equipment or building new plants) and therefore would show negative cash flows from investing activities. On the other hand, a firm that is divesting unprofitable divisions may realize cash inflows from the sale of assets and therefore would show a positive cash flow from investing activities.

Financing activities refer to cash-flow effects of financing decisions of the firm, including sale of new securities (such as stocks and bonds), repurchase of securities, and payment of dividends. Note that payment of interest to lenders is *not* included under financing activities. Accounting convention in determining the statement of cash flows assumes that interest payments are part of operating cash flows. Once the cash flows from the three different sources—operating, investing, and financing—are identified, the beginning and ending cash balances are reconciled.

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Table 11.4 Format of Statement of Cash Flows	
Cash flows from operating activities	$50,000
Cash flows from investing activities	($10,000)
Cash flows from financing activities	$5,000
Net increase (decrease) in cash	$45,000
Cash at beginning of period	$400,000
Cash at end of period	$445,000

Because this statement is most frequently used by those analyzing the firm, the use of a cash budget may be the best approach for an entrepreneur starting up a venture. The cash budget procedure is covered in the next section.

11-3 Preparing Financial Budgets

One of the most powerful tools the entrepreneur can use in planning financial operations is a budget.[6] The *operating budget* is a statement of estimated income and expenses during a specified period of time. Another common type of budget is the *cash-flow budget*, which is a statement of estimated cash receipts and expenditures during a specified period of time. It is typical for a firm to prepare both types of budgets by first computing an operating budget and then constructing a cash budget based on the operating budget. A third common type of budget is the *capital budget*, which is used to plan expenditures on assets whose returns are expected to last beyond one year. This section examines all three of these budgets: operating, cash flow, and capital. Then the preparation of pro forma financial statements from these budgets is discussed.

11-3a The Operating Budget

LO11.2 Outline the process of preparing an operating budget

Typically, the first step in creating an operating budget is the preparation of the sales forecast.[7] An entrepreneur can prepare the sales forecast in several ways. One way is to implement a statistical forecasting technique such as simple linear regression. Simple linear regression is a technique in which a linear equation states the relationship among three variables:

$$Y = a + bx$$

where Y is a dependent variable (it is dependent on the values of a, b, and x), x is an independent variable (it is not dependent on any of the other variables), a is a constant (in regression analysis, Y is dependent on the variable x, all other things held constant), and b is the slope of the line (the change in Y divided by the change in x). For estimating sales, Y is the variable used to represent the expected sales, and x is the variable used to represent the factor on which sales are dependent. Some retail stores may believe that their sales are dependent on their advertising expenditures, whereas other stores may believe that their sales are dependent on some other variable, such as the amount of foot traffic past the store.

When using regression analysis, the entrepreneur will draw conclusions about the relationship between, for example, product sales and advertising expenditures. Presented next is an example of how Mary Tindle, owner of a clothing store, used regression analysis:

> Mary began with two initial assumptions: (1) If no money is spent on advertising, total sales will be $200,000, and (2) for every dollar spent on advertising, sales will be increased by two times that amount. Relating these two observations yields the following simple linear regression formula:
>
> $$S = \$200{,}000 + 2A$$

where

S = projected sales
A = advertising expenditures

(Note that it is often easier to substitute more meaningful letters into an equation. In this case, the letter S was substituted for the letter Y simply because the word *sales* starts with that letter. The same is true for the letter A, which was substituted for the letter x.) In order to determine the expected sales level, Mary must insert different advertising expenditures and complete the simple linear regression formula for each different expenditure. The following data and Figure 11.1 demonstrate the results.

Another commonly used technique for the preparation of a sales forecast is the estimation that current sales will increase a certain percentage over the prior period's sales. This percentage is based on a trend line analysis that covers the five preceding sales periods and assumes that the seasonal variations will continue to run in the same pattern. Obviously, because

Figure 11.1 Regression Analysis

Simple Linear Regression ($000)		
A	$2A$	$S = \$200 \times 2A$
$50	$100	$300
100	200	400
150	300	500
200	400	600
250	500	700
300	600	800

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it needs five preceding sales periods, trend line analysis is used for more established ventures. It is nevertheless an important tool that entrepreneurs should be aware of as the venture grows and becomes more established. Following is an example of how John Wheatman, owner of North Central Scientific, used trend line analysis to forecast sales for his computer retail store:

> After considerable analysis of his store's sales history, John Wheatman decided to use trend line analysis and estimated that sales would increase 5 percent during the next year, with the seasonal variations following roughly the same pattern. Because he has a personal computer with an electronic spreadsheet program, John chose to use the input of last year's sales figures in the spreadsheet and then to increase each month by 5 percent. The results are shown in Table 11.5.

After a firm has forecast its sales for the budget period, expenses must be estimated. The first type of expenses that should be estimated is the cost of goods sold, which follows sales on the income statement. For retail firms, this is a matter of projecting purchases and the corresponding desired beginning and ending inventories. Many firms prefer to have a certain percentage of the next month's sales on hand in inventory. Here is how John Wheatman determines his store's expected purchases and inventory requirements:

> For determining his purchase requirements, John Wheatman believes that his gross profit will represent 20 percent of his sales dollar. This is based on analysis of the past five years' income statement. Consequently, cost of goods sold will represent 80 percent of the sales for the current month. In addition, John wants to have approximately one week's inventory on hand. Thus, the ending inventory is estimated to be 25 percent of next month's sales. The results are shown in Table 11.6.

A manufacturing firm, on the other hand, will need to establish its production budget, a material purchases budget based on the production budget, and the corresponding direct labor budget. The production budget is management's estimate of the number of units that need to be produced in order to meet the sales forecast. This budget is prepared by working backward through the cost of goods sold section. First, the predicted number of units that will be sold during that month is determined. Then the desired ending-inventory-level balance is added to this figure. The sum of these two figures is the number of units that will be needed in inventory. Once the inventory requirements have been determined, the entrepreneur must determine how many of these units will be accounted for by the beginning inventory (which is the prior month's ending inventory) and how many units will have to be produced. The production requirement is calculated by subtracting the period's beginning inventory from the inventory needed for that period. An example follows:

> Tom B. Good, president and founder of Dynamic Manufacturing, has decided to implement a budget to help plan for his company's growth. After Tom received the unit sales forecast from his sales manager, he examined last year's product movement reports and determined that he would like to have 11 percent of the next month's sales on hand as a buffer against possible fluctuations in demand. He also has received a report from his production manager that his ending inventory this year is expected to be 12,000 widgets, which also will be the beginning inventory for the budget period. Table 11.7 shows the results.

After the production budget has been calculated, the materials required for producing the specified number of units can be determined from an analysis of the bill of materials for the product being manufactured. In addition, by examining the amount of direct labor needed to produce each unit, management can determine the amount of direct labor that will be needed during the forthcoming budget period.

The last step in preparing the operating budget is to estimate the operating expenses for the period. Three of the key concepts in developing an expense budget are fixed, variable, and mixed costs. A fixed cost is one that does not change in response to changes in activity for a given period of time; rent, depreciation, and certain salaries are examples. A variable cost is one that changes in the same direction as and in direct proportion to changes in operating activity; direct labor, direct materials, and sales commissions are examples. Mixed costs are

Table 11.5 North Central Scientific: Sales Forecast for 2025

	January	February	March	April	May	June
Sales	$300	$350	$400	$375	$500	$450
×1.05	315	368	420	394	525	473
	July	**August**	**September**	**October**	**November**	**December**
Sales	$475	$480	$440	$490	$510	$550
×1.05	499	504	462	515	536	578

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Table 11.6 North Central Scientific: Purchase Requirements Budget for 2025

	Jan.	Feb.	Mar.	Apr.	May	Jun.	Jul.	Aug.	Sep.	Oct.	Nov.	Dec.
Sales revenue	$315	$368	$420	$394	$525	$473	$499	$504	$462	$515	$536	$578
Cost of goods sold												
Beginning inventory	$63	$74	$84	$79	$105	$95	$100	$101	$92	$103	$107	$116
Purchases	263	305	331	341	410	383	400	395	380	416	437	413
Cost of goods available	$326	$379	$415	$420	$515	$478	$500	$496	$472	$519	$544	$529
Ending inventory	74	85	79	105	95	100	101	92	102	107	116	66
Cost of goods sold	$252	$294	$336	$315	$420	$378	$399	$403	$370	$412	$428	$462
Gross profit	$63	$74	$84	$79	$105	$95	$100	$101	$92	$103	$108	$116

Cost of goods sold = Current period sales × .80
Ending inventory = Next month's sales × (0.80)(0.25) (since inventory is carried at cost)
Cost of goods available = Cost of goods sold − Ending inventory
Beginning inventory = Prior month's ending inventory or current month's sales × (0.80)(0.25)
Purchases = Cost of goods available − Beginning inventory
Gross profit = Sales − Cost of goods sold

Table 11.7 Dynamic Manufacturing: Production Budget Worksheet for 2025

	Jan.	Feb.	Mar.	Apr.	May	Jun.	Jul.	Aug.	Sep.	Oct.	Nov.	Dec.
Projected sales (units)	125	136	123	143	154	234	212	267	236	345	367	498
Desired ending inventory	14	12	14	15	23	21	27	24	35	37	50	26
Available for sale	139	148	137	158	177	255	239	291	271	382	417	524
Less: Beginning inventory	12	14	12	14	15	23	21	27	24	35	37	50
Total production requirements	127	134	125	144	162	232	218	264	247	347	380	474

a blend of fixed and variable costs. An example is utilities because part of this expense would be responsive to change in activity, and the rest would be a fixed expense, remaining relatively stable during the budget period. Mixed costs can present a problem for management in that it is sometimes difficult to determine how much of the expense is variable and how much is fixed.

After the expenses have been budgeted, the sales, cost of goods, and expense budget are combined to form the operating budget. Table 11.8 outlines North Central Scientific's anticipated expenses for the budget year and the completed operating budget for the period. Each month represents the pro forma, or projected, income and expenses for that period.

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Table 11.8 North Central Scientific: Expense and Operating Budgets

In order to identify the behavior of the different expense accounts, John Wheatman decided to analyze the past five years' income statements. Following are the results of his analysis:

- Rent is a constant expense and is expected to remain the same during the next year.
- Payroll expense changes in proportion to sales because the more sales the store has, the more people it must hire to meet increased consumer demands.
- Utilities are expected to remain relatively constant during the budget period.
- Taxes are based primarily on sales and payroll and are therefore considered a variable expense.
- Supplies will vary in proportion to sales. This is because most of the supplies will be used to support sales.
- Repairs are relatively stable and are a fixed expense. John has maintenance contracts on the equipment in the store, and the cost is not scheduled to rise during the budget period.

North Central Scientific: Expense Budget for 2025

	Jan.	Feb.	Mar.	Apr.	May	Jun.	Jul.	Aug.	Sep.	Oct.	Nov.	Dec.
Anticipated operating expenses												
Rent	$2	$2	$2	$2	$2	$2	$2	$2	$2	$2	$2	$2
Payroll	32	37	42	39	53	47	50	50	46	51	54	58
Utilities	5	5	5	5	5	5	5	5	5	5	5	5
Taxes	3	4	4	4	5	5	5	5	5	5	5	6
Supplies	16	18	21	20	26	24	25	25	23	26	27	29
Repairs	2	2	2	2	2	2	2	2	2	2	2	2
Total expenses	$60	$68	$76	$72	$93	$85	$89	$89	$83	$91	$95	$102
Sales revenue	$315	$368	$420	$394	$525	$473	$499	$504	$462	$515	$536	$578
Cost of goods sold												
Beginning inventory	$63	$74	$84	$79	$105	$95	$100	$101	$92	$103	$107	$116
Purchases	263	305	331	341	410	383	400	395	380	416	437	413
Cost of goods available	$326	$379	$415	$420	$515	$478	$500	$496	$472	$519	$544	$529
Ending inventory	74	85	79	105	95	100	101	92	102	107	116	66
Cost of goods sold	$252	$294	$336	$315	$420	$378	$399	$403	$370	$412	$428	$462
Gross profit	$63	$74	$84	$79	$105	$95	$100	$101	$92	$103	$108	$116
Operating expenses												
Rent	$2	$2	$2	$2	$2	$2	$2	$2	$2	$2	$2	$2
Payroll	32	37	42	39	53	47	50	50	46	51	54	58
Utilities	5	5	5	5	5	5	5	5	5	5	5	5
Taxes	3	4	4	4	5	5	5	5	5	5	5	6
Supplies	16	18	21	20	26	24	25	25	23	26	27	29
Repairs	2	2	2	2	2	2	2	2	2	2	2	2
Total expenses	$60	$68	$76	$72	$93	$85	$89	$89	$83	$91	$95	$102
Net profit	$3	$6	$8	$7	$12	$10	$11	$12	$9	$12	$12	$14

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11-3b The Cash-Flow Budget

LO11.3 Explain how to draw up a cash-flow statement

After the operating budget has been prepared, the entrepreneur can proceed to the next phase of the budget process: the cash-flow budget. This budget, which often is prepared with the assistance of an accountant, provides an overview of the cash inflows and outflows during the period. By pinpointing cash problems in advance, management can make the necessary financing arrangements.[8]

The first step in the preparation of the cash-flow budget is the identification and timing of cash inflows. For the typical business, cash inflows will come from three sources: (1) cash sales, (2) cash payments received on account, and (3) loan proceeds. Not all of a firm's sales revenues are cash. In an effort to increase sales, most businesses will allow some customers to purchase goods on account. Consequently, part of the funds will arrive in later periods and will be identified as cash payments received on account. Loan proceeds represent another form of cash inflow that is not directly tied to the sales revenues. A firm may receive loan proceeds for several reasons—for example, the planned expansion of the firm (new building and equipment) or meeting cash-flow problems stemming from an inability to pay current bills.

Some businesses have a desired minimum balance of cash indicated on the cash-flow budget, highlighting the point at which it will be necessary to seek additional financing. Table 11.9 provides an example of how North Central Scientific prepared its cash-flow budget.

Table 11.9 North Central Scientific: Cash-Flow Budget

John Wheatman has successfully completed his operating budget and is now ready to prepare his cash-flow worksheet. After analyzing the sales figures and the cash receipts, John has determined that 80 percent of monthly sales are in cash. Of the remaining 20 percent, 15 percent is collected in the next month, and the final 5 percent is collected in the month following (see the cash receipts worksheet below). Wheatman's purchases are typically paid during the week following the purchase. Therefore, approximately one-fourth of the purchases are paid for in the following month. Rent expense is paid a month in advance. However, because it is not expected to go up during the budget period, the monthly cash outlay for rent remains the same. All the other expenses are paid in the month of consumption (see the cash disbursements worksheet below). Finally, the cash-flow worksheet is constructed by taking the beginning cash balance, adding the cash receipts for that month, and deducting the cash disbursements for the same month.

North Central Scientific: Cash Receipts Worksheet for 2025

	Jan.	Feb.	Mar.	Apr.	May	Jun.	Jul.	Aug.	Sep.	Oct.	Nov.	Dec.
Sales	$315	$388	$420	$394	$525	$473	$499	$504	$462	$515	$536	$578
Current month	$252	$294	$336	$315	$420	$378	$399	$403	$370	$412	$428	$462
Prior month	82	47	55	63	59	79	71	75	76	69	77	80
Two months back	26	28	16	18	21	19	26	24	24	25	24	26
Cash receipts	$360	$369	$407	$396	$500	$476	$496	$502	$470	$506	$529	$568

North Central Scientific: Cash Disbursements Worksheet for 2025

	Jan.	Feb.	Mar.	Apr.	May	Jun.	Jul.	Aug.	Sep.	Oct.	Nov.	Dec.
Purchases	$263	$305	$331	$341	$410	$383	$400	$395	$380	$416	$437	$413
Current month	$197	$228	$248	$256	$307	$287	$300	$296	$285	$312	$328	$309
Prior month	98	66	76	83	85	102	96	100	99	95	104	109
Purchase payments	$295	$294	$324	$339	$392	$396	$396	$396	$384	$407	$432	$419
Operating expenses	$60	$68	$76	$72	$93	$85	$89	$89	$83	$91	$95	$102
Cash payments	$355	$362	$400	$412	$485	$481	$485	$485	$467	$498	$527	$521

(Continued)

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Table 11.9 North Central Scientific: Cash-Flow Budget (*Continued*)

North Central Scientific: Cash-Flow Worksheet for 2025												
	Jan.	Feb.	Mar.	Apr.	May	Jun.	Jul.	Aug.	Sep.	Oct.	Nov.	Dec.
Beginning cash	$122	$127	$134	$141	$127	$141	$143	$154	$170	$173	$181	$184
Add: receipts	360	369	407	396	500	476	496	502	470	506	529	568
Cash available	$482	$496	$541	$537	$627	$617	$639	$656	$640	$679	$710	$752
Less: payments	355	362	400	411	485	481	485	485	467	498	527	521
Ending cash	$127	$134	$141	$126	$142	$136	$154	$171	$173	$181	$183	$231

The Entrepreneurial Process

Characteristics of Credible Financials

Although every section of a business plan has its purpose, the financial section bears the most scrutiny. A business's financial statements are deserving of this attention for two reasons: (1) the management team has significant discretion in how the financials are constructed and (2) potential investors reviewing a business plan will be interested in the financial viability of the company's strategy. Following are characteristics that convincing financial statements have in common:

- **Holistic.** An income statement tells only part of your business's financial story; the balance sheet and cash-flow statement are necessary to fill in the remaining details. Investors and lenders are interested in every detail of your company's financial health, so never exclude relevant information, such as the amount of and the time line for the cash you will need.
- **Precise.** Although investors will carefully analyze your financial statements, helping them to pinpoint the important details will ensure that they do not lose patience searching through your plan. To aid the readers of your plan, focus your sales and cost of goods sold numbers on major product lines. In addition, pay attention to how you label your line items to ensure that your readers will understand what you are trying to communicate. For example, "costs" are what you pay for what you are selling, while "expenses," like payroll and rent, are overhead charges you would have without sales.
- **Realistic.** When you tailor your figures to achieve a predetermined revenue goal, you will have trouble justifying your numbers when questioned. Instead, build your financials by starting with your costs and sales in your local market to anchor your figures in reality. In addition, your projections beyond the first year should be annual or quarterly.
- **Simple.** Significant volatility in your industry should be noted, such as your business being impacted by seasonality; however, bogging down your plan with lengthy explanations regarding the probability of your projections will serve only to confuse the reader. Including clarifying statements, such as "most likely," and supporting addendums, such as your break-even analysis, will be sufficient.
- **Accurate.** Investors know that your plan will change repeatedly as you build your business; however, overlooking simple expenses, such as interest payments, can cast doubt on your attention to detail. Once you have your financial statements completed, verifying the finer points, such as the accuracy of the interest and tax rates, will show that you are able to take your business from plan to implementation.

Source: Adapted from Tim Berry, "The Facts about Financial Projections," *Entrepreneur*, May 2007, https://www.entrepreneur.com/startingabusiness/businessplans/businessplancoachtimberry/article178210.html, accessed June 21, 2008; Jim Casparie, "Realistic Projections That Attract Investors," *Entrepreneur*, April 2006, http://www.entrepreneur.com/money/financing/raisingmoneycoachjimcasparie/article159516.html, accessed June 21, 2008; and "5 Tips for Coming Up with Financial Projections for Your Business Plan, National Federation of Independent Business, http://www.nfib.com/business-resources/business-resourcesitem?cmsid=55331,accessed May 29, 2012.

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11-4 Pro Forma Statements

LO11.4 Describe how pro forma statements are prepared

The final step in the budget process is the preparation of pro forma statements, which are projections of a firm's financial position during a future period (pro forma income statement) or on a future date (pro forma balance sheet). In the normal accounting cycle, the income statement is prepared first, followed by the balance sheet. Similarly, in the preparation of pro forma statements, the pro forma income statement is followed by the pro forma balance sheet.

In the process of preparing the operating budget, the firm already will have prepared the pro forma income statements for each month in the budget period. Each month presents the anticipated income and expense for that particular period, which is what the monthly pro forma income statements do. To prepare an annual pro forma income statement, the firm combines all months of the year.

The process for preparing a pro forma balance sheet is more complex: the last balance sheet prepared before the budget period began, the operating budget, and the cash-flow budget are needed to prepare it. Starting with the beginning balance sheet balances, the projected changes as depicted on the budgets are added to create the projected balance sheet totals.

After preparing the pro forma balance sheet, the entrepreneur should verify the accuracy of their work with the application of the traditional accounting equation:

$$\text{Assets} = \text{Liabilities} + \text{Owner's Equity}$$

If the equation is not in balance, the work should be rechecked. Table 11.10 provides a brief account of the process of preparing pro forma financial statements for North Central Scientific.

Table 11.10 North Central Scientific: Pro Forma Statements

At this point in the budget process, John Wheatman has the information necessary to prepare pro forma financial statements. The first set he has decided to prepare is the pro forma income statements. To do this, John simply copies the information from the operating budget (see the following comparative income statements and compare with the operating budget). The next set of pro forma statements is the pro forma balance sheets. In order to compile these, John uses the following information along with the operating budget and the cash-flow worksheet he has prepared:

Cash. The ending cash balance for each month from the cash-flow worksheet.

Accounts receivable. 20 percent of the current month's sales plus 5 percent of the preceding month's sales.

Inventory. The current month's ending inventory on the pro forma income statements.

Prepaid rent. The $2,000 is expected to remain constant throughout the budget period and is always paid one month in advance.

Building and equipment. No new acquisitions are expected in this area, so the amount will remain constant.

Accumulated depreciation. Because no new acquisitions are anticipated, this will stay the same; all buildings and equipment are fully depreciated.

Accounts payable. 25 percent of current purchases.

Capital. Prior month's capital balance plus current month's net income.

North Central Scientific: Comparative Pro Forma Income Statements

	Jan.	Feb.	Mar.	Apr.	May	Jun.	Jul.	Aug.	Sep.	Oct.	Nov.	Dec.
Sales	$315	$388	$420	$394	$525	$473	$499	$504	$462	$515	$536	$578
Cost of goods sold												
Beginning inventory	$63	$74	$84	$79	$105	$95	$100	$101	$92	$103	$107	$116
Purchases	263	305	331	341	410	383	400	395	380	416	437	413
Cost of goods available	$326	$379	$415	$420	$515	$478	$500	$496	$472	$519	$544	$529
Ending inventory	74	85	79	105	95	100	101	92	102	107	116	66
Cost of goods sold	$252	$294	$336	$315	$420	$378	$399	$403	$370	$412	$428	$462
Gross profit	$63	$74	$84	$79	$105	$95	$100	$101	$92	$103	$108	$116

(*Continued*)

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Table 11.10 North Central Scientific: Pro Forma Statements (*Continued*)

Operating expenses												
Rent	$2	$2	$2	$2	$2	$2	$2	$2	$2	$2	$2	$2
Payroll	32	37	42	39	53	47	50	50	46	51	54	58
Utilities	5	5	5	5	5	5	5	5	5	5	5	5
Taxes	3	4	4	4	5	5	5	5	5	5	5	6
Supplies	16	18	21	20	26	24	25	25	23	26	27	29
Repairs	2	2	2	2	2	2	2	2	2	2	2	2
Total expenses	$60	$68	$76	$72	$93	$85	$89	$89	$83	$91	$95	$102
Net profit	$3	$6	$8	$7	$12	$10	$11	$12	$9	$12	$12	$14
North Central Scientific: Comparative Pro Forma Balance Sheet												
	Jan.	Feb.	Mar.	Apr.	May	Jun.	Jul.	Aug.	Sep.	Oct.	Nov.	Dec.
Assets												
Cash	$127	$134	$141	$126	$142	$136	$154	$171	$173	$181	$183	$231
Accounts receivable	91	89	102	100	125	121	123	126	117	126	133	142
Inventory	74	84	79	105	95	100	101	92	103	107	116	66
Prepaid rent	2	2	2	2	2	2	2	2	2	2	2	2
Building and equipment	350	350	350	350	350	350	350	350	350	350	350	350
Less: accumulated depreciation	–350	–350	–350	–350	–350	–350	–350	–350	–350	–350	–350	–350
Total assets	$294	$309	$324	$333	$364	$359	$380	$391	$395	$416	$434	$441
Liabilities												
Accounts payable	$66	$76	$83	$85	$102	$96	$100	$99	$95	$104	$109	$103
Capital	228	234	242	249	261	270	280	292	300	312	326	339
Total liabilities and equity	$294	$310	$325	$334	$363	$366	$380	$391	$395	$416	$435	$442

11-5 Capital Budgeting

LO11.5 Explain how capital budgeting can be used in the decision-making process

Entrepreneurs may be required to make several investment decisions in the process of managing their firms. The impact of some of these decisions will be felt primarily within one year. Returns on other investments, however, are expected to extend beyond one year. Investments that fit into this second category are commonly referred to as capital investments or capital expenditures. A technique the entrepreneur can use to help plan for capital expenditures is capital budgeting.[9]

The first step in capital budgeting is to identify the cash flows and their timing. The inflows—or returns as they are commonly called—are equal to net operating income before deduction of payments to the financing sources but after the deduction of applicable taxes and

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with depreciation added back, as represented by the following formula:

Expected Returns = $X(1 - 2T)1$ Depreciation

where X is equal to the net operating income and T is defined as the appropriate tax rate. An illustration follows:

> John Wheatman is faced with a dilemma. He has two mutually exclusive projects, both of which require an outlay of $1,000. The problem is that he can afford only one of the projects. After discussing the problem with his accountant, John discovers that the first step he needs to take is to determine the expected return on each project. In order to gather this information, he has studied the probable effect on the store's operations and has developed the data shown in Table 11.11.

Table 11.11 provides a good illustration of the expected returns for John Wheatman's two projects. At this point, however, the cash inflows of each year are shown without consideration of the time value of money. The cash outflow is used to refer to the initial cash outlay that must be made in the beginning (the purchase price). When gathering data to estimate the cash flows over the life of a project, it is imperative to obtain reliable estimates of the savings and expenses associated with the project.

The principal objective of capital budgeting is to maximize the value of the firm. It is designed to answer two basic questions:

1. Which of several mutually exclusive projects should be selected? (Mutually exclusive projects are alternative methods of doing the same job. If one method is chosen, the other methods will not be required.)
2. How many projects, in total, should be selected?[10]

The three most common methods used in capital budgeting are the payback method, the net present value (NPV) method, and the internal rate of return (IRR) method. Each has certain advantages and disadvantages. In this section, the same proposal is used with each method to more clearly illustrate these three techniques.

11-5a Payback Method

One of the easiest capital-budgeting techniques to understand is the payback method or, as it is sometimes called, the *payback period*. In this method, the length of time required to "pay back" the original investment is the determining criterion. The entrepreneur will select

Table 11.11 North Central Scientific: Expected Return Worksheet

Proposal A					
Year	X	$(1 - T)(T = .40)$	$X(1 - T)$	Depreciation	$X(1 - T)$ + Depreciation
1	$500	$0.60	$300	$200	$500
2	333	0.60	200	200	400
3	167	0.60	100	200	300
4	−300	0.60	−180	200	20
5	−317	0.60	−190	200	10
Proposal B					
Year	X	$(1 _ T)(T = .40)$	$X(1 - T)$	Depreciation	$X(1 - T)$ + Depreciation
1	−$167	$0.60	−$100	$200	$100
2	0	0.60	100	200	200
3	167	0.60	100	200	300
4	333	0.60	200	200	400
5	500	0.60	300	200	500

X = Anticipated change in net income

T = Applicable tax rate (0.40)

Depreciation = Depreciation (computed on a straight-line basis) Cost/Life 1,000/5

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a maximum time frame for the payback period. Any project that requires a longer period will be rejected, and projects that fall within the time frame will be accepted. Following is an example of the payback method used by North Central Scientific:

> John Wheatman has a decision to make. He would like to purchase a new cash register for his store but is unsure about which of two proposals to accept. Each machine costs $1,000. An analysis of the projected returns reveals the following information:

Year	Proposal A	Proposal B
1	$500	$100
2	400	200
3	300	300
4	20	400
5	11	500

> After careful consideration, John decides to use the payback method with a cutoff period of three years. In this case, he discovers that Proposal A would pay back his investment in 28 months; $900 of the original investment will be paid back in the first two years and the last $100 in the third year. Proposal B, on the other hand, will require four years for its payback. Using this criterion, John chooses Proposal A and rejects Proposal B.

One of the problems with the payback method is that it ignores cash flows beyond the payback period. Thus, it is possible for the wrong decision to be made. Nevertheless, many companies, particularly entrepreneurial firms, continue to use this method for several reasons: (1) it is very simple to use in comparison to other methods, (2) projects with a faster payback period normally have more favorable short-term effects on earnings, and (3) if a firm is short on cash, it may prefer to use the payback method because it provides a faster return of funds.

11-5b Net Present Value

The **net present value (NPV) method** is a technique that helps to minimize some of the shortcomings of the payback method by recognizing the future cash flows beyond the payback period. The concept works on the premise that a dollar today is worth more than a dollar in the future—how much more depends on the applicable cost of capital for the firm. The cost of capital is the rate used to adjust future cash flows to determine their value in present period terms. This procedure is referred to as *discounting the future cash flows*, and the discounted cash value is determined by the present value of the cash flow.

To use this approach, the entrepreneur must find the present value of the expected net cash flows of the investment, discounted at the appropriate cost of capital, and subtract from it the initial cost outlay of the project. The result is the NPV of the proposed project. Many financial accounting and finance textbooks include tables (called present value tables) that list the appropriate discount factors to multiply by the future cash flow to determine the present value. In addition, financial calculators are available that will compute the present value given the cost of capital, future cash flow, and the year of the cash flow. Finally, given the appropriate data, electronic spreadsheet programs can be programmed to determine the present value. After the NPV has been calculated for all of the proposals, the entrepreneur can select the project with the highest NPV. Following is an example of the NPV method used by North Central Scientific:

> John Wheatman is not very satisfied with the results he has obtained from the payback method, so he has decided to use the NPV method to see what result it would produce. After conferring with his accountant, John learns that the cost of capital for his firm is 11 percent. He then prepares the following tables:

Because Proposal B has the higher NPV, John selects Proposal B and rejects Proposal A.

11-5c Internal Rate of Return

The **internal rate of return (IRR) method** is similar to the NPV method in that the future cash flows are discounted. However, they are discounted at a rate that makes the NPV of the project equal to zero. This rate is referred to as the *internal rate of return* of the project. The project with the highest IRR is then selected. Thus, a project that would be selected under the NPV method also would be selected under the IRR method.

One of the major drawbacks to the use of the IRR method is the difficulty that can be encountered when using the technique. Using the NPV method, it is quite simple to look up the appropriate discount factors in the present value tables. When using the IRR concept, however, the entrepreneur must begin with a NPV of zero and work backward through the tables. What this means, essentially, is that the entrepreneur must estimate the approximate rate and eventually try to track the actual IRR for the project. Although this may not seem too difficult for projects with even cash flows (i.e., cash flows that are fairly equal over the business periods), projects with uneven cash flows (fluctuating periods of cash inflow and cash outflow) can be a nightmare.

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Proposal A			
Year	Cash Flow	Discount Factor	Present Value
1	$500	0.9091	$454.55
2	400	0.8264	330.56
3	300	0.7513	225.39
4	20	0.6830	13.66
5	11	0.6209	6.21
			$1,030.37
Less: initial outlay			−1,000.00
Net present value			$30.37

Proposal B			
Year	Cash Flow	Discount Factor	Present Value
1	$100	0.9091	$90.91
2	200	0.8264	165.28
3	300	0.7513	225.39
4	400	0.6830	273.20
5	500	0.6209	311.45
			$1,065.23
Less: initial outlay			−1,000.00
Net present value			$65.23

Unfortunately, reality dictates that most projects will probably have uneven cash flows. Fortunately, electronic calculators and spreadsheet programs are available that can determine the actual IRR given the cash flows, initial cash outlays, and appropriate cash-flow periods. Following is an example of the IRR method used by North Central Scientific:

> Having obtained different results from the payback period and the NPV method, John Wheatman is confused about which alternative to select. To alleviate this confusion, he has chosen to use the IRR to evaluate the two proposals, and he has decided that the project with the higher IRR will be selected (after all, it would win two out of three times). Accordingly, he has prepared the following tables with the help of his calculator:

Proposal B is selected because it has the higher IRR. This conclusion supports the statement that the project with the higher NPV will also have the higher IRR.

The North Central Scientific examples illustrate the use of all three capital-budgeting methods. Although Proposal A was chosen by the first method (payback), Proposal B surfaced as the better proposal when the other two methods (NPV and IRR) were used. It is important for entrepreneurs to understand all three methods and to use the one that best fits their needs. If payback had been John Wheatman's only consideration, then Proposal A would have been selected. When future cash flows beyond payback are to be considered, the NPV and IRR methods will determine the best proposal.

The budgeting concepts discussed so far are extremely powerful planning tools. But how can entrepreneurs monitor their progress during the budget period? How can they use the information accumulated during the course of the business to help plan for future periods? Can this information be used for pricing decisions? The answer to the third question is "yes," and the other questions are answered in the following sections.

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Proposal A (11.83% IRR)			
Year	Cash Flow	Discount Factor	Present Value
1	$500	0.8942	$447.11
2	400	0.7996	319.84
3	300	0.7151	214.53
4	20	0.6394	12.80
5	11	0.5718	5.73
			$1,000.00
Less: initial outlay			−1,000.00
Net present value			$0.00
Proposal B (12.01% IRR)			
Year	Cash Flow	Discount Factor	Present Value
1	$100	0.8928	$89.27
2	200	0.7971	159.42
3	300	0.7117	213.51
4	400	0.6354	254.15
5	500	0.5673	283.65
			$1,000.00
Less: initial outlay			−1,000.00
Net present value			$0.00

11-6 Break-Even Analysis

LO11.6 Illustrate how to use break-even analysis

In today's competitive marketplace, entrepreneurs need relevant, timely, and accurate information that will enable them to price their products and services competitively and still be able to earn a fair profit. Break-even analysis supplies this information.

11-6a Break-Even Point Computation

Break-even analysis is a technique commonly used to assess expected product profitability. It helps determine how many units must be sold to break even at a particular selling price.

Contribution Margin Approach

A common approach to break-even analysis is the contribution margin approach. Contribution margin is the difference between the selling price and the variable cost per unit. It is the amount per unit that is contributed to covering all other costs.[11] Because the break-even point occurs where income equals expenses, the contribution margin approach formula is

$$0 = (SP - VC)\,S - FC \text{ or } FC = (SP - VC)S$$

where

SP = unit selling price
VC = variable costs per unit
S = sales in units
FC = fixed cost

This model also can be used for profit planning by including the desired profit as part of the fixed cost.

Graphic Approach

Another approach to break-even analysis taken by entrepreneurial firms is the graphic approach. To use this approach, the entrepreneur needs to graph at least two

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numbers: total revenue and total costs. The intersection of these two lines (i.e., where total revenues are equal to the total costs) is the firm's break-even point. Two additional costs—variable costs and fixed costs—also may be plotted. Doing so enables the entrepreneur to visualize the various relationships in the firm's cost structure.

Handling Questionable Costs

Although the first two approaches are adequate for situations in which costs can be broken down into fixed and variable components, some firms have expenses that are difficult to assign. For example, are repairs and maintenance expenses fixed or variable expenses? Can firms that face this type of problem use break-even analysis for profit planning? The answer is "yes" thanks to a new technique designed specifically for entrepreneurial firms. This technique calculates break-even points under alternative assumptions of fixed or variable costs to see if a product's profitability is sensitive to cost behavior. The decision rules for this concept are as follows: if expected sales exceed the higher break-even point, then the product should be profitable regardless of the other break-even point; if expected sales do not exceed the lower break-even point, then the product should be unprofitable. Only if expected sales are between the two break-even points is further investigation of the questionable cost's behavior needed.[12]

The concept works by substituting the cost in question (QC) first as a fixed cost and then as a variable cost. The break-even formulas presented earlier would have to be modified to determine the break-even levels under the two assumptions. For the fixed-cost assumption, the entrepreneur would use the following equation:

$$0 = (SP - VC)\,S - FC - QC$$

To calculate the break-even point assuming that QC is variable, the following equation would be used:

$$0 = [SP - VC - (QC/U)]\,S - FC$$

U is the number of units for which the questionable cost normally would be appropriate. What the entrepreneur is determining is the appropriate unit cost that should be used if the cost is a variable cost. Following is an example of how an entrepreneur could use the technique:

> Tim Goodman, president of Dynamic Manufacturing—a small manufacturer of round widgets—has decided to use break-even analysis as a profit-planning tool for his company. He believes that using this technique will enable his firm to compete more effectively in the marketplace. From an analysis of the operating costs, Tim has determined that the variable cost per unit is $9, while fixed costs are estimated to be $1,200 per month. The anticipated selling price per unit is $15. He also has discovered that he is unable to classify one cost as either variable or fixed. It is a $200 repair and maintenance expense allocation. This $200 is appropriate for an activity level of 400 units; therefore, if the cost were variable, it would be $.50 per unit ($200/400). Finally, sales are projected to be 400 units during the next budget period.

The first step in this process is to determine the break-even point assuming that the cost in question is fixed. Consequently, Tim would use the following equation:

$$\begin{aligned} 0 &= (SC - VC)S - FC - QC \\ &= (15 - 9)S - 1{,}200 - 200 \\ &= 6S - 1{,}400 \\ 1{,}400 &= 6S \\ 234 &= S \end{aligned}$$

Figure 11.2 provides a graphic illustration of the results. The final quantity was rounded up to the next unit because a business normally will not sell part of a unit.

The next step in the process is to calculate the break-even point assuming that the cost in question is a variable cost. Tim would use the following equation to ascertain the second break-even point:

$$\begin{aligned} 0 &= [SC - VC - (QC/U)]S - FC \\ &= [15 - 9 - (200/400)]S - 1{,}200 \\ &= (6 - .50)S - 1{,}200 \\ 1{,}200 &= 5.50S \\ 219 &= S \end{aligned}$$

Figure 11.3 presents a graphic illustration of the results.

Now that the two possible break-even points have been established, Tim must compare them to his projected sales. The variable-cost sales of 400 units are greater than the larger break-even point of 234 units. Therefore, the product is assumed to be profitable regardless of the cost behavior of the repair and maintenance expense. It does not matter whether the cost is variable or fixed; the firm still will be profitable.

11-7 Ratio Analysis

LO11.7 Describe ratio analysis

Financial statements report on both a firm's position at a point in time and its operations during some past period. However, the real value of financial statements lies in the fact that they can be used to help predict the firm's earnings and dividends. From an investor's standpoint, predicting the future is what financial statement analysis is all about; from an entrepreneur's standpoint, financial statement analysis is useful both as a way to anticipate conditions and, more important, as a starting point for planning actions that will influence the course of events.

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Figure 11.2 Dynamic Manufacturing: Fixed-Cost Assumption

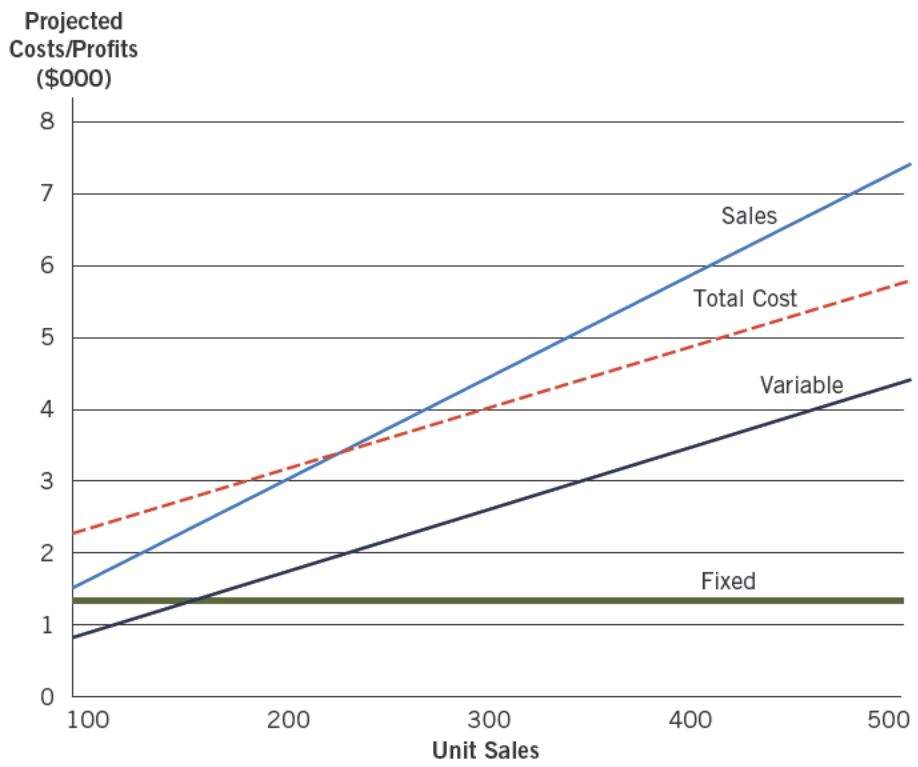
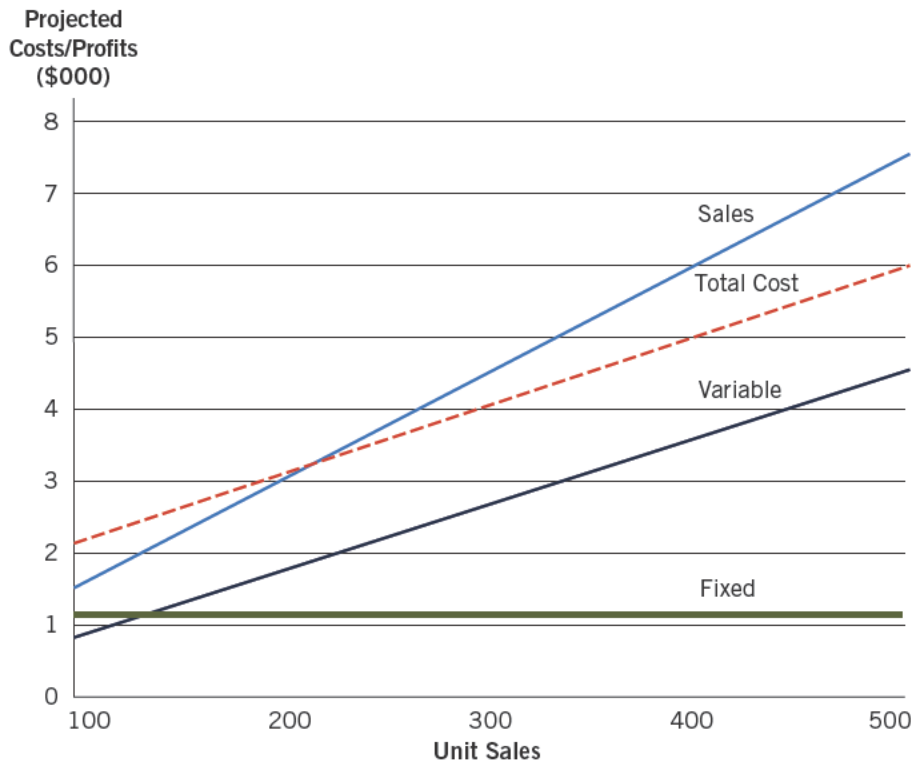


Figure 11.3 Dynamic Manufacturing: Variable-Cost Assumption



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An analysis of the firm's ratios is generally the key step in a financial analysis. The **ratios** are designed to show relationships among financial statement accounts. For example, Firm A might have a debt of $6,250,000 and interest charges of $520,000, whereas Firm B might have a debt of $62,800,000 and interest charges of $5,840,000. Which company is stronger? The true burden of these debts and the companies' ability to repay them can be ascertained (1) by comparing each firm's debt to its assets and (2) by comparing the interest each must pay to the income it has available for interest payment. Such comparisons are made by ratio analysis.[13]

LO11.8 Illustrate the use of some of the important ratio measures and their meanings

Table 11.12 displays a series of financial ratios useful for understanding the relationships among financial statements. The formulas for calculating each ratio are given along with explanations of what each ratio means for business decision making using a dollars-and-cents approach. Different ratios are important to owners, managers, and creditors for different reasons. As the table demonstrates, entrepreneurs can use ratios to gauge the advisability of various business decisions so that they know, for example, when it makes sense to borrow and if they have the capacity to meet short-term debt obligations. Ratios can be focused on the balance sheet, where issues of liquidity (e.g., current, quick, or cash ratios) as well as issues of stability (e.g., debt to worth) can be measured, or on the income statement, where margins for profitability can be examined. There are also efficiency ratios that compute general returns on assets and on investments in addition to specific points, such as inventory or accounts receivable turnover. These ratios provide the most effective tools

Table 11.12 Financial Ratios

Ratio Name	How to Calculate	What It Means in Dollars and Cents
Balance Sheet Ratios		
Current	$\frac{\textit{Current Assets}}{\textit{Current Liabilities}}$	Measures solvency: the number of dollars in current assets for every $1 in current liabilities *Example:* A current ratio of 1.76 means that for every $1 of current liabilities, the firm has $1.76 in current assets with which to pay it.
Quick	$\frac{\textit{Cash + Accounts Receivable}}{\textit{Current Liabilities}}$	Measures liquidity: the number of dollars in cash and accounts receivable for each $1 in current liabilities *Example:* A quick ratio of 1.14 means that for every $1 of current liabilities, the firm has $1.14 in cash and accounts receivable with which to pay it.
Cash	$\frac{\textit{Cash}}{\textit{Current Liabilities}}$	Measures liquidity more strictly: the number of dollars in cash for every $1 in current liabilities. *Example:* A cash ratio of 0.17 means that for every $1 of current liabilities, the firm has $0.17 in cash with which to pay it.
Debt-to-worth	$\frac{\textit{Total Liabilities}}{\textit{Net Worth}}$	Measures financial risk: the number of dollars of debt owed for every $1 in net worth *Example:* A debt-to-worth ratio of 1.05 means that for every $1 of net worth the owners have invested, the firm owes $1.05 of debt to its creditors.
Income Statement Ratios		
Gross margin	$\frac{\textit{Gross Margin}}{\textit{Sales}}$	Measures profitability at the gross profit level: the number of dollars of gross margin produced for every $1 of sales *Example:* A gross margin ratio of 34.4% means that for every $1 of sales, the firm produces 34.4¢ of gross margin.
Net margin	$\frac{\textit{Net Profit before Tax}}{\textit{Sales}}$	Measures profitability at the net profit level: the number of dollars of net profit produced for every $1 of sales *Example:* A net margin ratio of 2.9% means that for every $1 of sales, the firm produces 2.9¢ of net margin.

(*Continued*)

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Table 11.12 Financial Ratios (*Continued*)

Overall Efficiency Ratios		
Sales-to-assets	$\frac{\textit{Sales}}{\textit{Total Assets}}$	Measures the efficiency of total assets in generating sales: the number of dollars in sales produced for every $1 invested in total assets *Example:* A sales-to-assets ratio of 2.35 means that for every $1 invested in total assets, the firm generates $2.35 in sales.
Return on assets	$\frac{\textit{Net Profit before Tax}}{\textit{Total Assets}}$	Measures the efficiency of total assets in generating net profit: the number of dollars in net profit produced for every $1 invested in total assets *Example:* A return on assets ratio of 7.1% means that for every $1 invested in assets, the firm is generating 7.1¢ in net profit before tax.
Return on investment	$\frac{\textit{Net Profit before Tax}}{\textit{Net Worth}}$	Measures the efficiency of net worth in generating net profit: the number of dollars in net profit produced for every $1 invested in net worth *Example:* A return on investment ratio of 16.1% means that for every $1 invested in net worth, the firm is generating 16.1¢ in net profit before tax.
Specific Efficiency Ratios		
Inventory turnover	$\frac{\textit{Cost of Goods Sold}}{\textit{Inventory}}$	Measures the rate at which inventory is being used on an annual basis *Example:* An inventory turnover ratio of 9.81 means that the average dollar volume of inventory is used up almost 10 times during the fiscal year.
Inventory turn-days	$\frac{360}{\textit{Inventory Turnover}}$	Converts the inventory turnover ratio into an average "days inventory on hand" figure *Example:* An inventory turn-days ratio of 37 means that the firm keeps an average of 37 days of inventory on hand throughout the year.
Accounts receivable turnover	$\frac{\textit{Sales}}{\textit{Accounts Receivable}}$	Measures the rate at which accounts receivable are being collected on an annual basis *Example:* An accounts receivable turnover ratio of 8.00 means that the average dollar volume of accounts receivable is collected eight times during the year.
Average collection period	$\frac{360}{\textit{Accounts Receivable Turnover}}$	Converts the accounts receivable turnover ratio into the average number of days the firm must wait for its accounts receivable to be paid *Example:* An average collection period ratio of 45 means that it takes the firm 45 days on average to collect its receivables.
Accounts payable turnover	$\frac{\textit{Cost of Goods Sold}}{\textit{Accounts Payable}}$	Measures the rate at which accounts payable are being paid on an annual basis *Example:* An accounts payable turnover ratio of 12.04 means that the average dollar volume of accounts payable is paid about 12 times during the year.
Average payment period	$\frac{360}{\textit{Accounts Payable Turnover}}$	Converts the accounts payable turnover ratio into the average number of days a firm takes to pay its accounts payable *Example:* An accounts payable turnover ratio of 30 means that it takes the firm 30 days on average to pay its bills.

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Diversity in Entrepreneurship

Systemic Barriers to Minority Entrepreneurship Funding

For minority entrepreneurs across racial, ethnic, and gender dimensions, the entrepreneurship career path is certainly not an easy one. While every entrepreneur faces great challenges, numbers show significant disparities in ownership, funding, and representation of minorities in the entrepreneurship space. With regard to ownership, people of color, who represent 32 percent of the U.S. population, represent only 18 percent of business owners. These numbers worsened during the COVID-19 pandemic, when, from February to April 2020, the number of Black-owned small businesses fell 41 percent, Latinx ownership by 32 percent, and Asian ownership by 26 percent, whereas White-owned businesses slid by just 17 percent. The numbers do not look much better when it comes to funding. Less than 2 percent of total venture capital funding went to women-founded start-ups in 2018 (only 0.2 percent to women of color). Women overall lack equal control and access to funding power from venture capital funds to private equity and other funding. In fact, only 1.3 percent of funding is controlled by women-owned firms. These numbers are similar across other underrepresented groups.

This begs the question as to what causes such great disparities in ownership, funding, and representation. It is not that minority individuals lack the desire to enter an entrepreneurial path. Nor is it that they do not work as hard or that they otherwise lack some important trait or skill. We must recognize that minority entrepreneurs often face great systemic barriers that prevent them from pursuing an entrepreneurial venture. These systemic barriers are practices, procedures, or policies that have developed throughout the years and result in minority entrepreneurs receiving unequal access to an entrepreneurial career path. To have a better understanding of the challenges experienced by minority entrepreneurs, we need to have a look at some of the most significant systemic barriers they face.

It is not surprising that the most prominent barrier is access to funding. Adequate financing is essential for starting and running a business, making it one of the key determinants as to whether a venture will succeed or fail. Besides being largely excluded from the venture capital and private equity world, minority entrepreneurs tend to have weaker banking relationships and experience worse outcomes on credit applications, which makes them much more reliant on personal funds. A McKinsey & Company report found that just 29 percent of Black small-business owners are approved for bank loans in comparison to 60 percent of White entrepreneurs. Additionally, the Minority Business Development Agency (MBDA) found that, over the past 20 years, minority-owned businesses received an average of $3,379 in new equity investments, less than half the $7,858 of White-owned businesses. The MBDA, the only federal agency designed to promote growth and competitiveness of minority-owned businesses, acknowledges that there has been no progress in the legislation impacting minority-owned businesses since the 1960s, all while the business as a segment has evolved tremendously around the world.

While funding is an important barrier, the socioeconomic status of an entrepreneur plays a significant role as well. One study in Israel found that the number one factor for success of an entrepreneur was the wealth of the founder's parents that enabled the entrepreneur to receive a better education, develop a better network, have better access to mentors, and have more opportunities for a prestigious career. On the other hand, minority entrepreneurs might have to prioritize paying off student loans or supporting other members of the family rather than pursuing entrepreneurial dreams. We have all heard great success stories of Amazon, Facebook, or Microsoft. However, what these stories do not tell us is the amount of privilege that these entrepreneurs had in starting their businesses. Jeff Bezos received a substantial amount of money from his parents; Mark Zuckerberg reportedly took a loan from his father. Relying on family for capital is often not an option reserved for minority groups.

Entrepreneurship is a difficult career path on its own. With systemic barriers, entrepreneurship becomes an unthinkable struggle, one that underrepresented groups should not have to endure. It is important to understand the challenges that marginalized entrepreneurs face and hear from some who overcame those challenges. We need to talk about systemic barriers to increase our understanding, to build allies, and to build an ecosystem necessary to break these barriers. The burden should not lie solely with those who unfairly struggle with this issue; everybody needs to be a part of the solution.

Source: Adapted from Jeff Karoub, "Overcoming Systemic Barriers to Minority Entrepreneurship Requires Broad Effort," *Michigan News*, March 2021, https://news.umich.edu/overcoming-systemic-barriers-to-minority-entrepreneurship-requires-broad-effort; Leslie Hunter-Gadsden, "The State of Minority Entrepreneurship in America," *Next Avenue*, November 2021, https://www.nextavenue.org/minority-entrepreneurship-in-america; and Tom Quaadman, Evan Williams, Rick Wade, Thomas M. Sullivan, and Latricia Boone, "4 Ways to Improve Access to Capital for Minority-Owned Businesses," *U.S. Chamber of Commerce*, December 2021, https://www.uschamber.com/on-demand/diversity-and-inclusion/how-to-improve-access-to-capital-for-minority-owned-businesses.

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for monitoring a venture's performance over time; however, it should be kept in mind that effective ratio analysis must be done in comparison with firms within the same industry in order to gain the broadest possible insights.

Ratio analysis can be applied from two directions. **Vertical analysis** is the application of ratio analysis to one set of financial statements; an analysis "up and down" the statements is done to find signs of strengths and weaknesses. **Horizontal analysis** looks at financial statements and ratios over time. In horizontal analysis, the trends are critical: Are the numbers increasing or decreasing? Are particular components of the company's financial position getting better or worse?[14]

Summary

Three principal financial statements are important to entrepreneurs: the balance sheet, the income statement, and the cash-flow statement. The budgeting process facilitates financial statement preparation. Some key budgets that entrepreneurs should prepare are the operating budget, the cash-flow budget, and the capital budget. The operating budget typically begins with a sales forecast, followed by an estimation of operating expenses. A cash-flow budget provides an overview of the inflows and outflows of cash during a specific period. Pro forma financial statements then are prepared as projections of the firm's financial position over a future period (pro forma income statement) or on a future date (pro forma balance sheet). The operating and cash-flow budgets often are used to prepare these pro forma statements. The capital budget is used to help entrepreneurs make investment decisions. The three most common methods of capital budgeting are the payback period, the NPV method, and the IRR method.

Another commonly used decision-making tool is break-even analysis, which tells how many units must be sold to break even at a particular selling price. It is possible to use this analysis even when fixed or variable costs can only be estimated. The last part of the chapter examined ratio analysis, which can be a helpful analytical tool for entrepreneurs. Ratios are designed to show relationships between financial statement accounts.

Key Terms

accounts payable
accounts receivable
administrative expenses
balance sheet
break-even analysis
budget
capital budgeting
cash
cash-flow budget
cash-flow statement
contribution margin approach
expenses
financial expense
fixed assets
fixed cost
horizontal analysis
income statement
internal rate of return (IRR) method
inventory
liabilities
loan payable
long-term liabilities
mixed costs
net income
net present value (NPV) method
note payable
operating budget
operating expenses
owner's equity
payback method
prepaid expenses
pro forma statements
ratios
retained earnings
revenues
sales forecast
short-term liabilities (current liabilities)
simple linear regression
taxes payable
variable cost
vertical analysis

Review and Discussion Questions

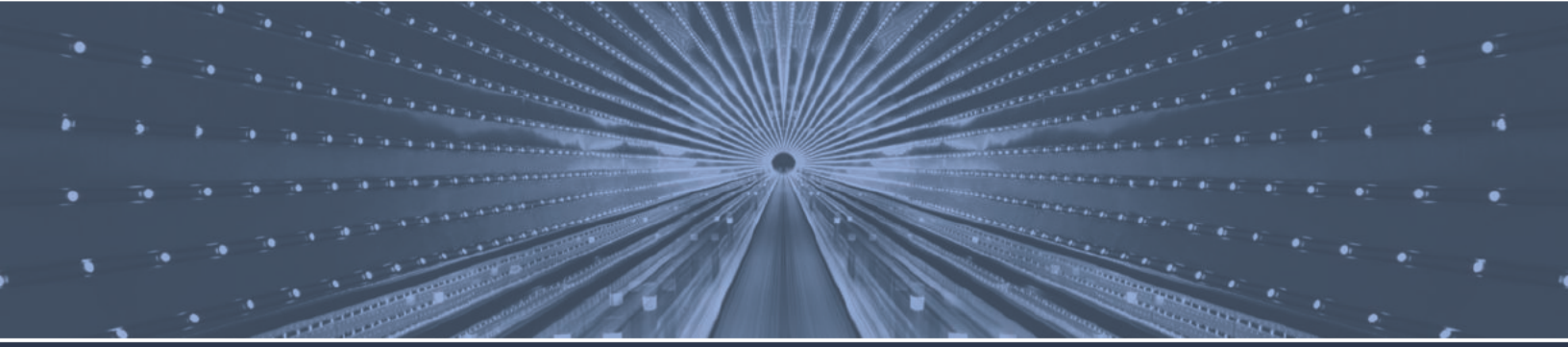
1. What is the importance of financial information for entrepreneurs? Briefly describe the key components.
2. What are the benefits of the budgeting process?
3. How is the statistical forecasting technique of simple linear regression used in making a sales forecast?
4. Describe how an operating budget is constructed.
5. Describe how a cash-flow budget is constructed.
6. What are pro forma statements? How are they constructed? Be complete in your answer.
7. Describe how a capital budget is constructed.
8. One of the most popular capital-budgeting techniques is the payback method. How does this method work? Give an example.
9. Describe the NPV method. When would an entrepreneur use this method? Why?
10. Describe the IRR method. When would an entrepreneur use this method? Why?
11. When would an entrepreneur be interested in break-even analysis?
12. If an entrepreneur wants to use break-even analysis but has trouble assigning some costs as either fixed or variable, can break-even analysis still be used? Explain.
13. What is ratio analysis? How is horizontal analysis different from vertical analysis?

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Chapter 12

Developing an Effective Business Plan

Learning Objectives

12.1. List the planning pitfalls that plague many new ventures
12.2. Explain the business model canvas as an initial step in the planning process
12.3. Describe a business plan and its value
12.4. Describe the benefits of a business plan
12.5. Explain the different viewpoints of those who read a business plan
12.6. Outline the importance of coordinating the business plan segments
12.7. Describe the key recommendations by venture capital experts regarding a plan
12.8. Highlight a complete outline of an effective business plan
12.9. Describe some helpful hints for writing an effective business plan
12.10. Explain the key points in the presentation of a business plan—the pitch

Entrepreneurial Thought

It is well established that you can't raise money without a business plan . . . a business plan is a work of art in its own right. It's the document that personifies and expresses your company. Each plan, like every snowflake, must be different. Each is a separate piece of art. Each must be reflective of the individuality of the entrepreneur. Just as you wouldn't copy someone else's romancing techniques, so should you seek to distinguish your plan for its differences.

—Joseph R. Mancuso, *How to Write a Winning Business Plan*

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12-1 Pitfalls to Avoid in the Venture Planning Process

LO12.1 List the planning pitfalls that plague many new ventures

A number of pitfalls in the business plan process should be avoided. The five pitfalls presented in this section represent the most common errors committed by entrepreneurs. To make these danger areas more easily recognizable, certain indicators or warning signs are presented. We also include a possible solution to each pitfall that will help entrepreneurs avoid the particular trap that limits a new venture's opportunity to succeed.

12-1a Pitfall 1: No Realistic Goals

Although this pitfall may sound self-explanatory, the following indicators demonstrate how common and well disguised it can be: lack of any attainable goals, lack of a time frame to accomplish things, lack of priorities, and lack of action steps.

One way to avoid this pitfall is to set up a timetable of specific steps to be accomplished during a specific period.

12-1b Pitfall 2: Failure to Anticipate Roadblocks

One of the most common pitfalls occurs when the entrepreneur is so immersed in their idea that objectivity goes out the window. In other words, the person does not recognize the possible problems that may arise. Indicators are no recognition of future problems, no admission of possible flaws or weaknesses in the plan, and no contingency or alternative plans.

The best way to avoid this pitfall is to list (1) the possible obstacles that may arise and (2) the alternatives that state what might have to be done to overcome the obstacles.

12-1c Pitfall 3: No Commitment or Dedication

Too many entrepreneurs appear to lack real commitment to their ventures. Although ventures may have started from a hobby or part-time endeavor, entrepreneurs must be careful to avoid the impression that they do not take their ventures seriously. Indicators are copying the latest social media craze, no interest in researching the idea, no desire to invest personal money, and the appearance of making a "fast buck" from an "app" or a "whim."

The easiest way to avoid this pitfall is to act quickly and to be sure to follow up all professional appointments. Also, be ready and willing to demonstrate a financial commitment to the venture.

12-1d Pitfall 4: Lack of Demonstrated Experience (Business or Technical)

Many investors weigh very heavily the entrepreneur's actual experience in a venture, so it is important that entrepreneurs demonstrate what background they possess. Because too many beginners attempt to promote ideas they really have no true knowledge of, they are doomed to fail simply because they are perceived as ignorant of the specifics in the proposed business. Indicators are no experience in business, no experience in the specific area of the venture, lack of understanding of the industry in which the venture fits, and failure to convey a clear picture of how and why the venture will work and who will accept it.

To avoid this pitfall, entrepreneurs need to give evidence of personal experience and background for the venture. If they lack specific knowledge or skills, they should obtain assistance from those who possess this knowledge or these skills. Demonstrating a team concept about those who help out also may be useful.

12-1e Pitfall 5: No Market Niche (Segment)

Many entrepreneurs propose an idea without establishing who the potential customers will be. Just because the entrepreneur likes the product or service does not mean that others will buy it. Numerous inventions at the U.S. Patent Office never reached the marketplace because no customers were targeted to buy them—no market was ever established. Indicators are uncertainty about who will buy the basic idea(s) behind the venture, no proof of a need or desire for the good or product proposed, and an assumption that customers or clients will purchase just because the entrepreneur thinks so.

The best possible way to avoid this pitfall is to have a market segment specifically targeted and to demonstrate why and how the specific product or service will meet the needs or desires of this target group. (See Chapter 10 for specific information on market research.)

The five pitfalls detailed here represent the most common points of failure entrepreneurs experience *before* their business plans ever gets reviewed. In other words, these critical areas must be carefully addressed before a business plan is developed. If these pitfalls can be avoided, the entire business plan will be written more carefully and thus will be reviewed more thoroughly. This preparation helps entrepreneurs establish a solid foundation on which to develop an effective business plan.

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12-2 Business Model Canvas: Initiating the Venture Formation Process

LO12.2 Explain the business model canvas as an initial step in the planning process

The **Business Model Canvas** is a structured brainstorming tool for entrepreneurs to use to define and understand the strategic focus and the questions that need to be answered for each of the nine business building blocks. The complete business plan provides a more specific and detailed exploration of the venture's goals and operations with a clear path on how the venture will succeed. Let's examine the business model canvas as a starting point.

A **business model** is a description of how a venture will create and deliver value. Since it is a strategic tool that was introduced decades ago, the sophistication levels have raised through the years. However, the Business Model Canvas was introduced as a way to simplify the process.[1] This entrepreneurial tool allows you to visually describe, design, challenge, invent, and pivot your business model. As shown in this design template helps the entrepreneur to systematically understand, design, and implement a game-changing business model. Along the way, an entrepreneur can gain a deeper understanding of their customers, distribution channels, partners, revenue streams, costs, and core value proposition.

There are nine essential components:[2]

1. **Value proposition.** The products and services that create value for a specific customer segment. A new venture's value proposition is what distinguishes it from potential competition. Value can be provided through various elements, such as newness, performance, customization, design, brand, status, price, risk reduction, accessibility, and convenience or usability.
2. **Customer segments.** The different groups of people or entities that the venture aims to reach and serve. As discussed in Chapter 10 on marketing, customers can be segmented (niche) based on the different needs and attributes to ensure that appropriate implementation of corporate strategy meets the characteristics of a selected group of clients.
3. **Channels.** Ways the venture communicates with and reaches its customer segments. A new venture can deliver its value proposition to its targeted customers through different channels, such as opening a store, using major distributors, or a combination of both. Effective channels will distribute a venture's value proposition in ways that are fast, efficient, and cost effective.
4. **Customer relationships.** The types of relationships a venture establishes with specific customer segments. To ensure the survival and success of any businesses, entrepreneurs must identify the type of relationship they want to create with their customer segments. Customer relationships can include personal assistance, self-service, automated services, or community platforms.
5. **Revenue streams.** The cash a new venture proposes to generate from the particular customer niche. Several ways to generate a revenue stream include selling an item, service fees, subscription fees, lease or rental income, licensing fees, or advertising income.
6. **Key activities.** The most important elements that a venture must do to make its business model work. For example, if lower prices are the unique value proposition, then creating an efficient supply chain to drive down costs would be a key activity.
7. **Key resources.** The most important assets required to make the business model work and create value for the customer. They are needed in order to sustain and support the business and could be human, financial, physical, or intellectual.
8. **Key partners.** The network of suppliers and partners that optimize operations and reduce risks to make the business model work. Complementary alliances also can be considered through joint ventures or strategic alliances with other firms.
9. **Cost structure.** The most significant costs incurred to operate the business model. Characteristics of cost structures include the following:
   - *Fixed costs*. Costs are unchanged across different applications (e.g., salary and rent).
   - *Variable costs*. These costs vary depending on the amount of production of goods or services (e.g., music festivals).
   - *Economies of scale*. Costs go down as the amount of good are ordered or produced.
   - *Economies of scope*. Costs go down due to incorporating other businesses that have a direct relation to the original product.

Once the nine elements of the business plan canvas are completed, the entrepreneur has a much greater understanding of the feasible value inherent in the proposed venture. If assessed as positive, then the next step is to develop the complete business plan that will serve as the major descriptive document for the venture.

12-3 What Is a Business Plan?

LO12.3 Describe a business plan and its value

A **business plan** is the written document that details the proposed venture. It must describe current status,

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expected needs, and projected results of the new business. Every aspect of the venture needs to be covered: the venture concept, value proposition, marketing, operations, management, critical risks, financial projections, exit strategy, and milestones or a timetable. A description of all of these facets of the proposed venture is necessary to demonstrate a clear picture of what that venture is, where it is projected to go, and how the entrepreneur proposes it will get there. The business plan is the entrepreneur's *road map* for a successful enterprise.[3]

In some professional areas, the business plan is referred to as a venture plan, a loan proposal, or an investment prospectus. Whatever the name, the business plan is the minimum document required by any financial source. The business plan allows the entrepreneur entrance into the investment process. Although it should be used as a working document once the venture is established, the major thrust of the business plan is to encapsulate the strategic development of the project in a comprehensive document for outside investors to read and understand.

The business plan describes to investors and financial sources all of the events that may affect the proposed venture. Details are needed for various projected actions of the venture, with associated revenues and costs outlined. It is vital to explicitly state the assumptions on which the plan is based. For example, increases/decreases in the market or upswings/downswings in the economy during the start-up period of the new venture should be stated.

The emphasis of the business plan always should be the final implementation of the venture. In other words, it's not just the writing of an effective plan that is important but also the translation of that plan into a successful enterprise.[4]

The comprehensive business plan, which should be the result of meetings and reflections on the direction of the new venture, is the major tool for determining the essential operation of a venture. It also is the primary document for managing the venture. One of the major benefits of this plan is that it helps the enterprise avoid common pitfalls that were mentioned that often undo all previous efforts.

12-4 Benefits of a Business Plan

LO12.4 Describe the benefits of a business plan

The entire business-planning process forces the entrepreneur to analyze all aspects of the venture and to prepare an effective strategy to deal with the uncertainties that arise. Thus, a business plan may help an entrepreneur avoid a project doomed to failure. As one researcher states, "If your proposed venture is marginal at best, the business plan will show you why and may help you avoid paying the high tuition of business failure. It is far cheaper not to begin an ill-fated business than to learn by experience what your business plan could have taught you at a cost of several hours of concentrated work."[5]

It is important that entrepreneurs prepare their own business plan. If an entrepreneurial team is involved, then all of the key members should be part of writing the plan; in this case, it is important that the lead entrepreneur understand the contribution of each team member. If consultants are sought to help prepare a business plan, the entrepreneur must remain the driving force behind the plan. Seeking the advice and assistance of outside professionals is always wise, but entrepreneurs need to understand every aspect of the business plan because they are the ones who come under the scrutiny of financial sources. Thus, the business plan stands as the entrepreneur's description and prediction for their venture, and it must be defended by the entrepreneur—simply put, it is the entrepreneur's responsibility.[6]

Other benefits are derived from a business plan for both the entrepreneur and the financial sources that read it and evaluate the venture. For the entrepreneur, the following benefits are gained:

- The time, effort, research, and discipline needed to put together a formal business plan force the entrepreneur to view the venture critically and objectively.
- The competitive, economic, and financial analyses included in the business plan subject the entrepreneur to close scrutiny of their assumptions about the venture's success.
- Because all aspects of the business venture must be addressed in the plan, the entrepreneur develops and examines operating strategies and expected results for outside evaluators.
- The business plan quantifies objectives, providing measurable benchmarks for comparing forecasts with actual results.
- The completed business plan provides the entrepreneur with a communication tool for outside financial sources as well as an operational tool for guiding the venture toward success.[7]

The financial sources that read the plan derive the following benefits from the business plan:

- The business plan provides the details of the market potential and plans for securing a share of that market.
- Through prospective financial statements, the business plan illustrates the venture's ability to service debt or provide an adequate return on equity.
- The plan identifies critical risks and crucial events with a discussion of contingency plans that provide opportunity for the venture's success.
- By providing a comprehensive overview of the entire operation, the business plan gives financial sources a

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clear, concise document that contains the necessary information for a thorough business and financial evaluation.

- For a financial source with no prior knowledge of the entrepreneur or the venture, the business plan provides a useful guide for assessing the individual entrepreneur's planning and managerial ability.[8]

12-5 Developing a Well-Conceived Business Plan

Most investors agree that only a well-conceived and well-developed business plan can gather the necessary support that will eventually lead to financing. The business plan must describe the new venture with excitement and yet with complete accuracy.

12-5a Who Reads the Plan?

LO12.5 Explain the different viewpoints of those who read a business plan

It is important to understand the audience for whom the business plan is written. Although numerous professionals may be involved with reading the business plan—such as venture capitalists, bankers, angel investors, potential large customers, lawyers, consultants, and suppliers—entrepreneurs need to clearly understand three main viewpoints when preparing the plan.[9]

The first viewpoint is, of course, the entrepreneur's because they are the ones developing the venture and clearly have the most in-depth knowledge of the technology or creativity involved. This is the most common viewpoint in business plans, and it is essential. However, too many plans emphasize this viewpoint and neglect the viewpoints of potential customers and investors.

More important than high technology or creative flair is the marketability of a new venture. This type of enterprise, referred to as "market driven," convincingly demonstrates the benefits to users (the particular group of customers it is aiming for) and the existence of a substantial market. This viewpoint—that of the marketplace—is the second critical emphasis that an entrepreneur must incorporate into a business plan. Yet, although the actual value of this information is considered high, too many entrepreneurs tend to deemphasize in-depth marketing information in their business plans.[10] Establishing an actual market (determining who will buy the product or use the service) and documenting that the anticipated percentage of this market is appropriate for the venture's success are valuable criteria for the business plan.

The third viewpoint is related to the marketing emphasis just discussed. The investor's point of view is concentrated on the financial forecast. Sound financial projections are necessary if investors are to evaluate the worth of their investment. This is not to say that an entrepreneur should fill the business plan with spreadsheets of figures. In fact, many venture capital firms employ a "projection discount factor," which merely represents the belief of venture capitalists that successful new ventures usually reach approximately 50 percent of their projected financial goals.[11] However, a three- to five-year financial projection is essential for investors to use in making their judgment of a venture's future success.

These three viewpoints have been presented in order of decreasing significance to point out the emphasis needed in a well-conceived business plan. If they are addressed carefully in the plan, then the entrepreneur has prepared for what experts term the **five-minute reading**. The following six steps represent the typical business plan reading process that many venture capitalists use (less than one minute is devoted to each step):

Step 1: Determine the characteristics of the venture and its industry.

Step 2: Determine the financial structure of the plan (amount of debt or equity investment required).

Step 3: Read the latest balance sheet (to determine liquidity, net worth, and debt/equity).

Step 4: Determine the quality of entrepreneurs in the venture (sometimes *the* most important step).

Step 5: Establish the unique feature in this venture (find out what is different).

Step 6: Read over the entire plan lightly (this is when the entire package is paged through for a casual look at graphs, charts, exhibits, and other plan components).[12]

These steps provide insight into how the average business plan is read. It may seem somewhat unjust that so much of the entrepreneur's effort is put into a plan that is given only a five-minute reading. However, that's the nature of the process for many venture capitalists. Other financial or professional sources may devote more time to analyzing the plan. But keep in mind that venture capitalists read through numerous business plans; thus, knowing the steps in their reading process is valuable for developing any plan. Related to the process of venture capitalists is this updated version of an old quote that links entrepreneurs and venture capitalists: "The people who manage people manage people who manage things, *but* the people who manage money manage the people who manage people."[13]

12-5b Putting the Package Together

LO12.6 Outline the importance of coordinating the business plan segments

When presenting a business plan to potential investors, the entrepreneur must realize that the entire package is

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important. Presented next is a summary of key issues that the entrepreneur needs to watch for if their plan is going to be viewed successfully. A business plan gives financiers their first impressions of a company and its principals.

Potential investors expect the plan to look good but not too good, to be the right length, to clearly and concisely explain (early on) all aspects of the company's business, and not to contain bad grammar and typographical or spelling errors.

Investors are looking for evidence that the principals treat their own property with care—and will likewise treat the investment carefully. In other words, form as well as content are important; investors know that good form reflects good content and vice versa.

Among the format issues we think most important are the following:

Appearance—The binding and printing must not be sloppy; neither should the presentation be too lavish. A stapled compilation of photocopied pages usually looks amateurish, whereas bookbinding with typeset pages may arouse concern about excessive and inappropriate spending. A plastic spiral binding, holding together a pair of cover sheets of a single color, provides both a neat appearance and sufficient strength to withstand handling by a number of people without damage.

Length—A business plan should be no more than 20–25 pages long. The first draft will likely exceed that, but editing should produce a final version that fits within the 20-page ideal. Adherence to this length forces entrepreneurs to sharpen their ideas and results in a document that is likely to hold investors' attention.

Background details can be included in an additional volume. Entrepreneurs can make this material available to investors during the investigative period, after the initial expression of interest.

The Cover and Title Page—The cover should bear the name of the company, its address and phone number, and the month and year in which the plan is issued. Surprisingly, a large number of business plans are submitted to potential investors without return addresses or phone numbers. An interested investor wants to be able to contact a company easily to request further information or express an interest, either in the company or in some aspect of the plan.

Inside the front cover should be a well-designed title page on which the cover information is repeated and, in an upper or a lower corner, the "copy number" provided. Besides helping entrepreneurs keep track of plans in circulation, holding down the number of copies outstanding—usually to no more than 10—has a psychological advantage. After all, no investor likes to think that the prospective investment is shopworn.

The Executive Summary—The two to three pages immediately following the title page should concisely explain the company's current status, its products or services, the benefits to customers, the financial forecasts, the venture's objectives in three to seven years, the amount of financing needed, and how investors will benefit.

This is a tall order for a two-page summary, but it will either sell investors on reading the rest of the plan or convince them to forget the whole thing.

The Table of Contents—After the executive summary, include a well-designed table of contents. List each of the business plan's sections and mark the pages for each section.

An attractive appearance, an effective length, an executive summary, a table of contents, proper grammar, correct typing, and a cover page—all are important factors when putting together a complete package. These points often separate successful plans from unacceptable ones.

12-5c Guidelines to Remember

LO12.7 Describe the key recommendations by venture capital experts regarding a plan

The following points are a collection of recommendations by experts in venture capital and new-venture development.[14] These guidelines are presented as tips for successful business plan development. Entrepreneurs need to adhere to them to understand the importance of the various segments of the business plan they create, which will be discussed in the next section.

Keep the Plan Respectably Short

Readers of business plans are important people who refuse to waste time. Therefore, entrepreneurs should explain the venture not only carefully and clearly but also concisely. (Ideally, the plan should be no more than 20 to 25 pages long, excluding the appendix.)

Organize and Package the Plan Appropriately

A table of contents, an executive summary, an appendix, exhibits, graphs, proper grammar, a logical arrangement of segments, and overall neatness are elements critical to the effective presentation of a business plan.

Orient the Plan toward the Future

Entrepreneurs should attempt to create an air of excitement in the plan by developing trends and forecasts that describe what the venture *intends* to do and what the opportunities are for the use of the product or service.

Avoid Exaggeration

Sales potentials, revenue estimates, and the venture's potential growth should not be inflated. Many times, a best-case, worst-case, and probable-case scenario should be developed for the plan. Documentation and research are vital to the plan's credibility. (See Table 12.1 for business plan phrases.)

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Table 12.1 Common Business Plan Phrases: Statement versus Reality

Statement	Reality
We conservatively project . . .	We read a book that said we had to be a $50 million company in five years, and we reverse-engineered the numbers.
We took our best guess and divided by 2.	We accidentally divided by 0.5.
We project a 10 percent margin.	We did not modify any of the assumptions in the business plan template that we downloaded from the Internet.
The project is 98 percent complete.	To complete the remaining 2 percent will take as long as it took to create the initial 98 percent but will cost twice as much.
Our business model is proven . . .	. . . if you take the evidence from the past week for the best of our 50 locations and extrapolate it for all the others.
We have a six-month lead.	We tried not to find out how many other people have a six-month lead.
We need only a 10 percent market share.	So do the other 50 entrants getting funded.
Customers are clamoring for our product.	We have not yet asked them to pay for it. Also, all of our current customers are relatives.
We are the low-cost producer.	We have not produced anything yet, but we are confident that we will be able to.
We have no competition.	Only IBM, Microsoft, Netscape, and Sun have announced plans to enter the business.
Our management team has a great deal of experience . . .	. . . consuming the product or service.
A select group of investors is considering the plan.	We mailed a copy of the plan to everyone in *Pratt's Guide.*
We seek a value-added investor.	We are looking for a passive, dumb-as-rocks investor.
If you invest on our terms, you will earn a 68 percent internal rate of return.	If everything that could ever conceivably go right does go right, you might get your money back.

Source: Adapted from William A. Sahlman, "How to Write a Great Business Plan," *Harvard Business Review*, July/August 1997, 106. Copyright © 1997 by the Harvard Business School Publishing. All rights reserved.

Highlight Critical Risks

The critical-risks segment of the business plan is important in that it demonstrates the entrepreneur's ability to analyze potential problems and develop alternative courses of action.

Give Evidence of an Effective Entrepreneurial Team

The management segment of the business plan should clearly identify the skills of each key person as well as demonstrate how all such people can effectively work together as a team to manage the venture.

Do Not Over-Diversify

Focus the attention of the plan on one main opportunity for the venture. A new business should not attempt to create multiple markets or pursue multiple ventures until it has successfully developed one main strength.

Identify the Target Market

Substantiate the marketability of the venture's product or service by identifying the particular customer niche being sought. This segment of the business plan is pivotal to the success of the other parts. Market research must be included to demonstrate how this market segment has been identified.

Keep the Plan Written in the Third Person

Rather than continually stating "I," "we," or "us," the entrepreneur should phrase everything as "he," "she," "they," or "them." In other words, avoid personalizing the plan and keep the writing objective.

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Capture the Reader's Interest

Because of the numerous business plans submitted to investors and the small percentage of business plans funded, entrepreneurs need to capture the reader's interest right away by highlighting the unique value proposition of the venture. Use the title page and executive summary as key tools to capture the reader's attention and create a desire to read more.

12-5d Questions to Be Answered

A well-written business plan is like a work of art: It's visually pleasing and makes a statement without saying a word. Unfortunately, the two are also alike in that they are worth money only if they're good. Researchers Donald F. Kuratko and Jeffrey S. Hornsby recommend the following key questions to consider when writing an effective business plan:

- *Is your plan organized so that key facts leap out at the reader?* Appearances do count. Your plan is a representation of yourself, so don't expect an unorganized, less-than-acceptable plan to be your vehicle for obtaining funds.
- *Is your product/service and business mission clear and simple?* Your mission should state very simply the value that you will provide to your customers. It shouldn't take more than a paragraph.
- *Are you focused on the right things?* Determine what phase of the business you are really in, focus on the right tasks, and use your resources appropriately.
- *Who is your customer?* Does the plan describe the business's ideal customers and how you will reach them? Is your projected share of the market identified, reasonable, and supported?
- *Why will customers buy? How much better is your product/service?* Define the need for your product and provide references and testimonial support to enhance it. Try to be detailed in explaining how the customer will benefit from buying your product.
- *Do you have a competitive advantage?* Focus on differences and any unique qualities. Proprietary processes/technology and patentable items/ideals are good things to highlight as competitive strengths.
- *Do you have a favorable cost structure?* Proper gross margins are key. Does the break-even analysis take into consideration the dynamics of price and variable costs? Identify, if possible, any economics of scale that would be advantageous to the business.
- *Can the management team build a business?* Take a second look at the management team to see whether they have relevant experience in small business and in the industry. Acknowledge the fact that the team may need to evolve with the business.
- *How much money do you need?* Financial statements—including the income statement, cash-flow statement, and balance sheet—should be provided on a monthly basis for the first year and on a quarterly basis for the following two or three years.
- *How does your investor get a cash return?* Whether it's through a buyout or an initial public offering, make sure your plan clearly outlines this important question regarding a harvest strategy.[15]

These guidelines and questions have been presented to help entrepreneurs who are preparing to write a business plan. The following section analyzes the 10 major segments of a business plan.

12-6 Elements of a Business Plan

LO12.8 Highlight a complete outline of an effective business plan

A detailed business plan usually includes anywhere from 6 to 10 sections (depending on the idea, the industry, and the technical details). The ideal length of a plan is 25 pages, although—depending on the need for detail—the overall plan can range from 20 to more than 30 pages if an appendix is included.[16] Table 12.2 provides an outline of a typical plan. The remainder of this section describes the specific parts of the plan. A complete business plan for Hydraulic Wind Power appears in Appendix 12A at the end of this chapter.

12-6a Executive Summary

Many people who read business plans (bankers, venture capitalists, and investors) like to see a summary of the plan that features its most important parts. Such a summary gives a brief overview of what is to follow, helps put all of the information into perspective, and should be no longer than two to three pages. The summary should be written only after the entire business plan has been completed. In this way, particular phrases or descriptions from each segment can be identified for inclusion in the summary. Because the summary is the first—and sometimes the only—part of a plan that is read, it must present the quality of the entire report. The summary must be a clever snapshot of the complete plan.

The statements selected for a summary segment should briefly touch on the venture itself, the value proposition, the market opportunities, the financial needs and projections, and any special research or technology associated with the venture. This should be done in such a way that the evaluator or investor will choose to read on. If this information is not presented in a concise, competent manner, the reader may put aside the plan or simply conclude that the project does not warrant funding.

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Table 12.2 Complete Outline of a Business Plan

Section I: Executive Summary

Section II: Venture Concept and Value Proposition
A. General description of the business
B. Value proposition
C. Goals and potential of the business and milestones (if any)
D. Uniqueness of product or service

Section III: Marketing
A. Research and analysis
   1. Target market (customers) identified
   2. Market size and trends
   3. Competition
   4. Estimated market share
B. Marketing plan
   1. Market strategy—go-to-market concepts
   2. Customer pain points
   3. Reachable market
   4. Pricing
   5. Advertising and promotions

Section IV: Operations
A. Identify channels of distribution
B. Facilities and logistics
C. Specific operational procedures
D. Personnel needs and uses
E. Proximity to supplies

Section V: Management
A. Management team—key personnel
B. Legal structure—stock agreements, employment agreements, ownership
C. Board of directors, advisers, consultants

Section VI: Financial
A. Financial forecast
   1. Profit and loss
   2. Cash flow
   3. Break-even analysis
   4. Cost controls
   5. Budgeting plans

Section VII: Critical Risks
A. Potential problems
B. Obstacles and risks
C. Alternative courses of action

Section VIII: Harvest (Exit) Strategy
A. Liquidity event (IPO or sale)
B. Continuity of business strategy
C. Identify successor

Section IX: Milestone Schedule
A. Timing and objectives
B. Deadlines and milestones
C. Relationship of events

Section X: Appendix or Bibliography

Source: Donald F. Kuratko, *The Complete Entrepreneurial Planning Guide* (Bloomington: Kelley School of Business, Indiana University, 2022).

12-6b Venture Concept and Value Proposition

First, the name of the venture should be identified, along with any special significance (e.g., family name or technical name). Second, the specific value proposition of the venture should be clearly identified, and the industry background should be presented in terms of current status and future trends. It is important to note any special industry developments that may affect the plan. If the company has an existing business or franchise, this is the appropriate place to discuss it. Third, the new venture should be thoroughly described, along with its proposed potential. All key terms should be defined and made comprehensible. Functional specifications or descriptions should be provided. Drawings and photographs also may be included. Fourth, the potential advantages the new venture possesses over the competition should be discussed at length. This discussion may include patents, copyrights, and trademarks as well as special technological or market advantages.

12-6c Marketing Segment

In the **marketing segment** of the plan, the entrepreneur must convince investors that a market exists, that sales projections *can be achieved,* and that the competition can be beaten.

This part of the plan is often one of the most difficult to prepare. It is also one of the most critical because almost all subsequent sections of the plan depend on the sales estimates developed here. The projected sales levels—which are based on the market research and analysis—directly influence the size of the manufacturing operation, the marketing plan, and the amount of debt and equity capital required.

Most entrepreneurs have difficulty preparing and presenting market research and analyses that will convince investors that the venture's sales estimates are accurate and attainable. The following are aspects of marketing that should be addressed when developing a comprehensive exposition of the market.

12-6d Market Niche and Market Share

A **market niche** is a homogeneous group with common characteristics—that is, all the people who have a need for the newly proposed product or service. When describing this niche, the writer should address the bases of customer purchase decisions: price, quality, service, personal contacts, or some combination of these factors.

Next, a list of potential customers who have expressed interest in the product or service—together with an explanation for their interest—should be included. If it is an existing business, the current principal customers

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should be identified and the sales trend discussed. It is important to describe the overall potential of the market. Sales projections should be made for at least three years, and the major factors affecting market growth (industry trends, socioeconomic trends, governmental policy, and population shifts) should be discussed. A review of previous market trends should be included, and any differences between past and projected annual growth rates should be explained. The sources of all data and methods used to make projections should be indicated. Then, if any major customers are willing to make purchase commitments, they should be identified, and the extent of those commitments should be indicated. Finally, the "go-to-market" concepts should be discussed. These include customer pain points, estimated market share, the actual reachable market, the market size and trends, the customers, and the projected sales in units and dollars for each of the next three years. The growth of the company's sales and its estimated market share should be related to the growth of the industry and the customer base.

Competitive Analysis

The entrepreneur should make an attempt to assess the strengths and weaknesses of the competing products or services. Any sources used to evaluate the competition should be cited. This discussion should compare competing products or services on the basis of price, performance, service, warranties, and other pertinent features. It should include a short discussion of the current advantages and disadvantages of competing products and services and why they are not meeting customer needs. Any knowledge of competitors' actions that could lead to new or improved products and an advantageous position also should be presented.

Finally, a review of competing companies should be included. Each competitor's share of the market, sales, and distribution and production capabilities should be discussed. Attention should be focused on profitability and the profit trend of each competitor. Who is the pricing leader? Who is the quality leader? Who is gaining? Who is losing? Have any companies entered or dropped out of the market in recent years?

Marketing Strategy

The general marketing philosophy and approach of the company should be outlined in the **marketing strategy**. A marketing strategy should be developed from market research and evaluation data and should include a discussion of (1) the kinds of customer groups to be targeted by the initial intensive selling effort, (2) the customer groups to be targeted for later selling efforts, (3) methods of identifying and contacting potential customers in these groups, (4) the features of the product or service (quality, price, delivery, warranty, and so on) to be emphasized to generate sales, and (5) any innovative or unusual marketing concepts that will enhance customer acceptance (e.g., leasing where only sales were previously attempted).

This section also should indicate whether the product or service initially will be introduced nationally or regionally. Consideration also should be given to any seasonal trends and what can be done to promote contraseasonal sales.

Pricing Policy

The price must be "right" to penetrate the market, maintain a market position, and produce profits. A number of pricing strategies should be examined, and then one should be convincingly presented. This pricing policy should be compared with the policies of the major competitors. The gross profit margin between manufacturing and final sales costs should be discussed, and consideration should be given to whether this margin is large enough to allow for distribution, sales, warranty, and service expenses; for amortization of development and equipment costs; and for profit. Attention also should be given to justifying any price increases over competitive items on the basis of newness, quality, warranty, or service.

Advertising Plan

For manufactured products, the preparation of product sheets and promotional literature; the plans for trade show participation, trade magazine advertisements, and direct mailings; and the use of advertising agencies should be presented. For products and services in general, a discussion of the advertising and promotional campaign contemplated to introduce the product and the kinds of sales aids to be provided to dealers should be included. Additionally, the schedule and cost of promotion and advertising should be presented; if advertising will be a significant part of the expenses, an exhibit that shows how and when these costs will be incurred should be included.

These five subsets of the marketing segment are needed to detail the overall marketing plan, which should describe *what* is to be done, *how* it will be done, and *who* will do it.

12-6e Research, Design, and Development Segment

The extent of any research, design, and development in regard to cost, time, and special testing should be covered in this segment. Investors need to know the

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status of the project in terms of prototypes, lab tests, and scheduling delays. Note that this segment is applicable only if research and development is involved in the business plan.

To achieve a comprehensive section, the entrepreneur should have (or seek out) technical assistance in preparing a detailed discussion. Blueprints, sketches, drawings, and models often are important.

It is equally important to identify the design or development work that still needs to be done and to discuss possible difficulties or risks that may delay or alter the project. In this regard, a developmental budget that shows the costs associated with labor, materials consulting, research, design, and the like should be constructed and presented.

12-6f Operations Segment

This segment always should begin by describing the facilities and logistics of the new venture. Important elements include labor availability, wage rate, proximity to suppliers and customers, channels of distribution, and key partnerships. In addition, local taxes and zoning requirements should be sorted out, and the support of area banks for new ventures should be touched on.

Specific needs should be discussed in terms of how the enterprise actually operates and the facilities required to handle the new venture (plant, warehouse storage, and offices), as well as any equipment that needs to be acquired (special tooling, machinery, computers, and vehicles).

The Entrepreneurial Process

Common Business Planning Mistakes

Entrepreneurs endure uncertainty in most everything they do. From hiring the right employees to finding reliable suppliers, building a business requires an entrepreneur to handle significant pressure on a daily basis. Given the variability inherent in any new venture, a business plan is crucial for effective management. In spite of the importance of business planning, few activities are more daunting for entrepreneurs than formalizing their thoughts on paper. In order for entrepreneurs to stay driven to succeed, they have to remain optimistic, so the fear of discovering some insurmountable obstacle while planning leads some management teams to avoid the process altogether. Whether the business is a start-up or a well-established corporation, a business plan, when done correctly, serves as the company's blueprint to ensure that all parties involved are in agreement regarding the business's overarching purpose. In the business plan sections listed below, we present some of the common mistakes that entrepreneurs make when developing their plan.

Overall Mistakes

- Entrepreneurs are unable to clearly articulate their vision in the plan.
- Entrepreneurs use acronyms and technical jargon without clearly explaining them early in the business plan.
- Entrepreneurs fail to provide sufficient details regarding the implementation of their strategy.
- Entrepreneurs ineffectively present the goals and objectives that are most important to the business's success.
- Entrepreneurs do not convincingly present the basis for their strategy.
- Entrepreneurs do not improve their plan based on the feedback from investors.

Executive Summary

- Entrepreneurs are not precise about their needs and capabilities.
- Entrepreneurs waste words with fillers and superfluous information.

Management

- Entrepreneurs forget to include their previous successes and/or failures.
- Entrepreneurs dismiss the importance investors place on an experienced management team.

Marketing

- Entrepreneurs rely heavily on secondary market research rather than soliciting the opinions of their potential customers.
- Entrepreneurs claim the percent of the market their company will own without research support.

Financials

- Entrepreneurs overlook and, in turn, underestimate their cash-flow requirements.
- Entrepreneurs inflate or understate their margins in order to arrive at their ideal profitability.

Source: Adapted from Mark Henricks, "Build a Better Business Plan," *Entrepreneur*, February 2007, https://www.entrepreneur.com/startingabusiness/businessplans/article174002.html, accessed June 21, 2008; Andrew J. Sherman, *Grow Fast, Grow Right: 12 Strategies to Achieve Breakthrough Business Growth* (Chicago: Kaplan Publishing, 2007), 20–26; and Jay Snider, "Don't Make These 5 Business Plan Mistakes," *Up and Running Blog*, http://upandrunning.bplans.com/2012/04/20/dont-make-these-5-business-plan-mistakes, accessed May 29, 2012.

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Other factors that might be considered are the suppliers (number and proximity) and the transportation costs involved in shipping materials. The labor supply and needed skilled positions also should be presented. Finally, the cost data associated with any of the operation factors should be presented. The financial information used here can be applied later to the financial projections.

12-6g Management Segment

This segment identifies the key personnel, their positions and responsibilities, and the career experiences that qualify them for those particular roles. Complete résumés should be provided for each member of the management team. In this section, the entrepreneur's role in the venture should be clearly outlined. Finally, any advisers, consultants, or members of the board should be identified and discussed.

The structure of payment and ownership (stock agreements, consulting fees, and so on) should be described clearly in this section. In summary, the discussion should be sufficient so that investors can understand each of the following critical factors that have been presented: (1) organizational structure, (2) management team and critical personnel, (3) experience and technical capabilities of the personnel, (4) ownership structure and compensation agreements, and (5) board of directors and outside consultants and advisers.

12-6h Financial Segment

The financial segment of a business plan must demonstrate the potential viability of the undertaking. Three basic financial statements must be presented in this part of the plan: the pro forma balance sheet, the income statement, and the cash-flow statement.

The Pro Forma Balance Sheet

Pro forma means "projected" as opposed to "actual." The pro forma balance sheet projects what the financial condition of the venture will be at a particular point in time. Pro forma balance sheets should be prepared at start-up, semiannually for the first years, and at the end of each of the first three years. The balance sheet details the assets required to support the projected level of operations and shows how these assets are to be financed (liabilities and equity). Investors will want to look at the projected balance sheets to determine if debt/equity ratios, working capital, current ratios, inventory turnover, and so on are within the acceptable limits required to justify the future financings projected for the venture.

The Income Statement

The income statement illustrates the projected operating results based on profit and loss. The sales forecast, which was developed in the marketing segment, is essential to this document. Once the sales forecast (earnings projection) is in place, production costs must be budgeted based on the level of activity needed to support the projected earnings. The materials, labor, service, and manufacturing overhead (fixed and variable) must be considered in addition to such expenses as distribution, storage, advertising, discounts, and administrative and general expenses (salaries, legal and accounting, rent, utilities, and telephone).

The Cash-Flow Statement

The cash-flow statement may be the most important document in new-venture creation because it sets forth the amount and timing of expected cash inflows and outflows. This section of the business plan should be carefully constructed.

Given a level of projected sales and capital expenditures for a specific period, the cash-flow forecast will highlight the need for and the timing of additional financing and will indicate peak requirements for working capital. Management must decide how this additional financing is to be obtained, on what terms, and how it is to be repaid. The total amount of needed financing may be supplied from several sources: part by equity financing, part by bank loans, and the balance by short-term lines of credit from banks. This information becomes part of the final cash-flow forecast. A detailed cash flow, if understood properly, can direct the entrepreneur's attention to operating problems before serious cash crises arise.

In the financial segment, it is important to mention any assumptions used to prepare the figures. Nothing should be taken for granted. This segment also should include how the statements were prepared (by a professional certified public accountant or by the entrepreneur) and who will be in charge of managing the business's finances.

The final document that should be included in the financial segment is a break-even chart, which shows the level of sales (and production) needed to cover all costs. This includes costs that vary with the production level (manufacturing labor, materials, and sales) and costs that do not change with production (rent, interest charges, and executive salaries).

12-6i Critical-Risks Segment

In this segment, potential risks such as the following should be identified: effect of unfavorable trends in the industry, design or manufacturing costs that have gone over estimates, difficulties of long lead times encountered when purchasing parts or materials, and unplanned-for new competition.

In addition to these risks, it is wise to cover the what-ifs. For example, what if the competition cuts prices, the industry slumps, the market projections are wrong, the sales projections are not achieved, the patents do not come through, or the management team breaks up?

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Finally, suggestions for alternative courses of action should be included. Certainly, delays, inaccurate projections, and industry slumps all can happen, and people reading the business plan will want to know that the entrepreneur recognizes these risks and has prepared for such critical events.

12-6j Harvest (Exit) Strategy Segment

Every business plan should provide insights into the future harvest strategy, sometimes referred to as an exit strategy. It is important for the entrepreneur to plan for a liquidity event as an exit strategy or for the orderly

The Entrepreneurial Process

Straying from Your Business Plan?

A well-written, thoughtful business plan is an important tool for any entrepreneur; however, even the most conservative strategy can fail to address some obstacles that are encountered between the inception of a concept and the eventual harvest of the business. One example of such a hurdle is when a business encounters an economic downturn. What is the appropriate strategy when the general economy has begun to falter, leading consumers to tuck away dollars that they would have otherwise spent at your business?

The answer is that there is not one solution for dealing with an ailing economy. Despite the need for a business plan, entrepreneurs often find that strict adherence to their plan is as dangerous as not having one at all. The key is to know when to stray from your plan. Following are steps to take when your plan does not effectively address the environment in which you find your business:

Partner together. Partnering with companies that offer complimentary products to your own is an effective way to share the responsibility of building the market. Not only can advertising expenses be split, but you can also introduce consumer incentives that encourage crossover purchasing from customers who otherwise would not have bought from your company. A common strategy is to determine what purchases your customers are currently making at other establishments that are closely associated with their purchases at your business. For example, if you own a coffee shop and your customers are regularly walking in with pastry purchases from a local bakery, a partnership with the bakery could be a logical fit. The key is to take advantage of the existing behavior of your customers rather than try to change it.

Communicate with customers. When times are lean, your existing customers are your lifeblood, so keeping them happy becomes increasingly important. If your marketing budget will not allow for extravagant advertising, shift your focus to working closely with your current customers. Often you will find that your customers are more than willing to share their perspective on your business, which could lead to easy and cheap modifications that will build loyalty. By keeping track of prospective customers, you will be in a better position to follow up with them when times are slow. For example, if your business involves providing quotes to potential customers, make note of those who chose not to make a purchase. When speaking with them, you will get insight about why they went elsewhere, and your efforts might convince them to rethink doing business with you.

Remain flexible. When the economy slackens, consumers become more conservative with their purchases and are more inclined to base their shopping on price alone. The problem with cutting prices during an economic downturn is that consumers will expect them to remain low when the economy improves. One way to avoid having to resort to cost-cutting measures is by offering more for the same price. For example, extending your business's hours to better accommodate your customers' schedules and offering free in-home estimates for service-related businesses are quick measure to take that could help set your business apart from the competition.

Build networks. As an entrepreneur, the ability to network is an important skill, especially when your business begins to wane. One important forum for many new ventures is the local chamber of commerce. By interacting with local businesses, entrepreneurs can keep close tabs on what the local economic trends are as well as gain access to potential commercial customers. In addition, working with other businesses can help you locate resources in your community, such as local talent and sources of funding; moreover, having a group of fellow entrepreneurs can be useful for vetting ideas as well as for moral support.

This list is not meant to be exhaustive. The underlying theme is that entrepreneurs need to maintain the versatility that they had when first starting their businesses. Developing a strategy is important for entrepreneurs to effectively manage their business, and formally documenting that strategy is important for ensuring the continuity of their business; however, entrepreneurs who depend solely on their business plan to direct their business decisions run the risk of locking themselves into a strategy that could quickly become obsolete due to a shift in the environment. Planning is crucial for your business, but knowing when to change your plan is equally important.

Source: Adapted from Rich Sloan, "Bad Economy? Time to Get Aggressive," *Fortune Small Business*, March 3, 2008, http://money.cnn.com/2008/03/03/smbusiness/startup_nation.fsb/index.htm, accessed May 12, 2012.

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transition of the venture if the plan is to grow and develop it. This section needs to deal with such issues as management succession and investor exit strategies. In addition, some thought should be given to change management—that is, the orderly transfer of the company assets if ownership of the business changes, continuity of the business strategy during the transition, and designation of key individuals to run the business if the current management team changes. With foresight, entrepreneurs can keep their dreams alive, ensure the security of their investors, and usually strengthen their businesses in the process. For this reason, a harvest strategy is essential.

12-6k Milestone Schedule Segment

The **milestone schedule segment** provides investors with a timetable for the various activities to be accomplished. It is important to show that realistic time frames have been planned and that the interrelationship of events within these time boundaries is understood. Milestone scheduling is a step-by-step approach to illustrating accomplishments in a piecemeal fashion. These milestones can be established within any appropriate time frame, such as quarterly, monthly, or weekly. It is important, however, to coordinate the time frame not only with such early activities as product design and development, sales projections, establishment of the management team, production and operations scheduling, and market planning but with other activities as well:

- Incorporation of the venture
- Completion of design and development and completion of prototypes
- Hiring of sales representatives and product display at trade shows
- Signing up distributors and dealers
- Ordering production quantities of materials and receipt of first orders
- First sales and first deliveries (dates of maximum interest because they relate directly to the venture's credibility and need for capital)
- Payment of first accounts receivable (cash in)

These items are the types of activities that should be included in the milestone schedule segment. The more detailed the schedule, the more likely the entrepreneur will persuade potential investors that they have thought things out and are therefore a good risk.

12-6l Appendix and Bibliography Segment

The final segment is not mandatory, but it allows for additional documentation that is not appropriate in the main parts of the plan. Diagrams, blueprints, financial data, vitae of management team members, and any bibliographical information that supports the other segments of the plan are examples of material that can be included. It is up to the entrepreneur to decide which, if any, items to put into this segment. However, the material should be limited to relevant and supporting information.

Table 12.3 provides an important recap of the major segments of a business plan, using helpful hints as practical reminders for entrepreneurs. By reviewing this, entrepreneurs can gain a macro view of the planning process. Table 12.4 is a personal checklist that gives entrepreneurs the opportunity to evaluate their business plan for each segment. The step-by-step evaluation is based on coverage of the particular segment, clarity of its presentation, and completeness. While it is understood that business plans will vary in the titles and headings that are used (see Appendix 12A), it is still valuable to assess each of the complete segments to see if and how they are presented in the final business plan.

12-7 Updating the Business Plan

LO12.9 Describe some helpful hints for writing an effective business plan

The business plan should serve as a planning tool to help guide the start-up and execution of a new venture. Once the venture is started, the business plan is still a vital tool for planning continued growth and/or profitability. There are several reasons to update the business plan, including the following:

- ***Financial changes.*** Update your plan on at least a yearly basis to project financials and plan for fiscal needs.
- ***Additional financing.*** If continued capital is needed, an updated business plan needs to reflect the current numbers and not the ones projected before the venture was started.
- ***Changes in the market.*** Changes in the customer base and competition should be tracked and strategized with regard to how they might affect your venture.
- ***Launch of a new product or service.*** Updating the business plan is an essential method to assess the feasibility of any proposed new product or service and determine its viability.
- ***New management team.*** Any new members of the management team should develop their own plan to initiate strategies for growth.
- ***Reflect the new reality.*** Business plans are written based on estimated numbers and projections that may not be accurate after the venture has started. Business plans should be updated to reflect the new reality that the entrepreneur experiences.[17]

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Table 12.3 Helpful Hints for Developing the Business Plan

I. Executive Summary
- No more than three pages. This is the most crucial part of your plan because you must capture the reader's interest.
- What, how, why, where, and so on must be summarized.
- Complete this part after you have a finished business plan.

II. Venture Concept and Value Proposition
- The name of your venture.
- A background of the industry with history of your company (if any) should be covered here.
- Value proposition of the new venture should be described clearly.
- Any uniqueness or distinctive features of this venture should be described clearly.

III. Marketing Segment
- Convince investors that sales projections and competition can be met.
- Use and disclose market studies.
- Identify target market, market position, and market share.
- Evaluate all competition and specifically cover why and how you will be better than your competitors. Identify all market sources and assistance used for this segment.
- Demonstrate pricing strategy. Your price must penetrate and maintain a market share to produce profits; thus, the lowest price is not necessarily the best price.
- Identify your advertising plans with cost estimates to validate proposed strategy.

IV. Operations Segment
- Describe the channels of distribution.
- List the production needs in terms of facilities (plant, storage, office space) and equipment (machinery, furnishings, supplies).
- Describe the specific operations of the venture.
- Indicate proximity to your suppliers.
- Describe the access to transportation for shipping and receiving.
- Provide estimates of operation costs—but be careful: too many entrepreneurs underestimate their costs.

V. Management Segment
- Supply résumés of all key people in the management of your venture.
- Carefully describe the legal structure of your venture (sole proprietorship, partnership, or corporation).
- Cover the added assistance (if any) of advisers, consultants, and directors.
- Give information on how and how much everyone is to be compensated.

VI. Financial Segment
- Give actual estimated statements.
- Describe the needed sources for your funds and the uses you intend for the money.
- Develop and present a budget.
- Create stages of financing for purposes of allowing evaluation by investors at various points.

VII. Critical-Risks Segment
- Discuss potential risks before investors point them out, for example,
- Price-cutting by competitors
- Any potentially unfavorable industry-wide trends
- Design or manufacturing costs in excess of estimates
- Sales projections not achieved
- Product development schedule not met
- Difficulties or long lead times encountered in the procurement of parts or raw materials
- Greater-than-expected innovation and development costs to stay competitive
- Some alternative courses of action.

VIII. Harvest (Exit) Strategy Segment
- Outline a plan for a liquidity event—IPO or sale.
- Describe the plan for transition of leadership.
- Mention the preparations (insurance, trusts, and so on) needed for continuity of the business.

IX. Milestone Schedule Segment
- Develop a timetable or chart to demonstrate when each phase of the venture is to be completed. This shows the relationship of events and provides a deadline for accomplishment.

X. Appendix or Bibliography

Source: Donald F. Kuratko, *The Complete Entrepreneurial Planning Guide* (Bloomington: Kelley School of Business, Indiana University, 2022).

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Table 12.4 Business Plan Assessment: A Complete Evaluation Tool

The Components

Presented here are 10 components of a business plan. As you develop your business plan, you should assess each component. Be honest in your assessment because the main purpose is to improve your business plan and increase your chances of success. For example, if your goal is to obtain external financing, you will be asked to submit a complete business plan for your venture. The business plan will help a funding source to more adequately evaluate your business idea.

Assessment

Directions. The brief description of each component will help you write that section of your plan. After completing your plan, use the scale provided to assess each component.

5	4	3	2	1
Outstanding	Very Good	Good	Fair	Poor
thorough and complete in all areas	most areas covered but could use improvement in detail	some areas covered in detail but other areas missing	a few areas covered but very little detail	no written parts

The 10 Components of a Business Plan

1. **Executive summary.** This is the most important section because it has to convince the reader that the business will succeed. In no more than three pages, you should summarize the highlights of the rest of the plan. This means that the key elements of the following components should be mentioned.

   The executive summary must be able to stand on its own. It is not simply an introduction to the rest of the business plan but rather discusses who will purchase your product or service, what makes your business unique, and how you plan to grow in the future. Because this section summarizes the plan, it is often best to write it last.

Rate this component:

5	4	3	2	1
Outstanding	Very Good	Good	Fair	Poor

2. **Description of the business.** This section should provide background information about your industry, a history of your company, a general description of your product or service, and your specific mission that you are trying to achieve. Your product or service should be described in terms of its unique qualities and value to the customer. Specific short-term and long-term objectives must be defined. You should clearly state what sales, market share, and profitability objectives you want your business to achieve.

Key Elements	Have you covered this in the plan?	Is the answer clear? (yes or no)	Is the answer complete? (yes or no)
a. What type of business will you have?			
b. What products or services will you sell?			
c. Why does it promise to be successful?			
d. What is the growth potential?			
e. How is it unique?			

Rate this component:

5	4	3	2	1
Outstanding	Very Good	Good	Fair	Poor

3. **Marketing.** There are two major parts to the marketing section. The first part is research and analysis. Here, you should explain who buys the product or service—in other words, identify your target market. Measure your market size and trends and estimate the market share you expect. Be sure to include support for your sales projections. For example, if your figures are based on published marketing research data, be sure to cite the source. Do your best to make realistic and credible projections. Describe your competitors in considerable detail, identifying their strengths and weaknesses. Finally, explain how you will be better than your competitors.

(*Continued*)

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Table 12.4 Business Plan Assessment: A Complete Evaluation Tool (*Continued*)

The second part is your marketing plan. This critical section should include your market strategy, sales and distribution, pricing, advertising, promotion, and public awareness efforts. Demonstrate how your pricing strategy will result in a profit. Identify your advertising plans and include cost estimates to validate your proposed strategy.

Key Elements	Have you covered this in the plan?	Is the answer clear? (yes or no)	Is the answer complete? (yes or no)
a. Who will be your customers? (*target market*)			
b. How big is the market? (*number of customers*)			
c. Who will be your competitors?			
d. How are their businesses prospering?			
e. How will you promote sales?			
f. What market share will you want?			
g. Do you have a pricing strategy?			
h. What advertising and promotional strategy will you use?			

Rate this component:



4. **Operations.** In this segment, you describe the actual operations and outline their advantages. Specific operational procedures, proximity to supplies, and personnel needs and uses should all be considered in this section.

Key Elements	Have you covered this in the plan?	Is the answer clear? (yes or no)	Is the answer complete? (yes or no)
a. Have you identified a specific location?			
b. Have you outlined the advantages of this location?			
c. Any specific operational procedures to be considered?			
d. What personnel needs are there?			
e. Will your suppliers be accessible?			

Rate this component:



5. **Management.** Start by describing the management team, their unique qualifications, and your plans to compensate them (including salaries, employment agreements, stock purchase plans, levels of ownership, and other considerations). Discuss how your organization is structured; consider including a diagram illustrating who reports to whom. Also include a discussion of the potential contribution of the board of directors, advisers, or consultants. Finally, carefully describe the legal structure of your venture (sole proprietorship, partnership, or corporation).

Key Elements	Have you covered this in the plan?	Is the answer clear? (yes or no)	Is the answer complete? (yes or no)
a. Who will manage the business?			
b. What qualifications do you have?			
c. How many employees will you have?			

(*Continued*)

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Table 12.4 Business Plan Assessment: A Complete Evaluation Tool (*Continued*)

Key Elements	Have you covered this in the plan?	Is the answer clear? (yes or no)	Is the answer complete? (yes or no)
d. What will they do?			
e. How much will you pay your employees, and what type of benefits will you offer them?			
f. What consultants or specialists will you use?			
g. What legal form of ownership will you have?			
h. What regulations will affect your business?			

Rate this component:

5	4	3	2	1
Outstanding	Very Good	Good	Fair	Poor

6. **Financial.** Three key financial statements must be presented: a balance sheet, an income statement, and a cash-flow statement. These statements typically cover a one-year period. Be sure you state any assumptions and projections made when calculating the figures.

   Determine the stages at which your business will require external financing and identify the expected financing sources (both debt and equity sources). Also, clearly show what return on investment these sources will achieve by investing in your business. The final item to include is a break-even analysis. This analysis should show what level of sales will be required to cover all costs.

   If the work is done well, the financial statements should represent the actual financial achievements expected from your business plan. They also provide a standard by which to measure the actual results of operating your business. They are a very valuable tool to help you manage and control your business.

Key Elements	Have you covered this in the plan?	Is the answer clear? (yes or no)	Is the answer complete? (yes or no)
a. What is your total expected business income for the first year? Quarterly for the next two years? (*forecast*)			
b. What is your expected monthly cash flow during the first year?			
c. Have you included a method of paying yourself?			
d. What sales volume will you need to make a profit during the three years?			
e. What will be the break-even point?			
f. What are your projected assets, liabilities, and net worth?			
g. What are your total financial needs?			
h. What are your funding sources?			

Rate this component:

5	4	3	2	1
Outstanding	Very Good	Good	Fair	Poor

7. **Critical risks.** Discuss potential risks before they happen. Examples include price-cutting by competitors, potentially unfavorable industry-wide trends, design or manufacturing costs that could exceed estimates, and sales projections that are not achieved. The idea is to recognize risks and identify alternative courses of action. Your main objective is to show that you can anticipate and control (to a reasonable degree) your risks.

(*Continued*)

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Table 12.4 Business Plan Assessment: A Complete Evaluation Tool (*Continued*)

Key Elements	Have you covered this in the plan?	Is the answer clear? (yes or no)	Is the answer complete? (yes or no)
a. What potential problems have you identified?			
b. Have you calculated the risks?			
c. What alternative courses of action exist?			

Rate this component: 5 Outstanding — 4 Very Good — 3 Good — 2 Fair — 1 Poor

8. **Harvest strategy.** Establishing an exit out of a venture is hard work. A founder's protective feelings for an idea built from scratch make it tough to grapple with issues such as management succession and harvest strategies. With foresight, however, an entrepreneur can either keep the dream alive and ensure the security of their venture or establish a plan for a liquidity event such as an IPO or the sale of the venture. Thus, a written plan for succession of your business is essential.

Key Elements	Have you covered this in the plan?	Is the answer clear? (yes or no)	Is the answer complete? (yes or no)
a. Have you planned for the orderly transfer of the venture assets if a liquidity event is established, such as an IPO or a sale?			
b. Is there a continuity of business strategy for an orderly transition if the venture is not looking for an exit?			

Rate this component: 5 Outstanding — 4 Very Good — 3 Good — 2 Fair — 1 Poor

9. **Milestone schedule.** This section is an important segment of the business plan because it requires you to determine what tasks you need to accomplish to achieve your objectives. Milestones and deadlines should be established and monitored on an ongoing basis. Each milestone is related to all others, and together all of them provide a timely representation of how your objective is to be accomplished.

Key Elements	Have you covered this in the plan?	Is the answer clear? (yes or no)	Is the answer complete? (yes or no)
a. How have you set your objectives?			
b. Have you set deadlines for each stage of your growth?			

Rate this component: 5 Outstanding — 4 Very Good — 3 Good — 2 Fair — 1 Poor

10. **Appendix.** This section includes important background information that was not included in the other sections. It is where you would put such items as résumés of the management team, names of references and advisers, drawings, documents, licenses, agreements, and any materials that support the plan. You may also wish to add a bibliography of the sources from which you drew information.

Key Elements	Have you covered this in the plan?	Is the answer clear? (yes or no)	Is the answer complete? (yes or no)
a. Have you included any documents, drawings, agreements, or other materials needed to support the plan?			
b. Are there any names of references, advisers, or technical sources you should include?			
c. Are there any other supporting documents?			

(*Continued*)

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Table 12.4 Business Plan Assessment: A Complete Evaluation Tool (*Continued*)

Rate this component:

5	4	3	2	1
Outstanding	Very Good	Good	Fair	Poor

Summary: Your Plan

Directions. For each of the business plan sections that you assessed earlier, circle the assigned points on this review sheet and then total the circled points.

Components	Points				
1. Executive summary	5	4	3	2	1
2. Description of the business	5	4	3	2	1
3. Marketing	5	4	3	2	1
4. Operations	5	4	3	2	1
5. Management	5	4	3	2	1
6. Financial	5	4	3	2	1
7. Critical risks	5	4	3	2	1
8. Harvest strategy	5	4	3	2	1
9. Milestone schedule	5	4	3	2	1
10. Appendix	5	4	3	2	1

Total Points: _____

***Scoring*:**

50 pts. — **Outstanding!** The ideal business plan. Solid!

45–49 pts. — **Very Good.**

40–44 pts. — **Good.** The plan is sound, with a few areas that need to be polished.

35–39 pts. — **Above Average.** The plan has some good areas but needs improvement before presentation.

30–34 pts. — **Average.** Some areas are covered in detail, yet other areas show weakness.

20–29 pts. — **Below Average.** Most areas need greater detail and improvement.

Below 20 pts. — **Poor.** Plan needs to be researched and documented much better.

Source: Donald F. Kuratko, *The Complete Entrepreneurial Planning Guide* (Bloomington: Kelley School of Business, Indiana University, 2022).

12-7a A Practical Example of a Business Plan

As we have stressed in this chapter, every new venture should have a business plan; however, many entrepreneurs have no idea about the details required for a complete business plan. An example of an actual business plan prepared for potential and business plan funding competitions is included at the end of this chapter as well as in Appendix 12A at the end of this chapter. The first plan at the end of the chapter—titled "Circle City Food"—was prepared for and presented to Silicon Valley venture capitalists and angel investors. The plan in Appendix 12A—titled "Hydraulic Wind Power"—was prepared for actual financial support and also was presented at national business plan competitions. Specific parts of a business plan discussed earlier in the chapter are illustrated in these detailed examples. By carefully reviewing these business plans, you will gain a much better perspective of the final appearance that an entrepreneur's plan must have.

12-8 Presentation of the Business Plan: The "Pitch"

LO12.10 Explain the key points in the presentation of a business plan—the pitch

Once a business plan is prepared, the next major challenge is presenting the plan to either a single financial person or, in some parts of the country, a forum at which

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numerous financial investors have gathered.[18] The oral presentation—commonly known as an **elevator pitch** (because of the analogy of riding an elevator and having only two minutes to get your story told to another person in the elevator)—provides the chance to sell the business plan to potential investors.

The presentation should be organized, well prepared, interesting, and flexible. Entrepreneurs should develop an outline of the significant highlights that will capture the audience's interest. Although the outline should be followed, they also must feel free to add or remove certain bits of information as the presentation progresses—a memorized presentation lacks excitement, energy, and interest.

An entrepreneur should use the following steps to prepare an oral presentation:

- Know the outline thoroughly.
- Use key words in the outline that help recall examples, visual aids, or other details.
- Rehearse the presentation to get a feel for its length.
- Be familiar with any equipment to be used in the presentation—use your own laptop.
- The day before, practice the complete presentation by moving through each slide.

12-8a Suggestions for Presentation

Entrepreneurs are naturally anxious to tell (and sell) their story. However, most venture capitalists agree that the content should be focused and the delivery should be sharp. In the content of the presentation, it is important to be brief and to the point, to summarize the critical factor or unique "hook" of your venture up front, and to use no more than 12 to 15 PowerPoint slides. Following are some key suggestions about the actual delivery of the pitch to prospective investors:

- Focus on the "**pain**" for which your venture will be the solution. Investors want to know exactly what problem is being solved by your venture. Pinpoint the target of your solution.
- Demonstrate the **reachable market**. Instead of a dramatic **potential market**, outline the immediate reachable group of customers that will be targeted.
- Explain the business model. How this venture is designed to make money is critical to investors. Demonstrating a clear method of getting to the market for sales will indicate a successful beginning to the new venture.
- Tout the **management team**. Every investor wants to know the skills and ability of the venture's team to deliver and operationalize the concept. Emphasize the experienced people on your team as well as any technical advisers who are on board.
- Explain your **metrics**. Rather than using generic assumptions such as the famous "1 percent rule" (when someone claims that he or she will simply get 1 percent of a huge market with no research to back the claim up), highlight the metrics that were used to calculate any revenue projections.
- *Motivate* the audience. The entire purpose of a venture pitch is to move the audience to the next step: another meeting to discuss everything in detail. Therefore, you must remember that enthusiasm is very important. The investors must believe that you are excited before they can be excited.
- Recent research has shown that entrepreneurs may benefit from being aware of their nonverbal expressions during a funding pitch, including their *facial expressions*, such as happiness, anger, and fear, which can prove beneficial but of course not to the extreme. Certain types of rhetoric that emphasize a sense of charisma can also be effective in venture pitches.[19]
- Emphasize your *character* and *trustworthiness* by highlighting examples of commitment to others and the manner in which you view the venture as a higher calling for everyone. Investors always believe that an honest and straightforward founder is critical for working through the challenges of a start-up.
- Listen clearly and intently to any suggestions or questions that are provided by the investors. This demonstrates your willingness to accept advice and be guided through unseen waters. Investors seek to be hands-on mentors, so they will judge the **coachability** of the founder.
- Why *you*, and why *now*? The final point must answer the daunting questions in the minds of the investors: Why are you the right venture, and why is this the right time for it to be launched? Be confident in yourself and your team. Always demonstrate a time line to show the speed with which your venture plans to capture a significant market.[20]

12-8b What to Expect

Entrepreneurs should realize that the audience reviewing their business plan and listening to their pitch is usually cynical and sometimes antagonistic. Venture capital sources often pressure entrepreneurs to test their venture as well as their mettle. Thus, entrepreneurs must expect and prepare for a critical (and sometimes skeptical) audience of financial sources. When you make your pitch and submit your business plan, the venture capitalist will listen and then glance at the plan briefly before beginning any initial comments. No matter how good you think your venture plan is, an investor is not going to look at it and say, "This is the greatest business plan I've ever seen!" Do not expect enthusiastic acceptance or even polite praise. It's highly likely that the remarks will

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Table 12.5 What to Do When a Venture Capitalist Turns You Down: 10 Questions

1. *Confirm the decision*: "That means you do not wish to participate at this time?"
2. *Sell for the future*: "Can we count you in for a second round of financing, after we've completed the first?"
3. *Find out why you were rejected:* "Why do you choose not to participate in this deal?" (Timing? Fit? All filled up?)
4. *Ask for advice*: "If you were in my position, how would you proceed?"
5. *Ask for suggestions*: "Can you suggest a source who invests in this kind of deal?"
6. *Get the name*: "Whom should I speak to when I'm there?"
7. *Find out why*: "Why do you suggest this firm, and why do you think this is the best person to speak to there?"
8. *Work on an introduction*: "Who would be the best person to introduce me?"
9. *Develop a reasonable excuse*: "Can I tell him that your decision to turn us down was based on _____?"
10. *Know your referral*: "What will you tell him when he or she calls?"

Source: Joseph R. Mancuso, *How to Write a Winning Business Plan* (Englewood Cliffs, NJ: Prentice Hall, 1985), 37. Reprinted with the permission of Simon & Schuster Adult Publishing Group. Copyright © 1985 by Prentice Hall, Inc.

be critical, and even if they aren't, they'll seem that way. Don't panic. Even if it seems like an avalanche of objections, bear in mind that some of the best venture capital deals of all time faced the same opposition. Never expect results in 20 minutes. Each pitch will be a learning experience that will build your confidence for the next one.

Entrepreneurs must be prepared to handle questions from the evaluators and to learn from their criticism. They should never feel defeated but rather should make a commitment to improving the business plan for future review. Table 12.5 outlines some of the key questions that an entrepreneur might ask when their business plan is turned down. Entrepreneurs should use the answers to these questions to revise, rework, and improve their business plan. Remember that you are starting out on a journey more similar to a marathon than a sprint. The goal is not so much to succeed the *first* time as it is to *succeed*.[21]

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Sample New Venture and Business Plan



Circle City Food
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Winter 2021
Permission granted by the author

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Executive Summary

The Problem

According to the Food and Agricultural Organization of the United Nations, one-third of all food produced around the world is wasted. The United States discards more food than any other country, and food takes up more space in landfills than anything else. Despite this, 50 million people suffer from food insecurity (*The Problem of Food Waste*). In Indiana alone, a study conducted by Feeding America reveals that 15 percent of the population is food insecure, which amounts to over a million people, including 335,000 children (*The State of Food Security and Nutrition in the World*).

The Solution

Circle City Food is an online marketplace that sources meals fast approaching their sell-by date from food generators such as restaurants and finds customers for this food, which is marked down at least 50 percent from its original price. In addition, every meal transaction made results in a meal donated to Feeding America. A meal donation costs only $0.10.

Food generators will be incentivized to use this system by the ability to sell food that may otherwise have been thrown away and to distribute this food in a convenient

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manner. For a monthly subscription, they can also post full-price food for sale. This provides an economic benefit for small-business owners who may not currently have an online presence. On the other hand, customers will be incentivized by the ability to support local businesses, access a marketplace of available discounted food, and save money. If the corresponding restaurants have the ability to support delivery, customers can also enable this convenience for a small extra charge. All parties using Circle City Food will create opportunities to help the community and environment, leading to a win-win-win situation.

The Competition

The competitors of Circle City Food fall into three main classes: those that sell excess food from food generators (usually for-profit with a sustainability focus), those that create a marketplace for food generators (usually for-profit with an economic focus), and those that serve the food-insecure community (usually not-for-profit). Circle City Food enables all purposes, thus being a more holistic solution.

Management Team

Currently, Circle City Food currently has only its founder, Nancy Tseng, driving it forward. However, during the course of concept development and problem validation, she consulted many local community leaders regarding food waste management. Nancy will be recruiting them and others to be part of her team or Board of Advisers. She is also actively looking for additional team members and resources who are knowledgeable in sustainability initiatives in Indianapolis and e-commerce marketplace development.

Finance and Implementation

It is free for customers to access Circle City Food and peruse the discounted food that is available for sale. There is a $60 annual fee for restaurants to sign into the system. A transaction fee of $1.00 to $1.79 is charged with each meal purchase. An extra charge of $0.50 is also applied if delivery is enabled on a particular order. Circle City Food anticipates earnings before interest, taxes, depreciation, and amortization (EBITDA) of $5,337,889 by the end of 2026. Currently, Nancy is seeking $500,000 in seed funding in return for 10 percent equity to support the next phase of development.

The Business Concept and Value Proposition

The Offering

In the United States, 30 to 40 percent of the entire food supply is wasted. Most of this estimated 108 billion pounds of food waste is perfectly edible and nutritious (*Food Waste in America in 2021*). Forty-three percent of this food waste comes from homes and restaurants and 40 percent from grocery stores and food service companies (*The Problem of Food Waste*). The main intent of Circle City Food is to rescue potential food waste from these sources by incentivizing their sale and distribution starting in the state of Indiana.

The focus on Indiana is intentional. Indiana is ranked second in the nation in terms of being the most wasteful state, and the situation is only getting worse as Indiana's landfills are growing the fastest in the nation (*American Wasteland*). Indianapolis is also the most wasteful big city in America. Compared to other cities such as San Francisco and Seattle, where over 60 percent of waste is recycled, only 7 percent of waste is recycled in Indianapolis (Bowman and Hopkins). Circle City is Indianapolis's nickname, so Circle City Food was born as a solution to engage more people in the city in the circular economy. Even after scaling this solution to include other states and municipalities, the founder wanted to honor the locale that inspired the initial idea.

In terms of how it works, Circle City Food creates an online marketplace for food generators, such as restaurants, to market meals that are close to their sell-by date and sell them to customers at a discount. Customers can purchase this food after filtering based on their location, available pickup times, and dietary needs, such as lactose-free, gluten-free, vegan, or vegetarian. After placing an order, customers pick up their food, and a meal is donated to Feeding America. The business model canvas for Circle City Food is in the Appendix.

Circle City Food differentiates itself from other food waste reduction platforms based on the ability for customers to filter for specific dietary restrictions and automatically donate a meal with each transaction despite having comparable pricing to its most prevalent competitor, Too Good to Go. In addition, the availability of competing platforms is heavily location dependent, and none currently operates in Indiana. Two other ways that Circle City Food differentiates itself are based on its enhanced ability to provide economic support to small businesses and the ability for customers to add in convenience/sustainability features as desired:

- In terms of economic support, small food generators, such as restaurants that are just starting up and currently do not have an online presence, can use Circle City Food to market full-price items. This can be especially helpful for small, local business owners who need a marketplace to advertise their products. The ease of use of the system allows businesses to quickly post their available offerings for customers to see.
- In terms of feature customization, customers can "favorite" certain food generators and receive notifications when food is available from these specific businesses. In addition, customers who want food

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delivery can select this option as long as restaurants have the ability to support it. This in turn gives restaurants the ability to deliver food without relying on traditional delivery models that charge a high commission. Customers who are more sustainability minded can also take part in an initiative to bring their own take-out containers to the restaurants. In future extensions of this marketplace, these customers can be further targeted to help with other sustainability movements.

Revenue Streams and Product Pricing

Circle City Food will charge restaurants an annual fee of $60 to join the marketplace. Customers can join the platform for free. Restaurants that enter a meal into the system will post the full price of the meal, and the app will automatically apply a 50 percent discount. Restaurants can adjust this discount to be higher if desired. For a monthly subscription price of $15, restaurants can opt out of this automatic discount feature and post the full price of the meal. When a purchase of more than $10 is made, a transaction fee of $1.79 is charged, which is the same as the main competitor, Too Good to Go (Sheppard).

However, if a purchase of less than $10 is made, a transaction fee of $1.00 is charged. Too Good to Go charges the $1.79 regardless of the size of the transaction. Independent contractors will also be employed for sales and customer support. When they sign on to be part of Circle City Food, they must pay $30 to enroll themselves to receive a training package and other instructions.

The final source of revenue is the extra charge of $0.50 that is applied if the delivery option is enabled between food generators and customers. However, this service is not linked to traditional delivery models such as Grubhub, DoorDash, and UberEats, so restaurants need to manage the delivery themselves. However, this is meant to give restaurants the freedom to choose their own delivery mechanism given that traditional models charge high commissions (20 to 30 percent) for every order. Legislators in cities such as New York and Los Angeles have had to cap fees at 15 percent per order due to the burden they placed on small businesses (Sharma). With Circle City Food, restaurants can set their own delivery fees in the app, all of which go back to their own workers.

Product Validation

Other food waste reduction platforms have proven the concept that customers will sign onto a food marketplace that incentivizes food waste reduction with discounts, although all have slightly different models. Summaries of the top six food waste apps follow (Wolken):

- **FoodforAll** charges a 10 percent transaction fee when restaurants sell food that is about to be thrown out. Customers must pick up the food one hour before closing time. The food is marked down at least 50 percent. Restaurants can also sign up for a premium plan that costs $14 per month for increased staff and customer support.
- **Flashfood** charges a transaction fee when grocers sell food close to its "best-before date." Each transaction made outside of Canada is also charged with a foreign transaction fee. The food is marked down up to 50 percent.
- **YourLocal** charges a transaction fee when restaurants or stores sell food that is about to be thrown out. Customers pick up the food at specific times. Each transaction made outside of Denmark is also charged with a foreign transaction fee. The food is marked down 50 to 70 percent.
- **Too Good to Go** charges $1.79 per transaction when restaurants or stores sell food that is about to be thrown out. This food is placed in "Magic Bags," which is a random grouping of food rather than a set meal. Customers do not choose what they are getting when they pick up the food at specific times.
- **Food Rescue US** is a not-for-profit that organizes community volunteers to deliver food surpluses from businesses to organizations that serve the food insecure.
- **Olio** charges a transaction fee when individuals share food with one another on their platform. This concept is similar to Facebook marketplace but for food.

Circle City Food's model is most similar to FoodforAll, YourLocal, and Too Good to Go. Currently, these competitors operate only in certain regions. FoodforAll is based in Boston and New York City, while YourLocal is based Denmark and New York City. Too Good to Go is the most prevalent competitor, as it has a strong base in Europe and has already spread to several states. A map showing the locations and number of businesses that it has partnered with is in the Appendix. It currently has no presence in the state of Indiana.

Primary Market Research

To gauge the readiness of the Indianapolis market in particular, a survey was sent out to the Facebook group Indy Local Foodies, an active community that writes reviews and gives recommendations on the food scene in Indianapolis. Eighty-seven people responded over the course of a week. The full results are in the Appendix, but the main insights are summarized below:

- Several survey respondents have seen this business model in other locations and want to have it in Indianapolis.
- All respondents were willing to pick up food close to its sell-by date from restaurants at a discount. Most customers eat out multiple times per month, spending $15 to $30 on average.

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- Cost and convenience rather than the focus of sustainability drive customer behavior. In the survey, customers prioritized the amount of money saved above all other decision factors with the second and third priorities being distance to the restaurant and the food being ready to eat at pickup, respectively. Knowing that they are helping the environment ranked last in terms of customer priorities.

Industry and Market Analysis

The Matter of Food Waste

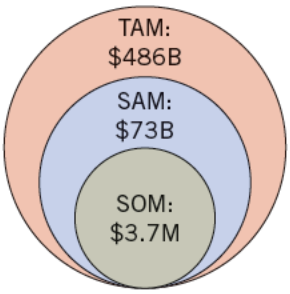
The United States is taking increased action against food waste. On September 16, 2015, the U.S. Department of Agriculture and the Environmental Protection Agency (EPA) announced the domestic goal to cut food loss and waste in half by 2030. In 2010, the baseline year when the EPA announced its goal, food loss was 31 percent of the food supply, which amounted to 133 billion pounds and an estimated value of $161.6 billion. Thus, the 2030 goal aims to cut the amount of food loss to 66 billion pounds (*United States 2030 Food Loss and Waste Reduction Goal*).

Several states across the country have taken action to curb food waste and improve food recovery. Legislators in California, Connecticut, Massachusetts, New York, Rhode Island, and Vermont have passed laws that restrict the amount of food waste going to landfills. This has been accomplished by increasing the amount of food donations, funding composting and organic collection programs, creating composting educational programs, reducing waste in schools, and starting to require that businesses separate organic waste. Thus, the concern around food waste is continuing to grow, and more states will likely take increased action over time (*Food Waste in America in 2021*).

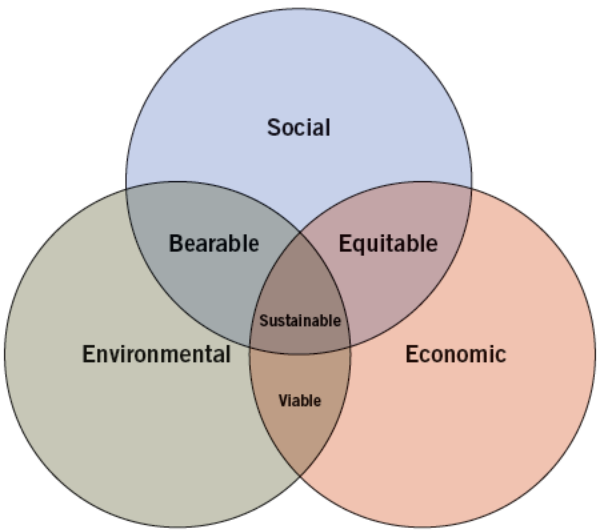
In fact, Indianapolis has already started to become focused on this issue with Thrive Indianapolis, which is the first-ever actionable plan created to bring together city agencies, community partners, and residents to make the city equitable, healthier, and prepared for the challenges of the twenty-first century. One of the main pillars of the plan is to reduce food insecurity in Indianapolis by 20 percent by 2025 while also reducing food waste (Thrive). Thus, Circle City Food provides solutions for the city's existing concerns.

Industry Overview and Trends

In 2020, consumers in the United States spent $769 billion ordering food from restaurants, and take-out orders accounted for $486 billion, or 63 percent of those sales (Guszkowski). This constitutes the total addressable market (TAM). The vast majority of take-out orders were placed using a digital channel, out of which 15 percent were initiated via a mobile app (Lock). Thus, the serviceable addressable market (SAM) is $73 billion. Even as dine-in restrictions due to the COVID-19 pandemic have started to loosen around the country, drive-through and pickup behaviors have continued to increase. In fact, one in three people surveyed by Bluedot, a provider of mobile app geolocation technology, said they will never return to pre-pandemic dining habits (Guszkowski).



As mentioned before, the initial focus of Circle City Food is the state of Indiana. Thus, the serviceable and obtainable market (SOM) is based on the consumers in the state who use an app to order food. Just taking the members of the Indy Local Foodies Facebook group who were surveyed in Product Validation into account leads to a very conservative estimate of the SOM of $3.7 million. These consumers are an ideal customer group, as they are technology literate, being engaged in an online community that regularly discusses food choices in the Indianapolis area. In addition, these members typically eat out several times per month. However, the true SOM is likely between the values for the SAM and SOM. According to the National Restaurant Association, Indiana's restaurants were estimated to make $12.8 billion in sales in 2018. Discounting this number by the expected portion of orders made digitally via an app leads to an SOM of $216 million. Thus, the different estimates of SOM are based on the calculation approach of either going bottom up ($3.7 million) or top down ($216 million). Both calculations are shown in the Appendix.



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Sustainable food trends are on the rise with 60 percent of consumers buying products and services from companies that are sustainable (Fromm). Sustainable development requires the alignment of three pillars: environment, social, and economic. Circle City Food addresses each of these components as it creates economic advantages for restaurants to market discounted food to customers, providing environmental benefits from reducing food waste and also social benefits to the food insecure.

Circle City Food also provides economic benefits to restaurants by providing the ability to market other full-price offerings on the app marketplace. For restaurants currently without an online platform, this translates into a heavy financial benefit, as 45 percent of consumers surveyed by PYMNTS/Paytronix said the ability to order online encourages them to spend more on food (Guszkowski). In addition, Circle City Food provides a system to organize delivery orders outside of using third-party delivery services.

Consumers have even started the trend of boycotting third-party delivery services in order to support small businesses, often using a restaurant's own app for ordering. In fact, 50 percent of consumers surveyed by Bluedot used restaurant apps once or twice a month compared to only 32 percent who used third-party delivery services. Thirty-six percent said they would never use third-party apps (Guszkowski).

Competitive Landscape

Competitors Dealing in Food Waste

As mentioned in the Product Validation section, the competitors for Circle City Food that similarly enable a system for minimizing food waste are highly dispersed, and none besides Flashfood have a presence in Indiana. However, Flashfood focuses more on the sale of groceries, whereas Circle City Food focuses on the sale of prepared meals.

Too Good to Go is the competitor that presents the most threat due to its scale. On October 5, 2021, on its website, Too Good to Go announced that it had already signed on 114,758 cafés, restaurants, bakeries, hotels, and other businesses as well as 45.6 million customers. In 2021 alone, it has launched into Chicago, Los Angeles, and Atlanta. However, even though its app has a rating of 4.9 out of 5 stars, customers who left a negative review shared several common issues. The table below shows the points of parity and differentiation between Too Good to Go and Circle City Food, the differentiating factors being based on Too Good to Go's negative reviews.

	Too Good to Go	Circle City Food
Ease of Use of App	Parity: the mapping function to locate food and set favorites will be similar.	
Presence in Indiana	Customers have noted there are not many offerings in an area after launch. It is also not available in Indiana.	The business will focus first on the Indianapolis area before scaling to other Indiana cities and states.
Cost of App	Restaurant annual fee is $59. Transaction cost is always $1.79.	Restaurant annual fee is $60. Transaction cost is $1.79 or $1.00 if an order is less than $10.
Setting Customer Dietary Preferences	Customers are not able to filter by dietary restrictions and must contact the restaurants themselves.	Customers will be able to filter by the common dietary restrictions.
Customer Pickup Experience	Customers have issues with food running out prior to pickup without any notification.	Restaurants will be able to easily update their offerings. Orders made must be honored by the restaurants.
Quality of Food	Customers have issues with food quality. Reviews have labeled the "Magic Bags" as "Rubbish Bags."	Customers can choose what they pick up rather than getting a randomized bag of food.
Solution for Small Restaurants	Small restaurants more than likely already take steps to reduce food waste due to tight margins.	The app creates a way for small restaurants to get online and reach a larger audience without applying a discount to meals.

Competitors Creating an Online Marketplace

Restaurants currently use various means in order to set up an online presence. Restaurants can create their own business account on Facebook or design their own website. It is free to create a landing page on Facebook, but there is no automated way to order food in this method. On the other hand, restaurants can build their own website with an online menu and integrated

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payment options. This allows restaurants to direct orders from customers to their point of sales (POS) in real-time, which then engages restaurant staff to complete the order. This then also allows restaurants to keep more of their profits since they pay $0 in commission fees (Krook). However, the average cost of setting up a restaurant website is $90 per hour, and the final receipt can be anywhere from $0 to $15,000 (Boiko). The lower end of the cost spectrum typically results in very limited online functionality and a clunky user experience.

Alternatively, restaurants can use a third-party takeout and delivery app such as UberEats, DoorDash, or Grubhub. These systems house an extensive list of restaurants that customers can choose from.

However, this system is not integrated with a restaurant's POS unless the restaurant pays for a separate system, such as Deliverect. From Deliverect's website, the cost to integrate a third-party system for a medium-size restaurant having 600 orders per month is $99 per month for 12 months and a one-time setup fee of about $150. Without this integration, staff members must constantly monitor orders that come in and transmit the information to the restaurant's POS. As mentioned before, using these third-party systems also usually results in high commissions being paid, cutting into a restaurant's profits.

Circle City Food allows restaurants to quickly set up their own online presence. Although the focus is on providing discounts on meals that are close to their sell-by date, the monthly subscription cost of $15 paid to market full-price items from a restaurant is much cheaper (even taking the $60 annual fee into account) and can be done much faster than setting up a new website. Restaurants that are just starting out or are developing their own system can take advantage of Circle City Food's marketplace to reach more customers and keep more of their beginning profits.

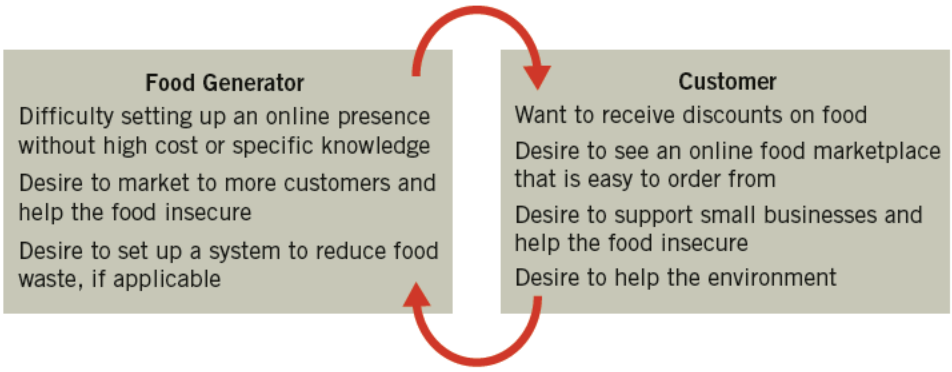
Competitors Donating to the Food Insecure

Certain apps, such as Food Rescue US, or local organizations, such as the Gleaners and Second Helpings, focus on supporting the food insecure. These are typically nonprofits that pick up food from different establishments and then distribute it to food pantries, soup kitchens, shelters, and other organizations that combat hunger. Some customers using Too Good to Go have noted that they are concerned that using a food waste app focusing on sales to customers cannibalizes the amount of food that is donated to those in need. However, food banks do not accept food that has a limited shelf life or that needs refrigeration. Thus, prepared meals that are close to their sell-by date, which is the prime product marketed by Circle City Food, will not cannibalize food donations. The focus on supporting the food insecure is further emphasized by the automatic meal matching program to Feeding America with every purchase.

Go-to-Market Plan

Food Generator and Customer Pains

Because Circle City Food is a platform that brings together food generators and customers, both sides need a specific strategy when going to market. Below is a summary of the primary characteristics from each side of the equation. These characteristics are in order of preference from top to bottom.



It will likely be more difficult setting up the initial relationship with food generators than it will be with customers. Erin McGeoy is a social entrepreneur who started Last Call for Food, which is a similar platform set up to fight food waste in the Washington, D.C., area that provided discounts to college students in the area. After three years of operating where she saved more than 5,000 pounds of food waste from going to landfill, she shut Last Call down to join Too Good to Go. In a personal interview with her, she noted that her main difficulty was in signing up restaurants due to lack of interest and lack of resources. She had tried relying on a volunteer model using students and creating an ambassador program. In the end, she had only eight restaurants in her program despite having over 1,200 customers with little to no marketing.

This is why Circle City Food provides more of a solution to restaurants by enabling the creation of an

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online marketplace and allowing them to post full-price items if desired. This creates an incentive for them to join if they already engage in their own solutions to reduce food waste. However, further market research will be done with restaurant owners once a minimum viable product (MVP) is created. With a tool in hand, concrete discussions to focus on restaurant pain points can be held to determine how Circle City Food will solve these pains.

As noted in the Indy Local Foodies survey results, customer also need more of an incentive beyond having a positive environmental impact via reducing food waste to engage in the app. Customers are driven more by the ability to receive discounts on food while still being able to enjoy a quality meal. In this way, Circle City Food truly differentiates itself from Too Good to Go, which provides a random grab bag of food that customers have no choice over. In conclusion, Circle City Food addresses more economic pain points for restaurants while providing delicious, discounted meals for customers who can choose what they are purchasing.

Target Markets

For food generators, casual dining restaurants make up the target market. Typical prices for these restaurants are $10 to $20, which is higher than the fast-food and fast casual markets. However, these latter markets are typically chains, which likely have their own online ordering solution in place and whose menus are already familiar to customers. The ideal casual dining restaurant for Circle City Food is locally owned and may or may not already have an online presence, depending on its maturity, the owners' technical knowledge, and the amount of resources it has to fund this system. These restaurant owners may be frustrated by the use and cost of third-party delivery systems and are looking for an alternative solution. Also, being locals, these owners are engaged in the community and would be more invested in giving back to it and the food insecure.

Reducing food waste and supporting the environment would be an ancillary concern, as these target restaurant owners are likely highly cognizant of their margins and may already take alternative measures to reduce food waste. Six different restaurant owners that fit this profile were asked how they handle food waste (Federal Fine Foods, Circa 1906, and the four who responded to the survey). Most of them made only enough to satisfy orders or ran until they sold out. One owner, Kris Kraut at Federal Fine Foods, even has his own composting system, so any leftovers are still diverted from the landfill.

For customers, the target markets are Indy foodies who enjoy eating out and university students. The foodies are city locals who are adventurous and enjoy eating out at least three times a month, typically paying $15 to $30 for their meals. They are willing to give food recommendations to others based on their expert knowledge of the Indianapolis food ecosystem and to receive recommendations of new places to try. They highly prioritize food quality and a high quantity-to-price ratio. On the other hand, university students are more opportunistic eaters who prioritize low cost. They also tend to be more technically literate and would appreciate an app that helps them locate good meal deals. University students also tend to be more environmentally conscious and would respond well to the message around reducing food waste.

Distribution

Distribution will occur primarily over the App Store. This will allow food generators and customers to download and access the platform easily on par with Circle City Food's competition. Since the pandemic started, a survey from Global WebIndex showed that people were spending more time engaging in various apps. After an app is developed enough to pass Apple's App Store guidelines and has been tested against bugs and crashes, an Apple Developer Program account needs to be created with a $299 annual fee. Then an icon, screenshots/previews, and metadata need to be prepared before publishing the app. Finally, the app can be submitted for review, which can take one to three days, to be released afterward (Oragui).

Sensor Tower predicts that by 2024, total annual app downloads will grow to 184 billion per year at a compounded annual growth rate (CAGR) of 9.8 percent (*App Download and Usage Statistics [2020]*). In the short term, iOS app download growth is expected to rise at a faster rate than Google Play downloads. However, in the long term, Google Play downloads will grow at a greater rate with a CAGR of 10.5 percent (*App Download and Usage Statistics [2020]*). Thus, the intent is to establish the app in Google Play later on after Circle City Food has established a foothold in Indiana.

Marketing Plan

Social media will be central to marketing Circle City Food. Facebook in particular will be a primary focus, as initial customer relationships were already formed here from the survey distributed in Product Validation. Another advantage is that many target restaurants also have their own landing page on Facebook and thus can be reached here. When it comes to social media, restaurants are most likely to use Facebook (91 percent) and Instagram (78 percent) (Boyarsky).

The final target market, university students, have always tended to be active in social media, and this has only increased since the onset of the pandemic. Facebook is currently the most popular online network among both millennials and college students, with 88 percent

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having an account that they regularly use (*How Millennials Use Social Media*). Instagram is the second most frequently logged into platform for teens and young adults. An initial website is also going to be developed to assist with marketing and will contain information on the mission of the company and the impact it is making in terms of customer savings, food waste reduction, and meals donated to Feeding America.

As Circle City Food is meant to first grow a strong base in Indianapolis, different channels specific to the city, such as the *Indianapolis Star* and the *Indianapolis Business Journal*, will also be used in marketing. In addition, there are various food halls around the city, such as the Indianapolis City Market, Garage Food Hall, and the AMP Artisan Marketplace at 16 Tech, that receive heavy foot traffic during lunch periods and on weekends. Here, physical flyers can be posted notifying customers that potential food savings are possible if they download the Circle City Food app.

Sales Structure, Process, and Terms

When focusing only on the Indianapolis market, the sales team will be restricted to the founder and the initial team that she builds. After building traction in the city and preparing to expand to other locations, the intent is to have others join the Circle City Food team as independent contractors. These contractors who are part of the gig economy will be responsible for onboarding new restaurants into the app as well as maintaining customer relationships with them, including answering requests for information, responding to restaurant and customer feedback, and validating the refund process should problems arise.

Using gig workers to build the relationships in the areas that they are familiar with is beneficial in that they likely have deeper knowledge of the target market than a team centrally located in Indianapolis. Doing this also helps to continue the message that Circle City Food is a system that helps the local economy, as it depends on locals to engage and support it. The gig economy is expected to reach a worth of $455.2 billion in the United States by 2023. This growth has not slowed with the onset of the pandemic. In fact, 78 percent of the gig workforce report that they expect to do the same or more gig work afterward (Djurovic).

People who want to participate in the gig workforce will first need to enroll to receive an initial training package that covers the mission and values of Circle City Food, how to help set up restaurants on the app, different marketing tools necessary to reach the target audience, and how to support food generators and customers alike. This training package will cost $30. Afterward, each worker will receive $50 for each food generator that they sign on with a verified purchase afterward and 1 percent of each meal transaction. This incentivizes the gig workers to continue maintaining good relationships with both food generators and customers.

At Too Good to Go, Erin McGeoy stated that the monthly sales quota was 15 to 20 food generators per month, which equates to signing on about one new restaurant per day. Assuming that a gig worker can do only one-quarter of this work and will sign on five restaurants per month, an average of 224 online orders per month, and an average transaction cost of $10, a typical beginning gig worker should make $362 per month. Around 85 percent of all gig workers reportedly earn less than $500 a month (Djurovic), so Circle City Food's opportunity should be appealing given the fact that the expected pay can grow to $922 per month after a six-month period as new restaurants are continuously signed on.

Operational Plan

Operational Overview

The key operation of Circle City Food will be to create its app e-commerce platform. This will begin with developing a wireframe, which will save time and money when working with an established application developer. Preliminary information flow architecture and a wireframe adapted from a food waste study in India are shown in the Appendix (Kalia). After wireframe development, an application developer will be hired to start developing a clickable prototype that will serve as the MVP. Further market testing through interviews with restaurant owners will be conducted using this MVP to gauge problem-solution fit and pricing. Some key features in this app to keep in mind based on gaps in existing solutions are listed below:

- *Ease of use*. This applies to the registration and sign-in process for both food generators and customers as well as app navigability. Restaurant owners should easily be able to post pictures and descriptions of their food offerings. Customers should be able to filter by food availability, food type, dietary restrictions, and restaurant location. In the future, a food recommendation system may also be set up based on machine learning and algorithms.
- *Push notifications on a customer's favorite food generators when new discounts are available*. Customers should also be able to turn off this feature if desired.
- *Capability to give feedback*. This applies to feedback on the purchase process as well as on the restaurant/food generator.
- *Clear order summary, status, and tracking options as well as communication of impact in terms of customer savings, food waste saved, and number of meals donated.*

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Key Activities, Resources, and Partnerships

In the early stages, key activities for Circle City Food include launching its app and website along with customer acquisition. Another vital activity is customer support, which is especially important when beginning to gain traction in the Indianapolis marketplace and building trust in the brand. Key resources include the technology powering the app and a good reputation with the local economy. This reputation will allow Circle City Food to create partnerships with local universities, local food banks and other organizations feeding the food insecure, and sustainability groups that can help market the app and potentially become more involved in future product extensions. Facebook, Instagram, and other local advertisers will also be partners to help market Circle City Food.

Another key partner will be RocketBuild, which is an onshore software development company known to partner with entrepreneurs to build mobile apps, web applications, websites, and complex integrations. After signing a detailed mobile app development agreement with a focus on the protection of intellectual property, which will be drafted with a lawyer, they will build the technology to power the app and website. Rose-Hulman Ventures was also consulted to be a potential app developer since they had comparable pricing to RocketBuild and are experts in rapid prototyping, product design, and development. However, their project teams normally sunset after an app is developed, so they would not perform any maintenance on the product after it is built. RocketBuild, on the other hand, has the capability to continue maintaining the app after development and can help troubleshoot technical issues that arise, add more features to the app in the future, and update the system as necessary. Thus, RocketBuild is the company Circle City Food has chosen to partner with.

Circle City Food will apply for trademarks on the company name and logo (the one shown on the first page is not finalized). Additionally, the company will file for a copyright for the developed application software system. Later, a lawyer will also be consulted to draft contractual agreements to start signing on independent contractors/gig workers to help spread Circle City Food to other locations.

These contracts will last for a six-month period and can turn into a longer working relationship given the success of the contractor in signing on new restaurants and maintaining relationships between food generators and customers.

Management Team

Management Structure

The current team is made up of only the founder, Nancy Tseng. Nancy has a background in chemical engineering, achieving her BSE from the University of Michigan in 2011. Since then, she has held various manufacturing leadership roles within the Dow Chemical Company, SABIC, and the Hydrite Chemical Company. In October 2021, she joined Elanco as the Clinton site's director of manufacturing engineering. She has always had an interest in food and sustainability, so this idea evolved naturally out of her passions. To help get her grounded on the issue of food waste in the local community, she has involved the following advisers.

Advisers

Dr. Shikha Bhattacharyya is the founder and executive director of ReTHink, Inc., which is a local nonprofit established in 2015 that educates the local community in the Wabash Valley on sustainability. It runs several programs, such as plastic upcycling, composting, community gardens, and a zero-waste shop (*About*). Shikha is a knowledgeable resource on different grant programs that can be used to fund sustainability initiatives.

John Etling is the agency director at Catholic Charities in Terre Haute, Indiana. This organization runs the Terre Haute Catholic Charities Food Bank, which collects food from local restaurants, grocery stores, and other businesses and redistributes them to a network of food pantries to support the food insecure (*Food Assistance and Nutrition Programs*).

Allison Finzel is the community wellness coordinator at Purdue University overseeing Vigo County as well as the president of the Wabash Valley Food Rescue. She works with local schools to implement educational programs to reduce food waste in cafeterias (Modesitt).

Mo McReynolds is the community engagement manager with the City of Indianapolis Office of Sustainability and is a key stakeholder in the previously mentioned Thrive Indianapolis program. The Office of Sustainability can help spread the word on Circle City Food as it aligns with many of Thrive's major objectives. Like Shikha, Mo is a knowledgeable resource on different grant programs that can be used to fund sustainability initiatives, especially within Indianapolis.

Joe Cudby and Tom Kilcoyne are two managing entrepreneurs at NEXT Studios, a B corporation venture studio based in Indianapolis. Nancy had previously attended Next Studio's Discovery Week, an intensive one-week program that allowed her to pressure test her venture idea using the lean canvas model. She is considering participating in the NEXT Up program, which would allow further development of her venture idea by focusing on risk reduction and market development. She is also thinking about applying for the NEXT Community Impact Fund. This fund supports companies led by entrepreneurs who are part of underappreciated communities, such as women, people of color, and LGBTQ founders.

Once the idea gains more traction, Nancy will invite these advisers to join either her team or her Board of Advisers. This initial network may also help recommend

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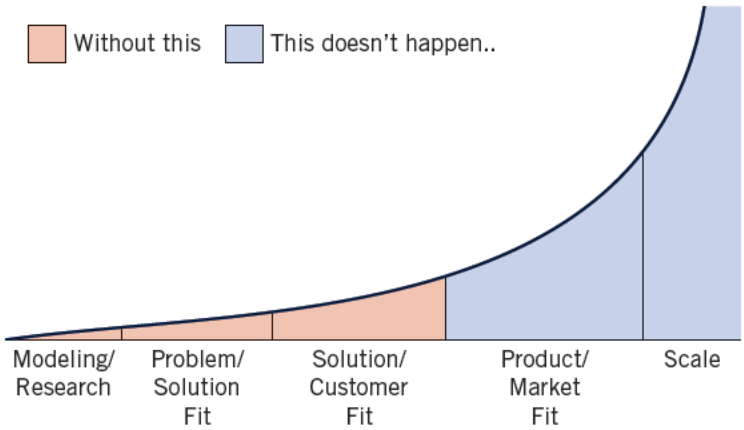
others who may be interested in becoming team members who can help further develop and market Circle City Food in its beginning stages.

Product Development, Growth, and Exit Strategy

Growth Plan, Milestones, and Time Line

By the end of 2021, the plan is to complete a preliminary wireframe of the app. While doing this, Nancy will be building her team and vetting different funding sources, such as the NEXT Community Impact Fund and potential sustainability grants with ReTHink and the City of Indianapolis Office of Sustainability. Of particular interest is the SustainIndy Community Grant Program, which awards up to $10,000 to support local initiatives to further economic development, ensure environmental integrity, and promote social and cultural vibrancy.

If venture capital is not secured, these various grants will fund the initial discovery, planning, and strategy sessions with RocketBuild in order to build the website and clickable prototype/MVP. The development of the MVP will cost approximately $25,000 as discussed with Nathan Zarse, senior director of marketing at RocketBuild.



After the clickable prototype is developed, Nancy and her team will conduct interviews with at least 30 restaurant owners to establish problem-solution fit and pricing. During these tests, Circle City Food will be established as an LLC. Conducting these interviews will also help to create contacts to kick-start a crowdfunding campaign that will provide the initial funds necessary to start the full development of the app, which is currently expected to cost $150,000. After crowdfunding, the intent is to sign on at least 50 restaurants prior to launching the app via the App Store. These restaurants will have a special promotion that waives their fee for the first year. The app will then launch, and marketing will begin via social media and other platforms to engage customers and other restaurants.

After Circle City Food reaches its break-even point, the team will start planning expansion into other cities and states by preparing the six-month contracts for potential gig workers. The intent is to spread to nearby cities of significant size, such as Carmel, Fishers, and Bloomington, with eventual expansion to larger Indiana cities that are more distantly located, such as Fort Wayne, Evansville, and South Bend.

Many of these larger cities contain a high populations of university students, which is one of the target customer markets. The Appendix has a Gantt chart summarizing the above key milestones and their place in the time line up to the end of year 5, which will be either the exit point for Circle City Food or its continuation to scale to other locations.

Future Product Extensions

Future product extensions of Circle City Food would include additional ways for sustainably minded customers and restaurants to contribute to the circular economy. One of the previously mentioned features in Circle City Food was the ability for restaurants to coordinate with customers to bring their own take-out containers. No incentive is provided from Circle City Food to support this initiative, so restaurants and customers who do this are personally motivated to be sustainable. Using past order history, Circle City Food can thus pinpoint this specific subset of food generators and customers and use them in the following two new programs to further support the circular economy:

1. *Deliver unsold food from food generators to organizations supporting the food insecure (as long as the food meets the organizations' quality standards) or to composting facilities*. This would be similar to how a subset of Circle City Food's competitors who tend to be nonprofits, such as Food Rescue US, Food Rescue Hero, and Food Cowboy, manage the logistics of delivering potential food waste

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from one point to another. In this way, Circle City Food would truly eliminate the food going to landfill. Circle City Food would be uniquely positioned to support this initiative due to its reliance on gig workers. As the gig economy supports transportation companies such as Uber and Lyft, either similar contracts can be drawn to employ new workers to divert food going to landfill or a partnership can be created with existing transportation companies to support this initiative.

2. *Sell sustainable food packaging to restaurants that is compostable or biodegradable*. These packaging containers would also provide a way for Circle City Food to market itself, as they can be branded with the logo of the company.

Risk Mitigation

The mitigation strategies outlined below will help reduce the underlined risks associated with Circle City Food.

Industry Risk: Too Good to Go's Prominence

As a competitor, Too Good to Go has many more resources and much more financial backing than Circle City Food. However, instead of being a threat, its presence can be seen as a positive, as it is educating the marketplace that food waste is an issue and building a story of sustainability that Circle City Food can leverage. Rather than just focusing on food waste, based on the target market, Circle City Food can advertise itself as an environmental solution (reducing food waste) or an economic one (saving money on meals and creating a marketplace for restaurants to launch on), thus appealing to more customers. In addition, painting the picture that Circle City Food is meant to help the local economy (hence its name) should inspire customer loyalty and help the company establish a foothold in Indianapolis if not the rest of Indiana. After establishing this foothold, if Too Good to Go has scaled to the point that Circle City Food has nowhere to go, being bought by Too Good to Go is a viable exit strategy.

Market Risk: Failure to Get Restaurants On Board the App

As mentioned before, getting restaurants to sign onto the system and pay the annual fee to join Circle City Food will likely be more difficult than getting customers to sign on for free. This is why so much attention was paid to establishing how the platform can help restaurants in terms of setting up an online presence and reducing the reliance on third-party delivery systems. A key development milestone is conducting interviews with at least 30 restaurant owners with the clickable prototype/MVP to get their feedback on problem-solution and customer-solution fit. These interviews can help owners not only become more exposed to the idea but also help fine-tune the app offering before it is fully developed and ready for launch. In addition, an incentive will be given when launching the app where the first 50 restaurants that sign on will have their first year's $60 fee waived.

Operations Risk: Technical Issues with the App

Many reviewers have noted the ease of use and easy-to-understand concept of Too Good to Go. Thus, technical issues with Circle City Food's offering will be a clear detractor. This is why RocketBuild, an experienced app development company, will be used for both the development and the long-term maintenance of the app and website. They have the experience necessary to create an engaging customer experience and can provide technology maintenance after launch.

Operations Risk: Failure of Gig Worker Model to Scale

There are two major operational risks involving the use of gig workers. First, Circle City Food may not even be able to hire them due to lack of interest. Establishing a base and positive reputation in Indianapolis is crucial in order to generate buzz around joining Circle City Food. Second, different platforms, such as Upwork, that are typically used by gig workers to find new job opportunities can be used in order to reach this market. If all else fails, it is still possible to depend on a traditional sales model in order to launch in other locations and hire employees.

Another risk of using gig workers is inadequate quality in terms of signing on new food generators into the platform or maintaining customer relationships. When hiring these workers, specific interview questions gauging a worker's experience in marketing and/or customer support, knowledge of the local food ecosystem, and sustainability initiatives will need to be asked. Limiting the contract length to six months also offsets the risk of ongoing poor work quality since the relationship with underperforming workers can expire at the end of the contract. Work quality in terms of successfully signing on food generators can be quantitatively established through the app, but it will be more difficult to gauge how workers are maintaining existing customer relationships. However, this may still be possible using automated surveys after a customer–gig worker interaction. If all else fails and if using gig workers to provide customer support is not sustainable, a more traditional customer support model centralized in Indianapolis can always be established.

Financial Risk: High Cost of the App

According to Nathan Zarse at RocketBuild, full development of the app is likely to cost $175,000 to $200,000. Thus, app development will progress side by side with customer interviews to verify that problem-solution and solution-market fit are solid prior to the bulk of the cost

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being incurred. Before launch, at least 50 restaurants will be interviewed in the Indianapolis area to determine their willingness to pay for this product as well as their interest in crowdfunding the app development. If customers and restaurant owners are unwilling to pay for the app, then Circle City Foods can either pivot in another direction or sunset without too much additional cost being incurred.

Key Partners Risk: Lack of a Team

As there is no current founding team, there is a high risk of having the founder manage everything herself, which can lead to burnout and then venture failure. Thus, one of the immediate actions going forward is talking with her current advisers to determine if any are willing to join her team or her board. This group can also help to recommend others who may be interested in joining Circle City Food.

Exit Strategy

There are three potential exit strategies for Circle City Food. First, it can sell its concept and marketplace participants to a third-party delivery platform, such as UberEats, DoorDash, or Grubhub. These platforms already have their own marketplace, and it may be possible for them to incorporate the discount feature for meals that are close to their sell-by date. However, this exit strategy may risk the reputation of the Circle City Food brand since one of its hallmarks is how it supports restaurants and small businesses so that they do not rely on these platforms. Thus, any potential offer will need to be carefully vetted.

Second, in a more ideal solution, Circle City Food can sell its concept and marketplace participants to Facebook. Facebook already reaches many of the target customers, and many restaurants also have a landing page on the platform. Facebook even features its own marketplace for users to buy and sell items. However, not much food is currently sold in this marketplace due to legal concerns. Although anyone can post food for sale, system administrators currently do not check for or mandate business licenses and health department–inspected kitchens for food preparation. Thus, Facebook would need to update its process to better qualify how people post food on its marketplace before it can operate how Circle City Food is intended to operate.

Finally, Circle City Food can be bought out by one of its competitors. Too Good to Go is the most likely option here due to the size of its operation. This would be the most ideal solution since the sustainability mission and values between Circle City Food and its competitors match. In addition, employees who desire to continue working for a concept such as Circle City Food may have the option to continue their work with the other company.

Finance

Summary of Financial Projections and Financing Plan

In the first half of 2022, the different costs of Circle City Food will be funded through the founder and her friends and family (F&F). This includes the money already spent in 2021, such as the $360 used to incentivize people to respond to survey and interview requests and $99 for financial statement templates. F&F will also fund the rest of the initial app development up to the completion of a clickable prototype/MVP, which is estimated to cost $20,000 according to RocketBuild plus $299 annually to participate in Apple's App Developer Program. F&F will also fund the use of a coworking space.

Although there are free coworking spaces, the Novel location in downtown Indianapolis is ideal due to its central location and the ability to do longer-term leases lasting beyond 24 months. A cost of $399 per month will provide long-term access for 1 to 20 people and eliminate the need to purchase utilities and furniture to start and run Circle City Food ("Lock It In with Long-Term Leasing"). Finally, a cost of $600 will be incurred in the first year of operations for legal concerns. It will cost $95 to establish Circle City Food as an LLC in Indiana ("How Much Does an LLC Cost in Indiana?"), and the remaining $505 will be spent establishing a working relationship with a lawyer going forward (Small).

An initial crowdfunding campaign will be set at $50,000 in order to start the developing the app, which is the same amount that FoodforAll raised via Kickstarter in the Boston/New York area. The additional funding necessary to complete app development can be raised via additional crowdfunding, F&F, grants, or small-business loans. Alternatively, Circle City Food is asking for $500,000 of capital investment to cover the majority of first- and-second-year costs for 10 percent equity. Injecting capital investment into the venture would speed up development, allowing one or more of the cofounding team to work full-time on the venture. Currently, the plan is for a cofounding team of three to be established, each initially receiving a salary of $150,000 and a 5 percent annual raise. However, none will receive a salary until funding is established via capital investment or revenue generation.

Without capital investment, app development will be completed by the start of 2024. Three months before launch, advertising on different Facebook groups, such as Indylicious and Indy Local Foodies, will commence to start creating awareness. These sites have an average of 2,868 posts each month. While it is free to post within these groups, $500 will be spent to create targeted ads in Facebook and newspapers; $323 of the $500 will be spent creating a column inch of black-and-white advertising space in the *Indianapolis Star*, which has a daily

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circulation of approximately 261,000 (Indianapolis). The remainder will be spent on Facebook, which has a cost per click of $1.27 for ads relating to new technologies ("How Much Does Facebook Advertising Cost in 2021?"). Before launch, the goal is to have 50 restaurants signed onto the system. The first-year fee for these initial restaurants will be waived.

Once Circle City Foods launches in January 2024, advertising expenses will rise to $800 per month to take customers through the customer acquisition funnel. Facebook ads cost $5.47 per app download with an additional $0.80 to post ads on Instagram ("How Much Does Facebook Advertising Cost in 2021?"). Additional regular expenses include $1,000 per month for accounting ("The Cost of E-Commerce Accounting"), $1,000 per month for website maintenance, $500 per quarter for legal consultation ("Small Business Lawyer Cost"), $750 per year for general liability insurance ("Business Insurance for App Developers"), and the continued cost of the coworking space. The five-year income statement summary below shows all of these various costs. Based on the financial projections, Circle City Food is expected to break even in April 2024, merely three months after launch. The Appendix contains the five-year summaries of the balance statement and cash-flow statement as well as a yearly breakdown of the income statement.

Circle City Food Income Statement

For the Year Ended December 31,	2022	2023	2024	2025	2026
Sales					
Food Transaction Revenue	-	-	1,195,240	3,457,439	5,968,835
New Restaurant Revenue	-	-	7,200	7,200	7,200
New City Expansion Revenue	-	-	-	50,830	-
Food Delivery Revenue	-	-	100,160	289,730	500,182
Total Sales	$ -	$ -	$ 1,302,600	$ 3,805,199	$ 6,476,217
Cost of Goods Sold					
Technology Development	78,632	91,966	-	-	-
Technology Maintenance	-	1,000	12,000	12,000	12,000
Total Cost of Goods Sold	$ 78,632	$ 92,966	$ 12,000	$ 12,000	$ 12,000
Gross Margin	$ (78,632)	$ (92,966)	$ 1,290,600	$ 3,793,199	$ 6,464,217
Percent	#DIV/0!	#DIV/0!	99%	100%	100%
Operating Expenses					
Advertising	-	1,500	9,600	9,888	10,185
Accounting	-	3,000	18,540	27,810	41,715
Legal	600	500	2,060	2,122	2,185
Credit Card Fees	-	-	40,250	121,108	212,302
Insurance	-	188	773	796	820
Coworking Space	4,788	4,788	4,932	5,080	5,232
2020 Expenses	459	-	-	-	-
Independent Contractor Program	-	-	-	7,500	-
Meal-Matching Program	-	-	66,773	193,153	333,454
Salaries	-	-	472,050	495,653	520,435
Total Operating Expenses	$ 5,847	$ 9,976	$ 614,978	$ 863,109	$ 1,126,328
Net Profit	$ (84,479)	$ (102,941)	$ 675,622	$ 2,930,090	$ 5,337,889
Income Tax	-	-	141,881	615,319	1,120,957
Net Income	$ (84,479)	$ (102,941)	$ 533,741	$ 2,314,771	$ 4,216,932
EBITDA	$ (84,479)	$ (102,941)	$ 675,622	$ 2,930,090	$ 5,337,889

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Explanation of Assumptions

At launch, the estimated number of customers who download the app is 2,628. Of these, 2,500 are customers from the Facebook groups, assuming that the 2,868 posts per month spread between Indy Local Foodies and Indylicious correlate to unique Facebook users and that most of them download the app. One hundred and twenty-eight customers come from people who download the app from the Facebook ads. This customer count is estimated to grow organically at a rate of 130 percent over the course of the year, which is the estimated growth rate of online take-out orders per Statista (Lock).

Taking the number of customers into account, the total revenue calculation for food transactions assumes that all these customers spend over $10 per month on their order and use the app three times per month. This can be expected per the survey results from the primary market research. Thirty percent of these orders are estimated to be delivery given that 31 percent of Americans are reported to order online delivery at least twice per week ("20 Food Delivery and Online Ordering Statistics for 2021"). This leads into the revenue calculation for food delivery.

Finally, the new restaurant revenue calculation assumes that 10 food generators join Circle City Food each month. This assumption was made given that Erin McGeoy's team at Too Good to Go has a sales goal to sign on 15 to 20 restaurants per month and have three to five salespeople per location. Thus, it is assumed that Circle City Food will be able to accomplish about half of this given its smaller sales team composed of its initial founding team of three.

For expenses, an annual inflation rate of 3 percent is used for all operating expenses besides three exceptions. Accounting costs will have an additional 50 percent year-over-year increase due to the increasing complexity of operations after launch. In addition, the monthly website maintenance fee of $1,000 will stay constant. According to RocketBuild, a maintenance cost of $12,000 per year is already the high end of the cost spectrum, so no further increase is currently accounted for. The last assumption on expenses is that the cost of the meal-matching program of $0.10 per meal will not increase over time.

Finally, for new city expansion revenue, five independent contractors will be hired to sign on new restaurants in another city in Indiana starting in June 2025. The assumptions are that these contractors will be able to each sign on five new restaurants per month and that these restaurants will support 224 orders per month with each order costing greater than $10. The average number of online orders an independent restaurant receives per month is $10 (Kathleen). As the contract period is expected to be only six months, these assumptions and the effectiveness of using contract workers can be trialed and verified in a fixed time period. If the trial is successful, then additional contracts can be written and/or extended. In the meantime, however, the financial statements currently account for only six months of contractual work. In addition, no revenue is currently taken into account for restaurants that want to upload their full-price menu on Circle City Food. Thus, additional revenue may be possible that is currently not shown in the financial projections.

Terminal Value

If instead of continuing to expand to new locations Circle City Food employs an exit strategy, a terminal value is estimated using an exit multiple of 6 on the EBITDA at the end of year 5. The resulting value at that point in time is $32 million. This means that investors would receive a return on investment more than six times the initial capital investment of the $500,000 being requested.

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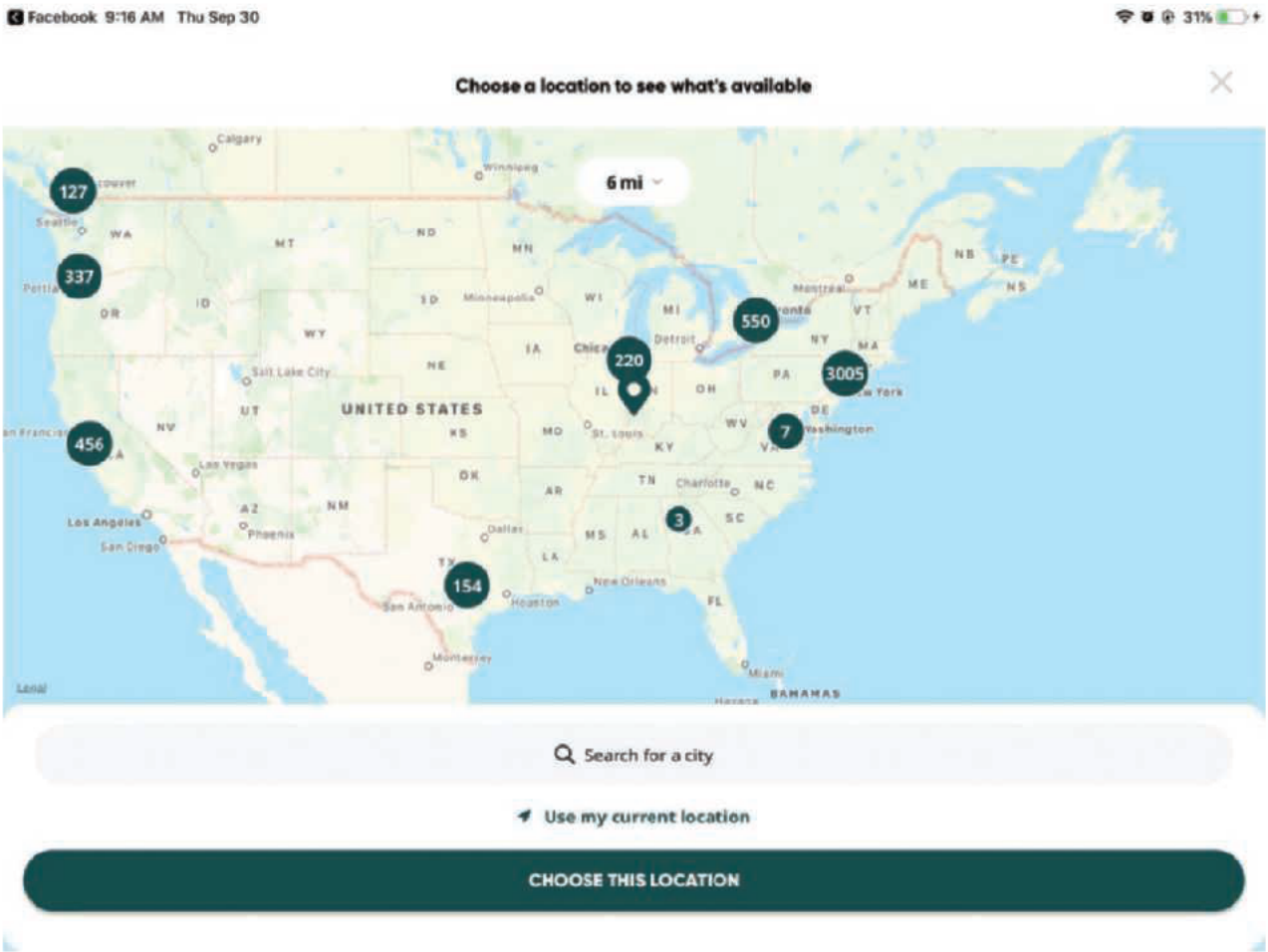
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Appendix

Business Model Canvas

<table>
<tr>
<td rowspan="2">Key Partners
Restaurant owners
Advertising agencies/social media
Local universities, food banks, and sustainability groups</td>
<td>Key Activities
Provide platform for the sale of discounted meals with customer support.</td>
<td rowspan="2">Value Preposition
Marketplace for surplus food from restaurants that are sold at a discount to customers
Too Good to Go + local economic support + customization”</td>
<td>Customer Relationships
Feedback/reviews from below channels</td>
<td rowspan="2">Customer Segments
Local foodies (people who enjoy eating out with an average bill of $15 to $30)
University students and other food-insecure communities</td>
</tr>
<tr>
<td>Key Resources
Website/app supported by RocketBuild
Gig workers in new locations</td>
<td>Channels
Website/app, social media, universities, food banks, and sustainability groups</td>
</tr>
<tr>
<td colspan="2">Cost Structure
Website/app development and maintenance
Meal-matching program with Feed America
Contract to employ gig workers</td>
<td colspan="3">Revenue Streams
$1 to $1.79 fee per transaction
$0.50 additional charge, allowing for delivery
$30 training package for gig workers</td>
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Too Good to Go Locations

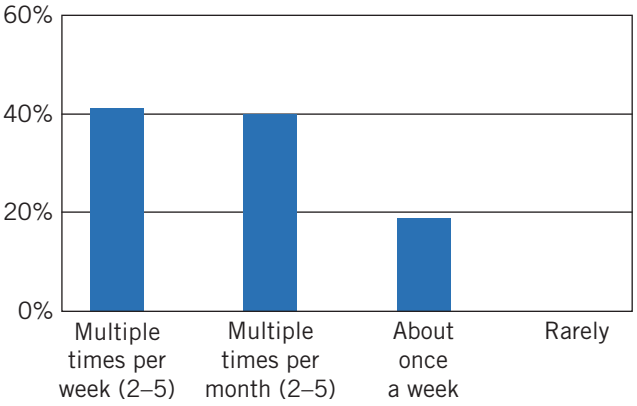


Source: Too Good to Go

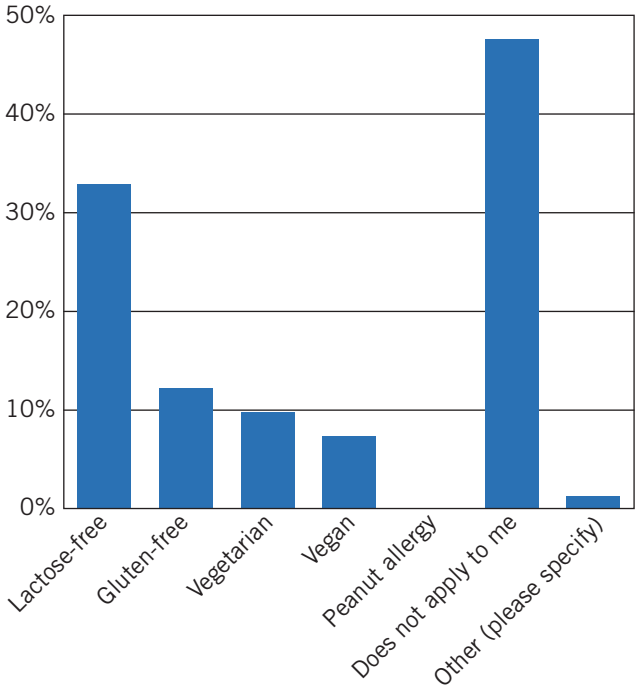
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Indy Local Foodies Survey Results

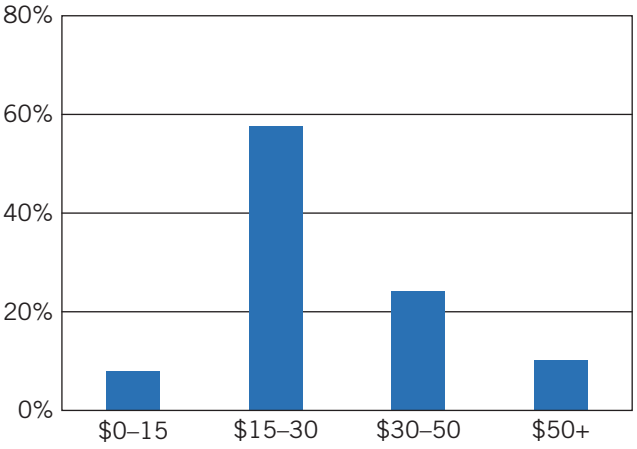
How often do you eat out (includes take-out and delivery)?



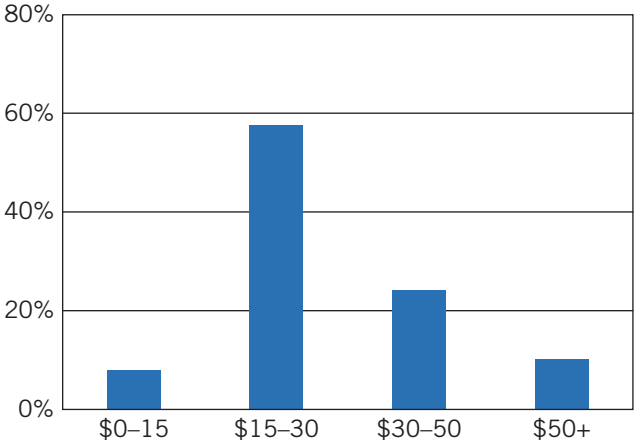
Do you have any specific food restrictions/allergies you would want restaurants to advertise?



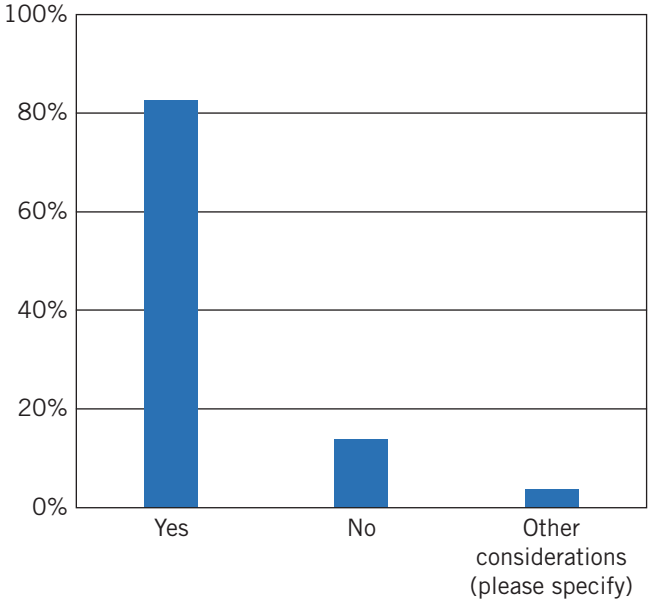
What is the average amount you spend on an order?



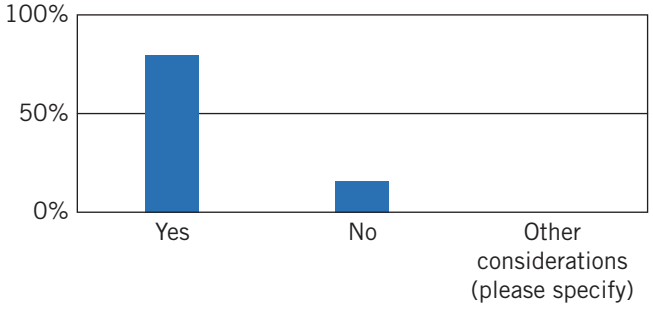
What is the average amount you spend on an order?



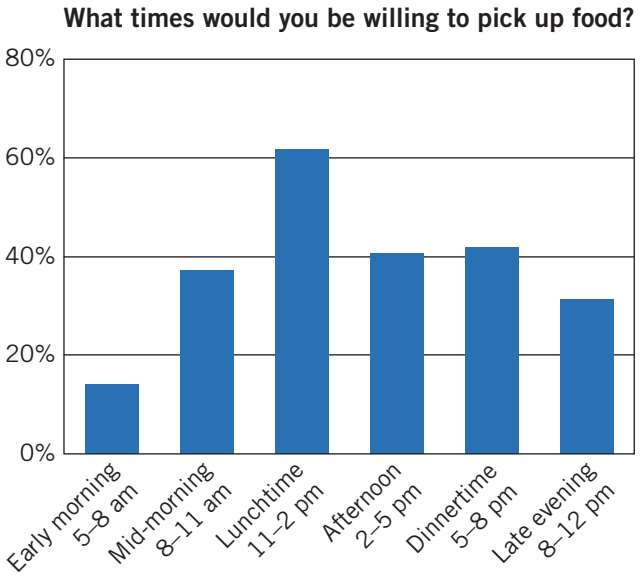
Would you be willing to pick up surplus food from restaurants at other times in the day that is more convenient for you at less of a discount (20–40%)?



Would you be willing to pick up surplus food from restaurants at a major discount (50–75%) in the evening when the restaurant is about to close?



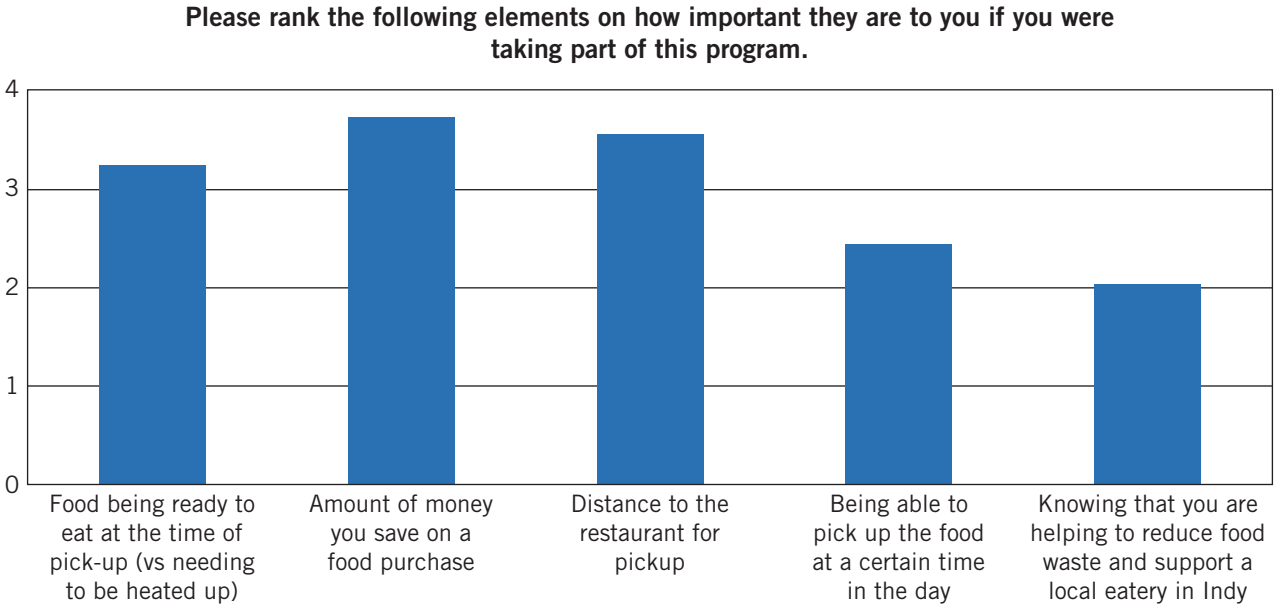
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How much more willing would you be to take part in this program if the restaurant had a delivery option for the food order? **63.2%**

How much more willing would you be to take part in this program if it included a meal-matching program with a local food bank? **63.2%**

How much more willing would you be to take part in this program if the materials used in the food take-out containers were sustainably sourced? **57.8%**



SOM Calculation

Bottom-Up Calculation

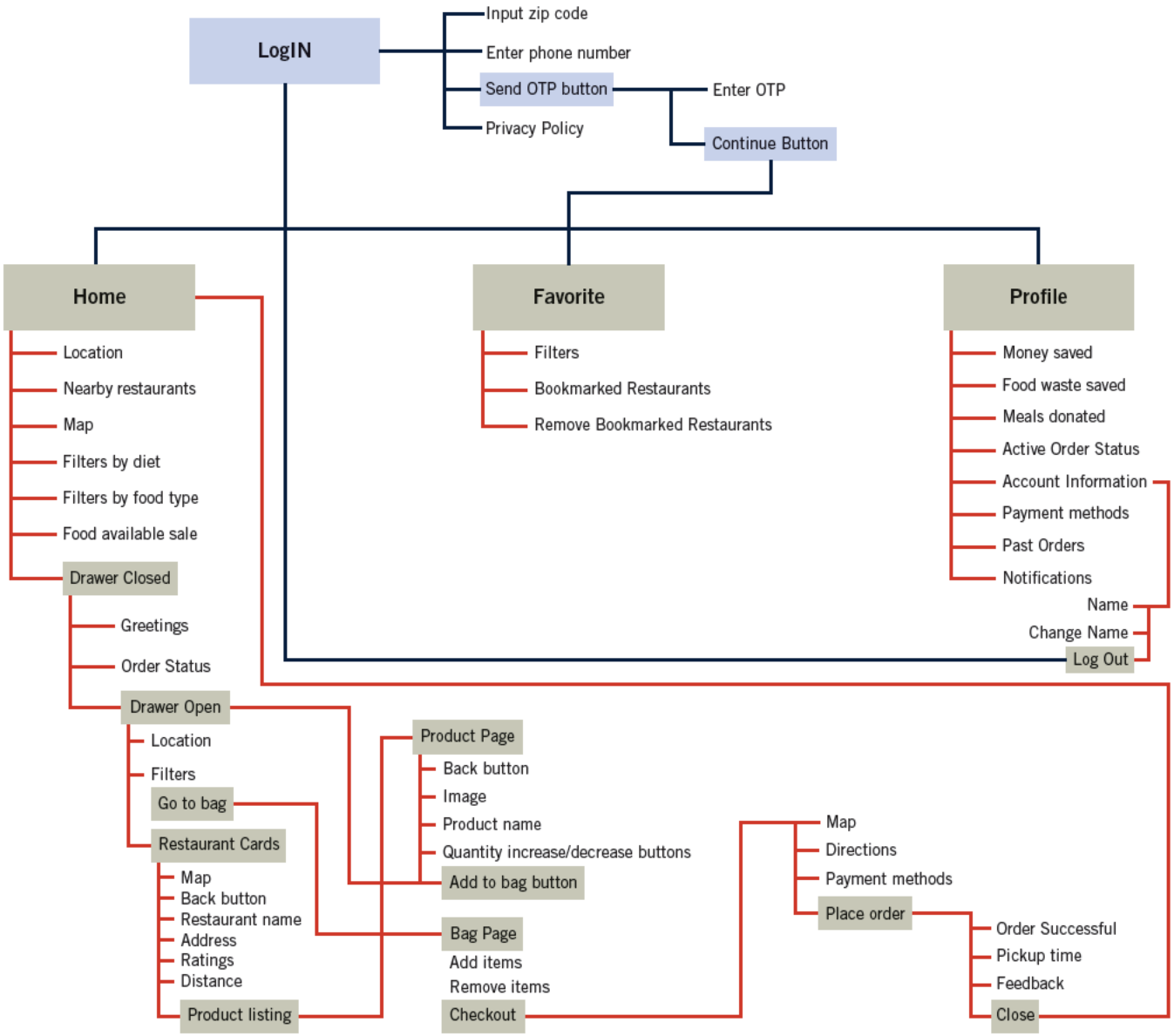
Approximately 58,000 members in Indy Local Foodies Facebook group × average 3 meals per month per member × $1.79 transaction cost per meal × 12 months per year = **$3.7 million**

Top-Down Calculation

$12.8 billion restaurant sales in Indiana/$10 average price per meal (Olito) × 1.79 transaction cost per meal × 63 percent of restaurant sales are take-out orders × 15 percent of take-out orders are made via an app = **$216 million**

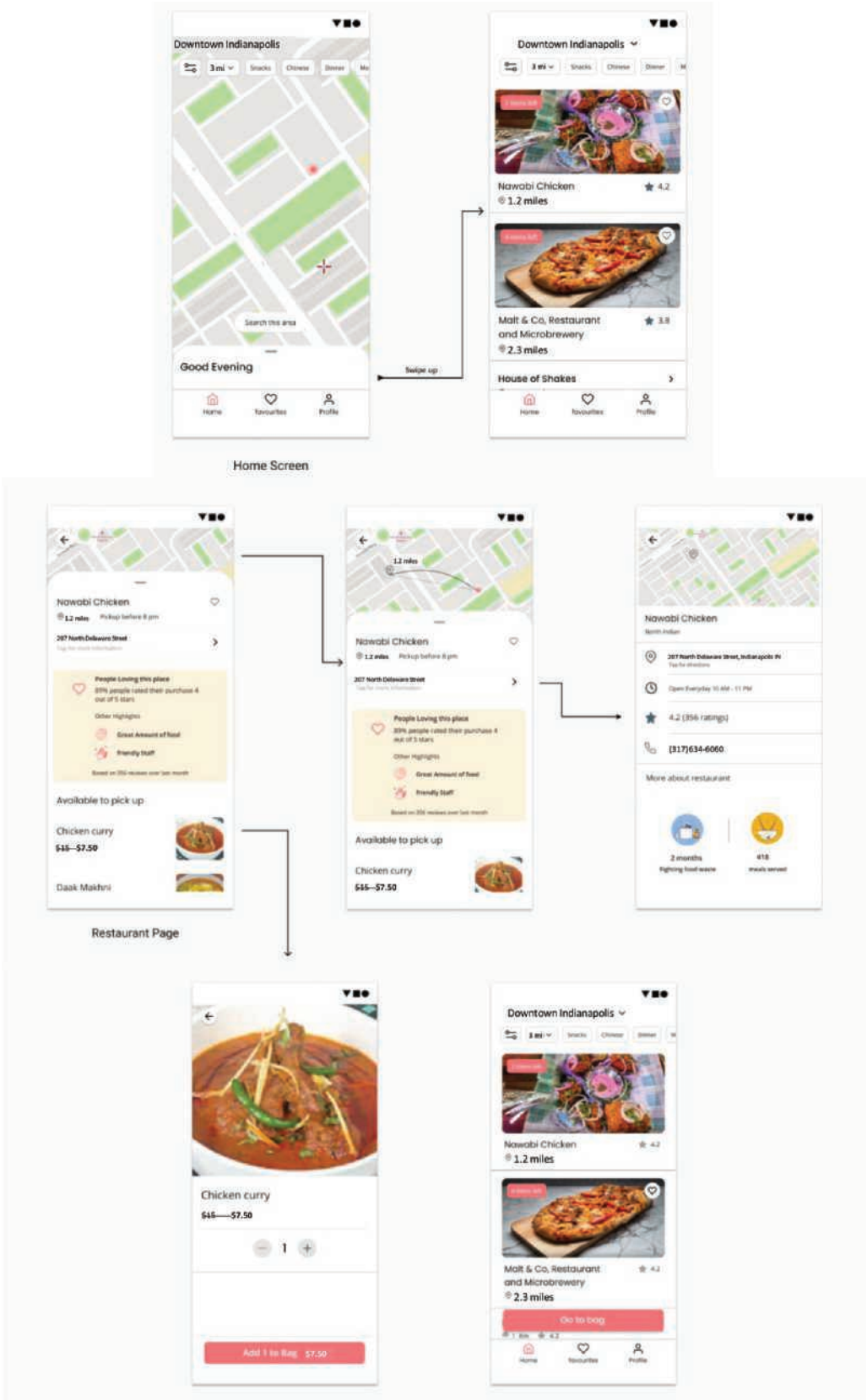
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Information Architecture

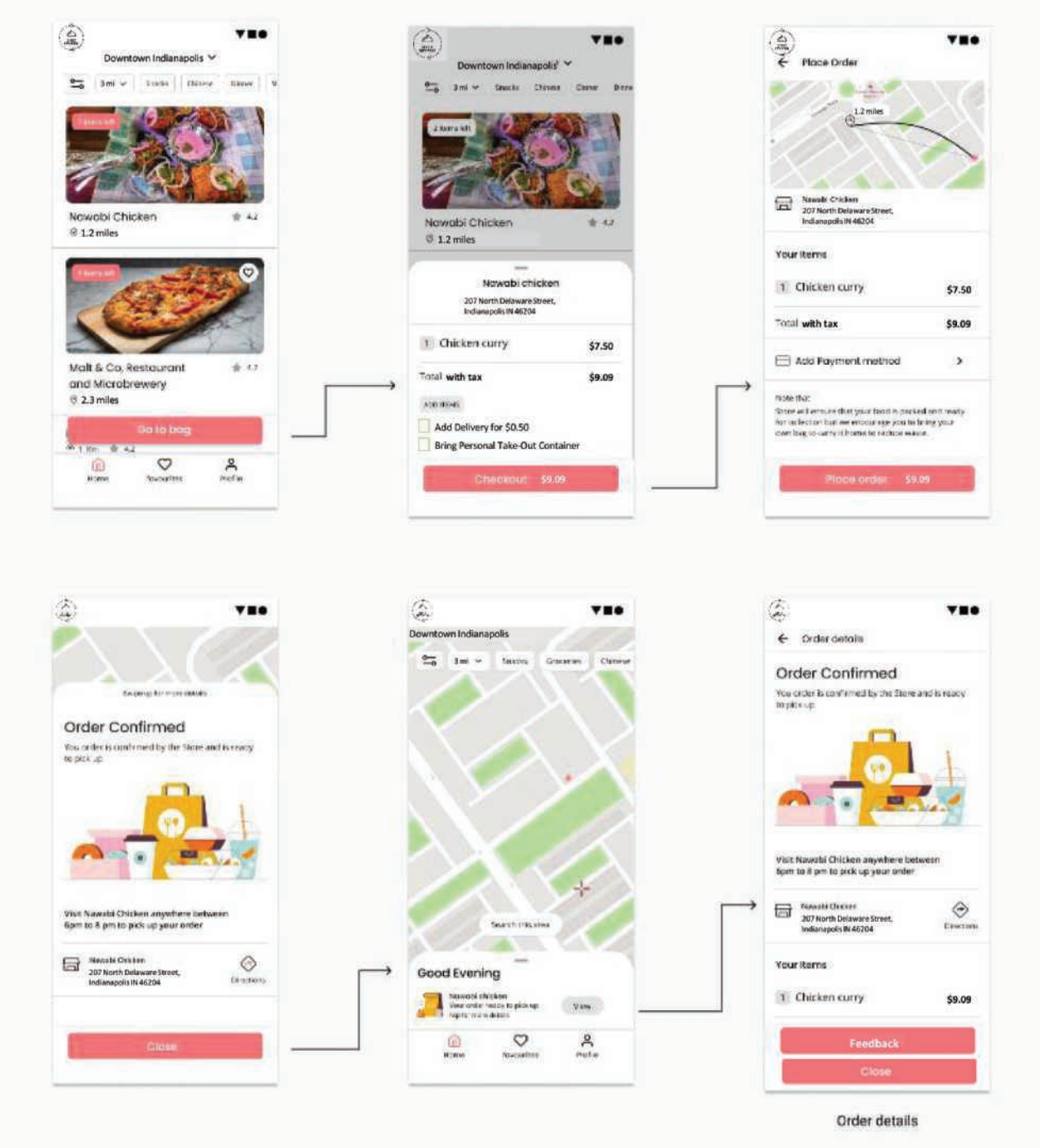


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Wireframe

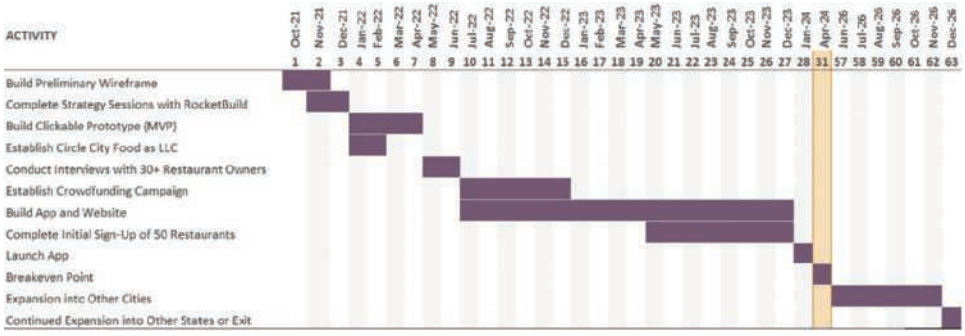


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Source: Wireframe

Gantt Chart



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Balance Statement Summary

Circle City Food Balance Sheet					
For the Year Ended December 31,	**2022**	**2023**	**2024**	**2025**	**2026**
Assets					
Current Assets					
Cash	(84,280)	(186,356)	375,659	2,701,469	6,929,637
Total Current Assets	$ (84,280)	$ (186,356)	$ 375,659	$ 2,701,469	$ 6,929,637
Total Fixed Assets Net	$ -	$ -	$ -	$ -	$ -
Total Assets	$ (84,280)	$ (186,356)	$ 375,659	$ 2,701,469	$ 6,929,637
Liabilities and Equity					
Current Liabilities					
Accounts Payable	200	1,064	29,338	40,377	51,613
Total Current Liabilities	$ 200	$ 1,064	$ 29,338	$ 40,377	$ 51,613
Total Long-Term Liabilities	$ -	$ -	$ -	$ -	$ -
Total Liabilities	$ 200	$ 1,064	$ 29,338	$ 40,377	$ 51,613
Shareholders' Equity					
Paid in Capital	-	-	-	-	-
Additional Equity Funding	-	-	-	-	-
Retained Earnings	(84,479)	(187,421)	346,321	2,661,092	6,878,024
Total Equity	$ (84,479)	$ (187,421)	$ 346,321	$ 2,661,092	$ 6,878,024
Total Liabilities and Equity	$ (84,280)	$ (186,356)	$ 375,659	$ 2,701,469	$ 6,929,637

Cash-Flow Statement Summary

Circle City Food Statement of Cash Flows					
For the Year Ended December 31,	**2022**	**2023**	**2024**	**2025**	**2026**
Cash at Beginning of Period	**$0**	**($84,280)**	**($186,356)**	**$375,659**	**$2,701,469**
Cash Receipts from Operating Activities					
Cash From Sales	-	-	1,302,600	3,805,199	6,476,217
Cash Payments for Operating Activities					
Cash paid for technology development	(78,632)	(92,966)	(12,000)	(12,000)	(12,000)
Cash paid for salaries	-	-	(452,381)	(494,669)	(519,403)
Cash paid for taxes	-	-	(141,881)	(615,319)	(1,120,957)
Advertising	-	(1,250)	(9,450)	(9,876)	(10,172)
Accounting	-	(2,500)	(18,268)	(27,424)	(41,136)
Legal	(600)	(417)	(2,058)	(2,119)	(2,183)
Credit Card Fees	-	-	(37,181)	(117,607)	(208,206)
Insurance	-	(156)	(772)	(795)	(819)
Coworking Space	(4,589)	(4,788)	(4,926)	(5,073)	(5,226)
2020 Expenses	(459)	-	-	-	-
Independent Contractor Program	-	-	-	(6,875)	(625)
Meal-Matching Program	-	-	(61,669)	(187,632)	(327,324)
Net Cash from Operating Activities	**$ (84,280)**	**$ (102,077)**	**$ 562,015**	**$ 2,325,810**	**$ 4,228,168**
Cash from Financing and Investing					
Cash from New Investments	-	-	-	-	-
Net Cash from Financing and Investing	$ -	$ -	$ -	$ -	$ -
Net Cash Inflow (Outflow)	**$ (84,280)**	**$ (102,077)**	**$ 562,015**	**$ 2,325,810**	**$ 4,228,168**
Cash at End of Period	**$ (84,280)**	**$ (186,356)**	**$ 375,659**	**$ 2,701,469**	**$ 6,929,637**

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Yearly Income Statements

Circle City Food
Pro Forma Income Statement
Year 1

Month	1	2	3	4	5	6	7	8	9	10	11	12	For the Year Ended
For the Month Ended	01/31/22	02/28/22	03/31/22	04/30/22	05/31/22	06/30/22	07/31/22	08/31/22	09/30/22	10/31/22	11/30/22	12/31/22	**12/31/22**
Sales													
Total Sales	$ -	$ -	$ -	$ -	$ -	$ -	$ -	$ -	$ -	$ -	$ -	$ -	$ -
Cost of Goods Sold													
Technology Development	10,000	2,500	2,500	2,500	2,500	8,632	8,333	8,333	8,333	8,333	8,333	8,333	**78,632**
Technology Maintenance	-	-	-	-	-	-	-	-	-	-	-	-	-
Total Cost of Goods Sold	$ 10,000	$ 2,500	$ 2,500	$ 2,500	$ 2,500	$ 8,632	$ 8,333	$ 8,333	$ 8,333	$ 8,333	$ 8,333	$ 8,333	$ 78,632
Gross Margin	(10,000)	(2,500)	(2,500)	(2,500)	(2,500)	(8,632)	(8,333)	(8,333)	(8,333)	(8,333)	(8,333)	(8,333)	(78,632)
Percent	0.00%	0.00%	0.00%	0.00%	0.00%	0.00%	0.00%	0.00%	0.00%	0.00%	0.00%	0.00%	**0.00%**
Operating Expenses													
Legal	-	-	600	-	-	-	-	-	-	-	-	-	**600**
Coworking Space	399	399	399	399	399	399	399	399	399	399	399	399	**4,788**
2020 Expenses	459	-	-	-	-	-	-	-	-	-	-	-	**459**
Total Operating Expenses	$ 858	$ 399	$ 999	$ 399	$ 399	$ 399	$ 399	$ 399	$ 399	$ 399	$ 399	$ 399	$ 5,847
Net Profit	$ (10,858)	$ (2,899)	$ (3,499)	$ (2,899)	$ (2,899)	$ (9,031)	$ (8,732)	$ (8,732)	$ (8,732)	$ (8,732)	$ (8,732)	$ (8,732)	$ (84,479)
Income Tax	-	-	-	-	-	-	-	-	-	-	-	-	-
Net Income	$ (10,858)	$ (2,899)	$ (3,499)	$ (2,899)	$ (2,899)	$ (9,031)	$ (8,732)	$ (8,732)	$ (8,732)	$ (8,732)	$ (8,732)	$ (8,732)	$ (84,479)

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Circle City Food
Pro Forma Income Statement
Year 2

Month	13	14	15	16	17	18	19	20	21	22	23	24	For the Year Ended
For the Month Ended	01/31/23	02/28/23	03/31/23	04/30/23	05/31/23	06/30/23	07/31/23	08/31/23	09/30/23	10/31/23	11/30/23	12/31/23	12/31/23
Sales													
Total Sales	$ -	$ -	$ -	$ -	$ -	$ -	$ -	$ -	$ -	$ -	$ -	$ -	$ -
Cost of Goods Sold													
Technology Development	8,632	8,333	8,333	8,333	8,333	8,333	8,333	8,333	8,333	8,333	8,333	-	**91,966**
Technology Maintenance	-	-	-	-	-	-	-	-	-	-	-	1,000	**1,000**
Total Cost of Goods Sold	$ 8,632	$ 8,333	$ 8,333	$ 8,333	$ 8,333	$ 8,333	$ 8,333	$ 8,333	$ 8,333	$ 8,333	$ 8,333	$ 1,000	$ 92,966
Gross Margin	(8,632)	(8,333)	(8,333)	(8,333)	(8,333)	(8,333)	(8,333)	(8,333)	(8,333)	(8,333)	(8,333)	(1,000)	(92,966)
Percent	0.00%	0.00%	0.00%	0.00%	0.00%	0.00%	0.00%	0.00%	0.00%	0.00%	0.00%	0.00%	**0.00%**
Operating Expenses													
Advertising	-	-	-	-	-	-	-	-	-	500	500	500	**1,500**
Accounting	-	-	-	-	-	-	-	-	-	1,000	1,000	1,000	**3,000**
Legal	-	-	-	-	-	-	-	-	-	167	167	167	**500**
Insurance	-	-	-	-	-	-	-	-	-	63	63	63	**188**
Coworking Space	399	399	399	399	399	399	399	399	399	399	399	399	**4,788**
Total Operating Expenses	$ 399	$ 399	$ 399	$ 399	$ 399	$ 399	$ 399	$ 399	$ 399	$ 2,128	$ 2,128	$ 2,128	$ 9,976
Net Profit	$ (9,031)	$ (8,732)	$ (8,732)	$ (8,732)	$ (8,732)	$ (8,732)	$ (8,732)	$ (8,732)	$ (8,732)	$ (10,462)	$ (10,462)	$ (3,128)	$ (102,941)
Income Tax	-	-	-	-	-	-	-	-	-	-	-	-	-
Net Income	$ (9,031)	$ (8,732)	$ (8,732)	$ (8,732)	$ (8,732)	$ (8,732)	$ (8,732)	$ (8,732)	$ (8,732)	$ (10,462)	$ (10,462)	$ (3,128)	$ (102,941)

Circle City Food
Pro Forma Income Statement
Year 3

Month	25	26	27	28	29	30	31	32	33	34	35	36	For the Year Ended
For the Month Ended	01/31/24	02/29/24	03/31/24	04/30/24	05/31/24	06/30/24	07/31/24	08/31/24	09/30/24	10/31/24	11/30/24	12/31/24	**12/31/24**
Sales													
Food Transaction Revenue	18,814	33,085	47,480	61,998	76,641	91,410	106,306	121,331	136,485	151,769	167,186	182,735	**1,195,240**
New Restaurant Revenue	600	600	600	600	600	600	600	600	600	600	600	600	**7,200**
New City Expansion Revenue	-	-	-	-	-	-	-	-	-	-	-	-	-
Food Delivery Revenue	1,577	2,773	3,979	5,195	6,422	7,660	8,908	10,167	11,437	12,718	14,010	15,313	**100,160**
Total Sales	**$ 20,990**	**$ 36,458**	**$ 52,058**	**$ 67,793**	**$ 83,663**	**$ 99,670**	**$ 115,815**	**$ 132,098**	**$ 148,522**	**$ 165,087**	**$ 181,796**	**$ 198,648**	**$ 1,302,600**
Cost of Goods Sold													
Technology Development	-	-	-	-	-	-	-	-	-	-	-	-	-
Technology Maintenance	1,000	1,000	1,000	1,000	1,000	1,000	1,000	1,000	1,000	1,000	1,000	1,000	**12,000**
Total Cost of Goods Sold	**$ 1,000**	**$ 1,000**	**$ 1,000**	**$ 1,000**	**$ 1,000**	**$ 1,000**	**$ 1,000**	**$ 1,000**	**$ 1,000**	**$ 1,000**	**$ 1,000**	**$ 1,000**	**$ 12,000**
Gross Margin	**19,990**	**35,458**	**51,058**	**66,793**	**82,663**	**98,670**	**114,815**	**131,098**	**147,522**	**164,087**	**180,796**	**197,648**	**1,290,600**
Percent	95.24%	97.26%	98.08%	98.52%	98.80%	99.00%	99.14%	99.24%	99.33%	99.39%	99.45%	99.50%	**99.08%**
Operating Expenses													
Advertising	800	800	800	800	800	800	800	800	800	800	800	800	**9,600**
Accounting	1,545	1,545	1,545	1,545	1,545	1,545	1,545	1,545	1,545	1,545	1,545	1,545	**18,540**
Legal	172	172	172	172	172	172	172	172	172	172	172	172	**2,060**
Credit Card Fees	649	1,127	1,609	2,095	2,585	3,080	3,579	4,082	4,589	5,101	5,617	6,138	**40,250**
Insurance	64	64	64	64	64	64	64	64	64	64	64	64	**773**
Coworking Space	411	411	411	411	411	411	411	411	411	411	411	411	**4,932**
Meal-Matching Program	1,051	1,848	2,652	3,464	4,282	5,107	5,939	6,778	7,625	8,479	9,340	10,209	**66,773**
Salaries	39,338	39,338	39,338	39,338	39,338	39,338	39,338	39,338	39,338	39,338	39,338	39,338	**472,050**
Total Operating Expenses	**$ 44,029**	**$ 45,304**	**$ 46,591**	**$ 47,888**	**$ 49,196**	**$ 50,516**	**$ 51,847**	**$ 53,190**	**$ 54,544**	**$ 55,909**	**$ 57,287**	**$ 58,676**	**$ 614,978**
Net Profit	**$ (24,039)**	**$ (9,847)**	**$ 4,468**	**$ 18,905**	**$ 33,467**	**$ 48,154**	**$ 62,968**	**$ 77,909**	**$ 92,978**	**$ 108,178**	**$ 123,509**	**$ 138,972**	**$ 675,622**
Income Tax	11,823	11,823.38	11,823	11,823	11,823	11,823	11,823	11,823	11,823	11,823	11,823	11,823	**141,881**
Net Income	**$ (35,862)**	**$ (21,670)**	**$ (7,356)**	**$ 7,082**	**$ 21,644**	**$ 36,331**	**$ 51,144**	**$ 66,085**	**$ 81,155**	**$ 96,355**	**$ 111,685**	**$ 127,148**	**$ 533,741**

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Circle City Food
Pro Forma Income Statement
Year 4

Month	37	38	39	40	41	42	43	44	45	46	47	48	For the Year Ended
For the Month Ended	01/31/25	02/28/25	03/31/25	04/30/25	05/31/25	06/30/25	07/31/25	08/31/25	09/30/25	10/31/25	11/30/25	12/31/25	12/31/25
Sales													
Food Transaction Revenue	198,446	214,286	230,262	246,376	262,629	279,022	295,557	312,235	329,058	346,025	363,140	380,403	**3,457,439**
New Restaurant Revenue	600	600	600	600	600	600	600	600	600	600	600	600	**7,200**
New City Expansion Revenue	-	-	-	-	-	3,635	5,470	7,454	9,439	11,424	13,409	-	**50,830**
Food Delivery Revenue	16,630	17,957	19,296	20,646	22,008	23,382	24,767	26,165	27,575	28,997	30,431	31,877	**289,730**
Total Sales	**$ 215,676**	**$ 232,843**	**$ 250,157**	**$ 267,622**	**$ 285,237**	**$ 306,639**	**$ 326,394**	**$ 346,455**	**$ 366,671**	**$ 387,046**	**$ 407,579**	**$ 412,880**	**$ 3,805,199**
Cost of Goods Sold													
Technology Development	-	-	-	-	-	-	-	-	-	-	-	-	-
Technology Maintenance	1,000	1,000	1,000	1,000	1,000	1,000	1,000	1,000	1,000	1,000	1,000	1,000	**12,000**
Total Cost of Goods Sold	**$ 1,000**	**$ 1,000**	**$ 1,000**	**$ 1,000**	**$ 1,000**	**$ 1,000**	**$ 1,000**	**$ 1,000**	**$ 1,000**	**$ 1,000**	**$ 1,000**	**$ 1,000**	**$ 12,000**
Gross Margin	**214,676**	**231,843**	**249,157**	**266,622**	**284,237**	**305,639**	**325,394**	**345,455**	**365,671**	**386,046**	**406,579**	**411,880**	**3,793,199**
Percent	99.54%	99.57%	99.60%	99.63%	99.65%	99.67%	99.69%	99.71%	99.73%	99.74%	99.75%	99.76%	**99.68%**
Operating Expenses													
Advertising	824	824	824	824	824	824	824	824	824	824	824	824	**9,888**
Accounting	2,318	2,318	2,318	2,318	2,318	2,318	2,318	2,318	2,318	2,318	2,318	2,318	**27,810**
Legal	177	177	177	177	177	177	177	177	177	177	177	177	**2,122**
Credit Card Fees	6,864	7,411	7,962	8,518	9,078	9,759	10,388	11,027	11,670	12,319	12,972	13,141	**121,108**
Insurance	66	66	66	66	66	66	66	66	66	66	66	66	**796**
Coworking Space	423	423	423	423	423	423	423	423	423	423	423	423	**5,080**
Independent Contractor Program	-	-	-	-	-	-	1,250	1,250	1,250	1,250	1,250	1,250	**7,500**
Meal-Matching Program	11,086	11,971	12,864	13,764	14,672	15,588	16,512	17,443	18,383	19,331	20,287	21,252	**193,153**
Salaries	41,304	41,304	41,304	41,304	41,304	41,304	41,304	41,304	41,304	41,304	41,304	41,304	**495,653**
Total Operating Expenses	**$ 63,063**	**$ 64,494**	**$ 65,938**	**$ 67,394**	**$ 68,863**	**$ 70,460**	**$ 73,262**	**$ 74,832**	**$ 76,415**	**$ 78,012**	**$ 79,621**	**$ 80,755**	**$ 863,109**
Net Profit	**$ 151,613**	**$ 167,348**	**$ 183,220**	**$ 199,228**	**$ 215,374**	**$ 235,179**	**$ 252,132**	**$ 270,623**	**$ 289,256**	**$ 308,034**	**$ 326,958**	**$ 331,125**	**$ 2,930,090**
Income Tax	51,277	51,277	51,277	51,277	51,277	51,277	51,277	51,277	51,277	51,277	51,277	51,277	**615,319**
Net Income	**$ 100,336**	**$ 116,072**	**$ 131,943**	**$ 147,951**	**$ 164,098**	**$ 183,903**	**$ 200,856**	**$ 219,346**	**$ 237,979**	**$ 256,757**	**$ 275,681**	**$ 279,849**	**$ 2,314,771**

Circle City Food
Pro Forma Income Statement
Year 5

Month	49	50	51	52	53	54	55	56	57	58	59	60	For the Year Ended
For the Month Ended	01/31/26	02/28/26	03/31/26	04/30/26	05/31/26	06/30/26	07/31/26	08/31/26	09/30/26	10/31/26	11/30/26	12/31/26	**12/31/26**
Sales													
Food Transaction Revenue	397,843	415,427	433,163	451,053	469,098	487,299	505,658	524,176	542,855	561,695	580,700	599,869	**5,968,835**
New Restaurant Revenue	600	600	600	600	600	600	600	600	600	600	600	600	**7,200**
New City Expansion Revenue	-	-	-	-	-	-	-	-	-	-	-	-	-
Food Delivery Revenue	33,339	34,812	36,299	37,798	39,310	40,835	42,374	43,925	45,491	47,069	48,662	50,268	**500,182**
Total Sales	**$ 431,782**	**$ 450,839**	**$ 470,062**	**$ 489,451**	**$ 509,008**	**$ 528,734**	**$ 548,631**	**$ 568,701**	**$ 588,945**	**$ 609,365**	**$ 629,962**	**$ 650,737**	**$ 6,476,217**
Cost of Goods Sold													
Technology Development	-	-	-	-	-	-	-	-	-	-	-	-	-
Technology Maintenance	1,000	1,000	1,000	1,000	1,000	1,000	1,000	1,000	1,000	1,000	1,000	1,000	**12,000**
Total Cost of Goods Sold	**$ 1,000**	**$ 1,000**	**$ 1,000**	**$ 1,000**	**$ 1,000**	**$ 1,000**	**$ 1,000**	**$ 1,000**	**$ 1,000**	**$ 1,000**	**$ 1,000**	**$ 1,000**	**$ 12,000**
Gross Margin	**430,782**	**449,839**	**469,062**	**488,451**	**508,008**	**527,734**	**547,631**	**567,701**	**587,945**	**608,365**	**628,962**	**649,737**	**6,464,217**
Percent	99.77%	99.78%	99.79%	99.80%	99.80%	99.81%	99.82%	99.82%	99.83%	99.84%	99.84%	99.85%	**99.81%**
Operating Expenses													
Advertising	849	849	849	849	849	849	849	849	849	849	849	849	**10,185**
Accounting	3,476	3,476	3,476	3,476	3,476	3,476	3,476	3,476	3,476	3,476	3,476	3,476	**41,715**
Legal	182	182	182	182	182	182	182	182	182	182	182	182	**2,185**
Credit Card Fees	14,155	14,779	15,409	16,045	16,686	17,333	17,985	18,643	19,307	19,976	20,651	21,332	**212,302**
Insurance	68	68	68	68	68	68	68	68	68	68	68	68	**820**
Coworking Space	436	436	436	436	436	436	436	436	436	436	436	436	**5,232**
Meal-Matching Program	22,226	23,208	24,199	25,198	26,207	27,223	28,249	29,284	30,327	31,380	32,441	33,512	**333,454**
Salaries	43,370	43,370	43,370	43,370	43,370	43,370	43,370	43,370	43,370	43,370	43,370	43,370	**520,435**
Total Operating Expenses	**$ 84,761**	**$ 86,369**	**$ 87,990**	**$ 89,625**	**$ 91,274**	**$ 92,937**	**$ 94,615**	**$ 96,308**	**$ 98,015**	**$ 99,737**	**$ 101,474**	**$ 103,226**	**$ 1,126,328**
Net Profit	**$ 346,020**	**$ 363,471**	**$ 381,072**	**$ 398,826**	**$ 416,734**	**$ 434,797**	**$ 453,016**	**$ 471,394**	**$ 489,930**	**$ 508,628**	**$ 527,488**	**$ 546,512**	**$ 5,337,889**
Income Tax	93,413	93,413	93,413	93,413	93,413	93,413	93,413	93,413	93,413	93,413	93,413	93,413	**1,120,957**
Net Income	**$ 252,607**	**$ 270,058**	**$ 287,659**	**$ 305,413**	**$ 323,321**	**$ 341,384**	**$ 359,603**	**$ 377,981**	**$ 396,517**	**$ 415,215**	**$ 434,075**	**$ 453,099**	**$ 4,216,932**

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Diversity in Entrepreneurship

Necessity Entrepreneurship

For the first time after a 40-year entrepreneurship slump, the number of start-ups is on the rise. While dips and spikes are not an unusual occurrence, what is unusual about this growth in start-ups is that it is happening during a recession. Usually start-ups have declined in recessions, but with the adverse effects of the COVID-19 pandemic and federal stimulus monies distributed, there has been a surge in new start-ups, especially in Black communities.

A study was performed on state-level registrations in eight states that gave researchers information on start-up activity by week and ZIP code. The researchers estimate that, at the start of the pandemic, the average ZIP code had an average of three or fewer businesses registered a week than is typical. However, after the CARES Act was signed in March 2020, the pace of weekly registrations more than doubled. Similarly, around the period when a supplementary aid package was signed in December, business registrations rose by 60 percent. Finally, after the third wave of stimulus in March, weekly business registrations rose by 20 percent, although the data around that time are less complete. The researchers caution that there might be other factors affecting the rise in start-ups, but the timing and the spikes are so stark that it is hard to think that it is merely a coincidence. Mapping the data by ZIP codes shows that business registrations in Black areas, particularly higher median-income Black neighborhoods, experienced the greatest increases even after controlling for other variables. Although the data do not directly inform us about the race of the entrepreneur, small-business owners tend to do the registration at their home address, which gives us an indication of their race.

While this influx of start-ups may be a positive sign, it may also be a sign of struggle. Indeed, Black communities have been disproportionately impacted by the pandemic when it comes to employment. The data suggest that Black individuals might have started their businesses because they had no other option. These are what Robert Fairlie, an economist at the University of California, Santa Cruz, calls "necessity businesses." According to research performed by Fairlie, the share of necessity businesses has increased substantially, from 13 percent in 2019 to 30 percent in 2020.

Whether these new registrations will translate into long-term businesses remains to be seen. The question is whether any of the new businesses will become disruptive enough to make a positive difference on economic growth and job creation. There are optimists who believe that the disruptive nature of the pandemic has presented entrepreneurs with new opportunities that did not exist before. With new business models, barriers to running a small business have changed. Instead of opening a storefront, entrepreneurs can now run ghost kitchens, pop-up restaurants, or online stores.

The challenges of becoming a successful entrepreneur are certainly still there, and probabilities of success remain low. Necessity has motivated many individuals to roll the dice and take advantage of the opportunities presented in the shifting economy. These were formed largely in Black communities that were disproportionately affected by the pandemic. Successful entrepreneurs will still have to overcome many barriers, and only time will tell whether the new influx in businesses is here to stay.

Source: Adapted from Quoctrung Bui, "Small Businesses Have Surged in Black Communities: Was It the Stimulus?," *New York Times*, May 2021; Ben Casselman "Start-Up Boom in the Pandemic Is Growing Stronger," *New York Times*, August 2021; and Gwynn Guilford and Charity L. Scott, "Is It Insane to Start a Business during Coronavirus? Millions of Americans Don't Think So," *Wall Street Journal*, September 2020.

Summary

This chapter provided a thorough definition and examination of an effective business plan. The critical factors in planning and the pitfalls to be avoided were discussed. Indicators of these pitfalls and ways to avoid them also were presented.

Next, the benefits for both entrepreneurs and financial sources were reviewed. Developing a well-conceived plan was presented from the point of view of the audience for whom the plan is written. The typical six-step reading process of a business plan was presented to help entrepreneurs better understand how to put the business plan together. Ten guidelines in developing a business plan were provided, collated from the advice of experts in venture capital and new-business development.

The next section illustrated some of the major questions that must be answered in a complete and thorough business plan. The business plan was outlined, and every major segment was addressed and explained.

The chapter then presented some helpful hints for preparing a business plan, along with a self-analysis checklist for doing a careful critique of the plan before it is presented to investors.

Finally, the chapter closed with a review of how to present a business plan to an audience of venture capital sources. Some basic presentation tips were listed, together with a discussion of what to expect from the plan evaluators.

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Key Terms

business model
business model canvas
business plan
coachability
elevator pitch
five-minute reading
management team
market niche
marketing segment
marketing strategy
metrics
milestone schedule
segment
pain
potential market
reachable market

Review and Discussion Questions

1. What is a business plan?
2. Describe each of the five planning pitfalls entrepreneurs often encounter.
3. Identify an indicator of each pitfall named in question 2. What would you do about each?
4. Identify the benefits of a business plan (a) for an entrepreneur and (b) for financial sources.
5. What are the three major viewpoints to be considered when developing a business plan?
6. Describe the six-step process venture capitalists follow when reading a business plan.
7. What are some components to consider in the proper packaging of a plan?
8. Identify 5 of the 10 guidelines to be used for preparing a business plan.
9. Briefly describe each of the major segments to be covered in a business plan.
10. Why is the summary segment of a business plan written last? Why not first?
11. What are five elements included in the marketing segment of a business plan?
12. What is the meaning of the term *critical risks*?
13. Describe each of the three financial statements that are mandatory for the financial segment of a business plan.
14. Why should a business plan be updated?
15. Outline some of the critical points to capture in an elevator pitch.

Notes

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3. See Jeffrey A. Timmons, Andrew Zacharakis, and Stephen Spinelli, *Business Plans That Work* (New York: McGraw-Hill, 2004); Jan Brinckmann, Dietmar Grichnik, and Diana Kapsa, "Should Entrepreneurs Plan or Just Storm the Castle? A Meta-Analysis on Contextual Factors Impacting the Business Planning–Performance Relationship in Small Firms," *Journal of Business Venturing* 25, no. 1 (2010): 24–40; and Anne Chwolka and Matthias G. Raith, "The Value of Business Planning before Start-up—A Decision-Theoretical Perspective," *Journal of Business Venturing* 27, no. 3 (2012): 385–99.
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11. Rich and Gumpert, "How to Write a Winning Business Plan," 159.
12. Mancuso, *How to Write a Winning Business Plan*, 52; see also Bruce R. Barringer, *Preparing Effective Business Plans: An Entrepreneurial Approach*, 2nd ed. (Upper Saddle River, NJ: Pearson/Prentice Hall, 2015).
13. Mancuso, *How to Write a Winning Business Plan*, 65.
14. These guidelines are adapted from Jeffrey A. Timmons, "A Business Plan Is More Than a Financing Device," *Harvard Business Review* 58, no. 2 (March/April 1980): 25–35; W. Keith Schilit, "How to Write a Winning Business Plan," *Business Horizons* 30, no. 5 (September/October 1987): 13–22; William A. Sahlman, "How to Write a Great Business Plan," *Harvard Business Review* (July/August 1997): 98–108; and Donald F. Kuratko, *The Complete Entrepreneurial*

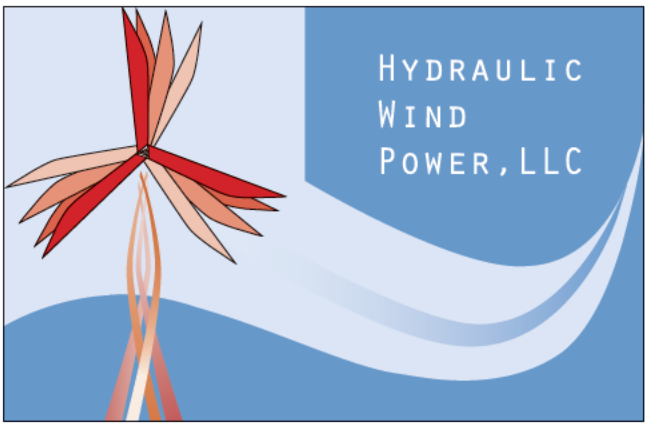
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18. For example, the Massachusetts Institute of Technology sponsors a business plan forum in Boston, and the Plug and Play Tech Center in Silicon Valley provides numerous forums where new ideas are "pitched."
19. See Benjamin J. Warnick, Blakley C. Davis, Thomas H. Allison, and Aaron H. Anglin, "Express Yourself: Facial Expression of Happiness, Anger, Fear, and Sadness in Funding Pitches," *Journal of Business Venturing* 36, no. 4 (2021): 106109; Paul Sanchez-Ruiz, Matthew S. Wood, and Anna Long-Ruboyianes, "Persuasive or Polarizing? The Influence of Entrepreneurs' Use of Ingratiation Rhetoric on Investor Funding Decisions, *Journal of Business Venturing* 36, no. 4 (2021): 106120; and Jordan J. McSweeney, Kevin T. Mc Sweeney, Justin W. Webb, and Cynthia E. Devers, "The Right Touch of Pitch Assertiveness: Examining Entrepreneurs' Gender and Project Category Fit in Crowdfunding," *Journal of Business Venturing* 37, no. 4 (2022): 106223.
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21. For excellent resources on business plan preparation and presentations, see Garage Technology Ventures at http://www.garage.com/resources.

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Appendix 12A: Hydraulic Wind Power LLC



12A-1 Executive Summary

12A-1a Overview

Hydraulic Wind Power LLC (HWP) is a renewable energy company with a patent-pending technology that can make the production of wind energy more economically viable. Our highly efficient hydraulic drivetrain significantly reduces overall costs and increases total energy production. These benefits will allow turbines utilizing our technology to produce a cost of energy (COE) that is directly competitive with other energy sources (such as coal, nuclear, and hydroelectric, which have a COE of 3 to 5 cents per kWh).

Our goal is to be the industry expert in hydraulic drivetrains for land-based wind farm applications and provide alternative designs to current large wind turbines that improve the reliability, durability, and profitability of wind power. The company was formed on August 17, 2010, as an Indiana Limited Liability Company (LLC). The company also executed its exclusive licensing agreement with the Indiana University Research and Technology Corporation on the same date. The company is located at the Hoosier Hatchery in Bloomington, Indiana.

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Adam Johnson—CEO
Justin Otani—COO

Director of research and development:
Dr. Afshin Izadian

Business advisers:
Dr. Donald F. Kuratko
Mark Long
Mark Need
Matt Rubin

Capital received to date:
$112,000

Capital seeking:
Series A of $1.8 million

Investors to date:
Founders
Indiana University

12A-2 Market

In 2008, the U.S. gearbox market was over $4.5 billion, which is part of the larger $151.3 billion wind energy market.[1] Wind energy currently generates around 2 percent of U.S. electricity needs, but future growth is projected to substantially increase.[2] The U.S. Department of Energy released, in 2008, a plan to provide 20 percent of U.S. electricity through wind power by 2030.[3] A more recent analysis of wind integration in the eastern region of the United States drew similar conclusions.[4]

Despite the significant drop in demand for wind energy in 2010, U.S. wind energy seems to again be ramping up. Figures for the first quarter of 2011 indicate that the industry seems poised for a renaissance. The under-construction figure is nearly twice the megawatts that the industry reported at this time in both 2009 and 2010; moreover, two-thirds of those megawatts are already locked in under long-term power purchase agreements with electric utilities, indicating an enduring industry that can endure a range of economic and policy conditions.[5]

However, wind energy still faces a number of key challenges that make improving the economic viability of wind critical to its future success. These challenges include the following:

The Low Price of Natural Gas At $35 a megawatt-hour, wind looked like a good deal back in 2007, when wholesale electric prices ranged between $45 and $85 per megawatt-hour. But the natural gas boom, plus the 2008 recession, drove prices under $30 by 2009, eliminating wind's financial edge. The price of natural gas has fallen by 77 percent since 2008, and the cost of producing electricity in gas plants is down

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40 percent, due in part by advances in horizontal drilling and the effective (though highly controversial) technique of hydraulic fracturing, or fracking.[6]

The Instability of Production Tax Credits The renewable energy production tax credit (PTC), a credit of 2.1 cents per kilowatt-hour, is the primary federal incentive for wind energy and has been essential to the industry's growth. The wind energy industry faces two troubles regarding the PTC. First, the credit is continually extended for only one- and two-year terms, discouraging companies from making long-term, sizable investments in wind power manufacturing and development. Second, in the current adverse financial climate, where demand for tax credits is limited, the PTC is providing little incentive to spur wind energy development. Also, NIMBY (Not In My Backyard) protests have made getting approval for a wind farm in the United States as difficult as getting it for a coal-fired plant.[7]

The Increasing Competition from Chinese Suppliers Chinese wind turbine producers have seen their market share rise dramatically in the past few years. Two of the top Chinese wind turbine producers now rank among the global top three manufacturers by megawatts of capacity sold. The rise has been fueled by domestic demand for wind power, supported by the government target, and a requirement for 70 percent of wind turbine components to be manufactured locally. With their domestic market saturated and clear signs of overcapacity and upcoming consolidation, the biggest Chinese producers have announced plans for international expansion.

12A-3 Problem

Our alternative approach to capturing and transferring energy from the rotor to the generator is able to solve one of the largest and most expensive problems with current wind turbines. Most wind turbines currently utilize a gearbox-based design. These gearboxes are expensive and heavy and fail often. Gearboxes need to be replaced on average about every five to seven years and cost over $500,000 per replacement.[8] Our company's solution utilizes a hydraulic system in a unique configuration to eliminate gearboxes and significantly improves the reliability, durability, and profitability of wind turbines.

Gearbox failures account for the largest amounts of downtime, maintenance, and lost power production. These costly failures can total 15 to 20 percent of the price of the turbine.[9] The frequent maintenance requirements and multiple (costly) gearbox replacements have proven especially problematic for developers of large wind power production facilities. Most wind farm developments today have maintenance teams in place to maintain and replace gearboxes. Many economic models factor in total gearbox replacements every five to seven years on each turbine.[10] The financial risk gearboxes represent is only somewhat mitigated by the large number of turbines in a major wind power production facility and developers' ability to amortize personnel, equipment, and consumables costs across a fleet of turbines.

Gearboxes are problematic by the very nature of the numerous moving parts and subsystems that are required for their operation and the demanding nature of the wind turbine application itself. It is generally accepted that the complexity and multiple moving parts involved in gearbox-driven designs are creating more opportunities for failure, more maintenance requirements, and costlier fixes.[11]

It is also not that surprising gearboxes have so many failures, especially if you compare them to car transmissions. A car transmission is functionally similar to a wind turbine's gearbox. Expecting a wind turbine's gearbox to last for 20 years of continuous operation would be like expecting a car's transmission to last for 4 million miles, which most would agree is an unreasonable expectation.[12]

The industry has attempted to solve these problems over the past two decades with wind turbine manufacturers, gear designers, bearing manufacturers, consultants, and lubrication engineers all working together to improve load prediction, design, fabrication, and operation. This collaboration has resulted in internationally recognized gearbox wind turbine design standards. However, despite reasonable adherence to these accepted design practices, wind turbine gearboxes have yet to achieve their design life goals of 20 years, with most systems requiring significant repair or overhaul well before the intended life is reached. The wind industry has reached a point where design practices for gearboxes do not result in sufficient life, and institutional barriers are hindering forward progress.[13]

12A-4 Technology

12A-4a Background

Since the acceptance of the gearbox-based configuration (which essentially won out during the 1990s as the dominant configuration and is used in most of today's modern wind turbines), despite their high costs and the high failure rates, U.S. wind turbine designers and manufacturers have proceeded only incrementally toward improvements in wind turbine design. These design and efficiency improvements are being achieved mostly by enlarging turbine size. The focus on incremental design changes has lessened design risk; however, as blades get longer, they challenge the ability of current designs and materials to support their own weight and withstand wind loads.[14]

One attempt by the industry to address these issues was the development of the direct drive system. The direct

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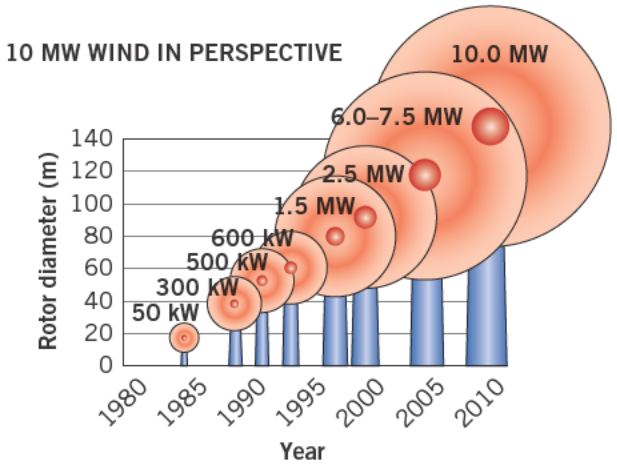
drive system was specifically designed to avoid the use of a gearbox. The system instead attaches the rotor directly to the generator and uses a costly variable-speed electronic system to convert the erratic generation of electricity into a steady flow that can be fed into the power grid. These systems, in order to work, require the use of rare specialized permanent magnets. The specialized generator and variable-speed electronic system make the direct drive system almost twice as expensive as the traditional gearbox design.

The required use of rare-earth metals also serves as a significant barrier to the widespread adoption of these systems. Rare earths are elements needed in many high-technology industries, including the manufacturing of wind turbines. China currently fulfills more than 90 percent of global demand for these elements, and last year, Beijing started to severely restrict its exports.[15] The cost and availability of these elements has limited the direct drive system's use to mostly offshore applications since these turbines' location makes them harder to repair and the larger units are able to generate enough power to justify the added costs.

12A-4b Opportunity

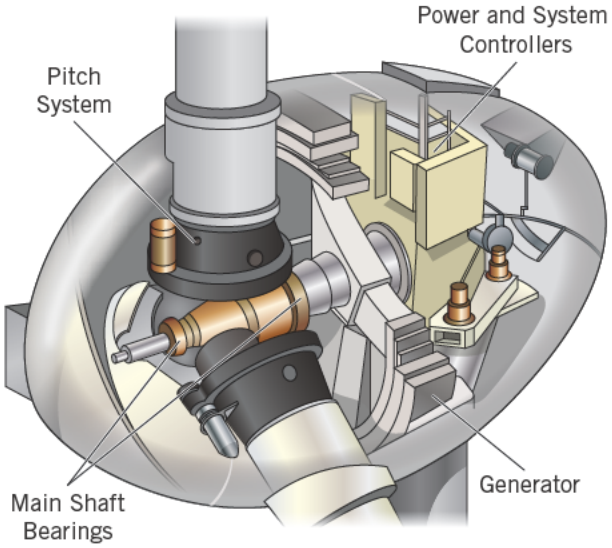
Some attempts at creating a hydraulic-based drivetrain comprising a pump and motor for main power transmission were attempted unsuccessfully in the early 1980s. Key problems that were identified were its inadequate capacity, efficiency, reliability, and life span of then existing commercial hydraulic components. The lack of components specifically designed for the needs of efficient wind power generation ultimately led to the determination that these systems were not as commercially viable as the gearbox-based drivetrains. However, the advances over the past 30 years in pump manufacturing for the oil and gas industry and in fields such as materials science, fluid dynamics, and computational design tools have solved many of these issues and have reopened the door of opportunity for these past innovative drivetrain concepts.[16]

Evolution of Wind Turbine Designs over the Past 25 Years

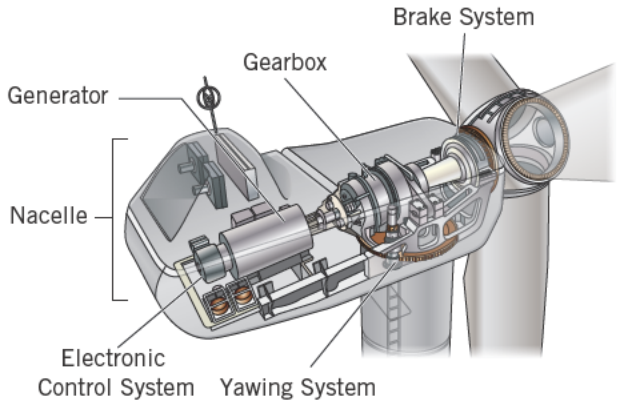


It is easier to appreciate the size of new 10-MW turbines with comparisons to previous generations. The Clipper Windpower Britannia turbines, for example, will have towers about as high as 50-story buildings.

Direct Drive Design



Traditional Gearbox Design

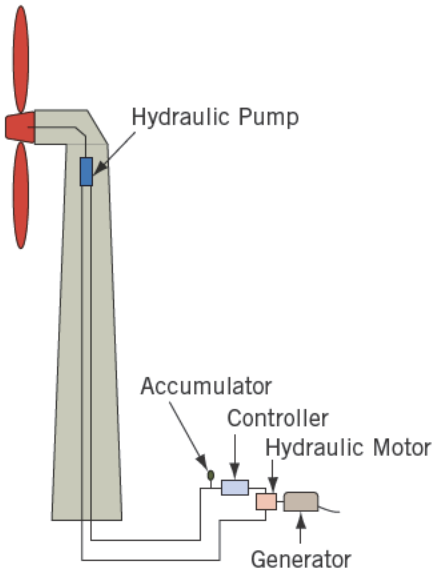


12A-5 Our Solution

Our company has created a unique solution to the problem of transferring energy by combining a novel hydraulic transmission system with a specialized closed-loop control system. Hydraulic transmission systems (HTS) are well known as an exceptional means of power transmission for energy applications in manufacturing, automation, and heavy-duty vehicles.[17] The HTS developed by HWP allows the rotor to operate at variable speeds, enables the use of efficient hydraulic components, and enables the use of synchronous generators (without requiring costly variable-speed electronic system).

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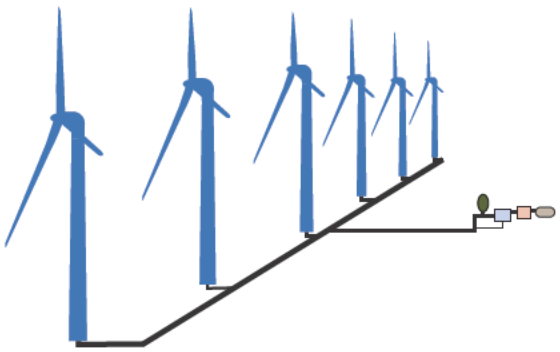
System Components



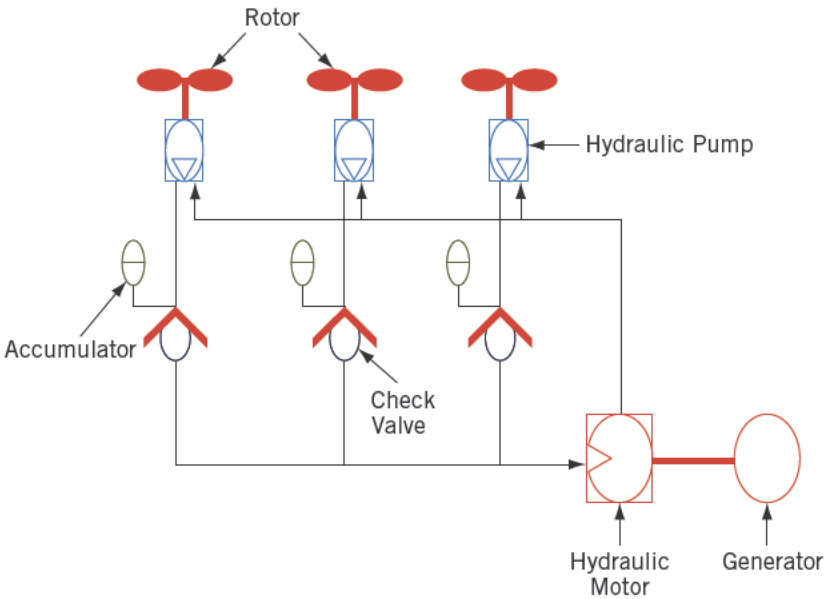
Operating at variable speeds increases the amount of energy captured, rotary hydraulics are extremely durable and highly efficient, and synchronous generators do not require a reactive magnetizing current and a reactive power compensation system (unlike induction generators, which are found in most current wind turbines), which reduce the efficiency of the system.

Utilizing our specialized closed-loop control system, our drivetrain is able to maintain a constant frequency at the generator while it transfers energy captured by the rotor to a generator on the ground and allows manufacturers to incorporate several turbines into a single centralized power generation unit (an ideal feature for wind farm applications).

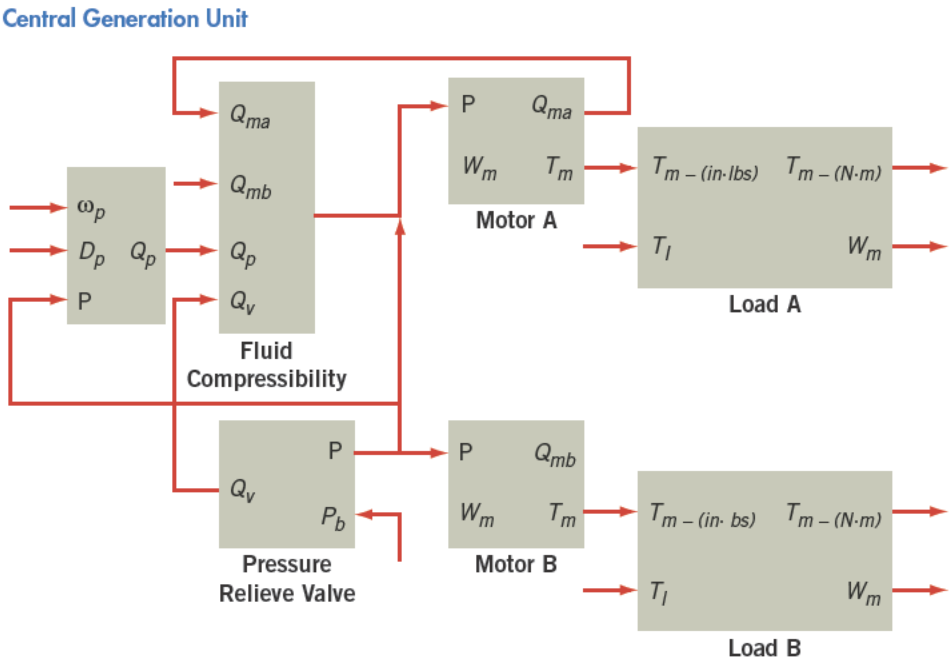
HWP's Multi-Tower Integrated Approach



System Layout Overview



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12A-5a Outside Validation

The company has received some initial feedback from the U.S. Department of Energy (DOE) on our technology. This feedback is highly encouraging and attests to the potential of the technology. The DOE did identify some areas of concern. However, the company has since worked hard to address these concerns and made substantial progress in the development of the technology. Dr. Izadian also has two peer-reviewed papers on the technology that have been accepted for publication (and are available on request).

12A-5b Competitive Advantage

Rather than attempting to create a solution using abstract or untested technologies, our innovative control and energy conversion system leverages current industrial technologies and expertise to create a practical and effective solution. This also gives HWP a unique advantage because the manufacturing and distribution infrastructure already exists that would enable the rapid deployment of our system into new wind farm projects once the full-scale system is completed, tested, and proven.

Our system has a number of additional advantages when compared to traditional gearbox designs, direct drive designs, and alternative hydraulic designs. The combination of these advantages is expected to significantly reduce a turbine's COE. These advantages can be broken down into two key areas: efficiency advantages and cost advantages. These advantages are listed below:

Efficiency Advantages:

- Variable-speed rotor
- Increased nominal speed; increased cut-out speed
- Reduced nacelle weight (also reduces costs)
- Improved generator efficiency and grid compatibility (also reduces costs)
- Elimination of large power electronics (also reduces costs)
- Enabled energy storage

Cost Advantages:

- Reduced downtime and repair costs
- Reduced investor risk
- Currently existing manufacturing infrastructure

Our system will enable manufacturers to provide developers a more reliable and durable turbine while also increasing overall profitability. Acquiring a license in an existing and proven technology will also allow licensees to avoid the delays, risks, and costs inherent with in-house development. It reduces the lead time needed to design and build new turbines and provides them access to an established component supply chain and supplier network.

12A-6 Development Plan

12A-6a Development Strategy

HWP has moved aggressively through the design and development of our hydraulic drivetrain system and its associated technologies. The company has begun to establish industry partnerships with one wind farm development company and one large energy company. The company has also developed contacts with several other companies and organizations in wind energy. We have identified four key phases for the development of

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the system and some alternative development options. These phases are as follows:

- Small-scale model and simulation
- Medium-scale simulation; large-scale simulation
- Full-scale build
- Medium build (alternative option)

Small-Scale Model and Simulation (Completed)

The initial phase of development included the development of a mathematical model, a computer simulation, and a small-scale prototype of the system. The simultaneous development of these three different approaches has ensured the accuracy of the results and created a strong and reliable foundation for scaling up the system to a commercial size.

The result of this phase was the successful implementation of model-based control strategies for hydraulic wind energy harvesting systems that maintain a constant frequency at the generator. An energy transmission system for a wind turbine was mathematically modeled with one fixed-displacement pump and two hydraulic motors. The obtained mathematical model was compared to the designed computer model using the SimHydraulic toolbox in MATLAB/Simulink and the experimental results obtained from the small-scale prototype of the hydraulic system. The result was that the experimental data from the small-scale prototype were equivalent to the simulated models, and it illustrated that the gearless hydraulic power transfer system is an efficient and effective means of transferring energy.

Medium-Scale Simulation (in Progress)

The company is currently in the process of scaling up the system into to a medium-size three-tower system (approximately 100 kW per tower). Scaling the system to a medium-size system prior to a full-scale system is critical to ensuring that the results of the small-scale designs are accurately translated into the system. This medium-size system can also be used as the basis for a fast and cost-effective development project with an industry partner to demonstrate the viability of the technology. The goals of this phase are to accurately determine the effects of tower height on the system and the effect of distance of the system to determine more accurate component specifications and to further refine the COE calculations.

Errol Dogar, HWP's adviser and cofounder of American Tool and Machining, Inc., currently has an underutilized 4,000-square-foot facility on a one-acre lot in northwest Indianapolis that includes all necessary machine tools and three-phase 480-volt power. With minor modifications, this building and lot is expected to be the base of operation for the prototype. This facility is fully capable of housing all needed equipment and personnel as well as being able to do any needed machining, welding, assembly, and testing to successfully complete the medium-scale prototype phase of development. HWP's access to this facility is expected to reduce the cost of the medium-scale prototype by roughly 60 percent.

The results of this actual-size prototype will demonstrate the superior cost and maintenance aspects of our hydraulic system. In addition, it will also provide valuable information in identifying problem areas and ways to improve the system. Once the concept is proven at realistic power levels, it will open up new sources of future funding as well as internal funding through retrofit sales and installations of medium-size turbines.

Large-Scale Simulations

After the development of the medium-size system, the company will continue to scale up the system into a full-size system (1.5 MW per tower). This phase will include identifying new components, determining key technical and performance metrics, updating the COE analysis, identifying and quantifying expected improvements by area compared to existing technologies, updating the schedule and cost estimates, and completing a manufacturing cost analysis on new components. This phase will also include the exact designs for two-tower system that will be used for a full-scale build.

Full-Scale Build

HWP has identified two potential avenues for building a full-scale prototype based on the large-scale simulations and the medium prototype results. The company plans to develop a partnership with an industry partner that would allow the company to retrofit two larger towers with our system. The preconstruction needs for this initial system are projected to take about four months. The construction itself is expected to take an additional six months. During this period, HWP is expected to optimize the product and address any unanticipated challenges that may arise. HWP will then use the next six months to test the system under different wind conditions and use the data collected to complete our design of HWP's commercial six-tower integrated system.

12A-7 Commercialization Plan

12A-7a Business Model

HWP is positioning itself to be the industry expert on hydraulic drivetrain systems for land-based wind farm applications. The company plans to emerge as an engineering design firm that will eventually expand on its core competency of designing hydraulic systems for wind turbines to also include construction, operations and maintenance, and supply chain expertise and assistance

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for the systems we design. This will allow customers to quickly and seamlessly integrate our system into their products or development projects.

The company plans to commercialize our technology by securing licensing agreements for the use of our system. In exchange for an up-front licensing fee and a fixed royalty rate determined by gross sales on a per-tower basis, HWP will provide manufacturers a complete product package. This package will include the right to build and sell turbines using our HTS and closed-loop control system, component drawings and specifications, a bill of materials (parts list), supply chain development assistance, assembly and testing documentation, transportation and logistics documentation, field installation and commissioning procedures, operation and maintenance manuals, engineering consulting services, and a training program for manufacturing and service.

Customers will benefit by acquiring a license to an existing and proven technology. This allows licensees to avoid the delays, risks, and costs inherent with in-house development. HWP allows manufacturers to incorporate an innovative technology into their turbines, break even faster, and make larger profits more quickly. It reduces the lead time needed to design and build new turbines, and it will provide them access to an established component supply chain and supplier network. Licensees will also have access to professional high-quality training and support from the development stage to full-scale implementation of the system.

As the premier experts on understanding and developing hydraulic drivetrains and related components (as opposed to expanding into blades or tower designs), the company expects to eventually expand our potential revenue streams (as our solution becomes more widely adopted) to also include operation and maintenance services and additional consulting services.

12A-7b Entry Strategy

The company plans to pursue multiple strategies for marketing the company and bringing our technology to the market. These include establishing industry partnerships and building a number of relationships in the industry. Once the technology development phase nears completion, the company plans to leverage these relationships to establish a pilot program with either a turbine manufacturer or a wind farm developer. This pilot program is expected to involve the implementation of our system into a smaller wind farm development project or as a smaller part of a larger project. This initial project will help establish the acceptance of the technology within the market while minimizing the risk to the company's partners.

12A-7c Target Customers

HWP anticipates three different types of potential customers: current wind turbine manufacturers, wind farm developers, and hydraulic component manufacturers. The company will initially target current turbine manufacturers for its first licensees. Licensing directly to wind turbine manufacturers increases the company's influence in the value chain and its ability to enter the market quickly. These manufacturers have an expertise in wind turbine manufacturing and have already existing relationships with wind farm developers.

Alternatively, HWP will also seek to secure licensing agreements with wind farm developers and hydraulic component manufacturers. Wind farm development projects have high initial capital requirements, and this has pushed wind farm developers to become increasingly vertically integrated in order to reduce these costs. Wind farm developers who manufacture their own turbines are also likely candidates to license our designs.

Our solution also represents a great opportunity for hydraulic component manufacturers to enter a new high-growth market. There are currently dozens of major hydraulics companies (including Caterpillar, Flowserve, Sulzer, and Eaton) that would possibly be interested in licensing HWP's technology. While the system is proprietary, the components that it uses are well known by these companies. Licensing our system to these manufacturers allows them access to a new market without their needing to look beyond their existing core competencies.

12A-7d Exit Strategy

The wind energy industry is characterized by a large number of strategic acquisitions. In 2010, there were 35 deals within North America, totaling $3.98 billion. Larger manufacturers have been quick to acquire smaller companies with improved technologies. For example, GE recently purchased Wind Tower Systems LLC to gain access to a technology for building tall towers more cheaply. HWP believes our alternative drivetrain system will make HWP a strong acquisition target for a larger manufacturer because of our technology's strong value proposition and ability to diversify a larger company's product portfolio.

12A-8 Executive Team

12A-8a Start-Up Management

Interim Chief Executive Officer (CEO) Adam Johnson (MBA) recently completed his MBA in entrepreneurship at the Indiana University Kelley School of Business. He has experience in the renewable energy sector working for a start-up, Microbial Energy Systems, and a background in finance, including working at Smith Barney Financial.

Chief Operating Officer (COO) Justin Otani (JD/MBA) is currently completing his JD in business law and intellectual property at the Indiana University Maurer School of Law and his MBA in entrepreneurship and corporate finance at the Indiana University Kelley

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School of Business. He has experience working in the technology transfer office at Indiana University.

Director of Research and Development Dr. Afshin Izadian is the inventor of HWP's technology and is providing technical advice and development assistance to HWP. Dr. Izadian is an electrical engineering professor at Indiana University–Purdue University Indianapolis (IUPUI). He is also a research member at the Energy Center, Discovery Park–Purdue University, and a research faculty member at the Richard Lugar Center for Renewable Energy.

12A-8b Advisory Board

The Advisory Board has a strong background in entrepreneurship, intellectual property, and bringing new technologies to the market. The board provides assistance with our business plan and investor presentation, legal services, and general guidance on business development. The Advisory Board currently includes Dr. Donald F. Kuratko ("Dr. K"), Professor Mark Need, and Mr. Matt Rubin. "Dr. K" is the executive director of the Johnson Center for Entrepreneurship and Innovation at Indiana University. Mark Need is the director of the Elmore Entrepreneurship Law Clinic at Indiana University. Matt Rubin is a business development manager for the Indiana University Research and Technology Corporation.

12A-9 Risks

12A-9a Industry Risk

The renewable energy PTC, a credit of 2.1 cents per kilowatt-hour, is the primary federal incentive for wind energy and has been essential to the industry's growth. The wind energy industry faces two troubles regarding the PTC. First, the credit is continually extended for only one- and two-year terms, discouraging companies from making long-term, sizable investments in wind power manufacturing and development. Second, in the current adverse financial climate, where demand for tax credits is limited, the PTC is providing little incentive to spur wind energy development.

Our system has the potential to make wind energy cost competitive without these government subsidies. This serves as a strong competitive advantage for our system. However, there is a risk that these PTCs may not be renewed prior to development and acceptance of HWP's system. If this occurs, it could result in a substantial decrease in demand for wind projects or investment in wind energy technologies, which could significantly slow the company's entry into the market. This risk is also mitigated because the wind turbine market is a global market, and even if this event occurs, the company will still be capable of commercializing our technology elsewhere.

12A-9b Alternative Technology Risks

Major turbine manufacturers have been working hard to make gearboxes more reliable. HWP recognizes the possibility that these companies may develop a more competitive solution to the gearbox problem. HWP feels that this risk is currently minimal considering the time and effort these companies have already incurred trying to improve current gearboxes. HWP strongly believes that our technology will be successful even if the lifetime of gearboxes is dramatically extended because of the decreases in initial capital costs, the decreases in turbine weight, and the decreases in costs of repairs when repairs are necessary.

12A-9c Hydraulic Fluid

Environmental concerns surrounding the use of hydraulic fluid is an area of potential concern. The company has already identified several environmentally friendly hydraulic fluids available in the market. Once the full-scale system is designed and analyzed, the optimal properties of a potential hydraulic fluid will be better known (viscosity, static pressure, vapor pressure, density, and so on). We anticipate that there will be an existing environmentally friendly fluid with these ideal properties. However, if there is not a fluid with the exact properties that would optimize the efficiency of the energy transferred, then it may require additional research into the development of fluid with the desired chemical properties.

12A-10 Financial Summary

12A-10a Financials

The financial proformas presented here are projections based in part on Windtec's success using a similar licensing model. HWP is confident in our ability to hit these revenue numbers when considering the advantages of the company's system over Windtec's gearbox-based systems. The company expects to sign their first licensing agreement within two years but possibly earlier. HWP's goal is to close a Series A round of $1.8 million to fund technology development and prepare the company to build a full-scale prototype.

The funding will also allow the company to hire key personnel. After receiving the Series A round of funding, the company hopes to hire a chief technology officer (CTO) and a chief executive officer (CEO). The CTO will lead the charge in the development of our engineering team, and the CEO will be responsible for overseeing the management of the business and securing additional capital.

HWP believes that bringing the technology development "in house" will be critical to the company's success. The company also anticipates needing to hire a senior electrical engineer and a senior control systems engineer in the first year. HWP also expects to hire a mechanical engineer and an electrical engineer in the second year.

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These engineers will be important as the company begins to prepare for the full-scale prototype build.

The company also anticipates closing a Series B round of $4 million to build a full-scale prototype. The financial projections are consistent with HWP's partnering with a wind farm developer to retrofit two existing towers. However, this partnership could take on many different forms that could reduce the cost of this full-scale build significantly. The costs of parts include a contingency fund of $500,000 in year 3 and $250,000 in year 4 in case the company has any complications with the build. In addition to this spare parts contingency fund, the company never drops below $380,000 in cash. The extra cash will make sure the company will be able to survive even if unexpected complications or expenses occur.

HWP will not need to invest heavily in capital expenditures beyond the full-scale prototype because of the company's licensing strategy. This approach allows the company to be a long-term self-sustaining company and will eliminate the need for a third round of funding. The company expects to be cash-flow positive within three years. Most of the expenses beyond the full-scale prototype will be focused on continued research and development as well as expanding and improving the engineering and sales teams.

Income Statement	Year 1	Year 2	Year 3	Year 4	Year 5
Licensing Fees		$ –	$ 500,000	$ 1,000,000	$ 3,000,000
Interest Revenue	$ 26,591	$ 112,886	$ 120,586	$ 91,472	$ 65,095
Royalties			$ 2,250,000	$ 10,500,000	$ 30,000,000
Other Revenue					
Total Revenue	$ 26,591	$ 112,886	$ 2,870,586	$ 11,591,472	$ 33,065,095
Pass-Through Royalties	$ –	$ –	$ 1,125,000	$ 5,250,000	$ 15,000,000
Total Salaries	$ 450,000	$ 796,167	$ 1,061,050	$ 1,495,595	$ 2,724,341
Total IUPUI Expenses	$ 140,394	$ 140,394			
Outside Contractors	$ 100,000	$ 115,000	$ 132,250	$ 152,088	$ 174,901
Total Supplies for Initial Build		$ 1,310,122	$ 1,560,122	$ 375,000	$ 125,000
Construction Expenses for Initial Build		$ 500,000	$ 500,000		
Operating Expenses					
Total Operating Costs	$ 214,100	$ 161,385	$ 202,698	$ 300,805	$ 378,512
Total Costs	$ 904,494	$ 3,023,067	$ 4,581,119	$ 7,573,487	$ 18,402,753
EBT	$ (877,903)	$ (2,910,181)	$ (1,710,533)	$ 4,017,984	$ 14,662,342
Taxes (35%)	$ –	$ –	$ –	$ (1,406,295)	$ (5,131,820)
Net Income	**$ (877,903)**	**$ (2,910,181)**	**$ (1,710,533)**	**$ 2,611,690**	**$ 9,530,522**

***Please refer to exhibits for more detailed financial information.**

12A-10b Exit

While our licensing model positions HWP to be a self-sustaining company, there is a strong likelihood the company will be acquired by a wind turbine manufacturer, hydraulic pump manufacturer, or wind farm developer. Therefore, based on an exit through acquisition in year 5, the company has a projected value of $162.8 million. This is based on a current industry standard of 11 times earnings before interest, taxes, depreciation, and amortization. Major companies have been quick to acquire smaller companies. This is evidenced by Mitsubishi Heavy Industries' (MHI) acquisition of Artemis IP and American.

Balance Sheet	Year 1	Year 2	Year 3	Year 4	Year 5
Assets					
Current Assets					
Cash	$ 943,075	$ 2,131,570	$ 386,284	$ 4,861,830	$ 19,851,153
Accounts Receivable		$ –	$ –	$ –	$ –
Total Assets	$ 943,075	$ 2,131,570	$ 386,284	$ 4,861,830	$ 19,851,153

(*Continued*)

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Balance Sheet	**Year 1**	**Year 2**	**Year 3**	**Year 4**	**Year 5**
Liabilities					
Current Liabilities					
Accounts Payable	$ 20,978	$ 119,653	$ 84,900	$ 242,462	$ 569,444
Total Liabilities	$ 20,978	$ 119,653	$ 84,900	$ 242,462	$ 569,444
Equity					
Capital Stock	$ 1,800,000	$ 5,800,000	$ 5,800,000	$ 5,800,000	$ 5,800,000
Retained Earnings	$ (877,903)	$ (3,788,083)	$ (5,498,616)	$ (1,480,632)	$ 13,181,710
Total Equity	$ 922,097	$ 2,011,917	$ 301,384	$ 4,319,368	$ 18,981,710
Total Liabilities and Equity	$ 943,075	$ 2,131,570	$ 386,284	$ 4,561,830	$ 19,551,153

Cash-Flow Statement	**Year 1**	**Year 2**	**Year 3**	**Year 4**	**Year 5**
Net Income (Loss)	$ (877,903)	$ (2,910,181)	$ (1,710,533)	$ 4,017,984	$ 14,662,342
Working Capital Changes					
Accounts Receivable (Increase)	$ –	$ –	$ –	$ 300,000	$ –
Accounts Payable (Increase)	$ 20,978	$ 98,676	($ 34,753)	$ 157,562	$ 326,982
Cash Used for Operations	$ (856,925)	$ (2,811,505)	$ (1,745,286)	$ 4,475,547	$ 14,989,323
Cash Used for Investments					
Cash from Financing Activities					
Capital Stock					
Change in Cash for Period	$ (856,925)	$ (2,811,505)	$ (1,745,286)	$ 4,475,547	$ 14,989,323
Cash: Beginning of Period	$ 1,800,000	$ 943,075	$ 2,131,570	$ 386,284	$ 4,861,830
Cash: End of Period	$ 943,075	$ 2,131,570	$ 386,284	$ 4,861,830	$ 19,851,153

*Please refer to exhibits for more detailed financial information.

Series A Expected Financial Return					
Year 5 EBITA	14.8 (millions)				
Multiple	11				
Terminal Value	$ 162.8				
Series B	TV	IRR	Periods	DTV	
PV	$ 163	0.94	3.5	$ 16.15	
Investment	$ 4			25%	Series B Final Ownership
Retention Ratio	75%				
Series A	TV	IRR	Periods	DTV	
PV	$ 163	0.94	5	$ 6.00	
Investment	$ 1.8			30%	Series A Final Ownership
				40%	Series A Current Ownership

(*Continued*)

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Series A Expected Financial Return

Ownership	Post A	Post B	Series A Valuation			
Founders	45%	28%	Premoney	$	2.72	Series A
ICP	5%	10%	Series A	$	1.80	Cash-on-cash Return
Option Pool	10%	8%	Postmoney	$	4.52	27
Series A	40%	30%				Exit Return
Series B		25%				$48.83
Total	100%	100%				

For the superconductor (AMSC) acquisition of Windtec, details of the Artemis IP deal were not disclosed, but MHI committed over $160 million in a larger deal that included the acquisition. In the Windtec deal, AMSC acquired Windtec for $12.4 million in AMSC stock. Windtec also had a tremendous backlog of orders that it could not fill at the time.

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Appendix for Hydraulic Wind Power LLC

Use of Funds

	Growth Rate	Year 1	Year 2	Year 3	Year 4	Year 5
Salary Expense						
Chief Executive Officer	10%	$ 125,000	$ 137,500	$ 151,250	$ 166,375	$ 183,013
Adam Johnson, Chief Financial Officer (CFO)	10%	$ 60,000	$ 80,000	$ 88,000	$ 96,800	$ 106,480
Justin Otani, Chief Operating Officer (COO)	10%	$ 40,000	$ 80,000	$ 88,000	$ 96,800	$ 106,480
Chief Technology Officer	10%	$ 100,000	$ 110,000	$ 121,000	$ 133,100	$ 133,100
Senior Electrical Engineer	10%	$ 75,000	$ 100,000	$ 110,000	$ 121,000	$ 121,000
Senior Control Systems Engineer	10%	$ 50,000	$ 100,000	$ 110,000	$ 121,000	$ 121,000
Junior Mechanical Engineer	10%		$ 50,000	$ 55,000	$ 60,500	$ 66,550
Junior Electrical Engineer	10%		$ 50,000	$ 55,000	$ 60,500	$ 66,550
Sales Manager	10%		$ 23,333	$ 70,000	$ 77,000	$ 84,700
Sales Manager	10%		$ 23,333	$ 70,000	$ 77,000	$ 84,700
Other Salaries	240%		$ 42,000	$ 142,800	$ 485,520	$ 1,650,768
Total Salaries		$ 450,000	$ 796,167	$ 1,061,050	$ 1,167,155	$ 1,283,871
IUPUI						
Principal Investigator		$ 6,590	$ 6,590			
Co–Principal Investigator		$ 4,000	$ 4,000			
Two Postdoctoral Fellows		$ 36,000	$ 36,000			
Two Graduate Research Assistants		$ 14,400	$ 14,400			
IUPUI Salaries		$ 60,990	$ 60,990			
		$ 0	$ 0			
Fringe Benefits/Payroll Benefits		0	0			
Principal Investigator/ Co–Principal Investigator		$ 2,783	$ 2,783			
Two Graduate Research Assistants		$ 2,278	$ 2,278			
Postdoctoral Fellows		$ 15,120	$ 15,120			
Total IUPUI Benefits		$ 20,181	$ 20,181			
		$ 0	$ 0			

(*Continued*)

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Use of Funds (*Continued*)

	Growth Rate	Year 1	Year 2	Year 3	Year 4	Year 5
Graduate Student Fee Remission		$ 11,000	$ 11,000			
		$ 0	$ 0			
Supplies/Materials		0	0			
One Synchronous Motor		0	0			
Computing Systems		0	0			
Replacement Parts		0	0			
Total IUPUI Supplies/Materials		$ 2,500	$ 2,501			
		$ 0	$ 1			
IUPUI Indirect Costs		$ 45,723	$ 45,723			
Total IUPUI		$ 140,394	$ 140,394			
Outside Contractors						
Engineer Consulting	15%	$ 100,000	$ 115,000	$ 132,250	$ 152,088	$ 174,901
Supplies for Initial Build						
Low-Speed Shafts			$ 195,000			
CV Joints			$ 12,000			
Bearings			$ 70,200			
Brake			$ 17,550			
Yaw Drive and Bearing			$ 75,000			
Control/Safety System			$ 204,750			
Mainframe			$ 420,000			
Electrical Connection			$ 274,743			
Large Hydraulic Pump			$ 180,000			
Generator			$ 300,000			
Hydraulic Tank			$ 21,000			
Bypass Valves			$ 60,000			
Electric Control Shutoff Valve			$ 45,000			
Check Valves			$ 30,000			
Pressure Relief Valves			$ 30,000			
Reduced Size Power Converter			$ 90,000			
Flow Control Valve			$ 30,000			

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Use of Funds (*Continued*)

	Growth Rate	Year 1	Year 2	Year 3	Year 4	Year 5
Pressure Booster Pump			$ 24,000			
Piping			$ 36,000			
Secondary Generator			$ 225,000			
Hydraulic Pump			$ 120,000			
Accumulator			$ 60,000			
Spare Parts			$ 100,000	$ 500,000	$ 250,000	
Total Supplies for Initial Build			$ 2,620,243	$ 500,000	$ 250,000	
Construction Costs for Initial Build			$ 1,000,000			
Operating Costs						
Payroll Processing Fees	8%	$ 2,000	$ 3,000	$ 3,000	$ 3,000	$ 3,000
Office Rent	5%		$ 15,000	$ 15,750	$ 15,750	$ 15,750
Fringe Benefits	35%	$ 6,000	$ 12,000	$ 16,200	$ 21,870	$ 29,525
Travel-Related Expenses	15%	$ 30,000	$ 34,500	$ 39,675	$ 45,626	$ 52,470
Trade Shows	15%	$ 4,000	$ 4,600	$ 5,290	$ 6,084	$ 6,996
Brochures and Publications	15%	$ 2,000	$ 2,300	$ 2,645	$ 3,042	$ 3,498
Market Research	15%	$ 5,000	$ 5,750	$ 6,613	$ 7,604	$ 8,745
Postage	15%	$ 500	$ 575	$ 661	$ 760	$ 875
Cell Phones	15%	$ 1,500	$ 1,725	$ 1,984	$ 2,281	$ 2,624
Legal Fees	15%	$ 10,000	$ 11,500	$ 13,225	$ 15,209	$ 17,490
Other Professional Fees	15%	$ 10,000	$ 11,500	$ 13,225	$ 15,209	$ 17,490
Website Development and Upkeep		$ 20,000	$ 1,500	$ 1,500	$ 1,500	$ 1,500
Dues and Subscriptions	15%	$ 900	$ 1,035	$ 1,190	$ 1,369	$ 1,574
Patent Costs		$ 80,000	$ 15,000	$ 30,000	$ 100,000	$ 150,000
Computers and Software (SimHydraulics)	18,200	13,800	20,000	25,000	25,000	
Office Equipment and Supplies	15%	$ 7,000	$ 8,050	$ 9,258	$ 10,646	$ 12,243
Telephone and Utility Expenses	15%	$ 3,000	$ 3,450	$ 3,968	$ 4,563	$ 5,247
Accounting Services	15%	$ 4,000	$ 4,600	$ 5,290	$ 6,084	$ 6,996
Miscellaneous	15%	$ 10,000	$ 11,500	$ 13,225	$ 15,209	$ 17,490
Total Operating Costs		**$ 214,100**	**$ 161,385**	**$ 202,698**	**$ 300,805**	$ **378,512**
Total Cost		**$ 904,494**	**$ 4,833,188**	**$ 1,895,998**	**$ 1,870,047**	**$ 1,837,283**

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Income Statement (Year 1):

Income Statement	1	2	3	4	5	6	7	8	9	10	11	12	Year 1
Licensing Revenue													
Interest Revenue	$ 3,159	$ 2,819	$ 2,698	$ 2,575	$ 2,453	$ 2,330	$ 2,207	$ 1,961	$ 1,784	$ 1,660	$ 1,535	$ 1,410	$ 26,591
Royalties													
Other Revenue													
Total Revenue	$ 3,159	$ 2,819	$ 2,698	$ 2,575	$ 2,453	$ 2,330	$ 2,207	$ 1,961	$ 1,784	$ 1,660	$ 1,535	$ 1,410	$ 26,591
Licensing Expense													
Labor and Related Costs													
Chief Executive Officer	$ 10,417	$10,417	$ 10,417	$ 10,417	$ 10,417	$ 10,417	$ 10,417	$ 10,417	$ 10,417	$ 10,417	$ 10,417	$ 10,417	$ 125,000
Adam Johnson, CFO	$ 5,000	$ 5,000	$ 5,000	$ 5,000	$ 5,000	$ 5,000	$ 5,000	$ 5,000	$ 5,000	$ 5,000	$ 5,000	$ 5,000	$ 60,000
Justin Otani, COO	$ 3,333	$ 3,333	$ 3,333	$ 3,333	$ 3,333	$ 3,333	$ 3,333	$ 3,333	$ 3,333	$ 3,333	$ 3,333	$ 3,333	$ 40,000
Chief Technology Officer	$ 8,333	$ 8,333	$ 8,333	$ 8,333	$ 8,333	$ 8,333	$ 8,333	$ 8,333	$ 8,333	$ 8,333	$ 8,333	$ 8,333	$ 100,000
Senior Electrical Engineer	$ 0	$ 0	$ 0	$ 8,333	$ 8,333	$ 8,333	$ 8,333	$ 8,333	$ 8,333	$ 8,333	$ 8,333	$ 8,333	$ 75,000
Senior Control Systems Engineer	$ 0	$ 0	$ 0	$ 0	$ 0	$ 0	$ 8,333	$ 8,333	$ 8,333	$ 8,333	$ 8,333	$ 8,333	$ 50,000
Junior Mechanical Engineer	$ 0	$ 0	$ 0	$ 0	$ 0	$ 0	$ 0	$ 0	$ 0	$ 0	$ 0	$ 0	$ –
Junior Electrical Engineer	$ 0	$ 0	$ 0	$ 0	$ 0	$ 0	$ 0	$ 0	$ 0	$ 0	$ 0	$ 0	$ –
Sales Manager	$ 0	$ 0	$ 0	$ 0	$ 0	$ 0	$ 0	$ 0	$ 0	$ 0	$ 0	$ 0	$ –
Sales Manager	$ 0	$ 0	$ 0	$ 0	$ 0	$ 0	$ 0	$ 0	$ 0	$ 0	$ 0	$ 0	$ –
Other Salaries	0	0	0	0	0	0	0	0	0	0	0	0	$ –
Total Salaries	$ 27,083	$27,083	$ 27,083	$ 35,417	$ 35,417	$ 35,417	$ 43,750	$ 43,750	$ 43,750	$ 43,750	$ 43,750	$ 43,750	$ 450,000
Total IUPUI Expenses	$ 140,394												
Outside Contractors	$ 8,333	$ 8,333	$ 8,333	$ 8,333	$ 8,333	$ 8,333	$ 8,333	$ 8,333	$ 8,333	$ 8,333	$ 8,333	$ 8,333	$ 100,000
Total Supplies for Initial Build													
Construction Costs for Initial Build													

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Income Statement (Year 1): (*Continued*)

Income Statement	1	2	3	4	5	6	7	8	9	10	11	12	Year 1
Operating Expenses													
Payroll Processing Fees	$ 167	$ 167	$ 167	$ 167	$ 167	$ 167	$ 167	$ 167	$ 167	$ 167	$ 167	$ 167	$ 2,000
Office Rent	$ –	$ –	$ –	$ –	$ –	$ –	$ –	$ –	$ –	$ –	$ –	$ –	$ –
Fringe Benefits	$ 500	$ 500	$ 500	$ 500	$ 500	$ 500	$ 500	$ 500	$ 500	$ 500	$ 500	$ 500	$ 6,000
Travel-Related Expenses	$ 2,500	$ 2,500	$ 2,500	$ 2,500	$ 2,500	$ 2,500	$ 2,500	$ 2,500	$ 2,500	$ 2,500	$ 2,500	$ 2,500	$ 30,000
Trade Shows	$ 333	$ 333	$ 333	$ 333	$ 333	$ 333	$ 333	$ 333	$ 333	$ 333	$ 333	$ 333	$ 4,000
Brochures and Publications	$ 167	$ 167	$ 167	$ 167	$ 167	$ 167	$ 167	$ 167	$ 167	$ 167	$ 167	$ 167	$ 2,000
Market Research	$ 417	$ 417	$ 417	$ 417	$ 417	$ 417	$ 417	$ 417	$ 417	$ 417	$ 417	$ 417	$ 5,000
Postage	$ 42	$ 42	$ 42	$ 42	$ 42	$ 42	$ 42	$ 42	$ 42	$ 42	$ 42	$ 42	$ 500
Cell Phones	$ 125	$ 125	$ 125	$ 125	$ 125	$ 125	$ 125	$ 125	$ 125	$ 125	$ 125	$ 125	$ 1,500
Legal Fees	$ 833	$ 833	$ 833	$ 833	$ 833	$ 833	$ 833	$ 833	$ 833	$ 833	$ 833	$ 833	$ 10,000
Other Professional Fees	$ 833	$ 833	$ 833	$ 833	$ 833	$ 833	$ 833	$ 833	$ 833	$ 833	$ 833	$ 833	$ 10,000
Website Development	$ 1,667	$ 1,667	$ 1,667	$ 1,667	$ 1,667	$ 1,667	$ 1,667	$ 1,667	$ 1,667	$ 1,667	$ 1,667	$ 1,667	$ 20,000
Dues and Subscriptions	$ 75	$ 75	$ 75	$ 75	$ 75	$ 75	$ 75	$ 75	$ 75	$ 75	$ 75	$ 75	$ 900
Patent Costs	$ 6,667	$ 6,667	$ 6,667	$ 6,667	$ 6,667	$ 6,667	$ 6,667	$ 6,667	$ 6,667	$ 6,667	$ 6,667	$ 6,667	$ 80,000
Computers and Software (SimHydraulics)	$ 1,517	$ 1,517	$ 1,517	$ 1,517	$ 1,517	$ 1,517	$ 1,517	$ 1,517	$ 1,517	$ 1,517	$ 1,517	$ 1,517	$ 18,200
Office Equipment and Supplies	$ 583	$ 583	$ 583	$ 583	$ 583	$ 583	$ 583	$ 583	$ 583	$ 583	$ 583	$ 583	$ 7,000
Telephone and Utility Expenses	$ 250	$ 250	$ 250	$ 250	$ 250	$ 250	$ 250	$ 250	$ 250	$ 250	$ 250	$ 250	$ 3,000
Accounting Services	$ 333	$ 333	$ 333	$ 333	$ 333	$ 333	$ 333	$ 333	$ 333	$ 333	$ 333	$ 333	$ 4,000
Miscellaneous	$ 833	$ 833	$ 833	$ 833	$ 833	$ 833	$ 833	$ 833	$ 833	$ 833	$ 833	$ 833	$ 10,000
Total Operating Costs	$ 17,842	$17,842	$ 17,842	$ 17,842	$ 17,842	$ 17,842	$ 17,842	$ 17,842	$ 17,842	$ 17,842	$ 17,842	$ 17,842	$ 214,100
Total Costs	$ 193,652	$	$ 53,258	$ 61,592	$ 61,592	$ 61,592	$ 69,925	$ 69,925	$ 69,925	$ 69,925	$ 69,925	$ 69,925	$ 904,494
Net Income (EBT)	$ (190,493)	$	$ (50,561)	$ (59,016)	$ (59,139)	$ (59,261)	$ (67,718)	$ (67,964)	$ (68,141)	$ (68,265)	$ (68,390)	$ (68,515)	$ (877,903)

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Balance Sheet (Year 1):

Balance Sheet	1	2	3	4	5	6	7	8	9	10	11	12	Year 1
Assets													
Current Assets													
Cash	$ 1,667,603	$ 1,575,046	$ 1,524,485	$ 1,467,969	$ 1,408,830	$ 1,349,569	$ 1,284,351	$ 1,216,387	$ 1,148,246	$ 1,079,980	$ 1,011,590	$ 943,075	$ 943,075
Accounts Receivable													
Total Assets	$ 1,667,603	$ 1,575,046	$ 1,524,485	$ 1,467,969	$ 1,408,830	$ 1,349,569	$ 1,284,351	$ 1,216,387	$ 1,148,246	$ 1,079,980	$ 1,011,590	$ 943,075	$ 943,075
Liabilities													
Current Liabilities													
Accounts Payable	$ 58,096	$ 15,978	$ 15,978	$ 18,478	$ 18,478	$ 18,478	$ 20,978	$ 20,978	$ 20,978	$ 20,978	$ 20,978	$ 20,978	$ 20,978
Total Liabilities	$ 58,096	$ 15,978	$ 15,978	$ 18,478	$ 18,478	$ 18,478	$ 20,978	$ 20,978	$ 20,978	$ 20,978	$ 20,978	$ 20,978	$ 20,978
Equity													
Capital Stock	$ 1,800,000	$ 1,800,000	$ 1,800,000	$ 1,800,000	$ 1,800,000	$ 1,800,000	$ 1,800,000	$ 1,800,000	$ 1,800,000	$ 1,800,000	$ 1,800,000	$ 1,800,000	$ 1,800,000
Retained Earnings	$ (190,493)	$ (240,932)	$ (291,492)	$ (350,509)	$ (409,647)	$ (468,909)	$ (536,627)	$ (604,591)	$ (672,732)	$ (740,997)	$ (809,387)	$ (877,903)	$ (877,903)
Total Equity	$ 1,609,507	$ 1,559,068	$ 1,508,508	$ 1,449,491	$ 1,390,353	$ 1,331,091	$ 1,263,373	$ 1,195,409	$ 1,127,268	$ 1,059,003	$ 990,613	$ 922,097	$ 922,097
Total Liabilities and Equity	$ 1,667,603	$ 1,575,046	$ 1,524,485	$ 1,467,969	$ 1,408,830	$ 1,349,569	$ 1,284,351	$ 1,216,387	$ 1,148,246	$ 1,079,980	$ 1,011,590	$ 943,075	$ 943,075

Cash Flow (Year 1):

Cash-Flow Statement	1	2	3	4	5	6	7	8	9	10	11	12	Year 1
Net Income (Loss)	$ (190,493)	$ (50,439)	$ (50,561)	$ (59,016)	$ (59,139)	$ (59,261)	$ (67,718)	$ (67,964)	$ (68,141)	$ (68,265)	$ (68,390)	$ (68,515)	$ (877,903)
Working Capital Changes													
Accounts Receivable (Increase)	$ –	$ –	$ –	$ –	$ –	$ –	$ –	$ –	$ –	$ –	$ –	$ –	$ –
Accounts Payable (Increase)	$ 58,096	$ (42,118)	$ 0	$ 2,500	$ 0	$ 0	$ 2,500	$ 0	$ 0	$ 0	$ 0	$ 0	$ 20,978
Cash Used for Operations	$ (132,397)	$ (92,557)	$ (50,561)	$ (56,516)	$ (59,139)	$ (59,261)	$ (65,218)	$ (67,964)	$ (68,141)	$ (68,265)	$ (68,390)	$ (68,515)	$ (856,925)
Cash Used for Investments													
Cash from Financing Activities													
Capital Stock	$ 1,800,000												
Change in Cash for Period	$ 1,667,603	$ (92,557)	$ (50,561)	$ (56,516)	$ (59,139)	$ (59,261)	$ (65,218)	$ (67,964)	$ (68,141)	$ (68,265)	$ (68,390)	$ (68,515)	$ (856,925)
Cash: Beginning of Period	$ 1,800,000	$ 1,667,603	$ 1,575,046	$ 1,524,485	$ 1,467,969	$ 1,408,830	$ 1,349,569	$ 1,284,351	$ 1,216,387	$ 1,148,246	$ 1,079,980	$ 1,011,590	$ 1,800,000
Cash: End of Period	$ 1,667,603	$ 1,575,046	$ 1,524,485	$ 1,467,969	$ 1,408,830	$ 1,349,569	$ 1,284,351	$ 1,216,387	$ 1,148,246	$ 1,079,980	$ 1,011,590	$ 943,075	$ 943,075

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Income Statement (Year 2):

Income Statement	13	14	15	16	17	18	19	20	21	22	23	24	Year 2
Licensing Revenue													$ –
Interest Revenue	$ 1,210	$ 978	$ 745	$ 13,030	$ 12,815	$ 12,599	$ 12,400	$ 12,208	$ 12,016	$ 11,822	$ 11,629	$ 11,434	$ 112,886
Royalties													
Other Revenue													
Total Revenue	$ 1,210	$ 978	$ 745	$ 13,030	$ 12,815	$ 12,599	$ 12,400	$ 12,208	$ 12,016	$ 11,822	$ 11,629	$ 11,434	$ 112,886
Licensing Expense													
Labor and Related Costs													
Chief Executive Officer	$ 11,458	$ 11,458	$ 11,458	$ 11,458	$ 11,458	$ 11,458	$ 11,458	$ 11,458	$ 11,458	$ 11,458	$ 11,458	$ 11,458	$ 137,500
Adam Johnson, CFO	$ 6,667	$ 6,667	$ 6,667	$ 6,667	$ 6,667	$ 6,667	$ 6,667	$ 6,667	$ 6,667	$ 6,667	$ 6,667	$ 6,667	$ 80,000
Justin Otani, COO	$ 6,667	$ 6,667	$ 6,667	$ 6,667	$ 6,667	$ 6,667	$ 6,667	$ 6,667	$ 6,667	$ 6,667	$ 6,667	$ 6,667	$ 80,000
Chief Technology Officer	$ 9,167	$ 9,167	$ 9,167	$ 9,167	$ 9,167	$ 9,167	$ 9,167	$ 9,167	$ 9,167	$ 9,167	$ 9,167	$ 9,167	$ 110,000
Senior Electrical Engineer	$ 8,333	$ 8,333	$ 8,333	$ 8,333	$ 8,333	$ 8,333	$ 8,333	$ 8,333	$ 8,333	$ 8,333	$ 8,333	$ 8,333	$ 100,000
Senior Control Systems Engineer	$ 8,333	$ 8,333	$ 8,333	$ 8,333	$ 8,333	$ 8,333	$ 8,333	$ 8,333	$ 8,333	$ 8,333	$ 8,333	$ 8,333	$ 100,000
Junior Mechanical Engineer	$ 4,167	$ 4,167	$ 4,167	$ 4,167	$ 4,167	$ 4,167	$ 4,167	$ 4,167	$ 4,167	$ 4,167	$ 4,167	$ 4,167	$ 50,000
Junior Electrical Engineer	$ 4,167	$ 4,167	$ 4,167	$ 4,167	$ 4,167	$ 4,167	$ 4,167	$ 4,167	$ 4,167	$ 4,167	$ 4,167	$ 4,167	$ 50,000
Sales Manager	$ 0	$ 0	$ 0	$ 0	$ 0	$ 0	$ 0	$ 0	$ 5,833	$ 5,833	$ 5,833	$ 5,833	$ 23,333
Sales Manager	$ 0	$ 0	$ 0	$ 0	$ 0	$ 0	$ 0	$ 0	$ 5,833	$ 5,833	$ 5,833	$ 5,833	$ 23,333
Other Salaries	$ 3,500	$ 3,500	$ 3,500	$ 3,500	$ 3,500	$ 3,500	$ 3,500	$ 3,500	$ 3,500	$ 3,500	$ 3,500	$ 3,500	$ 42,000
Total Salaries	$ 62,458	$ 62,458	$ 62,458	$ 62,458	$ 62,458	$ 62,458	$ 62,458	$ 62,458	$ 74,125	$ 74,125	$ 74,125	$ 74,125	$ 796,167
Total IUPUI Expenses	$ 140,394												$ 140,394
Outside Contractors	$ 9,583	$ 9,583	$ 9,583	$ 9,583	$ 9,583	$ 9,583	$ 9,583	$ 9,583	$ 9,583	$ 9,583	$ 9,583	$ 9,583	$ 115,000
Total Supplies for Initial Build							$ 218,354	$ 218,354	$ 218,354	$ 218,354	$ 218,354	$ 218,354	$ 1,310,122
Construction Costs for Initial Build							$ 83,333	$ 83,333	$ 83,333	$ 83,333	$ 83,333	$ 83,333	$ 500,000

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Income Statement (Year 2): (*Continued*)

Income Statement	13	14	15	16	17	18	19	20	21	22	23	24	Year 2
Operating Expenses													
Payroll Processing Fees	$ 250	$ 250	$ 250	$ 250	$ 250	$ 250	$ 250	$ 250	$ 250	$ 250	$ 250	$ 250	$ 3,000
Office Rent	$ 1,250	$ 1,250	$ 1,250	$ 1,250	$ 1,250	$ 1,250	$ 1,250	$ 1,250	$ 1,250	$ 1,250	$ 1,250	$ 1,250	$ 15,000
Fringe Benefits	$ 1,000	$ 1,000	$ 1,000	$ 1,000	$ 1,000	$ 1,000	$ 1,000	$ 1,000	$ 1,000	$ 1,000	$ 1,000	$ 1,000	$ 12,000
Travel-Related Expenses	$ 2,875	$ 2,875	$ 2,875	$ 2,875	$ 2,875	$ 2,875	$ 2,875	$ 2,875	$ 2,875	$ 2,875	$ 2,875	$ 2,875	$ 34,500
Trade Shows	$ 383	$ 383	$ 383	$ 383	$ 383	$ 383	$ 383	$ 383	$ 383	$ 383	$ 383	$ 383	$ 4,600
Brochures and Publications	$ 192	$ 192	$ 192	$ 192	$ 192	$ 192	$ 192	$ 192	$ 192	$ 192	$ 192	$ 192	$ 2,300
Market Research	$ 479	$ 479	$ 479	$ 479	$ 479	$ 479	$ 479	$ 479	$ 479	$ 479	$ 479	$ 479	$ 5,750
Postage	$ 48	$ 48	$ 48	$ 48	$ 48	$ 48	$ 48	$ 48	$ 48	$ 48	$ 48	$ 48	$ 575
Cell Phones	$ 144	$ 144	$ 144	$ 144	$ 144	$ 144	$ 144	$ 144	$ 144	$ 144	$ 144	$ 144	$ 1,725
Legal Fees	$ 958	$ 958	$ 958	$ 958	$ 958	$ 958	$ 958	$ 958	$ 958	$ 958	$ 958	$ 958	$ 11,500
Other Professional Fees	$ 958	$ 958	$ 958	$ 958	$ 958	$ 958	$ 958	$ 958	$ 958	$ 958	$ 958	$ 958	$ 11,500
Website Development	$ 125	$ 125	$ 125	$ 125	$ 125	$ 125	$ 125	$ 125	$ 125	$ 125	$ 125	$ 125	$ 1,500
Dues and Subscriptions	$ 86	$ 86	$ 86	$ 86	$ 86	$ 86	$ 86	$ 86	$ 86	$ 86	$ 86	$ 86	$ 1,035
Patent Costs	$ 1,250	$ 1,250	$ 1,250	$ 1,250	$ 1,250	$ 1,250	$ 1,250	$ 1,250	$ 1,250	$ 1,250	$ 1,250	$ 1,250	$ 15,000
Computers and Software (SimHydraulics)	$ 1,150	$ 1,150	$ 1,150	$ 1,150	$ 1,150	$ 1,150	$ 1,150	$ 1,150	$ 1,150	$ 1,150	$ 1,150	$ 1,150	$ 13,800
Office Equipment and Supplies	$ 671	$ 671	$ 671	$ 671	$ 671	$ 671	$ 671	$ 671	$ 671	$ 671	$ 671	$ 671	$ 8,050
Telephone and Utility Expenses	$ 288	$ 288	$ 288	$ 288	$ 288	$ 288	$ 288	$ 288	$ 288	$ 288	$ 288	$ 288	$ 3,450
Accounting Services	$ 383	$ 383	$ 383	$ 383	$ 383	$ 383	$ 383	$ 383	$ 383	$ 383	$ 383	$ 383	$ 4,600
Miscellaneous	$ 958	$ 958	$ 958	$ 958	$ 958	$ 958	$ 958	$ 958	$ 958	$ 958	$ 958	$ 958	$ 11,500
Total Operating Costs	$ 13,449	$ 13,449	$ 13,449	$ 13,449	$ 13,449	$ 13,449	$ 13,449	$ 13,449	$ 13,449	$ 13,449	$ 13,449	$ 13,449	$ 161,385
Total Costs	$ 225,884	$ 85,490	$ 85,490	$ 85,490	$ 85,490	$ 85,490	$ 387,177	$ 387,177	$ 398,844	$ 398,844	$ 398,844	$ 398,844	$ 3,023,067
Net Income (EBT)	$ (224,674)	$ (84,513)	$ (84,746)	$ (72,460)	$ (72,675)	$ (72,891)	$ (374,777)	$ (374,969)	$ (386,828)	$ (387,022)	$ (387,215)	$ (387,410)	$ (2,910,181)

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Balance Sheet (Year 2):

Balance Sheet	13	14	15	16	17	18	19	20	21	22	23	24	Year 2
Assets													
Current Assets													
Cash	$ 765,188	$ 638,557	$ 553,812	$ 4,481,351	$ 4,408,676	$ 4,335,785	$ 4,051,514	$ 3,676,545	$ 3,293,216	$ 2,906,195	$ 2,518,979	$ 2,131,570	$ 2,131,570
Accounts Receivable							$ –	$ –	$ –	$ –	$ –	$ –	$ –
Total Assets	$ 765,188	$ 638,557	$ 553,812	$ 4,481,351	$ 4,408,676	$ 4,335,785	$ 4,051,514	$ 3,676,545	$ 3,293,216	$ 2,906,195	$ 2,518,979	$ 2,131,570	$ 2,131,570
Liabilities													
Current Liabilities													
Accounts Payable	$ 67,765	$ 25,647	$ 25,647	$ 25,647	$ 25,647	$ 25,647	$ 116,153	$ 116,153	$ 119,653	$ 119,653	$ 119,653	$ 119,653	$ 119,653
Total Liabilities	$ 67,765	$ 25,647	$ 25,647	$ 25,647	$ 25,647	$ 25,647	$ 116,153	$ 116,153	$ 119,653	$ 119,653	$ 119,653	$ 119,653	$ 119,653
Equity													
Capital Stock	$ 1,800,000	$ 1,800,000	$ 5,800,000	$ 5,800,000	$ 5,800,000	$ 5,800,000	$ 5,800,000	$ 5,800,000	$ 5,800,000	$ 5,800,000	$ 5,800,000	$ 5,800,000	$ 5,800,000
Retained Earnings	$(1,102,577)	$(1,187,090)	$(1,271,835)	$(1,344,296)	$(1,416,971)	$(1,489,862)	$(1,864,640)	$(2,239,609)	$(2,626,437)	$(3,013,459)	$(3,400,674)	$(3,788,083)	$(3,788,083)
Total Equity	$ 697,423	$ 612,910	$ 4,528,165	$ 4,455,704	$ 4,383,029	$ 4,310,138	$ 3,935,360	$ 3,560,391	$ 3,173,563	$ 2,786,541	$ 2,399,326	$ 2,011,917	$ 2,011,917
Total Liabilities and Equity	$ 765,188	$ 638,557	$ 4,553,812	$ 4,481,351	$ 4,408,676	$ 4,335,785	$ 4,051,514	$ 3,676,545	$ 3,293,216	$ 2,906,195	$ 2,518,979	$ 2,131,570	$ 2,131,570

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Cash Flow (Year 2):

Cash-Flow Statement	13	14	15	16	17	18	19	20	21	22	23	24	Year 2
Net Income (Loss)	$(224,674)	$ (84,513)	$(84,746)	$ (72,460)	$ (72,675)	$ (72,891)	$ (374,777)	$ (374,969)	$ (386,828)	$ (387,022)	$ (387,215)	$ (387,410)	$(2,910,181)
Working Capital Changes													
Accounts Receivable (Increase)	$ –	$ –	–	$ –	$ –	$ –	$ –	$ –	$ –	$ –	$ –	$ –	$ –
Accounts Payable (Increase)	$ 46,788	($42,118)	$ 0	$ 0	$ 0	$ 0	$ 90,506	$ 0	$ 3,500	$ 0	$ 0	$ 0	$ 98,676
Cash Used for Operations	$(177,886)	$(126,631)	$(84,746)	$ (72,460)	$ (72,675)	$ (72,891)	$ (284,271)	$ (374,969)	$ (383,328)	$ (387,022)	$ (387,215)	$ (387,410)	$(2,811,505)
Cash Used for Investments													
Cash from Financing Activities													
Capital Stock				$4,000,000									
Change in Cash for Period	$(177,886)	$(126,631)	$(84,746)	$3,927,540	$ (72,675)	$ (72,891)	$ (284,271)	$ (374,969)	$ (383,328)	$ (387,022)	$ (387,215)	$ (387,410)	$(2,811,505)
Cash: Beginning of Period	$ 943,075	$ 765,188	$638,557	$ 553,812	$4,481,351	$4,408,676	$4,335,785	$4,051,514	$3,676,545	$3,293,216	$2,906,195	$2,518,979	$ 943,075
Cash: End of Period	$ 765,188	$ 638,557	$553,812	$4,481,351	$4,408,676	$4,335,785	$4,051,514	$3,676,545	$3,293,216	$2,906,195	$2,518,979	$2,131,570	$ 2,131,570

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Income Statement (Year 3):

Income Statement	25	26	27	28	29	30	31	32	33	34	35	36	Year 3
Licensing Revenue	$ 500,000												$ 500,000
Interest Revenue	$ 11,228	$ 11,016	$ 10,803	$ 10,590	$ 10,375	$ 10,161	$ 9,945	$ 9,729	$ 9,512	$ 9,294	$ 9,076	$ 8,857	$ 120,586
Royalties	$ 125,000	$ 125,000	$ 125,000	$ 125,000	$ 125,000	$ 125,000	$ 250,000	$ 250,000	$ 250,000	$ 250,000	$ 250,000	$ 250,000	$ 2,250,000
Other Revenue													
Total Revenue	$ 636,228	$ 136,016	$ 135,803	$ 135,590	$ 135,375	$ 135,161	$ 259,945	$ 259,729	$ 259,512	$ 259,294	$ 259,076	$ 258,857	$ 2,870,586
Licensing Expense	$ 62,500	$ 62,500	$ 62,500	$ 62,500	$ 62,500	$ 62,500	$ 125,000	$ 125,000	$ 125,000	$ 125,000	$ 125,000	$ 125,000	$ 1,125,000
Labor and Related Costs													
Chief Executive Officer	$ 12,604	$ 12,604	$ 12,604	$ 12,604	$ 12,604	$ 12,604	$ 12,604	$ 12,604	$ 12,604	$ 12,604	$ 12,604	$ 12,604	$ 151,250
Adam Johnson, CFO	$ 7,333	$ 7,333	$ 7,333	$ 7,333	$ 7,333	$ 7,333	$ 7,333	$ 7,333	$ 7,333	$ 7,333	$ 7,333	$ 7,333	$ 88,000
Justin Otani, COO	$ 7,333	$ 7,333	$ 7,333	$ 7,333	$ 7,333	$ 7,333	$ 7,333	$ 7,333	$ 7,333	$ 7,333	$ 7,333	$ 7,333	$ 88,000
Chief Technology Officer	$ 10,083	$ 10,083	$ 10,083	$ 10,083	$ 10,083	$ 10,083	$ 10,083	$ 10,083	$ 10,083	$ 10,083	$ 10,083	$ 10,083	$ 121,000
Senior Electrical Engineer	$ 9,167	$ 9,167	$ 9,167	$ 9,167	$ 9,167	$ 9,167	$ 9,167	$ 9,167	$ 9,167	$ 9,167	$ 9,167	$ 9,167	$ 110,000
Senior Control Systems Engineer	$ 9,167	$ 9,167	$ 9,167	$ 9,167	$ 9,167	$ 9,167	$ 9,167	$ 9,167	$ 9,167	$ 9,167	$ 9,167	$ 9,167	$ 110,000
Junior Mechanical Engineer	$ 4,583	$ 4,583	$ 4,583	$ 4,583	$ 4,583	$ 4,583	$ 4,583	$ 4,583	$ 4,583	$ 4,583	$ 4,583	$ 4,583	$ 55,000
Junior Electrical Engineer	$ 4,583	$ 4,583	$ 4,583	$ 4,583	$ 4,583	$ 4,583	$ 4,583	$ 4,583	$ 4,583	$ 4,583	$ 4,583	$ 4,583	$ 55,000
Sales Manager	$ 5,833	$ 5,833	$ 5,833	$ 5,833	$ 5,833	$ 5,833	$ 5,833	$ 5,833	$ 5,833	$ 5,833	$ 5,833	$ 5,833	$ 70,000
Sales Manager	$ 5,833	$ 5,833	$ 5,833	$ 5,833	$ 5,833	$ 5,833	$ 5,833	$ 5,833	$ 5,833	$ 5,833	$ 5,833	$ 5,833	$ 70,000
Other Salaries	$ 11,900	$ 11,900	$ 11,900	$ 11,900	$ 11,900	$ 11,900	$ 11,900	$ 11,900	$ 11,900	$ 11,900	$ 11,900	$ 11,900	$ 142,800
Total Salaries	$ 88,421	$ 88,421	$ 88,421	$ 88,421	$ 88,421	$ 88,421	$ 88,421	$ 88,421	$ 88,421	$ 88,421	$ 88,421	$ 88,421	$ 1,061,050
Total IUPUI Expenses													
Outside Contractors	$ 11,021	$ 11,021	$ 11,021	$ 11,021	$ 11,021	$ 11,021	$ 11,021	$ 11,021	$ 11,021	$ 11,021	$ 11,021	$ 11,021	$ 132,250
Total Supplies for Initial Build	$ 218,354	$ 218,354	$ 218,354	$ 218,354	$ 218,354	$ 218,354	$ 41,667	$ 41,667	$ 41,667	$ 41,667	$ 41,667	$ 41,667	$ 1,560,124
Construction Costs for Initial Build	$ 83,333	$ 83,333	$ 83,333	$ 83,333	$ 83,333	$ 83,333							$ 500,000

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Income Statement (Year 3): (*Continued*)

Income Statement	25	26	27	28	29	30	31	32	33	34	35	36	Year 3
Operating Expenses													
Payroll Processing Fees	$ 250	$ 250	$ 250	$ 250	$ 250	$ 250	$ 250	$ 250	$ 250	$ 250	$ 250	$ 250	$ 3,000
Office Rent	$ 1,313	$ 1,313	$ 1,313	$ 1,313	$ 1,313	$ 1,313	$ 1,313	$ 1,313	$ 1,313	$ 1,313	$ 1,313	$ 1,313	$ 15,750
Fringe Benefits	$ 1,350	$ 1,350	$ 1,350	$ 1,350	$ 1,350	$ 1,350	$ 1,350	$ 1,350	$ 1,350	$ 1,350	$ 1,350	$ 1,350	$ 16,200
Travel-Related Expenses	$ 3,306	$ 3,306	$ 3,306	$ 3,306	$ 3,306	$ 3,306	$ 3,306	$ 3,306	$ 3,306	$ 3,306	$ 3,306	$ 3,306	$ 39,675
Trade Shows	$ 441	$ 441	$ 441	$ 441	$ 441	$ 441	$ 441	$ 441	$ 441	$ 441	$ 441	$ 441	$ 5,290
Brochures and Publications	$ 220	$ 220	$ 220	$ 220	$ 220	$ 220	$ 220	$ 220	$ 220	$ 220	$ 220	$ 220	$ 2,645
Market Research	$ 551	$ 551	$ 551	$ 551	$ 551	$ 551	$ 551	$ 551	$ 551	$ 551	$ 551	$ 551	$ 6,613
Postage	$ 55	$ 55	$ 55	$ 55	$ 55	$ 55	$ 55	$ 55	$ 55	$ 55	$ 55	$ 55	$ 661
Cell Phones	$ 165	$ 165	$ 165	$ 165	$ 165	$ 165	$ 165	$ 165	$ 165	$ 165	$ 165	$ 165	$ 1,984
Legal Fees	$ 1,102	$ 1,102	$ 1,102	$ 1,102	$ 1,102	$ 1,102	$ 1,102	$ 1,102	$ 1,102	$ 1,102	$ 1,102	$ 1,102	$ 13,225
Other Professional Fees	$ 1,102	$ 1,102	$ 1,102	$ 1,102	$ 1,102	$ 1,102	$ 1,102	$ 1,102	$ 1,102	$ 1,102	$ 1,102	$ 1,102	$ 13,225
Website Development	$ 125	$ 125	$ 125	$ 125	$ 125	$ 125	$ 125	$ 125	$ 125	$ 125	$ 125	$ 125	$ 1,500
Dues and Subscriptions	$ 99	$ 99	$ 99	$ 99	$ 99	$ 99	$ 99	$ 99	$ 99	$ 99	$ 99	$ 99	$ 1,190
Patent Costs	$ 2,500	$ 2,500	$ 2,500	$ 2,500	$ 2,500	$ 2,500	$ 2,500	$ 2,500	$ 2,500	$ 2,500	$ 2,500	$ 2,500	$ 30,000
Computers and Software (SimHydraulics)	$ 1,667	$ 1,667	$ 1,667	$ 1,667	$ 1,667	$ 1,667	$ 1,667	$ 1,667	$ 1,667	$ 1,667	$ 1,667	$ 1,667	$ 20,000
Office Equipment and Supplies	$ 771	$ 771	$ 771	$ 771	$ 771	$ 771	$ 771	$ 771	$ 771	$ 771	$ 771	$ 771	$ 9,258
Telephone and Utility Expenses	$ 331	$ 331	$ 331	$ 331	$ 331	$ 331	$ 331	$ 331	$ 331	$ 331	$ 331	$ 331	$ 3,968
Accounting Services	$ 441	$ 441	$ 441	$ 441	$ 441	$ 441	$ 441	$ 441	$ 441	$ 441	$ 441	$ 441	$ 5,290
Miscellaneous	$ 1,102	$ 1,102	$ 1,102	$ 1,102	$ 1,102	$ 1,102	$ 1,102	$ 1,102	$ 1,102	$ 1,102	$ 1,102	$ 1,102	$ 13,225
Total Operating Costs	$ 16,891	$ 16,891	$ 16,891	$ 16,891	$ 16,891	$ 16,891	$ 16,891	$ 16,891	$ 16,891	$ 16,891	$ 16,891	$ 16,891	$ 202,698
Total Costs	$ 480,520	$ 480,520	$ 480,520	$ 480,520	$ 480,520	$ 480,520	$ 283,000	$ 283,000	$ 283,000	$ 283,000	$ 283,000	$ 283,000	$ 4,581,121
Net Income (EBT)	$ 155,708	$ (344,504)	$ (344,717)	$ (344,930)	$ (345,145)	$ (345,359)	$ (23,055)	$ (23,271)	$ (23,488)	$ (23,706)	$ (23,924)	$ (24,143)	$ (1,710,535)

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Balance Sheet (Year 3):

Balance Sheet	25	26	27	28	29	30	31	32	33	34	35	36	Year 3
Assets													
Current Assets													
Cash	$ 2,461,780	$ 1,967,276	$ 1,622,559	$ 1,277,629	$ 932,484	$ 587,125	$ 504,814	$ 481,543	$ 458,054	$ 434,349	$ 410,425	$ 386,282	$ 386,282
Accounts Receivable	$ 150,000												$ –
Total Assets	$ 2,611,780	$ 1,967,276	$ 1,622,559	$ 1,277,629	$ 932,484	$ 587,125	$ 504,814	$ 481,543	$ 458,054	$ 434,349	$ 410,425	$ 386,282	$ 386,282
Liabilities													
Current Liabilities													
Accounts Payable	$ 144,156	$ 144,156	$ 144,156	$ 144,156	$ 144,156	$ 144,156	$ 84,900	$ 84,900	$ 84,900	$ 84,900	$ 84,900	$ 84,900	$ 84,900
Total Liabilities	$ 144,156	$ 144,156	$ 144,156	$ 144,156	$ 144,156	$ 144,156	$ 84,900	$ 84,900	$ 84,900	$ 84,900	$ 84,900	$ 84,900	$ 84,900
Equity													
Capital Stock	$ 5,800,000	$ 5,800,000	$ 5,800,000	$ 5,800,000	$ 5,800,000	$ 5,800,000	$ 5,800,000	$ 5,800,000	$ 5,800,000	$ 5,800,000	$ 5,800,000	$ 5,800,000	$ 5,800,000
Retained Earnings	$(3,632,376)	$(3,976,880)	$(4,321,597)	$(4,666,527)	$(5,011,672)	$(5,357,031)	$(5,380,086)	$(5,403,358)	$(5,426,846)	$(5,450,551)	$(5,474,475)	$(5,498,618)	$(5,498,618)
Total Equity	$ 2,167,624	$ 1,823,120	$ 1,478,403	$ 1,133,473	$ 788,328	$ 442,969	$ 419,914	$ 396,642	$ 373,154	$ 349,449	$ 325,525	$ 301,382	$ 301,382
Total Liabilities and Equity	$ 2,311,780	$ 1,967,276	$ 1,622,559	$ 1,277,629	$ 932,484	$ 587,125	$ 504,814	$ 481,543	$ 458,054	$ 434,349	$ 410,425	$ 386,282	$ 386,282

Cash Flow (Year 3): (*Continued*)

Cash-Flow Statement	25	26	27	28	29	30	31	32	33	34	35	36	Year 3
Net Income (Loss)	$ 155,708	$ (344,504)	$ (344,717)	$ (344,930)	$ (345,145)	$ (345,359)	$ (23,055)	$ (23,271)	$ (23,488)	$ (23,706)	$ (23,924)	$ (24,143)	$ (1,710,535)
Working Capital Changes													
Accounts Receivable (Increase)	$ 150,000	$ (150,000)	$ –	$ –	$ –	$ –	$ –	$ –	$ –	$ –	$ –	$ –	$ –
Accounts Payable (Increase)	$ 24,503	$ 0	$ 0	$ 0	$ 0	$ 0	$ (59,256)	$ 0	$ 0	$ 0	$ 0	$ 0	$ (34,753)
Cash Used for Operations	$ 330,211	$ (494,504)	$ (344,717)	$ (344,930)	$ (345,145)	$ (345,359)	$ (82,311)	$ (23,271)	$ (23,488)	$ (23,706)	$ (23,924)	$ (24,143)	$ (1,745,288)
Cash Used for Investments													
Cash from Financing Activities													
Capital Stock													
Change in Cash for Period	$ 330,211	$ (494,504)	$ (344,717)	$ (344,930)	$ (345,145)	$ (345,359)	$ (82,311)	$ (23,271)	$ (23,488)	$ (23,706)	$ (23,924)	$ (24,143)	$ (1,745,288)
Cash: Beginning of Period	$ 2,131,570	$ 2,461,780	$ 1,967,276	$ 1,622,559	$ 1,277,629	$ 932,484	$ 587,125	$ 504,814	$ 481,543	$ 458,054	$ 434,349	$ 410,425	$ 2,131,570
Cash: End of Period	$ 2,461,780	$ 1,967,276	$ 1,622,559	$ 1,277,629	$ 932,484	$ 587,125	$ 504,814	$ 481,543	$ 458,054	$ 434,349	$ 410,425	$ 386,282	$ 386,282

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Income Statement (Year 4):

Income Statement	37	38	39	40	41	42	43	44	45	46	47	48	Year 4
Licensing Revenue	$ 1,000,000												$ 1,000,000
Interest Revenue	$ 8,661.32	$ 8,474.94	$ 8,287.78	$ 8,099.83	$ 7,911.08	$ 7,721.55	$ 7,531.22	$ 7,340.10	$ 7,148.46	$ 6,956.82	$ 6,765.19	$ 6,573.55	$ 91,471.83
Royalties	$ 500,000	$ 500,000	$ 500,000	$ 750,000	$ 750,000	$ 750,000	$ 1,000,000	$ 1,000,000	$ 1,000,000	$ 1,250,000	$ 1,250,000	$ 1,250,000	$ 10,500,000
Other Revenue													
Total Revenue	$ 1,508,661	$ 508,475	$ 508,288	$ 758,100	$ 757,911	$ 757,722	$ 1,007,531	$ 1,007,340	$ 1,007,148	$ 1,256,957	$ 1,256,765	$ 1,256,574	$ 11,591,472
Licensing Expense	$ 250,000	$ 250,000	$ 250,000	$ 375,000	$ 375,000	$ 375,000	$ 500,000	$ 500,000	$ 500,000	$ 625,000	$ 625,000	$ 625,000	$ 5,250,000
Labor and Related Costs													
Chief Executive Officer	$ 13,865	$ 13,865	$ 13,865	$ 13,865	$ 13,865	$ 13,865	$ 13,865	$ 13,865	$ 13,865	$ 13,865	$ 13,865	$ 13,865	$ 166,375
Adam Johnson, CFO	$ 8,067	$ 8,067	$ 8,067	$ 8,067	$ 8,067	$ 8,067	$ 8,067	$ 8,067	$ 8,067	$ 8,067	$ 8,067	$ 8,067	$ 96,800
Justin Otani, COO	$ 8,067	$ 8,067	$ 8,067	$ 8,067	$ 8,067	$ 8,067	$ 8,067	$ 8,067	$ 8,067	$ 8,067	$ 8,067	$ 8,067	$ 96,800
Chief Technology Officer	$ 11,092	$ 11,092	$ 11,092	$ 11,092	$ 11,092	$ 11,092	$ 11,092	$ 11,092	$ 11,092	$ 11,092	$ 11,092	$ 11,092	$ 133,100
Senior Electrical Engineer	$ 10,083	$ 10,083	$ 10,083	$ 10,083	$ 10,083	$ 10,083	$ 10,083	$ 10,083	$ 10,083	$ 10,083	$ 10,083	$ 10,083	$ 121,000
Senior Control Systems Engineer	$ 10,083	$ 10,083	$ 10,083	$ 10,083	$ 10,083	$ 10,083	$ 10,083	$ 10,083	$ 10,083	$ 10,083	$ 10,083	$ 10,083	$ 121,000
Junior Mechanical Engineer	$ 5,042	$ 5,042	$ 5,042	$ 5,042	$ 5,042	$ 5,042	$ 5,042	$ 5,042	$ 5,042	$ 5,042	$ 5,042	$ 5,042	$ 60,500
Junior Electrical Engineer	$ 5,042	$ 5,042	$ 5,042	$ 5,042	$ 5,042	$ 5,042	$ 5,042	$ 5,042	$ 5,042	$ 5,042	$ 5,042	$ 5,042	$ 60,500
Sales Manager	$ 6,417	$ 6,417	$ 6,417	$ 6,417	$ 6,417	$ 6,417	$ 6,417	$ 6,417	$ 6,417	$ 6,417	$ 6,417	$ 6,417	$ 77,000
Sales Manager	$ 6,417	$ 6,417	$ 6,417	$ 6,417	$ 6,417	$ 6,417	$ 6,417	$ 6,417	$ 6,417	$ 6,417	$ 6,417	$ 6,417	$ 77,000
Other Salaries	$ 40,460	$ 40,460	$ 40,460	$ 40,460	$ 40,460	$ 40,460	$ 40,460	$ 40,460	$ 40,460	$ 40,460	$ 40,460	$ 40,460	$ 485,520
Total Salaries	$ 124,633	$ 124,633	$ 124,633	$ 124,633	$ 124,633	$ 124,633	$ 124,633	$ 124,633	$ 124,633	$ 124,633	$ 124,633	$ 124,633	$ 1,495,595
Total IUPUI Expenses													
Outside Contractors	$ 12,674	$ 12,674	$ 12,674	$ 12,674	$ 12,674	$ 12,674	$ 12,674	$ 12,674	$ 12,674	$ 12,674	$ 12,674	$ 12,674	$ 152,088
Total Supplies for Initial Build	$ 41,667	$ 41,667	$ 41,667	$ 41,667	$ 41,667	$ 41,667	$ 20,833	$ 20,833	$ 20,833	$ 20,833	$ 20,833	$ 20,833	$ 375,000
Construction Costs for Initial Build													

Income Statement (Year 4): (*Continued*)

Income Statement	37	38	39	40	41	42	43	44	45	46	47	48	Year 4
Operating Expenses													
Payroll Processing Fees	$ 250	$ 250	$ 250	$ 250	$ 250	$ 250	$ 250	$ 250	$ 250	$ 250	$ 250	$ 250	$ 3,000
Office Rent	$ 1,313	$ 1,313	$ 1,313	$ 1,313	$ 1,313	$ 1,313	$ 1,313	$ 1,313	$ 1,313	$ 1,313	$ 1,313	$ 1,313	$ 15,750
Fringe Benefits	$ 1,823	$ 1,823	$ 1,823	$ 1,823	$ 1,823	$ 1,823	$ 1,823	$ 1,823	$ 1,823	$ 1,823	$ 1,823	$ 1,823	$ 21,870
Travel-Related Expenses	$ 3,802	$ 3,802	$ 3,802	$ 3,802	$ 3,802	$ 3,802	$ 3,802	$ 3,802	$ 3,802	$ 3,802	$ 3,802	$ 3,802	$ 45,626
Trade Shows	$ 507	$ 507	$ 507	$ 507	$ 507	$ 507	$ 507	$ 507	$ 507	$ 507	$ 507	$ 507	$ 6,084
Brochures and Publications	$ 253	$ 253	$ 253	$ 253	$ 253	$ 253	$ 253	$ 253	$ 253	$ 253	$ 253	$ 253	$ 3,042
Market Research	$ 634	$ 634	$ 634	$ 634	$ 634	$ 634	$ 634	$ 634	$ 634	$ 634	$ 634	$ 634	$ 7,604
Postage	$ 63	$ 63	$ 63	$ 63	$ 63	$ 63	$ 63	$ 63	$ 63	$ 63	$ 63	$ 63	$ 760
Cell Phones	$ 190	$ 190	$ 190	$ 190	$ 190	$ 190	$ 190	$ 190	$ 190	$ 190	$ 190	$ 190	$ 2,281
Legal Fees	$ 1,267	$ 1,267	$ 1,267	$ 1,267	$ 1,267	$ 1,267	$ 1,267	$ 1,267	$ 1,267	$ 1,267	$ 1,267	$ 1,267	$ 15,209
Other Professional Fees	$ 1,267	$ 1,267	$ 1,267	$ 1,267	$ 1,267	$ 1,267	$ 1,267	$ 1,267	$ 1,267	$ 1,267	$ 1,267	$ 1,267	$ 15,209
Website Development	$ 125	$ 125	$ 125	$ 125	$ 125	$ 125	$ 125	$ 125	$ 125	$ 125	$ 125	$ 125	$ 1,500
Dues and Subscriptions	$ 114	$ 114	$ 114	$ 114	$ 114	$ 114	$ 114	$ 114	$ 114	$ 114	$ 114	$ 114	$ 1,369
Patent Costs	$ 8,333	$ 8,333	$ 8,333	$ 8,333	$ 8,333	$ 8,333	$ 8,333	$ 8,333	$ 8,333	$ 8,333	$ 8,333	$ 8,333	$ 100,000
Computers and Software (SimHydraulics)	$ 2,083	$ 2,083	$ 2,083	$ 2,083	$ 2,083	$ 2,083	$ 2,083	$ 2,083	$ 2,083	$ 2,083	$ 2,083	$ 2,083	$ 25,000
Office Equipment and Supplies	$ 887	$ 887	$ 887	$ 887	$ 887	$ 887	$ 887	$ 887	$ 887	$ 887	$ 887	$ 887	$ 10,646
Telephone and Utility Expenses	$ 380	$ 380	$ 380	$ 380	$ 380	$ 380	$ 380	$ 380	$ 380	$ 380	$ 380	$ 380	$ 4,563
Accounting Services	$ 507	$ 507	$ 507	$ 507	$ 507	$ 507	$ 507	$ 507	$ 507	$ 507	$ 507	$ 507	$ 6,084
Miscellaneous	$ 1,267	$ 1,267	$ 1,267	$ 1,267	$ 1,267	$ 1,267	$ 1,267	$ 1,267	$ 1,267	$ 1,267	$ 1,267	$ 1,267	$ 15,209
Total Operating Costs	$ 25,067	$ 25,067	$ 25,067	$ 25,067	$ 25,067	$ 25,067	$ 25,067	$ 25,067	$ 25,067	$ 25,067	$ 25,067	$ 25,067	$ 300,805
Total Costs	$ 454,041	$ 454,041	$ 454,041	$ 579,041	$ 579,041	$ 579,041	$ 683,207	$ 683,207	$ 683,207	$ 808,207	$ 808,207	$ 808,207	$ 7,573,487
Net Income (EBT)	$ 1,054,620	$ 54,434	$ 54,247	$ 179,059	$ 178,870	$ 178,681	$ 324,324	$ 324,133	$ 323,942	$ 448,750	$ 448,558	$ 448,367	$ 4,017,984

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Balance Sheet (Year 4):

Balance Sheet	37	38	39	40	41	42	43	44	45	46	47	48	Year 4
Assets													
Current Assets													
Cash	$ 1,792,214	$ 1,546,648	$ 1,600,895	$ 1,817,454	$ 1,996,324	$ 2,175,005	$ 2,530,579	$ 2,854,712	$ 3,178,653	$ 3,664,903	$ 4,113,461	$ 4,561,828	$ 4,561,828
Accounts Receivable	$ 300,000												$ -
Total Assets	$ 2,092,214	$ 1,546,648	$ 1,600,895	$ 1,817,454	$ 1,996,324	$ 2,175,005	$ 2,530,579	$ 2,854,712	$ 3,178,653	$ 3,664,903	$ 4,113,461	$ 4,561,828	$ 4,561,828
Liabilities													
Current Liabilities													
Accounts Payable	$ 136,212	$ 136,212	$ 136,212	$ 173,712	$ 173,712	$ 173,712	$ 204,962	$ 204,962	$ 204,962	$ 242,462	$ 242,462	$ 242,462	$ 242,462
Total Liabilities	$ 136,212	$ 136,212	$ 136,212	$ 173,712	$ 173,712	$ 173,712	$ 204,962	$ 204,962	$ 204,962	$ 242,462	$ 242,462	$ 242,462	$ 242,462
Equity													
Capital Stock	$ 5,800,000	$ 5,800,000	$ 5,800,000	$ 5,800,000	$ 5,800,000	$ 5,800,000	$ 5,800,000	$ 5,800,000	$ 5,800,000	$ 5,800,000	$ 5,800,000	$ 5,800,000	$ 5,800,000
Retained Earnings	$ (4,443,998)	$ (4,389,564)	$ (4,335,317)	$ (4,156,258)	$ (3,977,388)	$ (3,798,708)	$ (3,474,383)	$ (3,150,250)	$ (2,826,309)	$ (2,377,559)	$ (1,929,001)	$ (1,480,634)	$ (1,480,634)
Total Equity	$ 1,356,002	$ 1,410,436	$ 1,464,683	$ 1,643,742	$ 1,822,612	$ 2,001,292	$ 2,325,617	$ 2,649,750	$ 2,973,691	$ 3,422,441	$ 3,870,999	$ 4,319,366	$ 4,319,366
Total Liabilities and Equity	$ 1,492,214	$ 1,546,648	$ 1,600,895	$ 1,817,454	$ 1,996,324	$ 2,175,005	$ 2,530,579	$ 2,854,712	$ 3,178,653	$ 3,664,903	$ 4,113,461	$ 4,561,828	$ 4,561,828

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Cash Flow (Year 4):

Cash-Flow Statement	37	38	39	40	41	42	43	44	45	46	47	48	Year 4
Net Income (Loss)	$ 1,054,620	$ 54,434	$ 54,247	$ 179,059	$ 178,870	$ 178,681	$ 324,324	$ 324,133	$ 323,942	$ 448,750	$ 448,558	$ 448,367	$ 4,017,984
Working Capital Changes													
Accounts Receivable (Increase)	$ 300,000	$ (300,000)	$ –	$ –	$ –	$ –	$ –	$ –	$ –	$ –	$ –	$ –	$ –
Accounts Payable (Increase)	$ 51,312	$ –	$ –	$ 37,500	$ –	$ –	$ 31,250	$ –	$ –	$ 37,500	$ –	$ –	$ 157,562
Cash Used for Operations	$ 1,405,933	$ (245,566)	$ 54,247	$ 216,559	$ 178,870	$ 178,681	$ 355,574	$ 324,133	$ 323,942	$ 486,250	$ 448,558	$ 448,367	$ 4,175,546
Cash Used for Investments													
Cash from Financing Activities													
Capital Stock													
Change in Cash for Period	$ 1,405,933	$ (245,566)	$ 54,247	$ 216,559	$ 178,870	$ 178,681	$ 355,574	$ 324,133	$ 323,942	$ 486,250	$ 448,558	$ 448,367	$ 4,175,546
Cash: Beginning of Period	$ 386,282	$ 1,792,214	$ 1,546,648	$ 1,600,895	$ 1,817,454	$ 1,996,324	$ 2,175,005	$ 2,530,579	$ 2,854,712	$ 3,178,653	$ 3,664,903	$ 4,113,461	$ 386,282
Cash: End of Period	$ 1,792,214	$ 1,546,648	$ 1,600,895	$ 1,817,454	$ 1,996,324	$ 2,175,005	$ 2,530,579	$ 2,854,712	$ 3,178,653	$ 3,664,903	$ 4,113,461	$ 4,561,828	$ 4,561,828

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Income Statement (Year 5):

Income Statement	49	50	51	52	53	54	55	56	57	58	59	60	Year 5
Licensing Revenue	$ 3,000,000												$ 3,000,000
Interest Revenue	$ 6,393	$ 6,217	$ 6,041	$ 5,865	$ 5,689	$ 5,513	$ 5,337	$ 5,161	$ 4,984	$ 4,808	$ 4,632	$ 4,456	$ 65,095
Royalties	$ 1,750,000	$ 1,750,000	$ 1,750,000	$ 2,250,000	$ 2,250,000	$ 2,250,000	$ 2,750,000	$ 2,750,000	$ 2,750,000	$ 3,250,000	$ 3,250,000	$ 3,250,000	$ 30,000,000
Other Revenue													
Total Revenue	$ 4,756,393	$ 1,756,217	$ 1,756,041	$ 2,255,865	$ 2,255,689	$ 2,255,513	$ 2,755,337	$ 2,755,161	$ 2,754,984	$ 3,254,808	$ 3,254,632	$ 3,254,456	$ 33,065,095
Licensing Expense	$ 875,000	$ 875,000	$ 875,000	$ 1,125,000	$ 1,125,000	$ 1,125,000	$ 1,375,000	$ 1,375,000	$ 1,375,000	$ 1,625,000	$ 1,625,000	$ 1,625,000	$ 15,000,000
Labor and Related Costs													
Chief Executive Officer	$ 15,251	$ 15,251	$ 15,251	$ 15,251	$ 15,251	$ 15,251	$ 15,251	$ 15,251	$ 15,251	$ 15,251	$ 15,251	$ 15,251	$ 183,013
Adam Johnson, CFO	$ 8,873	$ 8,873	$ 8,873	$ 8,873	$ 8,873	$ 8,873	$ 8,873	$ 8,873	$ 8,873	$ 8,873	$ 8,873	$ 8,873	$ 106,480
Justin Otani, COO	$ 8,873	$ 8,873	$ 8,873	$ 8,873	$ 8,873	$ 8,873	$ 8,873	$ 8,873	$ 8,873	$ 8,873	$ 8,873	$ 8,873	$ 106,480
Chief Technology Officer	$ 11,092	$ 11,092	$ 11,092	$ 11,092	$ 11,092	$ 11,092	$ 11,092	$ 11,092	$ 11,092	$ 11,092	$ 11,092	$ 11,092	$ 133,100
Senior Electrical Engineer	$ 10,083	$ 10,083	$ 10,083	$ 10,083	$ 10,083	$ 10,083	$ 10,083	$ 10,083	$ 10,083	$ 10,083	$ 10,083	$ 10,083	$ 121,000
Senior Control Systems Engineer	$ 10,083	$ 10,083	$ 10,083	$ 10,083	$ 10,083	$ 10,083	$ 10,083	$ 10,083	$ 10,083	$ 10,083	$ 10,083	$ 10,083	$ 121,000
Junior Mechanical Engineer	$ 5,546	$ 5,546	$ 5,546	$ 5,546	$ 5,546	$ 5,546	$ 5,546	$ 5,546	$ 5,546	$ 5,546	$ 5,546	$ 5,546	$ 66,550
Junior Electrical Engineer	$ 5,546	$ 5,546	$ 5,546	$ 5,546	$ 5,546	$ 5,546	$ 5,546	$ 5,546	$ 5,546	$ 5,546	$ 5,546	$ 5,546	$ 66,550
Sales Manager	$ 7,058	$ 7,058	$ 7,058	$ 7,058	$ 7,058	$ 7,058	$ 7,058	$ 7,058	$ 7,058	$ 7,058	$ 7,058	$ 7,058	$ 84,700
Sales Manager	$ 7,058	$ 7,058	$ 7,058	$ 7,058	$ 7,058	$ 7,058	$ 7,058	$ 7,058	$ 7,058	$ 7,058	$ 7,058	$ 7,058	$ 84,700
Other Salaries	$ 137,564	$ 137,564	$ 137,564	$ 137,564	$ 137,564	$ 137,564	$ 137,564	$ 137,564	$ 137,564	$ 137,564	$ 137,564	$ 137,564	$ 1,650,768
Total Salaries	$ 227,028	$ 227,028	$ 227,028	$ 227,028	$ 227,028	$ 227,028	$ 227,028	$ 227,028	$ 227,028	$ 227,028	$ 227,028	$ 227,028	$ 2,724,341
Total IUPUI Expenses													
Outside Contractors	$ 14,575	$ 14,575	$ 14,575	$ 14,575	$ 14,575	$ 14,575	$ 14,575	$ 14,575	$ 14,575	$ 14,575	$ 14,575	$ 14,575	$ 174,901
Total Supplies for Initial Build	$ 20,833	$ 20,833	$ 20,833	$ 20,833	$ 20,833	$ 20,833							$ 124,998
Construction Costs for Initial Build													

Income Statement (Year 5): (*Continued*)

Income Statement	49	50	51	52	53	54	55	56	57	58	59	60	Year 5
Operating Expenses													
Payroll Processing Fees	$ 250	$ 250	$ 250	$ 250	$ 250	$ 250	$ 250	$ 250	$ 250	$ 250	$ 250	$ 250	$ 3,000
Office Rent	$ 1,313	$ 1,313	$ 1,313	$ 1,313	$ 1,313	$ 1,313	$ 1,313	$ 1,313	$ 1,313	$ 1,313	$ 1,313	$ 1,313	$ 15,750
Fringe Benefits	$ 2,460	$ 2,460	$ 2,460	$ 2,460	$ 2,460	$ 2,460	$ 2,460	$ 2,460	$ 2,460	$ 2,460	$ 2,460	$ 2,460	$ 29,525
Travel-Related Expenses	$ 4,373	$ 4,373	$ 4,373	$ 4,373	$ 4,373	$ 4,373	$ 4,373	$ 4,373	$ 4,373	$ 4,373	$ 4,373	$ 4,373	$ 52,470
Trade Shows	$ 583	$ 583	$ 583	$ 583	$ 583	$ 583	$ 583	$ 583	$ 583	$ 583	$ 583	$ 583	$ 6,996
Brochures and Publications	$ 292	$ 292	$ 292	$ 292	$ 292	$ 292	$ 292	$ 292	$ 292	$ 292	$ 292	$ 292	$ 3,498
Market Research	$ 729	$ 729	$ 729	$ 729	$ 729	$ 729	$ 729	$ 729	$ 729	$ 729	$ 729	$ 729	$ 8,745
Postage	$ 73	$ 73	$ 73	$ 73	$ 73	$ 73	$ 73	$ 73	$ 73	$ 73	$ 73	$ 73	$ 875
Cell Phones	$ 219	$ 219	$ 219	$ 219	$ 219	$ 219	$ 219	$ 219	$ 219	$ 219	$ 219	$ 219	$ 2,624
Legal Fees	$ 1,458	$ 1,458	$ 1,458	$ 1,458	$ 1,458	$ 1,458	$ 1,458	$ 1,458	$ 1,458	$ 1,458	$ 1,458	$ 1,458	$ 17,490
Other Professional Fees	$ 1,458	$ 1,458	$ 1,458	$ 1,458	$ 1,458	$ 1,458	$ 1,458	$ 1,458	$ 1,458	$ 1,458	$ 1,458	$ 1,458	$ 17,490
Website Development	$ 125	$ 125	$ 125	$ 125	$ 125	$ 125	$ 125	$ 125	$ 125	$ 125	$ 125	$ 125	$ 1,500
Dues and Subscriptions	$ 131	$ 131	$ 131	$ 131	$ 131	$ 131	$ 131	$ 131	$ 131	$ 131	$ 131	$ 131	$ 1,574
Patent Costs	$ 12,500	$ 12,500	$ 12,500	$ 12,500	$ 12,500	$ 12,500	$ 12,500	$ 12,500	$ 12,500	$ 12,500	$ 12,500	$ 12,500	$ 150,000
Computers and Software (SimHydraulics)	$ 2,083	$ 2,083	$ 2,083	$ 2,083	$ 2,083	$ 2,083	$ 2,083	$ 2,083	$ 2,083	$ 2,083	$ 2,083	$ 2,083	$ 25,000
Office Equipment and Supplies	$ 1,020	$ 1,020	$ 1,020	$ 1,020	$ 1,020	$ 1,020	$ 1,020	$ 1,020	$ 1,020	$ 1,020	$ 1,020	$ 1,020	$ 12,243
Telephone and Utility Expenses	$ 437	$ 437	$ 437	$ 437	$ 437	$ 437	$ 437	$ 437	$ 437	$ 437	$ 437	$ 437	$ 5,247
Accounting Services	$ 583	$ 583	$ 583	$ 583	$ 583	$ 583	$ 583	$ 583	$ 583	$ 583	$ 583	$ 583	$ 6,996
Miscellaneous	$ 1,458	$ 1,458	$ 1,458	$ 1,458	$ 1,458	$ 1,458	$ 1,458	$ 1,458	$ 1,458	$ 1,458	$ 1,458	$ 1,458	$ 17,490
Total Operating Costs	$ 31,543	$ 31,543	$ 31,543	$ 31,543	$ 31,543	$ 31,543	$ 31,543	$ 31,543	$ 31,543	$ 31,543	$ 31,543	$ 31,543	$ 378,512
Total Costs	$ 1,168,979	$ 1,168,979	$ 1,168,979	$ 1,418,979	$ 1,418,979	$ 1,418,979	$ 1,648,146	$ 1,648,146	$ 1,648,146	$ 1,898,146	$ 1,898,146	$ 1,898,146	$ 18,402,751
Net Income (EBT)	$ 3,587,414	$ 587,238	$ 587,062	$ 836,886	$ 836,710	$ 836,533	$ 1,107,190	$ 1,107,014	$ 1,106,838	$ 1,356,662	$ 1,356,486	$ 1,356,310	$ 14,662,344

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Balance Sheet (Year 5):

Balance Sheet	49	50	51	52	53	54	55	56	57	58	59	60	Year 5
Assets													
Current Assets													
Cash	$ 9,157,473	$ 8,844,711	$ 9,431,773	$ 10,343,658	$ 11,180,368	$ 12,016,901	$ 13,192,842	$ 14,299,856	$ 15,406,695	$ 16,838,357	$ 18,194,843	$ 19,551,153	$ 19,551,153
Accounts Receivable	$ 900,000												$ -
Total Assets	$ 10,057,473	$ 8,844,711	$ 9,431,773	$ 10,343,658	$ 11,180,368	$ 12,016,901	$ 13,192,842	$ 14,299,856	$ 15,406,695	$ 16,838,357	$ 18,194,843	$ 19,551,153	$ 19,551,153
Liabilities													
Current Liabilities													
Accounts Payable	$ 350,694	$ 350,694	$ 350,694	$ 425,694	$ 425,694	$ 425,694	$ 494,444	$ 494,444	$ 494,444	$ 569,444	$ 569,444	$ 569,444	$ 569,444
Total Liabilities	$ 350,694	$ 350,694	$ 350,694	$ 425,694	$ 425,694	$ 425,694	$ 494,444	$ 494,444	$ 494,444	$ 569,444	$ 569,444	$ 569,444	$ 569,444
Equity													
Capital Stock	$ 5,800,000	$ 5,800,000	$ 5,800,000	$ 5,800,000	$ 5,800,000	$ 5,800,000	$ 5,800,000	$ 5,800,000	$ 5,800,000	$ 5,800,000	$ 5,800,000	$ 5,800,000	$ 5,800,000
Retained Earnings	$ 2,106,780	$ 2,694,017	$ 3,281,079	$ 4,117,965	$ 4,954,674	$ 5,791,208	$ 6,898,398	$ 8,005,412	$ 9,112,251	$ 10,468,913	$ 11,825,399	$ 13,181,710	$ 13,181,710
Total Equity	$ 7,906,780	$ 8,494,017	$ 9,081,079	$ 9,917,965	$ 10,754,674	$ 11,591,208	$ 12,698,398	$ 13,805,412	$ 14,912,251	$ 16,268,913	$ 17,625,399	$ 18,981,710	$ 18,981,710
Total Liabilities	$ 8,257,473	$ 8,844,711	$ 9,431,773	$ 10,343,658	$ 11,180,368	$ 12,016,901	$ 13,192,842	$ 14,299,856	$ 15,406,695	$ 16,838,357	$ 18,194,843	$ 19,551,153	$ 19,551,153

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Cash Flow (Year 5):

Cash-Flow Statement	49	50	51	52	53	54	55	56	57	58	59	60	Year 5
Net Income (Loss)	$ 3,587,414	$ 587,238	$ 587,062	$ 836,886	$ 836,710	$ 836,533	$ 1,107,190	$ 1,107,014	$ 1,106,838	$ 1,356,662	$ 1,356,486	$ 1,356,310	$ 14,662,344
Working Capital Changes													
Accounts Receivable (Increase)	$ 900,000	$ (900,000)	$ –	$ –	$ –	$ –	$ –	$ –	$ –	$ –	$ –	$ –	–
Accounts Payable (Increase)	$ 108,232	$ –	$ –	$ 75,000	$ –	$ –	$ 68,750	$ –	$ –	$ 75,000	$ –	$ –	$ 326,982
Cash Used for Operations	$ 4,595,645	$ (312,762)	$ 587,062	$ 911,886	$ 836,710	$ 836,533	$ 1,175,941	$ 1,107,014	$ 1,106,838	$ 1,431,662	$ 1,356,486	$ 1,356,310	$ 14,989,325
Cash Used for Investments													
Cash from Financing Activities													
Capital Stock													
Change in Cash for Period	$ 4,595,645	$ (312,762)	$ 587,062	$ 911,886	$ 836,710	$ 836,533	$ 1,175,941	$ 1,107,014	$ 1,106,838	$ 1,431,662	$ 1,356,486	$ 1,356,310	$ 14,989,325
Cash: Beginning of Period	$ 4,561,828	$ 9,157,473	$ 8,844,711	$ 9,431,773	$ 10,343,658	$ 11,180,368	$ 12,016,901	$ 13,192,842	$ 14,299,856	$ 15,406,695	$ 16,838,357	$ 18,194,843	$ 4,561,828
Cash: End of Period	$ 9,157,473	$ 8,844,711	$ 9,431,773	$ 10,343,658	$ 11,180,368	$ 12,016,901	$ 13,192,842	$ 14,299,856	$ 15,406,695	$ 16,838,357	$ 18,194,843	$ 19,551,153	$ 19,551,153

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Part 4 | Growth Strategies for Entrepreneurial Ventures



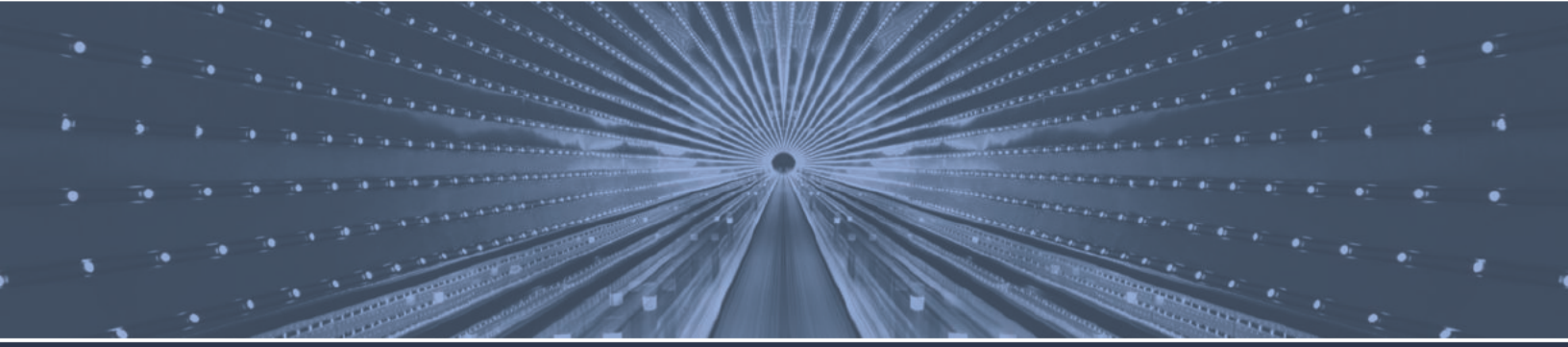
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Chapter 13

Strategic Entrepreneurial Growth: Scaling

Learning Objectives

13.1. Discuss the importance of strategic planning with emerging firms
13.2. Describe the nature of strategic planning
13.3. Outline the challenges of managing entrepreneurial growth
13.4. Explain the transition from an entrepreneurial to managerial approach
13.5. Identify the key factors that play a major role during the growth stage
13.6. Discuss the complex management of paradox and contradiction
13.7. List the steps useful for breaking through the growth wall
13.8. Explain the factors involved in growth hacking
13.9. Identify the challenges involved with "blitzscaling"
13.10. Explore the elements of building an entrepreneurial company
13.11. Identify the unique managerial concerns with growth businesses

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Entrepreneurial Thought

Without continual growth and progress, such words as improvement, achievement, and success have no meaning.

—Benjamin Franklin, founding father of the United States

There are no great limits to growth because there are no limits of human intelligence, imagination, and wonder.

—Ronald W. Reagan, 40th president of the United States

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13-1 Strategic Planning and Emerging Firms

LO13.1 Discuss the importance of strategic planning with emerging firms

Although most entrepreneurs do some form of planning, it often tends to be informal and unsystematic.[1] The actual need for systematic planning varies with the nature, size, and structure of the business. In other words, a small two-person operation may successfully use informal planning because little complexity is involved. But an emerging venture that is rapidly expanding with constant increases in personnel and market operations will need to formalize its planning because a great deal of complexity exists.

An entrepreneur's planning will need to shift from an informal to a formal systematic style for other reasons. First is the degree of uncertainty with which the venture is attempting to become established and to grow. With greater levels of uncertainty, entrepreneurs have a stronger need to deal with the challenges that face their venture, and a more formal planning effort can help them to do this. Second, the strength of the competition (in both numbers and quality of competitors) will add to the importance of more systematic planning in order for a new venture to monitor its operations and objectives more closely.[2] Finally, the amount and type of experience the entrepreneur has may be a factor in deciding the extent of formal planning. A lack of adequate experience, either technological or business, may constrain the entrepreneur's understanding and thus necessitate formal planning to help determine future paths for the organization. It is only through this type of planning that entrepreneurs can manage entrepreneurial growth.

13-2 The Nature of Strategic Planning

LO13.2 Describe the nature of strategic planning

Strategic planning is the formulation of long-range plans for the effective management of environmental opportunities and threats in light of a venture's strengths and weaknesses. It includes defining the venture's mission, specifying achievable objectives, developing strategies, and setting policy guidelines. Dynamic in nature, the strategic management process (see Figure 13.1) is the full set of commitments, decisions, and actions required for a firm to achieve strategic competitiveness and earn above-average returns. Relevant strategic inputs derived from analyses of the internal and external environments are necessary for effective strategy formulation and implementation. In turn, effective strategic actions are a prerequisite to achieving the desired outcomes of strategic competitiveness and above-average returns. Thus, the strategic management process is used to match the conditions of an ever-changing market and competitive structure with a firm's continuously evolving resources, capabilities, and core competencies (the sources of strategic inputs). Effective strategic actions that take place in the context of carefully integrated strategy formulation and implementation actions result in desired strategic outcomes.[3] Thus, strategic planning is the primary step in determining the future direction of a business. The "best" strategic plan will be influenced by many factors, among them the abilities of the entrepreneur, the complexity of the venture, and the nature of the industry. Yet, whatever the specific situation, five basic steps must be followed in strategic planning:

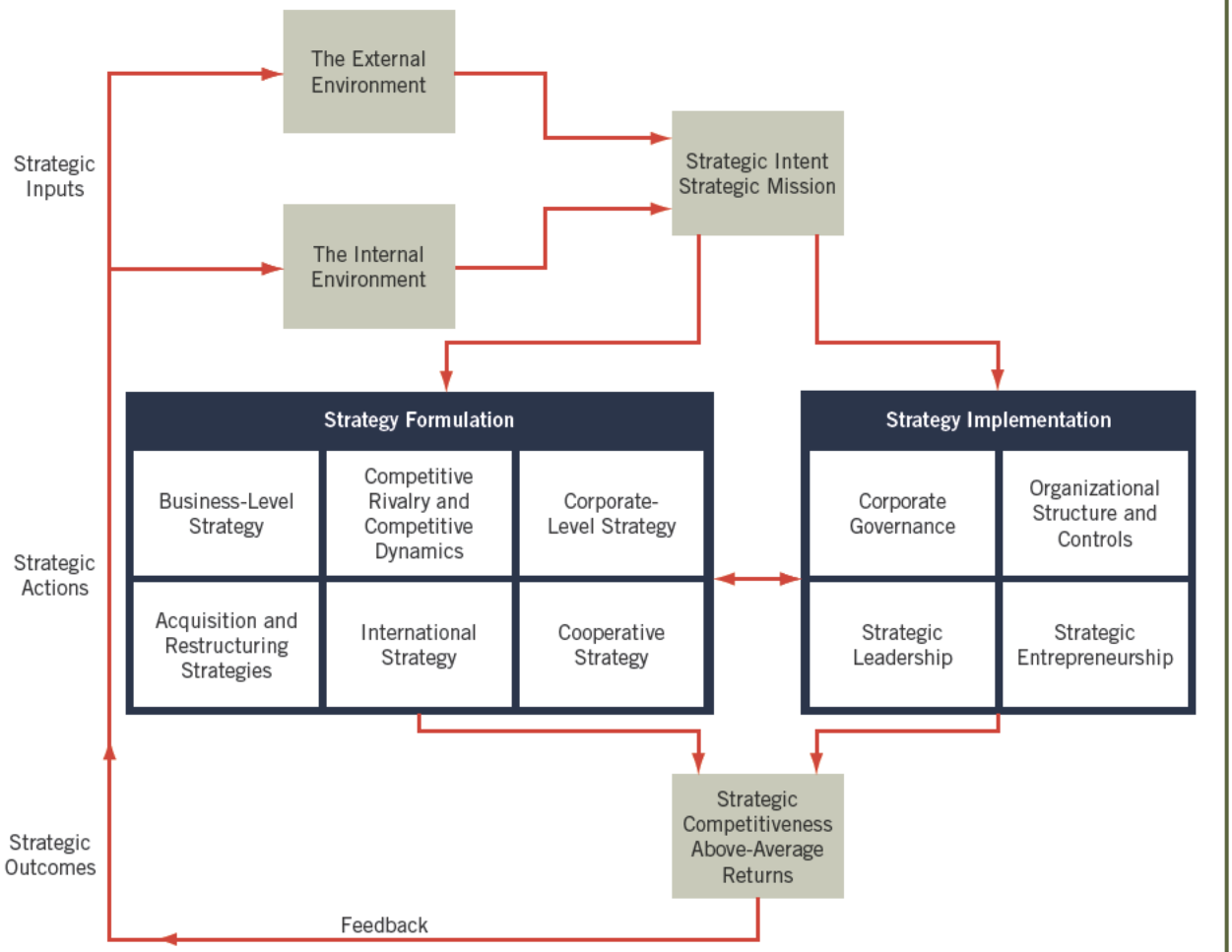
1. Examine the internal and external environments of the venture (strengths, weaknesses, opportunities, and threats).
2. Formulate the venture's long-range and short-range strategies (mission, objectives, strategies, and policies).
3. Implement the strategic plan (programs, budgets, and procedures).
4. Evaluate the performance of the strategy.
5. Take follow-up action through continuous feedback.

Figure 13.1 illustrates these basic steps in a flow diagram. The first step—examining the environment—can be one of the most critical for an emerging venture. Analyses of its external and internal environments provide a firm with the information required to develop its strategic intent and strategic mission. As shown in Figure 13.1, strategic intent and strategic mission influence strategy formulation and implementation actions. A clear review of a venture's internal and external factors is needed, and both sets of factors must be considered when performing an environmental analysis. This analysis is often called a **SWOT analysis**; SWOT is an acronym for a venture's internal *strengths* and *weaknesses* and its external *opportunities* and *threats*. The analysis should include not only the external factors most likely to occur and to have a serious impact on the company but also the internal factors most likely to affect the implementation of present and future strategic decisions. By focusing on this analysis, an emerging venture can proceed through the other steps of formulation, implementation, evaluation, and feedback.[4]

The greatest value of the strategic planning process is the "strategic thinking" it promotes among business owners. Although strategic thinking is not always articulated formally, it synthesizes the intuition and creativity of an entrepreneur into a vision for the future.[5]

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Figure 13.1 The Strategic Management Process



Source: Michael A. Hitt, R. Duane Ireland, and Robert E. Hoskisson, *Strategic Management*, 11th ed., © 2015 Cengage Learning.

13-2a The Lack of Strategic Planning

The importance of new ventures to the economy is substantial in terms of innovation, employment, and sales, and effective planning can help these new firms survive and grow. Unfortunately, research has shown a distinct lack of planning on the part of new ventures. Five reasons for the lack of strategic planning have been found:

1. *Time scarcity*. Entrepreneurs report that their time is scarce and difficult to allocate to planning in the face of day-to-day operating schedules.
2. *Lack of knowledge*. Entrepreneurs have minimal exposure to and knowledge of the planning process. They are uncertain of the components of the process and the sequence of those components. The entrepreneurs also are unfamiliar with many planning information sources and how they can be used.
3. *Lack of expertise/skills*. Entrepreneurs typically are generalists, and they often lack the specialized expertise necessary for the planning process.
4. *Lack of trust and openness*. Entrepreneurs are highly sensitive and guarded about their businesses and the decisions that affect them. Consequently, they are hesitant to formulate a strategic plan that requires participation by employees or outside consultants.
5. *Perception of high cost*. Entrepreneurs perceive the cost associated with planning to be very high. This fear of expensive planning causes many business owners to avoid or ignore planning as a viable process.[6]

In addition to these reasons, other factors have been reported as difficulties of the planning process. For example, both high-performing and low-performing small ventures have problems with long-range planning.

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Both time and expense are major obstacles. Additionally, low-performing firms report that a poor planning climate, inexperienced managers, and unfavorable economic conditions are problems. Quite obviously, strategic planning is no easy chore for new ventures. On the other hand, many benefits can be gained from such planning.

13-2b The Value of Strategic Planning

Does strategic planning pay off? Research shows it does. A number of studies have focused on the impact of planning on entrepreneurial firms.[7] These studies support the contention that strategic planning is of value to a venture. Most of the studies imply—if they do not directly state—that planning influences a venture's survival. In one study of 70,000 failed firms, lack of planning was identified as a major cause of failure,[8] and still another investigation demonstrated that firms engaged in strategic planning outperformed those that did not use such planning.[9] A study of 220 small firms further established the importance of selecting an appropriate strategy (niche strategy) for a venture to build distinctive competence and a sustainable competitive advantage.[10] Another research study examined the dynamic effects of strategies on company performance in the software industry and found that, when focus or differentiation strategies were established, performance by those firms was enhanced.[11] Finally, there was a study that examined 253 smaller firms to determine the relationship between performance and planning sophistication. The study classified companies into the following categories:

Category I: No written plan (101 firms, or 39.9 percent)

Category II: Moderately sophisticated planning, including a written plan and/or some quantified objectives, some specific plans and budgets, identification of some factors in the external environment, and procedures for anticipating or detecting differences between the plan and actual performance (89 firms, or 35.2 percent).

Category III: Sophisticated planning, including a written plan with all of the following: some quantified objectives, some specific plans and budgets, identification of some factors in the external environment, and procedures for anticipating or detecting differences between the plan and actual performance (63 firms, or 24.9 percent).

The results demonstrated that more than 88 percent of firms with Category II or Category III planning performed at or above the industry average compared with only 40 percent of those firms with Category I planning.[12]

In summary, all of the research indicates that emerging firms that engage in strategic planning are more effective than those that do not. Most important, the studies emphasize the significance of the planning process, rather than merely the plans, as a key to successful performance.[13]

13-2c Fatal Visions in Strategic Planning

The actual execution of a strategy is almost as important as the strategy itself. Many entrepreneurs make unintentional errors when they apply a specific strategy to their own specific venture. Competitive situations differ, and the particular application of known strategies must be tailored to those unique situations.

Researcher Michael E. Porter has noted five fatal mistakes entrepreneurs continually fall prey to in their attempt to implement a strategy.[14] Outlined next are these flaws and their explanations.

- *Fatal Vision #1: Misunderstanding industry attractiveness*. Too many entrepreneurs associate attractive industries with those that are growing the fastest, appear to be glamorous, or use the fanciest technology. This is wrong because attractive industries have high barriers to entry and the fewest substitutes. The more high-tech or popular a business is, the more likely a lot of new competitors will enter and make it unprofitable.
- *Fatal Vision #2: No real competitive advantage*. Some entrepreneurs merely copy or imitate the strategy of their competitors. That may be an easy tactic, and it is certainly less risky, but it means that an entrepreneur has no competitive advantage. To succeed, new ventures must develop unique ways to compete.
- *Fatal Vision #3: Pursuing an unattainable competitive position*. Many aggressive entrepreneurs pursue a position of dominance in a fast-growing industry. However, they are so busy getting off the ground and finding people to buy their products that they forget what will happen if the venture succeeds. For example, a successful software program will be imitated quickly; therefore, the advantage it alone gives cannot be sustained. Real competitive advantage in software comes from servicing and supporting buyers, providing regular upgrades, and getting a company online with customers so that their computer departments depend on the organization. That creates barriers to entry. Sometimes small companies simply cannot sustain an advantage.
- *Fatal Vision #4: Compromising strategy for growth*. A careful balance must exist between growth and the competitive strategy that makes a new venture successful. If an entrepreneur sacrifices their venture's unique strategy in order to have fast growth, then the venture may grow out of business. Although fast growth can be tempting in certain industries, it

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is imperative that entrepreneurs also maintain and grow their strategic advantage.

- *Fatal Vision #5: Failure to explicitly communicate the venture's strategy to employees.* It is essential for every entrepreneur to clearly communicate the company's strategy to every employee. Never assume that employees already know the strategy. Always be explicit.

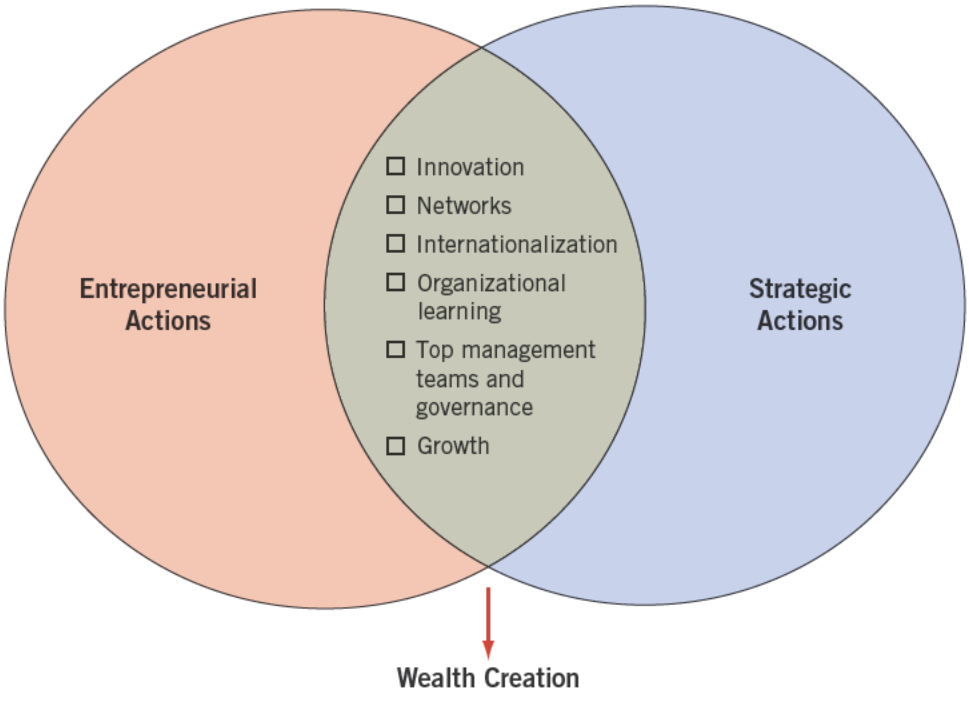
According to Porter, "One of the fundamental benefits of developing a strategy is that it creates unity, or consistency of action, throughout a company. Every department in the organization works toward the same objectives. But if people do not know what the objectives are, how can they work toward them? If they do not have a clear sense that low cost, say, is your ultimate aim, then all their day-to-day actions are not going to be reinforcing that goal. In any company, employees are making critical choices every minute. An explicit strategy will help them make the right ones."[15]

13-2d Entrepreneurial and Strategic Actions

Both entrepreneurship and strategic management are dynamic processes concerned with firm performance. Strategic management calls for firms to establish and exploit competitive advantages within a particular environmental context. Entrepreneurship promotes the search for competitive advantages through product, process, and market innovations. A new venture typically is created to pursue the marketplace promise from innovations.

Researchers R. Duane Ireland, Michael A. Hitt, S. Michael Camp, and Donald L. Sexton argue that entrepreneurial and strategic actions often are intended to find new market or competitive space for a firm to create wealth. Firms try to find fundamentally new ways of doing business that will disrupt an industry's existing competitive rules, leading to the development of new business models that create new competitive life forms. The degree to which a firm acts entrepreneurially in terms of innovativeness, risk taking, and proactivity is related to dimensions of strategic management. Within these commonalities between entrepreneurship and strategic management are specific domains of innovation, networks, internationalization, organizational learning, top management teams and governance, and growth (see Figure 13.2). Understanding the critical intersections of these specific domains allows entrepreneurs to increase their knowledge, which in turn leads to higher-quality entrepreneurial and strategic actions.[16]

Figure 13.2 The Integration of Entrepreneurial and Strategic Actions



Source: R. Duane Ireland, Michael A. Hitt, S. Michael Camp, and Donald L. Sexton, "Integrating Entrepreneurship and Strategic Management Actions to Create Firm Wealth," *Academy of Management Executive* 15, no. 1 (February 2001): 51.

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13-2e Strategic Positioning: The Entrepreneurial Edge

Strategic competition can be thought of as the process of perceiving new positions that attract customers from established positions or draw new customers into the market. In principle, incumbents and entrepreneurs face the same challenges in finding new strategic positions. In practice, entrepreneurs often have the edge.

Strategic positionings are often not obvious, and finding them requires creativity and insight. Entrepreneurs frequently discover unique positions that have been available but simply overlooked by established competitors. In addition, entrepreneurial ventures can prosper by occupying a position that a competitor once held but has ceded through years of imitation and straddling.

Fundamental approaches to strategic positioning include establishing and defending a defensible position, leveraging resources to dominate a market, and pursuing opportunities to establish new markets (see Table 13.1). Entrepreneurs must understand that the pursuit of opportunities provides the best choice for capitalizing on change.

Most commonly, new positions open up because of change: new customer groups or purchase occasions arise, new needs emerge as societies evolve, new distribution channels appear, new technologies develop, and new machinery or information systems become available. When such changes happen, entrepreneurial ventures unencumbered by long histories in the industry can often more easily perceive the potential for a new way of competing. Unlike incumbents, these organizations can be more flexible because they face no trade-offs with their existing activities.[17]

13-2f An Entrepreneurial Strategy Matrix Model

Based on the structure of traditional strategy matrices (such as the Boston Consulting Group matrix) that have been used for portfolio analysis, researchers Matthew C. Sonfield and Robert N. Lussier developed an **entrepreneurial strategy matrix** that measures risk and innovation.[18] For the purpose of this matrix, **innovation** is defined as the creation of something new and different. In terms of measurement, the newer and more different the proposed product or service is, the higher it would be scored on a measurement scale.

Risk is defined as the probability of major financial loss. What are the chances of the entrepreneurial venture failing? How serious would be the resulting financial loss? Whereas many ways exist to increase innovation, reducing risk focuses largely on financial factors, with a secondary consideration of self-image and ego.

The model allows even the most inexperienced entrepreneurs to characterize their new or existing venture situations and identify appropriate strategies. The model places innovation on the vertical axis and risk on the horizontal axis. It denotes the levels of these two

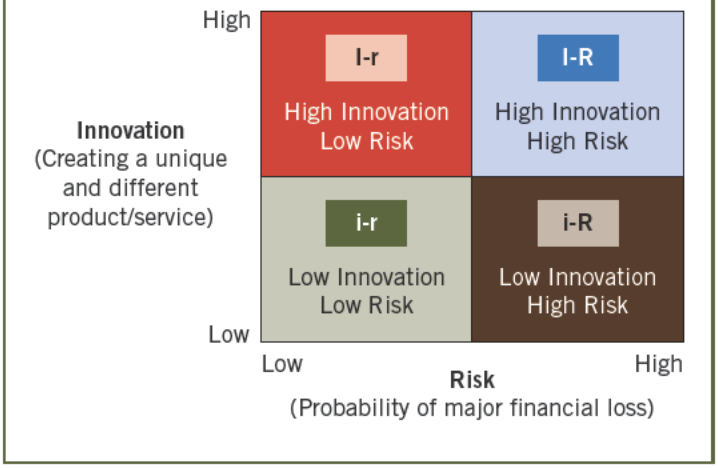
Table 13.1 Strategic Approaches: Position, Leverage, Opportunities

	Position	Leverage	Opportunities
Strategic logic	Establish position	Leverage resources	Pursue opportunities
Strategic steps	Identify an attractive market Locate a defensible position Fortify and defend	Establish a vision Build resources Leverage across markets	Jump into the confusion Keep moving Seize opportunities Finish strong
Strategic question	Where should we be?	What should we be?	How should we proceed?
Source of advantage	Unique, valuable position with tightly integrated activity system	Unique, valuable, inimitable resources	Key processes and unique simple rules
Works best in	Slowly changing, well-structured markets	Moderately changing, well-structured markets	Rapidly changing, ambiguous markets
Duration of advantage	Sustained	Sustained	Unpredictable
Risk	It will be too difficult to alter position as conditions change	Company will be too slow to build new resources as conditions change	Managers will be too tentative in executing on promising opportunities
	Profitability	Long-term dominance	Growth

Source: From "Strategy as Simple Rules," by Kathleen M. Eisenhardt and Donald N. Sull (January 2001): 109. Copyright © 2001 by the Harvard Business School Publishing. All rights reserved.

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Figure 13.3 The Entrepreneurial Strategy Matrix: Independent Variables



Source: Matthew C. Sonfield and Robert N. Lussier, "The Entrepreneurial Strategic Matrix: A Model for New and Ongoing Ventures." Reprinted with permission from *Business Horizons* 40, no. 3 (1997), by the trustees at Indiana University, Kelley School of Business.

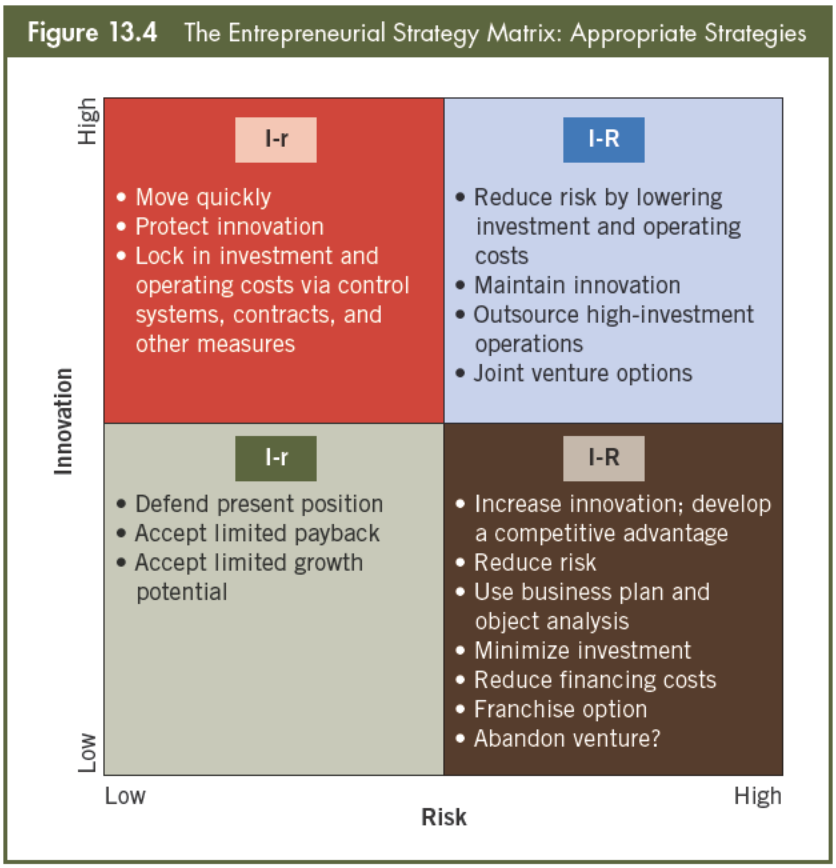
variables by using *I* and *R* for high levels and *i* and *r* for low levels (see Figure 13.3).

The value of the entrepreneurial strategy matrix is that it suggests appropriate avenues for different entrepreneurs. When the entrepreneur identifies the cell that best describes the new or existing venture being contemplated, then certain strategies are indicated as more likely to be effective (see Figure 13.4).

It should be obvious that certain cells are more advantageous than others. A high-innovation/low-risk venture is certainly preferable to a low-innovation/high-risk one. Yet, for every venture found in *I-r*, large numbers of ventures can be found in *i-R*. Risk is more common than innovativeness in the business world.

The strategic implications of the matrix are two-fold. First, entrepreneurs will find certain cells preferable to others, and one set of appropriate strategies involves moving from one cell to another. Second, such movement is not always possible for an entrepreneur, so the appropriate strategies involve reducing risk and increasing innovation within a cell.

Figure 13.4 The Entrepreneurial Strategy Matrix: Appropriate Strategies



Source: Matthew C. Sonfield and Robert N. Lussier, "The Entrepreneurial Strategic Matrix: A Model for New and Ongoing Ventures." Reprinted with permission from *Business Horizons* 40, no. 3 (1997), by the trustees at Indiana University, Kelley School of Business.

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13-3 Managing Entrepreneurial Growth

LO13.3 Outline the challenges of managing entrepreneurial growth

Managing entrepreneurial growth may be the most critical tactic for the future success of business enterprises. After initiation of a new venture, the entrepreneur needs to develop an understanding of management change. This is a great challenge because it often encompasses the art of balancing mobile and dynamic factors.[19]

Thus, the survival and growth of a new venture require that the entrepreneur possess both strategic and tactical skills and abilities. Which specific skills and abilities are needed depend in part on the venture's current development; Figure 13.5 illustrates the typical venture life cycle. Managing growth can be a formidable challenge to the successful development of any venture.

13-3a Venture Development Stages

As noted, Figure 13.5 represents the traditional life cycle stages of an enterprise. These stages include new-venture development, start-up activities, growth, stabilization, and innovation or decline. Other authors describe these stages in different terms. For example, Alfred Chandler identifies the following stages in a firm's evolution:

1. Initial expansion and accumulation of resources
2. Rationalization of the use of resources
3. Expansion into new markets to ensure the continued use of resources
4. Development of new structures to ensure continuing mobilization of resources[20]

These four phases are, in effect, the same major stages illustrated in Figure 13.5, with the exception of stabilization. In short, authors generally agree regarding a venture's life cycle. Presented next are the five major stages.

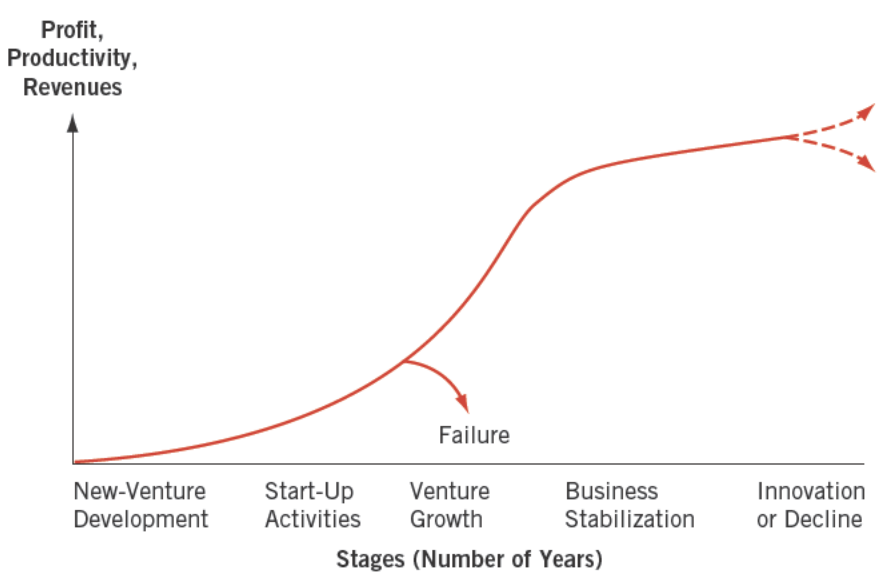
New-Venture Development

The first stage, new-venture development, consists of activities associated with the initial formulation of the venture. This initial phase is the foundation of the entrepreneurial process and requires creativity and assessment. In addition to the accumulation and expansion of resources, this is a creativity, assessment, and networking stage for initial entrepreneurial strategy formulation. The enterprise's general philosophy, mission, scope, and direction are determined during this stage.

Start-Up Activities

The second stage, start-up activities, encompasses the foundation work needed to create a formal business plan, search for capital, carry out marketing activities, and develop an effective entrepreneurial team. These activities typically demand an aggressive entrepreneurial strategy with maximum efforts devoted to launching the

Figure 13.5 A Venture's Typical Life Cycle



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venture. This stage is similar to Chandler's description of the rationalization of the use of resources. It is typified by strategic and operational planning steps designed to identify the firm's competitive advantage and uncover funding sources. Marketing and financial considerations tend to be paramount during this stage.[21]

Growth

The **growth stage** often requires major changes in entrepreneurial strategy. Competition and other market forces call for the reformulation of strategies. For example, some firms find themselves "growing out" of business because they are unable to cope with the growth of their ventures. Highly creative entrepreneurs sometimes are unable or unwilling to meet the administrative challenges that accompany this growth stage. As a result, they leave the enterprise and move on to other ventures.

This growth stage presents newer and more substantial problems than those the entrepreneur faced during the start-up stage.[22] These newer challenges force the entrepreneur into developing a different set of skills while maintaining an "entrepreneurial perspective" for the organization.[23] The growth stage is a transition from entrepreneurial one-person leadership to managerial team-oriented leadership.

Business Stabilization

The **stabilization stage** is a result of both market conditions and the entrepreneur's efforts. During this stage, a number of developments commonly occur, including increased competition, consumer indifference to the entrepreneur's good(s) or service(s), and saturation of the market with a host of "me too" look-alikes. Sales often begin to stabilize, and the entrepreneur must start to think about where the enterprise will go during the next three to five years. This stage is often a "swing" stage in that it precedes the period when the firm either swings into higher gear and greater profitability or swings toward decline and failure. During this stage, innovation is often critical to future success.

Innovation or Decline

Firms that fail to innovate will die. Financially successful enterprises often will try to acquire other innovative firms, thereby ensuring their own growth. Also, many firms will work on new product/service development to complement current offerings.

All of a venture's life cycle stages are important strategic points, and each requires a different set of strategies. However, this chapter concentrates specifically on the growth stage because entrepreneurs often ignore it. This happens not because of incompetence but rather because of the almost hypnotic effect a successful growth stage can cause. We shall now examine the key factors that affect the ability to manage this stage.

13-3b Transitioning from Entrepreneurial to Managerial

LO13.4 Explain the transition from an entrepreneurial to managerial approach

The transitions between stages of a venture are complemented (or in some cases inhibited) by the entrepreneur's ability to make a transition in style. A key transition occurs during the growth stage of a venture when the entrepreneur shifts into a managerial style. This is not easy to do. As researchers Charles W. Hofer and Ram Charan have noted, "Among the different transitions that are possible, probably the most difficult to achieve and also perhaps the most important for organizational development is that of moving from a one-person, entrepreneurially managed firm to one run by a functionally organized, professional management team."[24]

A number of problems can occur during this transition, especially if the enterprise is characterized by factors such as (1) a highly centralized decision-making system, (2) an overdependence on one or two key individuals, (3) an inadequate repertoire of managerial skills and training, and (4) a paternalistic atmosphere.[25] Although these characteristics often are effective for the new venture's start-up and initial survival, they pose a threat to the firm's development during the growth stage. Quite often, these characteristics inhibit development by detracting from the entrepreneur's ability to manage the growth stage successfully.

Balancing the Focus: Entrepreneurial versus Managerial

When managing the growth stage, entrepreneurs must remember two important points. First, an adaptive firm needs to retain certain entrepreneurial characteristics to encourage innovation and creativity. Second, the entrepreneur needs to translate this spirit of innovation and creativity to their personnel while personally making a transition toward a more managerial style.[26] This critical entrepreneur/manager balance is extremely difficult to achieve. Although every firm wants to be as innovative, flexible, and creative as Apple, Google, and Facebook, there are thousands of new restaurants, Internet businesses, retail stores, and high-tech ventures that presumably have tried to be innovative and grow but have failed.

Remaining entrepreneurial while making the transition to some of the more administrative traits is vital to the successful growth of a venture. Table 13.2 provides a framework for comparing the entrepreneurial and administrative characteristics and pressures relative to five major factors: strategic orientation, commitment to seize opportunities, commitment of resources, control of resources, and management structure. Each of these five areas is critical to the balance needed to manage

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The Entrepreneurial Process

From Entrepreneur to Manager

For many entrepreneurs, one of the most difficult tasks is to make the successful transition from a creative, task-juggling entrepreneur to a business-skill-applying manager. A number of top entrepreneurs have been successful in this challenging transition, while others have faltered. Most of the time, the success always relates to the entrepreneur's ability to grow and develop their workforce. Today, there are key management strategies that entrepreneurs should keep in mind when confronting the challenge of enhancing the abilities of their employees while growing their ventures.

There are effective human resource management practices that entrepreneurs need to develop and improve as they expand and grow their ventures. In many firms, the owner must personally handle all human resource practices, and thus inefficiencies may occur due to the amount of other activities the owner performs. This situation creates the danger that small entrepreneurs might fail to recognize or understand critical issues regarding human resources.

Researchers Jeffrey S. Hornsby and Donald F. Kuratko point out that dealing with the human resource issue may be the most critical challenge confronting entrepreneurs in the twenty-first century. In a number of studies they conducted on entrepreneurs' views of the human resource challenge, they found a number of critical issues that remain constant no matter how fast the business grows. Issues such as the availability and retention of quality workers, technology in the workplace, motivation of the workforce, and employee morale are considered to be foremost in the minds of most entrepreneurs seeking to manage a growing firm.

In trying to constantly improve employee performance, two control-related areas warrant the entrepreneur's attention. The first is the link between pay and performance. The second is the spirit of teamwork.

The Pay-Performance Link: One of the most common causes of poor morale can be tied to the pay/performance link. Do those who do the best work receive the highest salaries? In many growing ventures, all salaries are kept secret. Only the owner and the respective employee know how much the employee makes. Over time, however, raises usually are given to those who stay, and they are not uniform; some people get more money than others. This can create a morale problem when employees feel that raises are arbitrary and are not tied to performance. When this is the case, two things can happen. First, those who can make more money by going elsewhere will take advantage of such employment opportunities. Second, those who stay will do less work, reasoning that "I may not be paid what I'm worth, but I'm not putting forth as much effort as I used to, either." So it is imperative that the entrepreneur-manager try to tie raises to performance whenever possible. Not everyone's job is quantifiable. It may be easy to evaluate a salesperson's performance simply by looking at how much the person has sold, but a software developer's performance may call for a highly subjective evaluation. This is why some kind of evaluation system should be used. In addition, the entrepreneur-manager needs to remain alert to locally competitive salaries. Some businesses are unable to match the salaries of other employers, but they must come close or risk losing key personnel. Overall, however, few people leave their jobs just because of dissatisfaction with their pay. In many cases, that is just one of the reasons. Another is dissatisfaction with the work environment, as when it has no feeling of teamwork, so personnel simply do not like it there.

Develop Teamwork: Although some entrepreneur-managers believe they encourage teamwork, they actually promote competition. For example, the owner who goes overboard in praising and rewarding the best salesperson soon will find the other salespeople working to undermine that individual. The result is infighting among the personnel. The best way is to ensure that real teamwork is developing is to reward those who are team players and, most important of all, to reprimand (and, in some cases, fire) those who refuse to cooperate for the overall good.

Remember the work climate is most important among younger employees today. People want to find fulfillment in their jobs. Research shows that attending to the psychological side of the work environment, including aspects such as a feeling of importance, creating an opportunity to do meaningful work, and the belief that workers are contributing to the business, is often more important to employees than salary and working conditions. When these good feelings are present, morale tends to be high and performance good.

As one shining example of those issues, author Carmine Gallo, in his book *The Innovation Secrets of Steve Jobs*, outlines a number of significant managing principles that emanated from Apple founder and CEO Steve Jobs. Here are a few that apply to the challenge of employee motivation:

- *Help people find what they love in their work.* If people do what they love, motivation and performance are never questioned.
- *Put a dent in the universe.* Inspire your workforce to develop a sense of meaning in their performance as it relates to what the firm is trying to accomplish. Develop a sense of purpose in everyone's job.
- *Sell dreams not products.* Everyone wants to work at something significant in this world. Create a dream that is bigger than the entire workforce.
- *Say no to 1,000 things.* Remain focused on the simplicity of what can be done. Avoid the temptation to "add on" constantly and keep everyone aimed on the few areas of excellence.
- *Master the message.* Communicate with your employees continuously. Use stories and examples to make them understand the true message you intend for the atmosphere of the venture.

As you peruse the list, you can see how they relate to creating a unique and significant experience for the employees of a growing firm. Once an entrepreneur can understand and execute effectively on the challenge of human resources, the transition from entrepreneur to manager becomes a more successful one.

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entrepreneurially. At the two ends of the continuum (from entrepreneurial focus to administrative focus) are specific points of view. One study characterized these using a question format.

The Entrepreneur's Point of View

- Where is the opportunity?
- How do I capitalize on it?
- What resources do I need?
- How do I gain control over them?
- What structure is best?

The Administrative Point of View

- What resources do I control?
- What structure determines our organization's relationship to its market?
- How can I minimize the impact of others on my ability to perform?
- What opportunity is appropriate?[27]

The logic behind the variance in the direction of these questions can be presented in a number of different ways. For example, the commitment of resources in

Table 13.2 The Entrepreneurial Culture versus the Administrative Culture

	Entrepreneurial Focus		Administrative Focus	
	Characteristics	**Pressures**	**Characteristics**	**Pressures**
Strategic orientation	Driven by perception of opportunity	Diminishing opportunities Rapidly changing technology, consumer economics, social values, and political rules	Driven by controlled resources	Social contracts Performance measurement criteria Planning systems and cycles
Commitment to seize opportunities	Revolutionary, with short duration	Action orientation Narrow decision windows Acceptance of reasonable risks Few decision constituencies	Evolutionary, with long duration	Acknowledgment of multiple constituencies Negotiation about strategic course Risk reduction Coordination with existing resource base
Commitment of resources	Many stages, with minimal exposure at each stage	Lack of predictable resource needs Lack of control over the environment Social demands for appropriate use of resources Foreign competition Demands for more efficient use	A single stage, with complete commitment out of decision	Need to reduce risk Incentive compensation Turnover in managers Capital budgeting systems Formal planning systems
Control of resources	Episodic use or rent of required resources	Increased resource specialization Long resource life compared with need Risk of obsolescence Risk inherent in the identified opportunity Inflexibility of permanent commitment to resources	Ownership or employment of required resources	Power, status, and financial rewards Coordination of activity Efficiency measures Inertia and cost of change Industry structures
Management structure	Flat, with multiple informal networks	Coordination of key noncontrolled resources Challenge to hierarchy Employees' desire for independence	Hierarchy	Need for clearly defined authority and responsibility Organizational culture Reward systems Management theory

Source: An exhibit from "The Heart of Entrepreneurship," by Howard H. Stevenson and David E. Gumpert, March/April 1985, 89. Copyright © 1985 by the President and Fellows of Harvard College. All rights reserved.

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the entrepreneurial frame of mind responds to changing environmental needs, whereas the managerial point of view is focused on the reduction of risk. In the control of resources, entrepreneurs will avoid ownership because of the risk of obsolescence and the need for more flexibility, whereas managers will view ownership as a means to accomplish efficiency and stability. In terms of structure, the entrepreneurial emphasis is placed on a need for flexibility and independence, whereas the administrative focus is placed on ensuring integration with a complexity of tasks, a desire for order, and controlled reward systems.

These examples of differences in focus help establish the important issues involved at both ends of the managerial spectrum. Each point of view—entrepreneurial and administrative—has important considerations that need to be balanced if effective growth is going to take place.

13-3c Understanding the Growth Stage

LO13.5 Identify the key factors that play a major role during the growth stage

The growth stage often signals the beginning of a metamorphosis from a personal venture to a group-structured operation. Domination by the lead entrepreneur gives way to a team approach based heavily on coordination and flexibility.

Key Factors during the Growth Stage

Entrepreneurs must understand four key factors about the specific managerial actions that are necessary during the growth stage. These factors are control, responsibility, tolerance of failure, and change.

Control Growth creates problems in command and control. When dealing with these problems, entrepreneurs need to answer three critical questions: (1) Does the control system imply trust? (2) Does the resource allocation system imply trust? (3) Is it easier to ask permission than to ask forgiveness? These questions reveal a great deal about the control of a venture. If they are answered with "yes," the venture is moving toward a good blend of control and participation. If they are answered with "no," the reasons for each negative response should be closely examined.

Responsibility As the company grows, the distinction between authority and responsibility becomes more apparent. This is because authority always can be delegated, but it is most important to create a sense of responsibility. This action establishes flexibility, innovation, and a supportive environment. People tend to look beyond the job alone if a sense of responsibility is developed, so the growth stage is better served by the innovative activity and shared responsibility of all of the firm's members.

Tolerance of Failure Even if a venture has avoided the initial start-up pitfalls and has expanded to the growth stage, it is still important to maintain a tolerance of failure. The level of failure the entrepreneur experienced and learned from at the start of the venture should be the same level expected, tolerated, and learned from in the growth stage. Although no firm should seek failure, to continually innovate and grow, it should tolerate a certain degree of failure as opposed to punishing it.

Three distinct forms of failure should be distinguished:

- ***Moral failure***. This form of failure is a violation of internal trust. Because the firm is based on mutual expectations and trust, this violation is a serious failure that can result in negative consequences.
- ***Personal failure***. This form of failure is brought about by a lack of skill or application. Usually, responsibility for this form of failure is shared by the firm and the individual. Normally, therefore, an attempt is made to remedy the situation in a mutually beneficial way.
- ***Uncontrollable failure***. This form of failure is caused by external factors and is the most difficult to prepare for or deal with. Resource limitations, strategic direction, and market changes are examples of forces outside the control of employees. Top management must carefully analyze the context of this form of failure and work to prevent its recurrence.

Change Planning, operations, and implementation are all subject to continual changes as the venture moves through the growth stage and beyond. Retaining an innovative and opportunistic posture during growth requires a sense of change and variation from the norm. Entrepreneurs must realize, however, that change holds many implications for the enterprise in terms of resources, people, and structure. It is therefore important during growth that the flexibility regarding change be preserved. This allows for faster managerial response to environmental conditions.

13-3d Managing Paradox and Contradiction

LO13.6 Discuss the complex management of paradox and contradiction

When a venture experiences surges in growth, a number of structural factors begin to present multiple challenges. Entrepreneurs constantly struggle over whether to organize these factors—such as cultural elements, staffing and development of personnel, and appraisal and rewards—in a rigid, bureaucratic design or a flexible, organic design.

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Research has shown that new-venture managers experiencing growth, particularly in emerging industries, need to adopt flexible, organic structures.[28] Rigid, bureaucratic structures are best suited for mature, stabilized companies. Thus, the cultural elements need to follow a flexible design of autonomy, risk taking, and entrepreneurship. This type of culture is a renewal of the entrepreneur's original force that created the venture. Although the entrepreneur's focus makes a transition toward a more administrative style, as mentioned earlier, the culture of the organization must be permeated with a constant renewal of the virtues of innovation and entrepreneurship.

When entrepreneurs design a flexible structure for high growth, they must realize that a number of contradictory forces are at work in certain other structural factors. Consider the following.

Bureaucratization versus Decentralization

Increased hiring stimulates bureaucracy. Firms formalize procedures as staffing doubles and triples. Employee participation and autonomy decline, and internal labor markets develop. Tied to growth, however, is also an increased diversity in product offering that favors less formalized decision processes, greater decentralization, and the recognition that the firm's existing human resources lack the necessary skills to manage the broadening portfolio.

Environment versus Strategy

High environmental turbulence and competitive conditions favor company cultures that support risk taking, autonomy, and employee participation in decision making. Firms confront competitors, however, through strategies whose implementation depends on the design of formal systems that inhibit risk taking and autonomy.

Strategic Emphases: Quality versus Cost versus Innovation

Rapidly growing firms strive to simultaneously control costs, enhance product quality, and improve product offerings. Minimizing costs and undercutting competitors' product prices, however, are best achieved by traditional hierarchical systems of decision making and evaluations Yet, these strategies conflict with the kinds of autonomous processes most likely to encourage the pursuit of product quality and innovation.[29]

These factors emphasize the importance of managing paradox and contradiction. Growth involves the multiple challenges of (1) the stresses and strains induced by attempts to control costs while simultaneously enhancing quality and creating new products to maintain competitive parity and (2) centralizing to retain control while simultaneously decentralizing to encourage the contributions of autonomous, self-managed professionals to the embryonic corporate culture. Rapidly growing firms are challenged to strike a balance among these multiple pulls when designing their managerial systems.

13-3e Confronting the Growth Wall

LO13.7 List the steps useful for breaking through the growth wall

In attempting to develop a managerial ability to deal with venture growth, many entrepreneurial owners confront a **growth wall** that seems too gigantic to overcome. Thus, they are unable to begin the process of handling the challenges that growth brings about.

Researchers have identified a number of fundamental changes that confront rapid-growth firms, including instant size increases, a sense of infallibility, internal turmoil, and extraordinary resource needs. In addressing these changes that can build a growth wall, successful growth-oriented firms have exhibited a few consistent themes:

- The entrepreneur is able to envision and anticipate the firm as a larger entity.
- The team needed for tomorrow is hired and developed today.
- The original core vision of the firm is constantly and zealously reinforced.
- New "big-company" processes are introduced gradually as supplements to rather than replacements for existing approaches.
- Hierarchy is minimized.
- Employees hold a financial stake in the firm.[30]

These themes are important for entrepreneurs to keep in mind as they develop their abilities to manage growth.

One researcher found that internal constraints such as lack of growth capital, limited spans of control, and loss of entrepreneurial vitality occur in growth firms that struggle to survive versus those that successfully achieve high growth. In addition, fundamental differences exist in the firms' approach to environmental changes and trends.[31] Thus, a few key steps are recommended for breaking through the inability to handle environmental changes or trends. These include *creating a growth task force* to organize and interpret the environmental data, to identify the venture's strengths and weaknesses, to brainstorm new ideas that leverage the firm's strengths, and to recommend key ideas that should be developed further; *planning for growth* with strategies to resolve the stagnation, a set of potential results, and identification of the necessary resources; *maintaining a growth culture* that encourages and rewards a growth-oriented attitude; and *developing an outside board of advisers* to become an integral part of the venture's growth. This board should help determine, design, and implement an organizational structure to enhance the desire for growth.[32]

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13-3f The Rise of Growth Hacking

LO13.8 Explain the factors involved in growth hacking

As companies have become increasingly digital, **growth hacking** has emerged as a new way of scaling businesses. Originally identified by author and entrepreneur Sean Ellis, growth hacking is described as a combination of creative marketing, data analysis, and coding with the focus being on growth. Enabled by digital transformation, growth hacking relies on rapid experimentation following the Lean Startup philosophy. As we outlined in Chapter 6, the Lean Startup philosophy is about agility, frequent step-by-step experimentation, and testing in an iterative process. There are three key elements to growth hacking:

1. *Marketing*. Growth hacking is involved in all stages of the customer journey in order to achieve long-term sustainable growth, which is in line with the traditional marketing concept including the famous 4 Ps: product, price, promotion, and place.
2. *Data analysis*. Big data is a tool that helps collect customer information regarding behavior and preferences. It can directly translate this information into enhanced decision making and superior growth.
3. *Coding and artificial intelligence*. Artificial intelligence is on the rise, and it will interpret customer data, learn from it, and use the learnings to reach an objective by adapting to specific needs and circumstances without being explicitly programmed. Relying on machine learning mechanisms, artificial intelligence utilizes external information obtained through big data sources to identify underlying structures and patterns.[33]

While still relatively new, growth hacking presents a number of opportunities and challenges for start-up ventures. Researchers Rene Bohnsack and Meike Malena Liesner clearly articulated some of these. For example, opportunities include improved communication by setting up a growth hacking team with representatives from the different areas of the venture. Like we described in Chapter 6 about design thinking, utilizing customer feedback and the iterative process, ventures can create better products at lower development costs. Challenges include the quality of data that are gathered, the proper training of personnel, and the recognition of how fast the online landscape continues to change with trends and preferences.[34] Table 13.3 outlines these opportunities and challenges.

Table 13-3 Growth Hacking: Opportunities and Challenges

Opportunities	Challenges
Greater Communication	**Data Quality**
⇨ Needs departmental collaboration	⇨ Establish quality control measures
Enhanced Products	**Training of Personnel**
⇨ Using a holistic view with the customer	⇨ Provide training for proper procedures
Improved Development Costs	**Perishability with Trends**
⇨ Experimentation reduces costs	⇨ Monitor trends on social media
Satisfied Customers	
⇨ Personalized marketing and better pricing	

Source: Adapted from Rene Bohnsack and Meike Malena Liesner, "What the Hack? A Growth Hacking Taxonomy and Practical Applications for Firms," *Business Horizons* 62, no. 6 (2019): 805.

13-3g The Challenges of Blitzscaling

LO13.9 Identify the challenges involved with "blitzscaling"

In the pursuit of market dominance, new ventures scale up to expand their markets and obtain new customers. While traditional scaling strategies move along based on the actual growth of the venture, **blitzscaling** tries to push the growth faster by prioritizing speed over efficiency in an environment of uncertainty. Not only are new ventures in competition for a first-mover advantage, but they must also achieve a certain level of growth before they run out of capital. As we discussed in Chapter 6 with the Lean Startup method, it is important to validate the value of the proposed idea and estimate the potential growth in the market before the venture can drastically scale. In order to do so, the venture will release a minimum viable product. Keep in mind that blitzscaling is not appropriate for all industries, as a minimum viable product may not be feasible in certain areas, such as pharmaceuticals or hospitals. (See the Entrepreneurial Process on whether blitzscaling is the right approach for growth.) Thus, intangible products such as software may be better suited for blitzscaling because they can be launched quickly and updated with relative ease.

For most technology start-ups, the general appeal of blitzscaling is that it leads to rapid growth on a global scale. This type of growth enables new technology start-ups to achieve a first-mover advantage in new global markets. Normally, the start-up is blitzscaling toward the launch of an original or revolutionary product. In some cases, this concept or product may not be fully developed, or the business may not have experience in the target market. As a result, the process of blitzscaling is riddled with uncertainty, the only certainty being that a mistake will be made along the way. Immediately integrating

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The Entrepreneurial Process

Is Blitzscaling the Right Approach to Growth?

Accelerated growth, where speed is prioritized over efficiency, is the definition of *blitzscaling*. It originates from the word *lightning*, "Blitzen." The speed of blitzscaling has to do with the velocity of growing a product life cycle, measured in months instead of years. It requires the investment of venture capitalists so that a company can grow through various stages and valuations. There is a family stage, which is one to nine employees, all the way to the nation stage, which is over 10,000 employees. Often during the blitzscaling stages, the company is not profitable. It may take the company several years to expand and reach efficiencies.

Is it the right decision for every company in the early years? Is the risk of errors and inefficient investment worth market dominance and at what cost? Entrepreneurs should consider the following thoughts:

1. Certain products and markets lend themselves better to blitzscaling, such as software and technology. Hardware products require launching a perfectly made product, not one that can be tweaked after launch. Bringing a faulty product to market too quickly could be the death of that product or company. And beauty and food items (consumer package goods [CPG]), crowded with competitors, often grow slowly due to the iterative nature of finding their niche market. And there is also the initial difficulty of measuring growth versus repeat sales with the CPG market.
2. Blitzscaling requires raising enough funds to manage unforeseen expenses and growth. Both funding targets need to be managed carefully along with growth targets for employees. There should be no pressure to overspend or over-deliver. Overspending can result in not investing wisely or entering markets too soon. The pressure to over-deliver means promising customers to deliver results that they are not ready to deliver. When this happens, the integrity of the company is at stake.
3. A healthy culture of communication up and down the organization will be key during a time of rapid growth. Problem solving by all employees will be key as the company expands. Embrace chaos.
4. The success of blitzscaling can result in market domination and great earning potential, the ability to branch into other products before competitors because of early name recognition, or the opportunity of selling your company to another for a large profit.

There is also no reason why entrepreneurs should not consider self-funded growth instead. It has been possible for many start-up companies to have been profitable from day one. Self-funded businesses allow entrepreneurs to build businesses they love and help them operate them for many years. When they leave the business, they own more of the proceeds.

The decision to grow swiftly, dominate the market, and give up something in return, a share of the company for the support, must be weighed carefully. One critic suggests that blitzscaling isn't truly success but rather survivorship disguised as a strategy. And blitzscaling is not a guarantee for success, but under the right conditions and for the right company, it may be very lucrative.

Source: Adapted from Donald F. Kuratko, Harrison L. Holt, and Emily Neubert, "Blitzscaling: The Good, the Bad, and the Ugly," *Business Horizons* 63, no. 1 (2020): 109–19; James Richardson, "Why Exponential Growth Works Better Than Blitzscaling for New Consumer Brands," https://foodinstitute.com/focus/why-exponential-growth-works-better-than-blitzscaling-for-new-consumer-brands, accessed January 28, 2022; Tim O'Reilly, "The Fundamental Problem with Silicon Valley's Favorite Growth Strategy," https://www.yahoo.com/entertainment/fundamental-problem-silicon-valley-favorite-130055251.html?guce_referrer=aHR0cHM6Ly93d3cuZ29vZ2xlLmNvbS8&guce_referrer_sig=AQAAADHeuTJNGgfNz6W2UcUW4eHrQW3IN-mJBAf6unhms2wYqPTijNLuJqy8NpiKkY-iResQfly5S8a0276nEMLy5p3qyCjCtBz8PiHXx-3sDO0f2cKiYU3VxnmtERVIQEXH4KKe2QUW_UUehfVzRnEmQwxRAzEfLDLZjfTFwaN2uZpZ, accessed October 27, 2022.

blitzscaling with a venture results in managerial inefficiencies, increased capital expenditures, and instability in the company's culture. A venture incurs a massive amount of risk when blitzscaling its business or product. If successful with this strategy, the venture may experience numerous strikeouts, but if eventually successful, the outcome of the contest is sometimes changed dramatically.

Silicon Valley created a culture of "fake it till you make it," which means deceptively claiming that a new venture exhibits characteristics of successful entrepreneurial ventures to gain support from others when in fact that is not the truth. This can become a slippery slope in which deception escalates to the point where stakeholders accuse entrepreneurs of committing fraud. Indeed, "fake it till you make it" underpins the phenomenon of blitzscaling, where entrepreneurs strive to bring new offerings to the market as quickly as possible and then rapidly scale to attract and satisfy investors.[35] (See the Entrepreneurial Process story of Theranos.)

As blitzscaling requires companies to prioritize speed over efficiency, companies that grow rapidly are often pressured to cut corners and sacrifice culture and ethics in pursuit of growth. Researchers Donald F. Kuratko, Harrison Holt, and Emily Neubert identified a set of principles to assist new ventures considering blitzscaling:

Principle #1: Seek environments that enable healthy blitzscaling. New ventures pursuing blitzscaling should look for access to venture capital funding, talented employees, and adaptable customers.

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Principle #2: Raise enough funding to mitigate errors, but not overfunding. Ventures must raise enough funding to overcome unforeseen issues while blitzscaling to avoid potential failure. However, firms must be cautious of overfunding because excessive financing rounds can result in unnecessary spending and premature expansion.

Principle #3: Set realistic expectations with reasonable targets. Set high expectations with challenging targets, but those targets should still be achievable. If targets appear to be impossible, employees may feel pressured to cut corners to deliver results.

Principle #4: Maintain a healthy ethical culture. Unhealthy cultures foster dishonesty and unethical behavior. Firms pursuing blitzscaling should promote open communication throughout the organization and seek to reward good behavior while punishing unwarranted behavior so that everyone understands the ethical expectations.

Principle #5: Structure to support growth. Rapid growth without proper management and control can result in chaos. As firms grow in number of employees and customers, it is vital to make sure other functions and support departments are able to support the expansion.

The Entrepreneurial Process

The Ugly Side of Blitzscaling

Silicon Valley is synonymous with technological innovation and the launching point for many of today's groundbreaking technology companies, such as Facebook, Alphabet, Tesla, and Apple. Over the years, Silicon Valley has created the ideal ecosystem for technological innovation through their trademark "start-up culture." However, the start-up culture fostered by Silicon Valley can present numerous complications, especially when blitzscaling new ventures for aggressive growth.

Elizabeth Holmes dropped out of Stanford in 2003 to start a clinical laboratory company that would revolutionize the health care industry through a disruptive technology in blood-testing technology. The company was named Theranos. Holmes claimed that the technology could perform hundreds of tests on only a few drops of blood. Holmes attracted over $800 million in investment from the likes of Rupert Murdoch, Betsy DeVos, Carlos Slim, the Waltons, and the Cox Family, none of whom have any health care background. By 2014 and after six rounds of funding, Theranos achieved a valuation of over $9 billion.

Holmes and her company looked unstoppable. She graced the cover of *Fortune*, *Forbes*, and *The New Yorker* in 2014, often being compared to the brilliant Steve Jobs. Theranos' board of directors was seen as one of the most notable in U.S. corporate history. Theranos President Sunny Balawani (Elizabeth Holmes's partner) told investors that Theranos had generated over $100 million in revenues and was on track for $1 billion in revenues in 2015. The company had barely generated over $100,000 in revenue. Meanwhile, Holmes raved about the revolutionary miniLab technology that Theranos utilized to complete blood tests on single pricks of blood. In reality, Theranos never used the miniLab for patients testing in its clinical laboratory but conducted the tests on regular unmodified devices bought from other companies or sent out to third-party laboratories. Theranos opened 40 wellness centers in a variety of Walgreens stores using nonfunctional machines, resulting in 7.5 million voidable blood test results. By introducing their nonfunctional miniLab devices into the consumer market, Theranos took on an unsuitable level of risk. Behind the curtain of it all, Holmes created a culture of secrecy where she and Balwani regarded anyone who raised a concern or an objection as a cynic or a naysayer.

However, problems were brewing as employees raised issues with the viability and accuracy of Theranos' technology. The New York State Department of Health received a formal complaint from a Theranos employee in April 2014. In October 2015, the *Wall Street Journal* shined a light on Theranos' issues with its technology, prompting other investigations into Theranos by the U.S. Food and Drug Administration and the Centers for Medicare and Medicaid Services. The investigations and rumors came to a dramatic head in March 2018 when the U.S. Securities and Exchange Commission charged Theranos, as well as Holmes and COO Sunny Balwani, with massive fraud. Later that year, the Department of Justice charged Holmes and Balwani with wire fraud, Holmes stepped down as CEO, and Theranos officially closed its doors in September 2018. In January 2022, a jury found Elizabeth Holmes guilty of defrauding investors out of hundreds of millions of dollars. After more than 50 hours of deliberations over seven days, the jury convicted Holmes of three counts of wire fraud and one count of conspiracy to commit wire fraud for lying to investors about devices developed by Theranos.

In the span of only four years, Theranos went from one of the top start-ups, valued at $9 billion, to an illegal and unethical venture that had to shut down. Silicon Valley culture and blitzscaling techniques fueled their prompt growth and expansion but also induced many of the fraudulent and unethical behaviors that lead to their ultimate demise.

Source: Adapted from John Carreyrou, *Bad Blood: Secrets and Lies in a Silicon Valley Startup* (New York: Knopf, 2018); R. Parloff, "A Singular Board at Theranos," *Fortune*, 2014, http://fortune.com/2014/06/12/theranos-board-directors; L. Ramsey, "The Rise and Fall of Theranos, the Blood-Testing Startup That Went from Silicon Valley Darling to Facing Fraud Charges," *Business Insider*, 2019, https://www.businessinsider.com/the-history-of-silicon-valley-unicorn-theranos-and-ceo-elizabeth-holmes-2018-5; and U.S. Securities and Exchange Commission, "Theranos, CEO Holmes, and Former President Balwani Charged with Massive Fraud," 2018, https://www.sec.gov/news/press-release/2018-41.

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Principle #6: Understand customer expectations. Not all products are suitable for blitzscaling. The expectations for a minimum viable product can vary by product type or industry, so it is important to understand target customers' values and expectations regarding the degree of refinement in product releases before pursuing blitzscaling.

Adhering to these principles will not guarantee that a venture will find blitzscaling a most successful strategy but it will certainly enhance the odds of avoiding many of the pitfalls suffered by companies in the past.[36]

13-4 Building an Entrepreneurial Company in the Twenty-First Century

LO13.10 Explore the elements of building an entrepreneurial company

The pace and magnitude of change continues to accelerate in the second decade of the twenty-first century; having the evolution and transformation of entrepreneurial firms match this pace is critical. How to build dynamic capabilities that are differentiated from those of the emerging competitors is the major challenge for growing firms that seek to adapt to the changing landscape. Two ways of building dynamic capabilities are internal (utilization of the creativity and knowledge from employees) and external[37] (the search for external competencies to complement the firm's existing capabilities).[38] The trend toward globalization, the advent of new technology, and the information movement are all examples of forces in this new millennium that are causing firms to examine their cultures, structures, and systems for flexibility and adaptability. Innovation and entrepreneurial thinking are essential elements in the strategies of growing ventures.

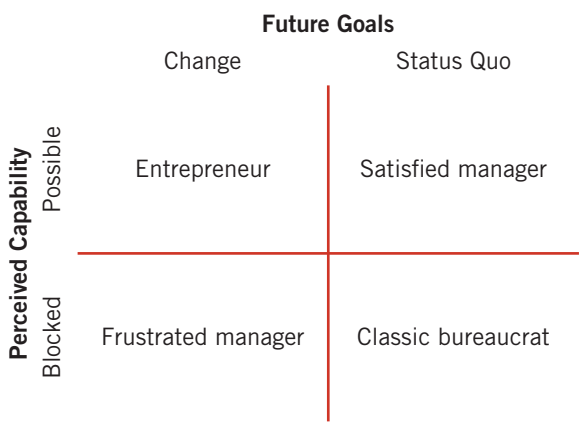
It has been noted that entrepreneurs (1) perceive an opportunity, (2) pursue this opportunity, and (3) believe that success of the venture is possible.[39] This belief is often due to the uniqueness of the idea, the strength of the product, or some special knowledge or skill the entrepreneur possesses. These same factors must be translated into the organization itself as the venture grows.

13-4a The Entrepreneurial Mindset

It is important for the venture's manager to maintain an entrepreneurial frame of mind. Figure 13.6 illustrates the danger of entrepreneurs evolving into bureaucrats who in turn stifle innovation. Table 13.4 provides a delineation of the differences between a managerial mindset versus an entrepreneurial mindset from the perspective of decision-making assumptions, values, beliefs, and approaches to problems.

In some cases, success will affect an entrepreneur's willingness to change and innovate. This is particularly true when the enterprise has developed a sense of complacency and the entrepreneur likes this environment: the person does not want to change. In fact, some entrepreneurs will create a bureaucratic environment in which orders are issued from the top down and change initiated at the lower levels is not tolerated.[40] As a result, no one in the venture is willing (or encouraged) to become innovative or entrepreneurial because the owner/founder stifles such activity.

Figure 13.6 The Entrepreneurial Mindset



One study found that the entrepreneur directly affects the firm's growth orientation as measured by profitability goals, product/market goals, human resource goals, and flexibility goals.[41] If the entrepreneur hopes to maintain the creative climate that helped launch the venture in the first place, specific steps or measures must be taken.

13-4b Key Elements for an Entrepreneurial Firm

It is important for entrepreneurs to establish a business that remains flexible beyond start-up. An **entrepreneurial firm** increases opportunity for its employees, initiates change, and instills a desire to be innovative. Entrepreneurs can build this type of firm in several ways.[42] The following are not inflexible rules, but they do enhance a venture's chance of remaining adaptive and innovative both through and beyond the growth stage.

Share the Entrepreneur's Vision

The entrepreneur's vision must be permeated throughout the organization for employees to understand the company's direction and share in the responsibility for its growth. The entrepreneur can communicate the vision directly to the employees through meetings, conversations, or seminars. It also can be shared through symbolic events or activities, such as social gatherings, recognition events, and displays. Whatever the format, having shared vision allows the venture's personnel to catch the dream and become an integral part of creating the future.[43]

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Table 13.4 The Managerial versus the Entrepreneurial Mindset

	Managerial Mindset	Entrepreneurial Mindset
Decision-making assumptions	The past is the best predictor of the future. Most business decisions can be quantified.	A new idea or an insight from a unique experience is likely to provide the best estimate of emerging trends.
Values	The best decisions are those based on quantitative analyses. Rigorous analyses are highly valued for making critical decisions.	New insights and real-world experiences are more highly valued than results based on historical data.
Beliefs	Law of large numbers: Chaos and uncertainty can be resolved by systematically analyzing the right data.	Law of small numbers: A single incident or several isolated incidents quickly become pivotal for making decisions regarding future trends.
Approach to problems	Problems represent an unfortunate turn of events that threaten financial projections. Problems must be resolved with substantiated analyses.	Problems represent an opportunity to detect emerging changes and possibly new business opportunities.

Source: Mike Wright, Robert E. Hoskisson, and Lowell W. Busenitz, "Firm Rebirth: Buyouts as Facilitators of Strategic Growth and Entrepreneurship," *Academy of Management Executive* 15, no. 1 (2001): 114.

Increase the Perception of Opportunity

This can be accomplished with careful job design. The work should have defined objectives for which people will be responsible. Each level of the hierarchy should be kept informed of its role in producing the final output of the product or service. This often is known as "staying close to the customer." Another way to increase the perception of opportunity is through a careful coordination and integration of the functional areas. This allows employees in different functional areas to work together as a cohesive whole.

Institutionalize Change as the Venture's Goal

This entails a preference for innovation and change rather than preservation of the status quo. If opportunity is to be perceived, the environment of the enterprise must not only encourage it but also establish it as a goal. Within this context, a desire for opportunity can exist if resources are made available and departmental barriers are reduced.

Instill the Desire to Be Innovative

The desire of personnel to pursue opportunity must be carefully nurtured. Words alone will not create the innovative climate.[44] Specific steps, such as the following, should be taken.

A Reward System Explicit forms of recognition should be given to individuals who pursue innovative opportunities. For example, bonuses, awards, salary advances, and promotions should be tied directly to the innovative attempts of personnel.

An Environment That Allows for Failure The fear of failure must be minimized by the general recognition that often many attempts are needed before a success is achieved. This does not imply that failure is sought or desired. However, learning from failure, as opposed to expecting punishment for it, is promoted. When this type of environment exists, people become willing to accept the challenge of change and innovation.

Flexible Operations Flexibility creates the possibility of change taking place and having a positive effect. If a venture remains too rigidly tied to plans or strategies, it will not be responsive to new technologies, customer changes, or environmental shifts. Innovation will not take place because it will not "fit in."

The Development of Venture Teams In order for the environment to foster innovation, venture teams and team performance goals need to be established. These must not be just work groups but visionary, committed teams that have the authority to create new directions, set new standards, and challenge the status quo.[45]

13-5 Unique Managerial Concerns of Growing Ventures

LO13.11 Identify the unique managerial concerns with growth businesses

Emerging businesses differ in many ways from larger, more structured businesses. Several unique managerial concerns involve growing businesses in particular. These concerns may seem insignificant to the operation of a large business, but often they become important to emerging entrepreneurs.

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13-5a The Distinctiveness of Size

The distinction of *smallness* gives emerging businesses certain disadvantages. The limited market, for example, restricts a small firm. Because a small size limits a company's ability to geographically extend throughout a region or state, the firm must recognize and service its available market. Another disadvantage is the higher ordering costs that burden many small firms. Because they do not order large lots of inventory from suppliers, small businesses usually do not receive quantity discounts and must pay higher prices. Finally, a smaller staff forces small firms to accept less specialization of labor. Thus, employees and managers are expected to perform numerous functions.

However, the distinction of small size is not all bad, and the advantages to smallness should be recognized and capitalized on. One advantage is greater flexibility. In smaller ventures, decisions can be made and implemented immediately, without the input of committees and the delay of bureaucratic layers. Production, marketing, and service are all areas that can be adjusted quickly for a competitive advantage over larger businesses in the same field. A second advantage is constant communication with the community.[46] An entrepreneur lives in the community and is personally involved in its affairs. The special insight of this involvement allows the entrepreneur to adjust products or services to suit the specific needs or desires of the particular community. This leads to the third and probably most important advantage of closeness to the customer: the ability to offer personal service. The personal service that an entrepreneur can provide is one of the key elements of success today. Major corporations work feverishly to duplicate or imitate the idea of personal service. Because the opportunity to provide personal service is an advantage that emerging firms possess by nature of their size, it *must* be capitalized on.

13-5b The One-Person-Band Syndrome

Most entrepreneurs start their businesses alone or with a few family members or close associates. In effect, the business *is* the entrepreneur, and the entrepreneur *is* the business.[47] However, a danger arises if the entrepreneur refuses to relinquish any authority as the emerging business grows. The **one-person-band syndrome** exists when an entrepreneur fails to delegate responsibility to employees, thereby retaining *all* decision-making authority. One study revealed that most planning in entrepreneurial firms is done by the owner alone, as are other operational activities.[48] This syndrome often is derived from the same pattern of independence that helped start the business in the first place. However, the owner who continues to perform as a one-person band can restrict the growth of the firm because the owner's ability is limited. How can proper planning for the business be accomplished if the owner is immersed in daily operations? Thus, the entrepreneur must recognize the importance of delegation. If the owner can break away from the natural tendency to do *everything*, then the business will benefit from a wider array of that person's abilities.

13-5c Time Management

Effective time management is not exclusively a challenge to entrepreneurs. However, limited size and staff force the entrepreneur to face this challenge most diligently. It has been said a person never will *find* time to do anything but must, in fact, *make* time. In other words, entrepreneurs should learn to use time as a resource and not allow time to use them.[49] To perform daily managerial activities in the most time-efficient manner, owner/managers should follow four critical steps:

1. *Assessment*. The business owner should analyze their daily activities and rank them in order of importance. (A written list on a notepad is recommended.)
2. *Prioritization*. The owner should divide and categorize the day's activities based on their ability to devote the necessary time to the task that day. In other words, the owner should avoid a procrastination of duties.
3. *Creation of procedures*. Repetitive daily activities can be handled easily by an employee if instructions are provided. This organizing of tasks can be a major time-saver for the owner that would allow the fourth and last step to be put into effect.
4. *Delegation*. Delegation can be accomplished after the owner creates procedures for various jobs. As mentioned in the description of the one-person-band syndrome, delegation is a critical skill that entrepreneurs need to develop.

All of these steps in effective time management require self-discipline on the part of entrepreneurs.

13-5d Community Pressures

Proximity to the community was mentioned earlier as a size advantage for small emerging ventures. However, unlike major corporations with public relations departments, the entrepreneur is involved with community activities directly. The community presents unique pressure to emerging entrepreneurs in three ways: participation, leadership, and donations.

Each of these expectations from the community requires entrepreneurs to plan and budget carefully. Many community members believe that the entrepreneur

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has "excess" time because they own the business. They also believe that the owner has leadership abilities needed for various community activities. Although the latter may be true, the owner usually does not have excess time. Therefore, entrepreneurs need to plan carefully the activities they believe would be most beneficial. One consideration is the amount of advertising or recognition the business will receive for the owner's participation. When the owner can justify their community involvement, both the business and the community benefit.

Financial donations also require careful analysis and budgeting. Again, because consumers have access to the entrepreneur (as opposed to the chief executive officer of a major corporation), they may be inundated with requests for donations to charitable and community organizations. Although each organization may have a worthy cause, the entrepreneur cannot support every request and remain financially healthy. Thus, the owner needs to decide which of the organizations to assist and to budget a predetermined amount of money for annual donations. Any other solicitations for money must be placed in writing and submitted to the entrepreneur for consideration. This is the only way entrepreneurs can avoid giving constant cash donations without careful budget consideration.

The critical fact to remember is that time and money are extremely valuable resources for an entrepreneur. They should be budgeted in a meaningful way. Therefore, entrepreneurs need to analyze their community involvement and continuously reassess the costs versus the benefits.[50]

13-5e Continuous Learning

A final unique concern for the entrepreneur is continuous learning. All of the previously mentioned concerns leave very little time for owners to maintain or improve their managerial and entrepreneurial knowledge. However, the environment of the twenty-first century has produced dramatic changes that can affect the procedures, processes, programs, philosophy, or even the product of a growing business. The ancient Greek philosopher Epictetus once said, "It is impossible for a man to learn what he thinks he already knows." This quote illustrates the need for entrepreneurs to dedicate time to learning new techniques and principles for their businesses. Trade associations, seminars, conferences, publications, and college courses all provide opportunities for entrepreneurs to continue their entrepreneurial education. Staying abreast of industry changes is another way that entrepreneurs can maintain a competitive edge.

13-6 Achieving Entrepreneurial Leadership for the Future

Entrepreneurial leadership may be the most critical element in the management of high-growth ventures. Terms such as *visionary* and *strategic* have been used when describing different types of leaders. Table 13.5 provides a comprehensive description of strategic leaders, visionary leaders, and managerial leaders. Research has demonstrated that the concept behind strategic leadership is the most effective in growing organizations.[51] Researchers R. Duane Ireland and Michael A. Hitt identified some of the most important concepts in effective strategic leadership.[52] This type of leadership can be classified as **entrepreneurial leadership**, which arises when an entrepreneur attempts to manage a fast-paced, growth-oriented company.[53]

Entrepreneurial leadership can be defined as the entrepreneur's ability to anticipate, envision, maintain flexibility, think strategically, and work with others to initiate changes that will create a viable future for the organization. If these leadership processes are difficult for competitors to understand—and, hence, to imitate—the firm will create a competitive advantage.

Today's fast-paced economy has created a new competitive landscape—one in which events change constantly and unpredictably. These changes are revolutionary in nature—that is, they happen swiftly and are relentless in their frequency, affecting virtually all parts of an organization simultaneously. The ambiguity that results from revolutionary changes challenges firms and their strategic abilities to increase the speed of the decision-making processes through which strategies are formulated and implemented.[54]

Growth-oriented firms need to adopt a new competitive mindset—one in which flexibility, speed, innovation, and strategic leadership are valued highly. With this mindset, firms can identify and completely exploit opportunities that emerge in the new competitive landscape. These opportunities surface primarily because of the disequilibrium that is created by continuous changes (especially technological changes). More specifically, although uncertainty and disequilibrium often result in seemingly hostile and intensely rivalrous conditions, these conditions may simultaneously yield significant product-driven growth opportunities. Through effective entrepreneurial leadership, growth firms can adapt their behaviors and exploit such opportunities.[55]

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Table 13.5 Strategic, Visionary, and Managerial Leadership

Strategic Leaders	
• synergistic combination of managerial and visionary leadership • emphasis on ethical behavior and value-based decisions • oversee operating (day-to-day) and strategic (long-term) responsibilities • formulate and implement strategies for immediate impact and preservation of long-term goals to enhance organizational survival, growth, and long-term viability • have strong, positive expectations of the performance they expect from their superiors, peers, subordinates, and themselves • use strategic controls and financial controls, with emphasis on strategic controls • use, and interchange, tacit and explicit knowledge on individual and organizational levels • use linear and nonlinear thinking patterns • believe in strategic choice, that is, their choices make a difference in their organizations and environment	
Visionary Leaders	**Managerial Leaders**
• are proactive, shape ideas, change the way people think about what is desirable, possible, and necessary	• are reactive; adopt passive attitudes toward goals; goals arise out of necessities, not desires and dreams; goals based on past
• work to develop choices, fresh approaches to long-standing problems; work from high-risk positions	• view work as an enabling process involving some combination of ideas and people interacting to establish strategies
• are concerned with ideas; relate to people in intuitive and empathetic ways	• relate to people according to their roles in the decision-making process
• feel separate from their environment; work in, but do not belong to, organizations; sense of who they are does not depend on work	• see themselves as conservators and regulators of existing order; sense of who they are depends on their role in organization
• influence attitudes and opinions of others within the organization	• influence actions and decisions of those with whom they work
• concerned with insuring future of organization, especially through development and management of people	• involved in situations and contexts characteristic of day-to-day activities
• more embedded in complexity, ambiguity, and information overload; engage in multifunctional, integrative tasks	• concerned with, and more comfortable in, functional areas of responsibilities
• know less than their functional area experts	• expert in their functional area
• more likely to make decisions based on values	• less likely to make value-based decisions
• more willing to invest in innovation, human capital, and creating and maintaining an effective culture to ensure long-term viability	• engage in, and support, short-term, least-cost behavior to enhance financial performance figures
• focus on tacit knowledge and develop strategies as communal forms of tacit knowledge that promote enactment of a vision	• focus on managing the exchange and combination of explicit knowledge and ensuring compliance to standard operating procedures
• utilize nonlinear thinking	• utilize linear thinking
• believe in strategic choice, that is, their choices make a difference in their organizations and environment	• believe in determinism, that is, the choices they make are determined by their internal and external environments

Source: W. Glenn Rowe, "Creating Wealth in Organizations: The Role of Strategic Leadership," *Academy of Management Executive* 15, no. 1 (2001): 82.

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Diversity in Entrepreneurship

Real Business Diversity: Beyond the Numbers

The rallying cries for more diversity in companies have made one thing clear: good intentions do not necessarily create good outcomes. We have all heard the narratives that companies with a diverse workforce outperform the rest. When women are at the decision-making table, they say, the decision-making process is better and the organization stronger. The business case for hiring more women and people of color has been extensively discussed. However, even with such strong evidence in support of workplace diversity, organizations have largely failed to reap its benefits. The problem is that these claims misconstrue or simply ignore the key findings that research on diversity has made clear: simply "adding diversity" in your workforce by hiring more underrepresented workers will not automatically make your team more efficient or financially better off.

Let us consider the studies claiming that putting more women on corporate boards leads to better financial performance. What those studies show are correlations, not causality. In reality, there may be other factors affecting the company's performance, such as an increase in firm size that led to more women hires and to subsequent improvements in the firm's performance. We cannot say for sure whether the increase in the overall firm size—and therefore its operations, bargaining power, or economies of scale—was the defining factor or whether it was the addition of female board members. Overall, board decisions are typically too far removed from a firm's financial performance to warrant a direct and absolute effect.

Another flaw in the business case for diversity is the claim that diverse teams have richer discussions that lead to better decision making. As many of us have probably experienced, having diverse people in a team does not guarantee better teamwork. In fact, while it can present opportunities, it can also present challenges. Research has shown that increasing diversity can often lead to increased tensions and conflict, which actually decreases a team's performance.

Additionally, diversity advocates who justify its benefits in the financial realm (the core idea behind the business case) may actually be doing more harm than good. Research suggests that company diversity statements that emphasize the financial gains can discourage underrepresented individuals from applying as they start questioning their place in the organization. At the same time, if a diversity initiative does not deliver on financial promises, people may start to question its benefits and are likely to withdraw their support for it.

If we go back to the decades of research on the impact of diversity on organizations and take a deeper look at it, we can actually find more complex conclusions:

- "Introducing diversity to formerly homogeneous teams lowers cohesiveness and increases conflict."
- "Organizational context and culture better explain organizational success than race or gender diversity do."
- "Only mature teams, not young or immature teams, benefit from diversity."

These findings show the complex nature of diversity and that reaping benefits from diversity is not as simple as increasing the number of employees from underrepresented backgrounds. This is not to suggest that there is no business case for diversity; rather, the purpose of diversity and the way we approach it may need to evolve. Organizations need to learn how to harness diversity and be willing to reshape their power structure in order to do so. They need to start listening to empirically based conclusions rather than wishful statements. And they need to move beyond financial performance as their sole reason for existence by embracing a wider definition of success that includes not only financial indicators but also less tangible factors, such as learning, equity, and human dignity. The true business case for diversity appears only after hard work—the question is, which companies are willing to go the extra mile?

Source: Adapted from Lily Zheng, "The Business Case for Diversity is a Sinking Ship," *Medium*, July 2019, and Robin J. Ely and David A. Thomas, "Getting Serious about Diversity: Enough Already with the Business Case," *Harvard Business Review*, December 2020.

Summary

Although many ways of strategically planning a venture exist, all have one common element: each is an extension of the entrepreneur's vision—each takes the owner's concept of the business and puts it into action. Entrepreneurs may not use strategic planning for many reasons, among them scarcity of time, lack of knowledge about how to plan, lack of expertise in the planning process, and lack of trust in others.

A number of benefits to strategic planning exist. In particular, studies have shown that small firms that use this process tend to have better financial performance than those that do not. Other benefits include more efficient resource allocation, improved competitive position, higher employee morale, and more rapid decision making.

The challenges of managing entrepreneurial growth were then examined. A typical life cycle of a venture has five stages: development, start-up, growth, stabilization, and innovation or decline. This chapter focused on ways to maintain an entrepreneurial frame of mind while making the necessary adjustments to deal with the growth phase. The balance of entrepreneurial and managerial approaches was reviewed in this section. This balance was

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demonstrated by considering five major factors: strategic orientation, commitment to seize opportunities, commitment of resources, control of resources, and management structure. This differentiation of major factors is important for analyzing aspects of the venture that need either more administrative or more entrepreneurial emphasis.

The chapter then examined the importance of a venture's growth stage. Underscoring the metamorphosis a venture goes through, four factors were discussed: control, responsibility, tolerance of failure, and change. In addition, the challenge of managing paradox and contradiction was presented.

The newest strategies of growth hacking and blitzscaling were described as means of achieving faster growth with a new venture. The opportunities and challenges associated with each were outlined.

The elements involved in building an entrepreneurial firm were then discussed. When building the desired entrepreneurial firm, entrepreneurs need to be concerned with three important responsibilities: (1) increasing the perception of opportunity, (2) institutionalizing change as the venture's goals, and (3) instilling the desire to be innovative. In addition, the unique managerial concerns of growing ventures were outlined for entrepreneurs.

Finally, the concept of entrepreneurial leadership was introduced as a way for entrepreneurs to anticipate, envision, maintain flexibility, think strategically, and work with others to initiate changes that will create a viable future for the growth-oriented venture.

Key Terms

blitzscaling
entrepreneurial firm
entrepreneurial leadership
entrepreneurial strategy matrix
growth hacking
growth stage
growth wall
innovation
lack of expertise/skills
lack of knowledge
lack of trust and openness
life cycle stages
moral failure
new-venture development
one-person-band syndrome
perception of high cost
personal failure
stabilization stage
start-up activities
strategic planning
strategic positioning
SWOT analysis
time scarcity
uncontrollable failure

Review and Discussion Questions

1. In what way does an entrepreneur's vision affect the company's strategic plan?
2. How is the strategic plan of an engineer/scientist entrepreneur likely to be different from that of an entrepreneur whose primary strength is in the manufacturing area? Be complete in your answer.
3. Give three reasons why many entrepreneurs do not like to formulate strategic plans.
4. Does strategic planning really pay off for entrepreneurial ventures?
5. Describe the entrepreneurial strategy matrix and explain why it is effective for entrepreneurs.
6. Briefly identify and describe the stages of development for a new venture.
7. Firms that fail to innovate will die. What does this statement mean in the context of new ventures?
8. How can entrepreneurs build an entrepreneurial firm? Be complete in your answer.
9. Successful ventures balance entrepreneurial characteristics with managerial style. What does this statement mean?
10. Identify and describe the four key factors that need to be considered during the growth stage.
11. What is meant by managing paradox and contradiction?
12. Identify the key factors in growth scaling
13. Define blitzscaling and identify its challenges.
14. Identify five unique managerial concerns of growing businesses.
15. Define the one-person-band syndrome.
16. Explain the concept of entrepreneurial leadership.

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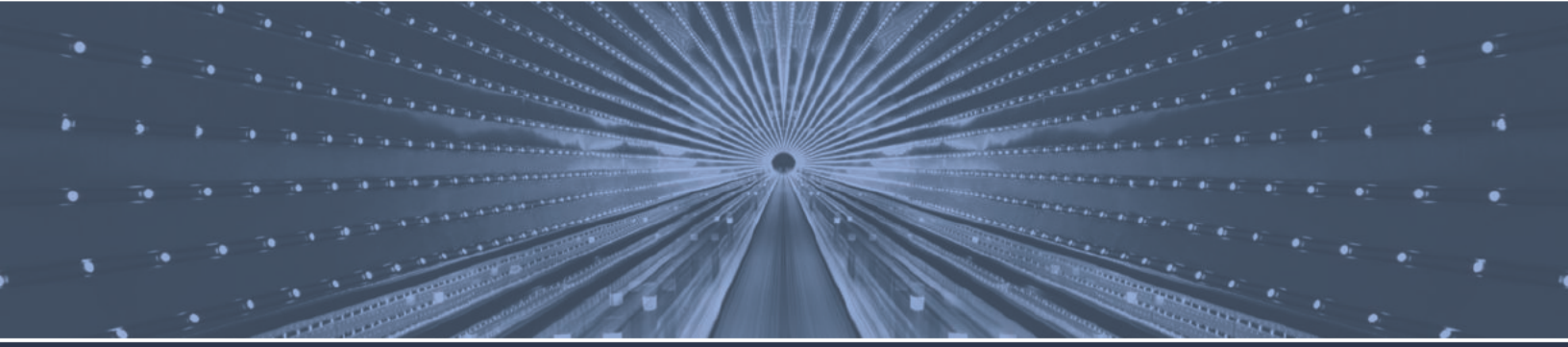
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Chapter 14

Valuation of Entrepreneurial Ventures

Learning Objectives

14.1. Explain the importance of valuation
14.2. Outline the underlying issues involved in the acquisition process
14.3. Describe the basic elements of due diligence
14.4. Outline the various aspects of analyzing a business
14.5. List the major points to consider when establishing a firm's value
14.6. Highlight the available methods of valuing a venture
14.7. Discuss the three principal methods currently used in business valuations
14.8. Explain the additional factors that affect a venture's valuation

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Entrepreneurial Thought

Not everything that can be counted counts, and not everything that counts can be counted

—Albert Einstein

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14-1 The Importance of Business Valuation

LO14.1 Explain the importance of valuation

Every entrepreneur should be able to calculate the value of their business and also should be able to determine the value of a competitor's operation. Such **business valuation** is essential in the following situations:

- Buying or selling a business, division, or major asset
- Establishing an employee stock option plan or profit-sharing plan for employees
- Raising growth capital through stock warrants or convertible loans
- Determining inheritance tax liability (potential estate tax liability)
- Giving a gift of stock to family members
- Structuring a buy/sell agreement with stockholders
- Attempting to buy out a partner
- Going public with the company or privately placing the stock

Equally important is the entrepreneur's desire to know the real value of the venture. This valuation can provide a scorecard for periodically tracking the increases or decreases in the business's value.[1]

14-2 Underlying Issues When Acquiring a Venture

LO14.2 Outline the underlying issues involved in the acquisition process

As we demonstrated in Chapter 6, acquisition of a venture is one pathway to entering the entrepreneurial arena. Because one of the main reasons a valuation would take place with a venture is that it is being sold, we will examine a few more points concerning acquisition of a venture. Three issues underlie the proper valuation of a venture set to be acquired: (1) the differing goals of a buyer and seller, (2) the emotional bias of the seller, and (3) the reasons for the acquisition.

14-2a Goals of the Buyer and Seller

It is important to remember one's reasons for valuing an enterprise. Both major parties to the transaction, buyer and seller, will assign different values to the enterprise because of their basic objectives. The seller will attempt to establish the highest possible value for the business and will not heed the realistic considerations of the market, the environment, or the economy. To the seller, the enterprise may represent a lifetime investment—or, at the very least, one that took a lot of effort. The buyer, on the other hand, will try to determine the lowest possible price to be paid. The enterprise is regarded as an investment for the buyer, and they must assess the profit potential. As a result, a pessimistic view often is taken. An understanding of both positions in the valuation process is important.

14-2b Emotional Bias

The second issue in valuing a business is the **emotional bias** of the seller. Whenever someone starts a venture, nurtures it through early growth, and makes it a profitable business, the person tends to believe that the enterprise is worth a great deal more than outsiders believe it is worth. Entrepreneurs therefore must try to be as objective as possible in determining a fair value for the enterprise (realizing that this fair amount will be negotiable).

14-2c Reasons for the Acquisition

The third issue in valuing a business is the reason an entrepreneur's business is being acquired. The following are some of the most common reasons for acquisition:

- Developing more growth-phase products by acquiring a firm that has developed new products in the company's industry
- Increasing the number of customers by acquiring a firm whose current customers will broaden substantially the company's customer base
- Increasing market share by acquiring a firm in the company's industry
- Improving or changing distribution channels by acquiring a firm with recognized superiority in the company's current distribution channel
- Expanding the product line by acquiring a firm whose products complement and complete the company's product line
- Developing or improving customer service operations by acquiring a firm with an established service operation as well as a customer service network that includes the company's products
- Reducing operating leverage and increasing absorption of fixed costs by acquiring a firm that has a lower degree of operating leverage and can absorb the company's fixed costs
- Using idle or excess plant capacity by acquiring a firm that can operate in the company's current plant facilities
- Integrating vertically, either backward or forward, by acquiring a firm that is a supplier or distributor

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- Reducing inventory levels by acquiring a firm that is a customer (but not an end user) and adjusting the company's inventory levels to match the acquired firm's orders
- Reducing indirect operating costs by acquiring a firm that will allow elimination of duplicate operating costs (e.g., warehousing and distribution)
- Reducing fixed costs by acquiring a firm that will permit elimination of duplicate fixed costs (e.g., corporate and staff functional groups)[2]

In summary, it is important that the entrepreneur and all other parties involved objectively view the firm's operations and potential. An evaluation of the following points can assist in this process:

- A firm's potential to pay for itself during a reasonable period of time
- The difficulties the new owners face during the transition period
- The amount of security or risk involved in the transaction; changes in interest rates
- The effect on the company's value if a turnaround is required
- The number of potential buyers
- Current managers' intentions to remain with the firm
- The taxes associated with the purchase or sale of an enterprise[3]

14-3 Due Diligence

LO14.3 Describe the basic elements of due diligence

When considering the acquisition of a venture, an entrepreneur should perform a complete **due diligence,** which means a thorough analysis of every facet of the existing business. Table 14.1 provides a due diligence outline that is used to assess the viability of a firm's business plan. Notice how each major segment is analyzed by applying specific questions to that part.

The entrepreneur also may apply a more general approach to better assess the viability of the potential

Table 14.1 Performing Due Diligence

Understanding the key questions to ask in a due diligence evaluation may be a critical step for any entrepreneur considering an acquisition. Provided here are those questions that impact each of the major sections analyzed in a potential candidate for acquisition.

I. Industry Analysis

A. General industry questions
1. What are the chief characteristics of the industry (economic, technological, political, social, change)?
2. How does the plan address these? How is the proposed venture impacted by these?
3. How attractive is the industry in terms of its prospects for above-average profitability?
4. What has the industry growth rate been for the past five years, and what is it projected to be for the next five? Give specific support or justification for these projections.
5. Have there been any recent transactions in the industry, such as IPOs, leveraged buyouts, private placements, mergers, or acquisitions? Describe the transactions and provide a brief explanation of the financial arrangements of each transaction.

B. Competitive environment questions
1. What competitive forces (entry barriers, substitutes, power of buyers and suppliers [rivalry is addressed in next section]) are at work in the industry and how strong are they?
2. Has the plan identified the competitive environment and how the company will fit into that environment, including the degree of market saturation?
3. Calculate total market available in dollars.

C. Primary competitor analysis
1. Compare and contrast *major* competitors along core competitive dimensions, including the following:

Product/service	First mover
Pricing	Market share
Distribution	Technology
Marketing	Financial backing
Strategic partnerships	Financial performance

2. Calculate market share available for this firm not already captured by competitors (dollars and users). Is this enough market share to achieve the financial projections in the plan?
3. Which companies are in the strongest/weakest competitive position?

(*Continued*)

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Table 14.1 Performing Due Diligence (*Continued*)

4. Who will likely make what competitive moves next?
5. What key factors will determine competitive success or failure?

II. Target Market Analysis

A. Describe the target market: size, scope, growth, growth potential, demand drivers, price sensitivity, and sales cycle.
B. What is the need or want that the company is satisfying?
C. What are the barriers that will keep competitors from copying this venture's product or service? What market inefficiencies exist?
D. How strong are competitive forces (rivalry, substitutes) within this target market?
E. What has the growth rate of the target market been for the past five years, and what is it projected to be for the next five? Provide support/justification for these projections.

III. Venture Analysis

A. Value proposition
   1. What does the venture do, and how does it provide value to its customers and investors?
B. Management team
   1. Does this team have what it takes to make this venture a success?
   2. Is success dependent on one key person? If so, is this recognized and dealt with in the plan (succession, key man replacement, and so on)?
   3. Employee gaps? Plans to address gaps?
C. Business model
   1. How does the company make money?
   2. How and when does it plan to be profitable?
   3. Does the plan follow a demonstrated success formula? For example, discuss similar companies in terms of size (revenues/employees), operations, revenue model, and/or business model. These companies could be direct competitors or similar firms that are not in the same market but instead just a similar type of company/model.
D. Strategy
   1. How does the venture plan on achieving success in its business model?
   2. What other strategic approaches might work well in this situation?
E. Marketing plan
   1. How will the venture convert prospects into customers?
   2. Who makes the customer's purchase decisions? When and how are the decisions made? What dimensions are critical to the customer in making the decisions? Is the plan specific in defining their strategy in this area?
   3. Does the venture have a base of current customers?
F. Operations
   1. Does the venture's operating plan make sense in terms of supporting its strategy and business model?

IV. Situation Analysis

A. What are the company's strengths, weaknesses, opportunities, and threats?
B. Look at your competitor analysis; is the company competitive on cost? Is it differentiated compared to competitors? How?
C. How strong is the company's competitive position? Are there entry barriers that protect the company? What key strategic factors support this proposition? Which ones are counter to its success?
D. What strategic issues does the company face?

V. Financial Analysis

A. Ratio analysis: liquidity, solvency, profitability, and viability.
B. Compare projected growth rates versus historical industry growth rates. State why this company will be able to sustain the projected rate above that of its industry. If it is determined that the projections are too optimistic, what can be expected?
C. Valuation
   1. Calculate pre-money valuation. What supports this valuation (number of shares, price per share, current audited balance sheet/accepted revenue multiples, and so on)?
   2. Triangulate this valuation by (1) comparing the P/E ratios or revenue multiples of similar companies and (2) discounting the company's cash flow projections.

(*Continued*)

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Table 14.1 Performing Due Diligence (*Continued*)

D. Other financial considerations:
   1. Start-up cash spent or needed
   2. Current cash "burn rate"
   3. Cash needed for years 1 to 5
   4. Five-year revenues
   5. Five-year profits
   6. Breakeven:
      a. Revenues
      b. Time line

E. Additional considerations:
   1. Accuracy
   2. Abnormalities. Is the budget in line or out of hand? Is the accounting correct?
   3. Needed assumptions
      a. Is the plan well written? Is it concise and to the point?
      b. Can the "layperson" understand it?
      c. Is the idea viable?
      d. Is this appropriate for venture investing? Can we expect enough growth? What is the risk/reward relationship?
      e. Other

Appendices

A. Are there resources and/or a bibliography listed to check?

B. Is there any other detailed support for particular sections of the plan?

purchase; however, one critical area that always needs to be addressed is *the future trends of the business*, which require an overall look at the particular industry trends and how this business will fit into them. In addition, the financial health of the business needs to be projected, and *how much capital is needed to buy the venture* must be determined; this step requires understanding that the final purchase price is not the only factor that needs to be taken into consideration. Repairs, new inventory, opening expenses, and working capital are just a few of the additional costs that should be considered. Figure 14.1 illustrates how to calculate the total amount needed to buy a business venture.[4]

14-4 Analyzing the Business

LO14.4 Outline the various aspects of analyzing a business

When analyzing small, closely held businesses, entrepreneurs should not make comparisons with larger corporations. Many factors distinguish these types of corporations, and valuation factors that have no effect on large firms may be significantly important to smaller enterprises. For example, many closely held ventures have the following shortcomings:

- *Lack of management depth*. The degrees of skills, versatility, and competence are limited.
- ***Undercapitalization***. The amount of equity investment is usually low (often indicating a high level of debt).
- *Insufficient controls*. Because of the lack of available management and extra capital, measures in place for monitoring and controlling operations are usually limited.
- ***Divergent goals***. The entrepreneur often has a vision for the venture that differs from the investors' goals or stockholders' desires, thus causing internal conflicts in the firm.

These weaknesses indicate the need for careful analysis of the small business.

The checklist in Table 14.2, which is patterned after the information required for an effective business plan (see Chapter 12), provides a concise method for examining the various factors that differentiate one firm from another.

14-5 Establishing a Firm's Value

LO14.5 List the major points to consider when establishing a firm's value

After using the checklist in Table 14.2, the entrepreneur can begin to examine the various methods used to valuate a business. The establishment of an actual value is more of an art than a science—estimations, assumptions,

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Figure 14.1 Total Amount Needed to Buy a Business

Family living expenses	From last paycheck to takeover day	$_____
	Moving expense	_____
	For three months after takeover day	_____
Purchase price	Total amount (or down payment plus three monthly installments)	_____
Sales tax	On purchased furniture and equipment	_____
Professional services	Escrow, accounting, legal	_____
Deposits, prepayments, licenses	Last month's rent (first month's rent in Operating Expense below)	_____
	Utility deposits	_____
	Sales tax deposit	_____
	Business licenses	_____
	Insurance premiums	_____
Takeover announcements	Newspaper advertising	_____
	Mail announcements	_____
	Exterior sign changes	_____
	New stationery and forms	_____
New inventory		_____
New fixtures and equipment		_____
Remodeling and redecorating		_____
Three months' operating expense	Including loan repayments	_____
Reserve to carry Customer accounts		_____
Cash	Petty cash, change, etc.	Total $_____

Note: Money for living and business expenses for at least three months should be set aside in a bank savings account and not used for any other purpose. This is a cushion to help get through the start-up period with a minimum of worry. If expense money for a longer period can be provided, it will add to peace of mind and help the buyer concentrate on building the business.

Table 14.2 Checklist for Analyzing a Business

History of the Business
The original name of business and any subsequent name changes
Date company was founded
Names of all subsidiaries and divisions; when they were formed and their function

(*Continued*)

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Table 14.2 Checklist for Analyzing a Business (*Continued*)
States where company is incorporated
States where company is licensed to do business as a foreign corporation
Review of corporate charter, bylaws, and minutes
Company's original line of business and any subsequent changes
Market and Competition
Company's major business and market
Description of major projects
Sales literature on products
Growth potential of major markets in which company operates
Name, size, and market position of principal competitors
How does company's product differ from that of the competition?
Company's market niche
Information on brand, trade, and product names
Sales pattern of product lines—that is, are sales seasonal or cyclical?
Review of any statistical information available on the market—for example, trade associations, government reports, and Wall Street reports
Comparative product pricing
Gross profit margin on each product line (analyze sales growth and profit changes for three years)
Concentration of government business
Research and development expenditures—historical and projected
Sales and Distribution
How does company sell—own sales force or through manufacturer representatives?
Compensation of sales force
Details on advertising methods and expenditures
Details on branch sales offices, if any
Details on standard sales terms, discounts offered, and return and allowance policies
Are any sales made on consignment?
Does company warehouse its inventory?
If company uses distributors, how are they paid, and what are their responsibilities?
(For example, do they provide warranty services?)
Are company's products distributed nationwide or in a certain geographic area?
Names and addresses of company's principal customers
Sales volume of principal customers by product line for last few years

(*Continued*)

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Table 14.2 Checklist for Analyzing a Business (*Continued*)
How long have customers been buying from company?
Credit rating of principal customers
Historical bad debt experience of company
Details on private-label business, if any
Do sales terms involve any maintenance agreements?
Do sales terms offer any express or implied warranties?
Has company experienced any product liability problems?
Does company lease, as well as sell, any of its products?
What is the percentage of foreign business? How is this business sold, financed, and delivered?
Have any new products come on the market that would make company's products obsolete or less competitive?
Have any big customers been lost? If so, why?
Size and nature of market—fragmented or controlled by large companies?
Manufacturing
Full list of all manufacturing facilities
Are facilities owned or leased?
Does company manufacture from basic raw materials, or is it an assembly-type operation?
Types and availability of materials required to manufacture the product
Time length of production cycle
Does company make a standard shelf-type product, manufacture to specification, or both?
How is quality control handled in the factory?
What is the accounting system for work in process?
Are any licenses needed to manufacture product?
What is the present sales capacity based on current manufacturing equipment?
Does company have a proprietary manufacturing process?
What is company's safety record in its factory operations?
Do any problems with Occupational Safety and Health Administration (OSHA) or federal or state environmental regulations exist?
What is stability of company's supplier relationships?
Employees
Total number of employees by function
Does a union exist? If not, what is the probability of unionization? If a union exists, what have been its historical relations with company?
Any strikes or work stoppages?

(*Continued*)

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Table 14.2 Checklist for Analyzing a Business (*Continued*)
Details on local labor market
Details on company's wage and personnel policies
Is employee level fixed, or can workforce be varied easily in terms of business volume?
What is company's historical labor turnover, especially in key management?
Analysis of working conditions
Analysis of general employee morale
Has the company ever been cited for a federal violation—for example, OSHA, Pregnancy Discrimination Act, Fair Labor Practices?
What are fringe benefits, vacation time, sick leave, and so on?
Physical Facilities
List of all company-used facilities, giving location, square footage, and cost
Which facilities are owned? Which leased?
What is present condition of all facilities, including machinery and equipment?
If any facilities are leased, what are the details of expiration term, cost, renewal options, and so on?
Are current facilities adequate for current and projected needs?
Will any major problems occur if expansion is needed?
Is adequate insurance maintained?
Are facilities adequately protected against casualty loss, such as fire damage, through sprinkler systems, burglar alarms, or other measures?
Are facilities modern and functional for work process and employees?
Are facilities air conditioned, and do they have adequate electric, heat, gas, water, and sanitary service?
Are facilities easily accessible to required transportation?
What is cost, net book value, and replacement value for company-owned buildings and equipment?
Ownership
List of all current owners of the company's common and preferred stock, by class if applicable
List of all individuals and the number of their shares exercisable under stock option and warrant agreements with prices and expiration dates
Breakdown of ownership by shares and percentage: actual and pro forma (assuming warrants and stock options exercised)
Does common stock have preemptive rights or liquidation or dividend preference?
Do the shares carry an investment letter?
Do restrictions on the transferability of the shares or on their use as collateral exist?
Do any buy/sell agreements exist?
Does an employee stock ownership plan or stock bonus plan exist?
Are the shares fully paid for?

(*Continued*)

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Table 14.2 Checklist for Analyzing a Business (*Continued*)
Are any shareholders' agreements outstanding?
Has any stock been sold below par or stated value?
Does cumulative voting exist?
With respect to the principal owner's stock, have any shares been gifted or placed in a trust?
How many shares does the principal stockholder own directly and beneficially (including family)?
If all stock options and warrants are exercised, will the principal stockholder still control 51 percent of the company?
If a business is being bought or sold, what percentage of the total outstanding shares is needed for approval?
Financial
Three years of financial statements
• Current ratio and net quick ratio
• Net working capital and net quick assets
• Total debt as a percentage of stockholder's equity
• Source and application of funds schedules
Analysis of the company's basic liquidity and turnover ratios
• Cash as a percent of current liabilities
• Accounts receivable and inventory turnovers
• Age of accounts payable
• Sales to net working capital
If company has subsidiaries (or divisions), consolidating statements of profit and loss
Verification of the cash balance and maximum and minimum cash balances needed throughout year
If company owns marketable securities, what is their degree of liquidity (salability) and current market values?
Age of all accounts and notes receivable, any customer concentration, and the adequacy of bad debt reserve
Cost basis for recording inventories and any inventory reserves; age of inventory and relation to cost of sales (turnover)
Details on all fixed assets, including date of purchase, original cost, accumulated depreciation, and replacement value
Current market appraisals on all fixed assets, real estate, and machinery and equipment
Analysis of any prepaid expenses or deferred charges as to nature and as to amortization in or advance to affiliates; comparison of true value to book value; financial statements
Personal financial statements of principal stockholders
If company carries any goodwill or intangible items, such as patents or trademarks, what is their true value (to extent possible)? Does company have any intangible assets of value not carried on books (such as mailing lists in a publishing operation)?
Analysis of all current liabilities, including age of accounts payable and details of all bank debt and lines of credit, including interest rate, term, and collateral; loan agreements
Details on all long-term debt by creditor, including loan agreement covenants that may affect future operations

(*Continued*)

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Table 14.2 Checklist for Analyzing a Business (*Continued*)
Do any contingent liabilities or other outstanding commitments, such as long-term supplier agreements, exist?
Details on franchise, lease, and royalty agreements
Income statement accounts for at least three years and analysis of any significant percentage variances, that is, cost of sales as percent of sales
Company's tax returns—do they differ from its financial statements? Which years still may be open for audit?
Three-year projection of income and cash flow for reasonableness of future sales and profits and to establish financing needs
Pension, profit-sharing, and stock bonus plans for contractual commitments and unfunded past-service liability costs
Management
Details on all officers and directors—length of service, age, business background, compensation, and fringe benefits
Ownership positions: number of shares, stock options, and warrants
Similar details on other nonofficer/nondirector key management
Organizational chart
What compensation-type fringe benefits are offered to key management: bonuses, retirement-plan stock bonuses, company-paid insurance, deferred compensation?
What is management's reputation in its industry?
Does management have any personal interests in any other businesses? Does it have any other conflicts of interest?
Does key management devote 100 percent of its time to the business?
Any employment contracts—amount of salary, length of time, other terms
Has key management agreed to a noncompete clause and agreed not to divulge privileged information obtained while employed with company?

and projections are all part of the process. The quantified figures are calculated based, in part, on such hidden values and costs as goodwill, personal expenses, family members on the payroll, planned losses, and the like.[5]

Several traditional valuation methods are presented here, each using a particular approach that covers these hidden values and costs. Employing these methods will provide the entrepreneur with a general understanding of how the financial analysis of a firm works. Remember also that many of these methods are used concurrently and that the *final* value determination will be the actual price agreed on by the buyer and seller.

14-5a Valuation Methods

LO14.6 Highlight the available methods of valuing a venture

Table 14.3 lists the various methods that may be used for business valuation. Each method is described, and key points about them are presented. In this section, specific attention will be concentrated on the three methods that are considered the principal measures used in current business valuations: (1) adjusted tangible assets (balance sheet values), (2) price/earnings (multiple earnings value), and (3) discounted future earnings.

Adjusted Tangible Book Value

LO14.7 Discuss the three principal methods currently used in business valuations

A common method of valuing a business is to compute its net worth as the difference between total assets and total liabilities. However, it is important to adjust for certain assets in order to assess true economic worth because inflation and depreciation affect the value of some assets.

In the computation of the adjusted tangible book value, goodwill, patents, deferred financing costs, and other intangible assets are considered with the other assets and deducted from or added to net worth. This upward or

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Table 14.3 Methods for Venture Valuation

Method	Description/Explanation	Notes/Key Points
Fixed price	Two or more owners set initial value based on what owners "think" business is worth Uses figures from any one or a combination of methods Common for buy/sell agreements	Inaccuracies exist due to personal estimates Should allow periodic update
Book value (known as balance sheet method) 1. Tangible 2. Adjusted tangible	3. *Tangible book value:* Set by the business's balance sheet Reflects net worth of the firm Total assets less total liabilities (adjusted for intangible assets) 4. *Adjusted tangible book value:* Uses book value approach Reflects fair market value for certain assets Upward/downward adjustments in plant and equipment, inventory, and bad debt reserves	Some assets also appreciate or depreciate substantially, thus not an accurate valuation Adjustments in assets eliminate some of the inaccuracies and reflect a fair market value of each asset
Multiple of earnings	Net income capitalized using a price/earnings ratio (net income multiplied by P/E number) 15% capitalization rate often used (equivalent to a P/E multiple of 6.7, which is 1 divided by 0.15) High-growth businesses use lower capitalization rate (e.g., 5%, which is a multiple of 20) Stable businesses use higher capitalization rate (e.g., 10%, which is a multiple of 10) Derived value divided by number of outstanding shares to obtain per-share value	Capitalization rates vary as to firm's growth; thus, estimates or P/E used must be taken from similar publicly traded corporation
Price/earnings ratio (P/E)	Similar to a return-on-investment approach Determined by price of common stock divided by after-tax earnings Closely held firms must multiply net income by an appropriate multiple, usually derived from similar publicly traded corporations Sensitive to market conditions (prices of stocks)	More common with public corporations Market conditions (stock prices) affect this ratio
Discounted future earnings (discounted cash flow)	Attempts to establish future earning power in current dollars Projects future earnings (five years), calculates present value using a then discounted rate Based on projected "timing" of future income	Based on premise that cash flow is most important factor Effective method if (1) business being valued needs to generate a return greater than investment and (2) only cash receipts can provide the money for reinvesting in growth
Return on investment (ROI)	Net profit divided by investment Provides an earnings ratio Need to calculate probabilities of future earnings Combination of return ratio, present value tables, and weighted probabilities	Will *not* establish a value for the business Does not provide projected future earnings
Replacement value	Based on value of each asset if it had to be *replaced* at current cost Firm's worth calculated as if building from "scratch" Inflation and annual depreciation of assets are considered in raising the value above reported book value Does *not* reflect earning power or intangible assets	Useful for selling a company that's seeking to break into a new line of business Fails to consider earnings potential Does not include intangible assets (goodwill, patents, and so on)

(*Continued*)

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Table 14.3 Methods for Venture Valuation (*Continued*)

Liquidation value	Assumes business ceases operation Sells assets and pays off liabilities Net amount after payment of all liabilities is distributed to shareholders Reflects "bottom value" of a firm Indicates amount of money that could be borrowed on a secured basis Tends to favor seller since all assets are valued as if converted to cash	Assumes each division of assets sold separately at auction Effective in giving absolute bottom value below which a firm should liquidate rather than sell
Excess earnings	Developed by the U.S. Treasury to determine a firm's intangible assets (for income tax purposes) Intent is for use only when no better method available Internal Revenue Service refers to this method as a last resort Method does not include intangibles with estimated useful lives (i.e., patents, copyrights)	Method of last resort (if no other method available) Very seldom used
Market value	Needs a "known" price paid for a similar business Difficult to find recent comparisons Methods of sale may differ—installment versus cash Should be used only as a reference point	Valuable only as a reference point Difficult to find recent, similar firms that have been sold

downward adjustment reflects the excess of the fair market value of each asset above or below the value reported on the balance sheet. Following is an example:

	Book Value	Fair Market Value
Inventory	$100,000	$125,000
Plant and equipment	400,000	600,000
Other intangibles		(50,000)
	—	—
	$500,000	$675,000
Excess = $175,000		

Remember that in industry comparisons of adjusted values, only assets used in the actual operation of the business are included.

Other significant balance sheet and income statement adjustments include (1) bad debt reserves; (2) low-interest, long-term debt securities; (3) investments in affiliates; and (4) loans and advances to officers, employees, or other companies. Additionally, earnings should be adjusted. Only true earnings derived from the operations of the business should be considered. One-time items (e.g., from the sale of a company division or asset) should be excluded. Also, if the company has been using a net operational loss carry forward so that its pretax income has not been fully taxed, this also should be considered.

Upward (or downward) income and balance sheet adjustments should be made for any unusually large bad debt or inventory write-off and for certain accounting practices, such as accelerated versus straight-line depreciation.

Price/Earnings Ratio (Multiple of Earnings) Method

The **price/earnings ratio** (**P/E**) is a common method used for valuing publicly held corporations. The valuation is determined by dividing the market price of the common stock by the earnings per share. A company with 100,000 shares of common stock and a net income of $100,000 would have earnings per share of $1. If the stock price rose to $5 per share, the P/E would be 5 ($5 divided by $1). Additionally, since the company has 100,000 shares of common stock, the valuation of the enterprise now would be $500,000 (100,000 shares × $5).

The primary advantage of a price/earnings approach is its simplicity. However, this advantage applies only to publicly traded corporations. Closely held companies do not have prices in the open market for their stock and thus must rely on the use of a multiple derived by comparing the firm to similar public corporations. This approach has four major drawbacks:[6]

1. The stock of a private company is not publicly traded. It is illiquid and may actually be restricted from sale (i.e., not registered with the Securities and Exchange Commission). Thus, any P/E multiple usually must, by definition, be subjective and lower than the multiple commanded by comparable publicly traded stocks.
2. The stated net income of a private company may not truly reflect its actual earning power. To avoid

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or defer paying taxes, most business owners prefer to keep pretax income down. In addition, the closely held business may be "overspending" on fringe benefits instituted primarily for the owner's benefit.

3. Common stock that is bought and sold in the public market normally reflects only a small portion of the business's total ownership. The sale of a large controlling block of stock (typical of closely held businesses) demands a premium.
4. It is very difficult to find a truly comparable publicly held company, even in the same industry. Growth rates, competition, dividend payments, and financial profiles (liquidity and leverage) rarely will be the same.

When applied to a closely held firm, the following is an example of how the multiple-of-earnings method could be used:

Shares of common stock = 100,000
2015 net income = $100,000
15% capitalization rate assumed = 6.7 price/earnings multiple (derived by dividing 1 by 15 and multiplying the result by 100)
Price per share = $6.70
Value of company = 100,000 × $6.70
= $670,000

Discounted Earnings Method

Most analysts agree that the real value of any venture is its potential earning power. The discounted earnings method, more than any other, determines the firm's true value. One example of a pricing formula that uses earning power as well as adjusted tangible book value is illustrated in Figure 14.2.

The idea behind discounting the firm's cash flows is that dollars earned in the future (based on projections) are worth less than dollars earned today (due to the loss

The Entrepreneurial Process

Do IPO Valuations Translate to Performance?

In 2021, a record-breaking number of companies went public worldwide, nearly double the number of companies from 2020. This record-breaking number includes both SPACs and IPOs. These new companies raised nearly $500 billion in capital. But did those initial valuations of the top companies translate into increased performance the following year? Here is a look at a few highly touted valuations in 2021.

Rivian, an electrical car manufacturer, was the highest with a market valuation of $104.4 billion.

One year later: −60% return on investment.

Coinbase, a remote crypto-trading company, got a lot of attention with its IPO valuation of $86 billion.

One year later: −47% return on investment.

Robinhood, currently the most downloaded trading app on both the Apple and Google app stores, was launched 2015. It had its IPO in 2021 with a $32 billion valuation

One year later: −67% return on investment.

Roblox, an online game creation system allowing users to program and play games created by other users, had an IPO valuation of $30 billion when it was released in 2021.

One year later: −35% return on investment.

Bumble, an online dating application where users, who can "swipe left" to reject a candidate or "swipe right" to indicate interest. The firm had an IPO valuation of $8.2 billion.

One year later: −74% return on investment.

Warby Parker, an online retail B-corp that makes fashionable eyeglasses, contact lenses, and sunglasses, based in New York City. Initial IPO valuation of $6 billion.

One year later: −46% return on investment.

These are just a few examples of companies that had IPO valuations that raised the expectations of potential investors. However, the challenge with all valuations is that they are market driven and do not reflect the actual performance of the firm. The lesson is to be wary of extremely high valuations on new ventures entering the market.

Source: Adapted from Christine Lagorio-Chafkin, "The Most Fascinating IPOs of 2021," *Inc*, 2022, *https://www.inc.com/christine-lagorio-chafkin/most-important-ipos-2021.html*; Margaret Gikles, "The Biggest IPOs of 2021," *Morningstar*, December 15, 2021, https://www.morningstar.com/articles/1072332/the-biggest-ipos-of-2021; and Taylor Tepper, "10 Upcoming IPOs to Watch," *Forbes*, 2022, https://www.forbes.com/advisor/investing/upcoming-ipos.

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Figure 14.2 The Pricing Formula

The following step-by-step process outlines the traditional pricing formula used when calculating the value of a business:

Step 1. Determine the adjusted tangible net worth of the business. (The total market value of all current and long-term assets less liabilities.)

Step 2. Estimate how much the buyer could earn annually with an amount equal to the value of the tangible net worth invested elsewhere.

Step 3. Add to this a salary normal for an owner-operator of the business. This combined figure provides a reasonable estimate of the income the buyer can earn elsewhere with the investment and effort involved in working in the business.

Step 4. Determine the average annual net earnings of the business (net profit before subtracting owner's salary) over the past few years.

This is before income taxes, to make it comparable with earnings from other sources or by individuals in different tax brackets. (The tax implications of alternative investments should be carefully considered.)

This trend of earnings is a key factor. Have they been rising steadily, falling steadily, remaining constant, or fluctuating widely? The earnings figure should be adjusted to reflect these trends.

Step 5. Subtract the total of earning power (2) and reasonable salary (3) from this average net earnings figure (4). This gives the extra earning power of the business.

Step 6. Use this extra earnings figure to estimate the value of the intangibles. This is done by multiplying the extra earnings by what is termed the "years-of-profit" figure.

This "years-of-profit" multiplier pivots on these points. How unique are the intangibles offered by the firm? How long would it take to set up a similar business and bring it to this stage of development? What expenses and risks would be involved? What is the price of goodwill in similar firms? Will the seller be signing an agreement with a covenant not to compete?

If the business is well-established, a factor of five or more might be used, especially if the firm has a valuable name, patent, or location. A multiplier of three might be reasonable for a moderately seasoned firm. A younger but profitable firm might merely have a one-year profit figure.

Step 7. Final price equals adjusted tangible net worth plus value of intangibles (extra earnings times "years of profit").

Example	Enterprise X	Enterprise Y
1. Adjusted value of tangible net worth (assets less liabilities)	2,000,000	2,000,000
2. Earning power at 8%[a] of an amount equal to the adjusted tangible net worth, if invested in a comparable risk business	160,000	160,000
3. Reasonable salary for owner-operator in the business	50,000	50,000
4. Net earnings of the business over recent years (net profit before subtracting owner's salary)	255,000	209,000
5. Extra earning power of the business (line 4 minus lines 2 and 3)	45,000	(1,000)
6. Value of intangibles—using three-year profit figure for moderately well-established firm (3 times line 5)	135,000	0
7. Final price (lines 1 and 6)	2,135,000	2,000,000 (or less)

With *Enterprise X*, the seller receives a value for goodwill because the business is moderately well established and earning more than the buyer could earn elsewhere with similar risks and effort.

With *Enterprise Y*, the seller receives no value for goodwill because the business, even though it may have existed for a considerable time, is not earning as much as the buyer could through outside investment and effort. In fact, the buyer may feel that even an investment of $2,000,000—the current appraised value of net assets—is too much because it cannot earn sufficient return.

[a]This is an arbitrary figure, used for illustration. A reasonable figure depends on the stability and relative risks of the business and the investment picture generally. The rate of return should be similar to that which could be earned elsewhere with the same approximate risk.

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The Entrepreneurial Process

Knowing a Venture's Pre-Money and Post-Money Valuation

Even though the final valuation of any venture is the final price at which a willing buyer and seller agree on for a venture, the world of venture capital is filled with terms and procedures in valuation that may seem confusing. Let's examine two of the key terms and methods that are typical in today's venture capital market for new ventures seeking to be valued.

Pre-Money versus Post-Money Valuation. This terminology is in reference to the money that a venture investor puts into the new venture. In other words, it is the timing of the valuation. Both pre-money and post-money are valuation measures of new ventures. Pre-money refers to a venture's value *before* it receives outside financing, while post-money refers to its value *after* it gets outside funds. It is important to know which is being referred to, as they are critical concepts in valuation.

In simpler terms, the valuation is based on either "before" the investor puts the money in or "after" the investor puts the money in the venture. For example, a $2.5 million investment based on a $10 million valuation must be clarified. An entrepreneur may assume that the venture investor now owns 25 percent of the company. However, that depends on whether the $10 million valuation is pre-money or post-money. If the investor is basing the valuation on the addition of the $2.5 million, then that means the pre-money valuation would have been $7.5 million. That allows the venture investor to now own 33 percent of the venture. If the valuation of $10 million is considered pre-money, then with the addition of the $10 million, the venture investor would then own 25 percent.

So the pre-money value plus the investment equals the post-money value. Or, to put it another way, the post-money value minus the investment equals the pre-money value. It may sound simple, but it is extremely important to be aware of in any negotiation for the value of a new venture. Here are the formal equations for pre-money valuation and post-money valuation:

1. Pre-money Valuation = Post-money Valuation − Venture Capital Investment
2. Post-money Valuation = Venture Capital Investment ÷ Venture Capital Ownership Percentage

Using these equations, we can provide one more example. A venture capital firm provides a $4 million investment at a $6 million pre-money valuation. To determine how much the start-up venture gives up in exchange for the $4 million, use equation (1) from above: $6 million = Post-money valuation − $4 million. Solving for Post-money valuation (Post-money = Pre-money + Investment) gives us $10 million. Next, use equation (2) from above to find the Venture Capital firm's percentage: $10 million = $4 million/Venture Capital Firm Ownership Percentage (VCFOP). Solving for VCFOP (VCFOP = $4 million divided into the $10 million) equals 40 percent.

The key to working with any venture capital investor is to understand the terminology associated with their valuation techniques.

of purchasing power). With this in mind, the "timing" of projected income or cash flows is a critical factor.

The discounted earnings method for calculating the value of a venture uses a four-step process:

1. Expected cash flow is estimated. For long-established firms, historical data are effective indicators, although adjustments should be made when available data indicate that future cash flows will change.
2. An appropriate discount rate is determined. The buyer's viewpoint has to be considered in the calculation of this rate. The buyer and seller often disagree because each requires a particular rate of return and will view the risks differently. Another point the seller often overlooks is that the buyer will have other investment opportunities to consider. The appropriate rate, therefore, must be weighed against these factors.
3. A reasonable life expectancy of the business must be determined. All firms have a life cycle that depends on such factors as whether the business is one product/one market or multiproduct/multimarket.
4. The firm's value is then determined by discounting the estimated cash flow by the appropriate discount rate over the expected life of the business.[7]

14-6 Term Sheets in Venture Valuation

Whenever investors are examining a venture for potential infusion of capital, the value of the venture comes into play. This always involves what is called the term sheet. This document outlines the material terms and conditions of a venture agreement. (See Appendix 14-A at the end of this chapter for a complete sample term sheet.) After a term sheet has been executed, it guides legal counsel in the preparation of a proposed final agreement. It then guides but is not necessarily binding the final terms of the agreement.

Term sheets are very similar to letters of intent (LOIs) in that both are preliminary, mostly nonbinding documents meant to record two or more parties' intentions

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to enter into a future agreement based on specified (but incomplete or preliminary) terms. Many LOIs, however, contain provisions that are binding, such as nondisclosure agreements, a covenant to negotiate in good faith, or a "stand-still" provision that promises exclusive rights to negotiate.

The purposes of an LOI may be the following:

- To clarify the key points of a complex transaction for the convenience of the parties
- To declare officially that the parties are currently negotiating
- To provide safeguards in case a deal collapses during negotiation

The difference between a term sheet and an LOI is slight and mostly a matter of style: an LOI is typically written in letter form and focuses on the intentions; a term sheet skips most of the formalities and lists deal terms in bullet-point format. To help clarify the concepts of term sheets in the valuation process, we present the following terminology that is common in these documents.

Price/Valuation The value of a company is what drives the price investors will pay for a piece of the action. The information used to determine valuation comes out of the due diligence process and has to do with the strength of the management team, market potential, the sustainable advantage of the product/service, and potential financial returns. Another way to look at valuation is how much money it will take to make the company a success. In the end, the value of a company is the price at which a willing buyer and seller can complete a transaction.

Fully Diluted Ownership and valuation is typically calculated on a **fully diluted** basis. This means that all securities (including preferred stock, options, and warrants) that can result in additional common shares are counted in determining the total amount of shares outstanding for the purposes of determining ownership or valuation.

Type of Security Investors typically receive convertible preferred stock in exchange for making the investment in a new venture. This type of stock has priority over common stock if the company is acquired or liquidated and assets are distributed. The higher priority of the preferred stock justifies a higher price, compared to the price paid by founders for common stock. *Convertible* means that the shares may be exchanged for a fixed number of common shares.

Liquidation Preference When the company is sold or liquidated, the preferred stockholders will receive a certain fixed amount before any assets are distributed to the common stockholders; this is known as **liquidation preference**. A *participating preferred* stockholder not only will receive the fixed amount but will also share in any additional amounts distributed to common stock.

Dividend Preference Dividends are paid first to preferred stock and then to common stock. This dividend may be cumulative so that it accrues from year to year until paid in full—or noncumulative and discretionary.

Redemption Preferred stock may be redeemed or retired either at the option of the company or the investors or on a mandatory basis—frequently at some premium over the initial purchase price of the stock. One reason why venture firms want this right is due to the finite life of each investment partnership managed by the firm.

Conversion Rights Preferred stock may be converted into common stock at a certain conversion price, generally whenever the stockholder chooses. Conversion may also happen automatically in response to certain events, such as when the company goes public.

Antidilution Protection The conversion price of the preferred stock is subject to adjustment for certain diluting events, such as stock splits or stock dividends; this is known as **antidilution protection**. The conversion price is typically subject to *price protection*, which is an adjustment based on future sales of stock at prices below the conversion price. Price protection can take many forms. One form is called *ratchet* protection, which lowers the conversion price to the price at which any new stock is sold no matter the number of shares. Another form is broad-based *weighted average* protection, which adjusts the conversion price according to a formula that incorporates the number of new shares being issued and their price. In many cases, a certain number of shares are exempted from this protection to cover anticipated assurances to key employees, consultants, and directors.

Voting Rights Preferred stock has a number of votes equal to the number of shares of common stock into which it is convertible. Preferred stock usually has special voting rights, such as the right to elect one or more of the company's directors or to approve certain types of corporate actions, such as amending the articles of incorporation or creating a new series of preferred stock.

Right of First Refusal Holders of preferred stock typically have the right to purchase additional shares when issued by the company, up to their current aggregate ownership percentage.

Co-Sale Right Founders will often enter into a co-sale agreement with investors. A co-sale right gives investors some protection against founders selling their interest to a third party by giving investors the right to sell some of their stock as part of such a sale.

Registration Rights Registration rights are generally given to preferred investors as part of their

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investment. These rights provide investors liquidity by allowing them to require the company to register their shares for sale to the public—either as part of an offering already planned by the company (called piggyback rights) or in a separate offering initiated at the investors' request (called demand rights).

Vesting on Founders' Stock A percentage of founders' stock, which decreases over time, can be purchased by the company at cost if a founder leaves the company. This protects investors against founders leaving the company after it gets funded.[8]

14-7 Additional Factors in the Valuation Process

LO14.8 Explain the additional factors that affect a venture's valuation

After reviewing these valuation methods, the entrepreneur needs to remember that additional factors intervene in the valuation process and should be given

Diversity in Entrepreneurship

Diversity in Venture Capital

Pat Brown had an idea to revolutionize the meat and dairy industry with plants. After several years and more than a billion dollars in venture money, his company became a sensation. Worth around $7 billion, his company, called Impossible Foods, makes plant-based substitutes for meat products. Now what would have happened to Pat Brown's idea without venture capital (VC)? Just take a look at the 10 biggest companies in the world as measured by market capitalization: seven are American, and six of those—Apple, Microsoft, Amazon, Tesla, Facebook, and Alphabet (the parent company of Google)—raised VC funding. While not every company needs or should go down the VC path in order to succeed, VC does play an outsized role in innovation. These investors are willing to take a risk and give start-ups time and space to develop without having to worry about short-term profitability performance, the kind of performance that stock markets have prioritized since the 1980s.

Although VC as an industry is no more than 50 years old, it has fueled the advancement of American innovation and created value, jobs, wealth, and life-changing products and services. Throughout all the innovation, however, the industry workforce has stagnated in a few demographics. Women, people of color, and other underrepresented groups have been generally excluded from opportunities and benefits of VC investing and funding. With their small size, slow turnover of senior investment positions, and apprenticeship-based recruitment reliant on existing networks and common attributes between past hires, the VC workforce has been slow to change. In addition, VC returns can take over 10 years to realize, which makes it hard to demonstrate VC success and extremely challenging for newcomers to penetrate the industry. This lack of diversity among VC investment professionals trickles down to the lack of diversity in the leadership of VC-backed start-ups, as studies have shown that unconscious bias can play a role in deciding which entrepreneurs investors decide to fund. In fact, only 1 percent of VC-backed founders are Black, and fewer than 2 percent are Hispanic. Yet one study has shown that start-ups with diverse founding teams generated 30 percent greater multiples, while start-ups with diverse executive teams generated 64 percent greater multiples on acquisitions and IPOs compared to White-only teams. Another study found that start-ups with women founders are likely to exit at least one year faster than other firms.

While VCs give entrepreneurs a booster shot that helps them thrive, they do much more than that: they also provide counsel. When Bill Gates initially founded Microsoft, they did not need money, but they did not know how to bring their company to the next level, so they needed guidance from VCs. Studies have shown that start-ups backed by a high-quality VC grew nearly 50-fold in comparison to 20-fold with a low-quality VC. Thus, by excluding underrepresented groups from getting access to VC, you are not only creating barriers to a start-up's full potential but also harming the VC's full potential that could be achieved with a diverse VC team. In fact, one of the biggest arguments for diversity and inclusion in VC firms is that they provide improved financial performance and more innovation—something that VC firms strive to do. One study found that a 10 percent increase in the proportion of female partner hires results in an average 1.5 percent increase in the overall fund returns each year. A Goldman Sachs analysis of investment returns found that all-female and mixed-gender portfolio management teams at U.S. large-cap equity funds outperformed all-male teams, even after adjusting for risk.

For the venture industry to reach its full potential, it is important to expand opportunities for people of all backgrounds to access, participate, and thrive in the ecosystem. Increased diversity among check writers at VC firms is likely to improve the diversity of founders receiving venture funding. The long-term nature of the industry will likely slow the pace of progress, but firms acting with intentionality and urgency now can drive meaningful change.

Source: Adapted from Stephen J. Dubner, "Is Venture Capital the Secret Sauce of the American Economy?," *Freakonomics*, November 2021, and "VC Human Capital Survey," *Deloitte*, March 2021.

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consideration. Presented next are three factors that may influence the final valuation of the venture.

14-7a Avoiding Start-Up Costs

Some buyers are willing to pay more for a business than what the valuation methods illustrate its worth to be. This is because buyers often are trying to avoid the costs associated with start-up and are willing to pay a little more for an existing firm. The higher price they pay will be still less than actual start-up costs and also avoids the problems associated with working to establish a clientele. Thus, for some buyers, a known commodity may command a higher price.

14-7b Accuracy of Projections

The sales and earnings of a venture are always projected on the basis of historical financial and economic data. Short histories, fluctuating markets, and uncertain environments are all reasons for buyers to keep projections in perspective. It is critical that they examine the trends, fluctuations, or patterns involved in projections for sales revenues (higher prices or more customers?), market potential (optimistic or realistic assumptions?), and earnings potential (accurate cost/revenue/market data?) because each area has specific factors that need to be either understood or measured for the accuracy of the projection.

14-7c Control Factor

The degree of control, or **control factor**, that an owner legally has over the firm can affect its valuation. If the owner's interest is 100 percent or such that the complete operation of the firm is under their influence, then that value is equal to the enterprise's value. If the owner does not possess such control, then the value is less. For example, buying out a 49 percent shareholder will not be effective in controlling a 51 percent shareholder. Also, two 49 percent shareholders are equal until a 2 percent "swing vote" shareholder makes a move. Obviously, minority interests also must be discounted due to lack of liquidity—a minority interest in a privately held corporation is difficult to sell. Overall, it is important to look at the control factor as another facet in the purchase of any interest in a firm.

Summary

Entrepreneurs need to understand how to valuate a business for either purchase or sale. Many would like to know the value of their businesses. Sometimes this is strictly for informational purposes, and other times it is for selling the operation. In either case, a number of ways of valuing an enterprise exist.

The first step is to analyze the business's overall operations with a view to acquiring a comprehensive understanding of the firm's strong and weak points. Table 14.2 provided a checklist for this purpose. The second step is to establish a value for the firm. Table 14.3 set forth 10 methods for the valuation of a venture. Three of the most commonly used are (1) adjusted tangible assets, (2) P/E (multiple of earnings), and (3) discounted future earnings.

The adjusted tangible book value method computes the value of the business by revaluing the assets and then subtracting the liabilities. This is a fairly simple, straightforward process.

The P/E method divides the market price of the common stock by the earnings per share and then multiplies by the number of shares issued. For example, a company with a price/earnings multiple of 10 and 100,000 shares of stock would be valued at $1 million.

The discounted earnings method takes the estimated cash flows for a predetermined number of years and discounts these sums back to the present using an appropriate discount rate. This is one of the most popular methods of valuing a business. Other factors to consider for valuing a business include start-up costs, accuracy of projections, and the control factor.

Key Terms

adjusted tangible book value
antidilution protection
business valuation
control factor
discounted earnings method
divergent goals
due diligence
emotional bias
fully diluted
letter of intent (LOI)
liquidation preference
price/earnings ratio (P/E)
term sheet
undercapitalization

Review and Discussion Questions

1. Identify and discuss the three underlying issues in the evaluation of a business.
2. Define the term *due diligence*. How is it applied to the acquisition of an existing venture?
3. To analyze a business, what types of questions or concerns should the entrepreneur address in the following areas: history of the business, market and competition, sales and distribution, management, and finances?

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4. One of the most popular methods of business valuation is the adjusted tangible book value. Describe how this method works.
5. Explain how the P/E method of valuation works. Give an example.
6. What are the steps involved in using the discounted earnings method? Give an example.
7. How do the following methods of valuing a venture work: fixed price, multiple of earnings, return on investment, replacement value, liquidation value, excess earnings, and market value? In each case, give an example.
8. Explain why the following are important factors to consider when valuing a business: start-up costs, accuracy of projections, and degree of control.

Notes

1. See, for example, David B. Audretsch and Albert N. Link, "Valuing an Entrepreneurial Enterprise," *Small Business Economics* 38, no. 2 (2012): 139–45; W. G. Sanders and S. Bovie, "Sorting Things Out: Valuation of New Firms in Uncertain Markets," *Strategic Management Journal* 25, no. 2 (February 2004): 167–86; and Saikat Chaudhuri and Behnam Tabrizi, "Capturing the Real Value in High-Tech Acquisitions," *Harvard Business Review* 77, no. 4 (September/October 1999): 123–30.
2. "Acquisition Strategies—Part 1," *Small Business Reports*, January 1987, 34, reprinted with permission from *Small Business Reports*; see also Laurence Capron, "The Long-Term Performance of Horizontal Acquisitions," *Strategic Management Journal* 20, no. 11 (November 1999): 987–1018, and Mark Humphery-Jenner, "Takeover Defenses, Innovation, and Value Creation: Evidence from Acquisition Decisions," *Strategic Management Journal* 35, no. 5 (2014): 668–90.
3. "Valuing a Closely Held Business," *Small Business Report*, November 1986, 30–31; see also Hal B. Heaton, "Valuing Small Businesses: The Cost of Capital," *Appraisal Journal* 66, no. 1 (January 1998): 11–16; Alan Mitchell, "How Much Is Your Company Really Worth?," *Management Today*, January 1999, 68–70; Patrick L. Anderson, "The Value of Private Businesses in the United States," *Business Economics* 44 (2009): 87–108; and Trent Lee, "How to Determine What Your Business Is Worth in Five Minutes or Less," *Forbes*, May 14, 2020, https://www.forbes.com/sites/theyec/2020/05/14/how-to-determine-what-your-business-is-worth-in-five-minutes-or-less/?sh=55de68b45657.
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5. Gary R. Trugman, *Understanding Business Valuation: A Practical Guide to Valuing Small to Medium-Sized Businesses* (New York: American Institute of Certified Public Accountants, 1998); Robert W. Pricer and Alec C. Johnson, "The Accuracy of Valuation Methods in Predicting the Selling Price of Small Firms," *Journal of Small Business Management* 35, no. 4 (October 1997): 24–35; see also Wayne Lonergan, *The Valuation of Businesses, Shares and Other Equity* (Crows Nest: Allen & Unwin, 2003).
6. Adapted from Albert N. Link and Michael B. Boger, *The Art and Science of Business Valuation* (Westport, CT: Quorum Books, 1999), and Stanley J. Feldman, "Business Valuation 101: The Five Myths of Valuing a Private Business," *SCORE*, May 10, 2011, https://axiomvaluation.com/190-2.
7. "Valuing a Closely Held Business," 34; see also Daniel Kehrer, "Putting a Value on Your Business: Why and How," *SCORE*, May 10, 2022, https://www.score.org/resource/article/putting-value-your-business-why-and-how, and Ed Powers, "5 Key Numbers a Buyout Firm Uses to Value Your Company," *Inc.*, January 31, 2014.
8. Justin J. Camp, *Venture Capital Due Diligence* (New York: Wiley, 2002); see also John B. Vinturella and Suzanne M. Erickson, *Raising Entrepreneurial Capital* (Burlington, MA: Elsevier, 2004); Mike Moyer, *Slicing Pie* (Lake Forest, Il: Lake Shark Ventures, 2016); and Brad Feld and Jason Mendelson, *Venture Deals*, 3rd ed. (Hoboken, NJ: Wiley, 2016).

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Appendix 14A: Term Sheet

This sample document is the work product of a coalition of attorneys who specialize in venture capital financings, working under the auspices of the National Venture Capital Association (NVCA). See the NVCA website for a list of the working group's members. This document is intended to serve as a starting point only and should be tailored to meet your specific requirements. This document should not be construed as legal advice for any particular facts or circumstances. Note that this sample presents an array of (often mutually exclusive) options with respect to particular deal provisions.

This Term Sheet summarizes the principal terms of the Series A Preferred Stock Financing of [_____], Inc., a [Delaware] corporation (the "Company"). In consideration of the time and expense devoted and to be devoted by the Investors with respect to this investment, the No Shop/Confidentiality and Counsel and Expenses provisions of this Term Sheet shall be binding obligations of the Company whether or not the financing is consummated. No other legally binding obligations will be created until definitive agreements are executed and delivered by all parties. This Term Sheet is not a commitment to invest, and is conditioned on the completion of due diligence, legal review and documentation that is satisfactory to the Investors. This Term Sheet shall be governed in all respects by the laws of the [State of Delaware].

Offering Terms	
Closing Date:	As soon as practicable following the Company's acceptance of this Term Sheet and satisfaction of the Conditions to Closing (the "Closing"). [*provide for multiple closings if applicable*]
Investors:	Investor No. 1: [_____] shares ([_____]%), $[_____]
	Investor No. 2: [_____] shares ([_____]%), $[_____]
	[as well other investors mutually agreed upon by Investors and the Company]
Amount Raised:	$[_____], [including $[_____] from the conversion of principal [and interest] on bridge notes].[1]
Price per Share:	$[_____] per share (based on the capitalization of the Company set forth below) (the "Original Purchase Price").
Pre-Money Valuation:	The Original Purchase Price is based upon a fully-diluted pre-money valuation of $[_____] and a fully diluted post-money valuation of $[_____] (including an employee pool representing [_____] % of the fully diluted post-money capitalization).
Capitalization:	The Company's capital structure before and after the Closing is set forth below:

	Pre-Financing		**Post-Financing**	
Security	**# of Shares**	**%**	**# of Shares**	**%**
Common – Founders				
Common – Employee				
Stock Pool				
Issued				
Unissued				
[Common – Warrants]				
Series A Preferred				
Total				

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Charter[2]	
Dividends:	[*Alternative 1*: Dividends will be paid on the Series A Preferred on an as converted basis when, as, and if paid on the Common Stock.]
	[*Alternative 2*: Noncumulative dividends will be paid on the Series A Preferred in an amount equal to $[_____] per share of Series A Preferred when and if declared by the Board.]
	[*Alternative 3*: The Series A Preferred will carry an annual [_____]% cumulative dividend [compounded annually], payable upon a liquidation or redemption. For any other dividends or distributions, participation with Common Stock on an as-converted basis.][3]
Liquidation Preference:	In the event of any liquidation, dissolution, or winding up of the Company, the proceeds shall be paid as follows:
	[*Alternative 1 (nonparticipating Preferred Stock)*: First pay [one] times the Original Purchase Price [plus accrued dividends] [plus declared and unpaid dividends] on each share of Series A Preferred. The balance of any proceeds shall be distributed to holders of Common Stock.]
	[*Alternative 2 (full participating Preferred Stock)*: First pay [one] times the Original Purchase Price [plus accrued dividends] [plus declared and unpaid dividends] on each share of Series A Preferred. Thereafter, the Series A Preferred participates with the Common Stock on an as-converted basis.]
	[*Alternative 3 (cap on Preferred Stock participation rights)*: First pay [one] times the Original Purchase Price [plus accrued dividends] [plus declared and unpaid dividends] on each share of Series A Preferred. Thereafter, Series A Preferred participates with Common Stock on an as-converted basis until the holders of Series A Preferred receive an aggregate of [_____] times the Original Purchase Price.] A merger or consolidation (other than one in which stockholders of the Company own a majority by voting power of the outstanding shares of the surviving or acquiring corporation) and a sale, lease, transfer, or other disposition of all or substantially all of the assets of the Company will be treated as a liquidation preferences described above [unless the holders of [_____]% of the Series A Preferred elect otherwise].
Voting Rights:	The Series A Preferred Stock shall vote together with the Common Stock on an as-converted basis, and not as a separate class, except (i) the Series A Preferred as a class shall be entitled to elect [_____] [()] members of the Board (the "Series A Directors"), (ii) as provided under "Protective Provisions" below or (iii) as required by law. The Company's Certificate of Incorporation will provide that the number of authorized shares of Common Stock may be increased or decreased with the approval of a majority of the Preferred and Common Stock, voting together as a single class, and without a separate class vote by the Common Stock.[4]
Protective Provisions:	So long as [*insert fixed number, or %, or "any"*] shares of Series A Preferred are outstanding, the Company will not, without the written consent of the holders of at least [_____]% of the Company's Series A Preferred, either directly or by amendment, merger, consolidation, or otherwise: (i) liquidate, dissolve, or wind up the affairs of the Company, or effect any Deemed Liquidation Event; (ii) amend, alter, or repeal any provision of the Certificate of Incorporation or Bylaws [in a manner adverse to the Series A Preferred];[5] (iii) create or authorize the creation of or issue any other security convertible into or exercisable for any equity security, having rights, preferences, or privileges senior to or on parity with the Series A Preferred, or increase the authorized number of shares of Series A Preferred; (iv) purchase or redeem or pay any dividend on any capital stock prior to the Series A Preferred [other than stock repurchased from former employees or consultants in connection with the cessation of their employment/ services, at the lower of fair market value or cost;] [other than as approved by the Board, including the approval of [_____] Series A Director(s)]; or (v) create or authorize the creation of any debt security [if the Company's aggregate indebtedness would exceed $[_____] [other than equipment leases or bank lines of credit][other than debt with no equity feature][unless such debt security has received the prior approval of the Board of Directors, including the approval of [_____] Series A Director (s)]; (vi) increase or decrease the size of the Board of Directors.

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Optional Conversion:	The Series A Preferred initially converts 1:1 to Common Stock at any time at option of holder, subject to adjustments for stock dividends, splits, combinations, and similar events and as described below under "Anti-Dilution Provisions."
Anti-Dilution Provisions:	In the event that the Company issues additional securities at a purchase price less than the current Series A Preferred conversion price, such conversion price shall be adjusted in accordance with the following formula:
	[*Alternative 1*: "Typical" weighted average:
	CP2 = CP1 * (A + B)/(A + C)
	CP2 = New Series A Conversion Price
	CP1 = Series A Conversion Price in effect immediately prior to new issue
	A = Number of shares of Common Stock deemed to be outstanding immediately prior to new issue (includes all shares of stock, all shares of outstanding common outstanding preferred stock on an as-converted basis, and all outstanding options on an as-exercised basis; and does not include any convertible securities converting into this round of financing) B = Aggregate consideration received by the Corporation with respect to the new issue divided by CP1 C = Number of shares of stock issued in the subject transaction] [*Alternative 2*: Full-ratchet—the conversion price will be reduced to the price at which the new shares are issued.] [*Alternative 3*: No price-based anti-dilution protection.] The following issuances shall not trigger anti-dilution adjustment:[6] (i) securities issuable upon conversion of any of the Series A Preferred, or as a dividend or distribution on the Series A Preferred; (ii) securities issued upon the conversion of any debenture, warrant, option, or other convertible security; (iii) Common Stock issuable upon a stock split, stock dividend, or any subdivision of shares of Common Stock; and (iv) shares of Common Stock (or options to purchase such shares of Common Stock) issued or issuable to employees or directors of, or consultants to, the Company pursuant to any plan approved by the Company's Board of Directors [including at least [_____] Series A Director(s)] [(v) shares of Common Stock issued or issuable to banks, equipment lessors pursuant to a debt financing, equipment leasing, or real property leasing transaction approved by the Board of Directors of the Corporation [including at least [_____] Series A Director(s)].
Mandatory Conversion:	Each share of Series A Preferred will automatically be converted into Common Stock at the then applicable conversion rate in the event of the closing of a [firm commitment] underwritten public offering with a price of [_____] times the Original Purchase Price (subject to adjustments for stock dividends, splits, combinations, and similar events) and [net/gross] proceeds to the Company of not less than $[_____] (a "QPO"), or (ii) upon the written consent of the holders of [_____]% of the Series A Preferred.[7]
Pay-to-Play:	[Unless the holders of [_____]% of the Series A elect otherwise,] on any subsequent down round all [Major] Investors are required to participate to the full extent of their participation rights (as described below under "Investor Rights Agreement—Right to Participate Pro Rata in Future Rounds"), unless the participation requirement is waived for all [Major] Investors by the Board [(including vote of [a majority of] the Series A Director[s])]. All shares of Series A Preferred[8] of any [Major] Investor failing to do so will automatically [lose anti-dilution rights] [lose right to participate in future rounds] [convert to Common Stock and lose the right to a Board seat if applicable].[9]
Redemption Rights:[10]	The Series A Preferred shall be redeemable from funds legally available for distribution at the option of holders of at least [_____]% of the Series A Preferred commencing any time after the fifth anniversary of the Closing at a price equal to the Original Purchase Price [plus all accrued but unpaid dividends]. Redemption shall occur in three equal annual portions. Upon a redemption request from the holders of the required percentage of the Series A Preferred, all Series A Preferred shares shall be redeemed [(except for any Series A holders who affirmatively opt-out)].[11]

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Stock Purchase Agreement	
Representations and Warranties:	Standard representations and warranties by the Company. [Representations and warranties by Founders regarding [technology ownership, etc.].[12]
Conditions to Closing:	Standard conditions to Closing, which shall include, among other things, satisfactory completion of financial and legal due diligence, qualification of the shares under applicable Blue Sky laws, the filing of a Certificate of Incorporation establishing the rights and preferences of the Series A Preferred, and an opinion of counsel to the Company.
Counsel and Expenses:	[Investor/Company] counsel to draft closing documents. Company to pay all legal and administrative costs of the financing [at Closing], including reasonable fees (not to exceed $[_____]) and expenses of Investor counsel [unless the transaction is not completed because the Investors withdraw their commitment without cause].[13]
	Company Counsel: [_____ _____ _____] Investor Counsel: [_____ _____]
Investor Rights Agreement	
Registration Rights:	
Registrable Securities:	All shares of Common Stock issuable upon conversion of the Series A Preferred and [any other Common Stock held by the Investors] will be deemed "Registrable Securities."[14]
Demand Registration:	Upon earliest of (i) [three to five] years after the Closing; or (ii) [six] months following an initial public offering ("IPO"), persons holding [_____]% of the Registrable Securities may request [one][two] (consummated) registrations by the Company of their shares. The aggregate offering price for such registration may not be less than $[5 to 10] million. A registration will count for this purpose only if (i) all Registrable Securities requested to be registered are registered and (ii) it is closed, or withdrawn at the request of the Investors (other than as a result of a material adverse change to the Company).
Registration on Form S-3:	The holders of [10 to 30]% of the Registrable Securities will have the right to require the Company to register on Form S-3, if available for use by the Company, Registrable Securities for an aggregate offering price of at least $[1 to 5 million]. There will be no limit on the aggregate number of such Form S-3 registrations, provided that there are no more than [two] per year.
Piggyback Registration:	The holders of Registrable Securities will be entitled to "piggyback" registration rights on all registration statements of the Company, subject to the right, however, of the Company and its underwriters to reduce the number of shares proposed to be registered to a minimum of [30]% on a pro rata basis and to complete reduction on an IPO at the underwriter's discretion. In all events, the shares to be registered by holders of Registrable Securities will be reduced only after all other stockholders' shares are reduced.
Expenses:	The registration expenses (exclusive of stock transfer taxes, underwriting discounts, and commissions) will be borne by the Company. The Company will also pay the reasonable fees and expenses [not to exceed $] of one special counsel to represent all the participating stockholders.
Lockup:	Investors shall agree in connection with the IPO, if requested by the managing underwriter, not to sell or transfer any shares of Common Stock of the Company [(excluding shares acquired in or following the IPO)] for a period of up to 180 days following the IPO (provided all directors and officers of the Company and [1 to 5]% stockholders agree to the same lockup). Such lockup agreement shall provide that any discretionary waiver or termination of the restrictions of such agreements by the Company or representatives of the underwriters shall apply to [Major] Investors, pro rata, based on the number of shares held. A "Major Investor" means any Investor who purchases at least $[_____] of Series A Preferred.

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Termination:	Earlier of [five] years after IPO, upon a Deemed Liquidation Event, or when all shares of an Investor are eligible to be sold without restriction under Rule 144(k) within any 90-day period. No future registration rights may be granted without consent of the holders of a [majority] of the Registrable Securities unless subordinate to the Investor's rights.
Management and Information Rights:	A Management Rights letter from the Company, in a form reasonably acceptable to the Investors, will be delivered prior to Closing to each Investor that requests one.[15] Any Major Investor [(who is not a competitor)] will be granted access to Company facilities and personnel during normal business hours and with reasonable advance notification. The Company will deliver to such Major Investor (i) annual, quarterly, [and monthly] financial statements, and other information as determined by the Board; (ii) 30 days prior to the end of each fiscal year, a comprehensive operating budget forecasting the Company's revenues, expenses, and cash position on a month-to-month basis for the upcoming fiscal year; and (iii) promptly following the end of each quarter an up-to-date capitalization table, certified by the CFO.
Right to Participate Pro Rata in Future Rounds:	All [Major] Investors shall have a pro rata right, based on their percentage equity ownership in the Company (assuming the conversion of all outstanding Preferred Stock into Common Stock and the exercise of all options outstanding under the Company's stock plans), to participate in subsequent issuances of equity securities of the Company (excluding those issuances listed at the end of the "Anti-Dilution Provisions" section of this Term Sheet and issuances in connection with acquisitions by the Company). In addition, should any [Major] Investor choose not to purchase its full pro rata share, the remaining [Major] Investors shall have the right to purchase the remaining pro rata shares.
Matters Requiring	[So long as [_____]% of the originally issued Series A Preferred remains outstanding] the Company will not, without Board approval, which approval must include the affirmative vote of [_____] of the Series A Director(s):
Investor Director Approval:	(i) make any loan or advance to, or own any stock or other securities of, any subsidiary or other corporation, partnership, or other entity unless it is wholly owned by the Company; (ii) make any loan or advance to any person, including any employee or director, except advances and similar expenditures in the ordinary course of business or under the terms of an employee stock or option plan approved by the Board of Directors; the Company or any subsidiary arising in the ordinary course of business; (iv) make any investment other than investments in prime commercial paper, money market funds, certificates of deposit in any United States bank having a net worth in excess of $100,000,000, or obligations issued or guaranteed by the United States of America, in each case having a maturity not in excess of [two years]; (v) incur any aggregate indebtedness in excess of $[_____] that is not already included in a Board-approved budget, other than trade credit incurred in the ordinary course of business; (vi) enter into or be a party to any transaction with any director, officer, or employee of the Company or any "associate" (as defined in Rule 12b-2 promulgated under the Exchange Act) of any such person [except transactions resulting in payments to or by the Company in an amount less than $[60,000] per year], [or transactions made in the ordinary course of business and pursuant to reasonable requirements of the Company's business and upon fair and reasonable terms that are approved by a majority of the Board of Directors];[16] (vii) hire, fire, or change the compensation of the executive officers, including approving any option plans; (viii) change the principal business of the Company, enter new lines of business, or exit the current line of business; or (ix) sell, transfer, license, pledge, or encumber technology or intellectual property, other than licenses granted in the ordinary course of business.
Noncompetition and Non-Solicitation and Agreements:[17]	Each Founder and key employee will enter into a [one] year noncompetition and non-solicitation agreement in a form reasonably acceptable to the Investors.
Nondisclosure and Developments Agreement:	Each current and former Founder, employee, and consultant with access to Company confidential information/trade secrets will enter into a nondisclosure and proprietary rights assignment agreement in a form reasonably acceptable to the Investors.
Board Matters:	Each Board Committee shall include at least one Series A Director. The Board of Directors shall meet at least [monthly][quarterly], unless otherwise agreed by a vote of the majority of Directors.

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	The Company will bind D & O insurance with a carrier and in an amount satisfactory to the Board of Directors. In the event the Company merges with another entity and is not the surviving corporation, or transfers all of its assets, proper provisions shall be made so that successors of the Company assume Company's obligations with respect to indemnification of Directors.
Employee Stock Options:	All employee options to vest as follows: [25% after one year, with remaining vesting monthly over next 36 months]. [Immediately prior to the Series A Preferred Stock investment, [_____] shares will be added to the option pool creating an unallocated option pool of [_____] shares.]
Key Person Insurance:	Company to acquire life insurance on Founders [*name each Founder*] in an amount satisfactory to the Board. Proceeds payable to the Company.
[IPO Directed Shares:[18]	To the extent permitted by applicable law and SEC policy, upon an IPO consummated one year after Closing, Company to use reasonable best efforts to cause underwriters to designate [10]% of the offering as directed shares, 50% of which shall be allocated by Major Investors.]
[QSB Stock:	Company shall use reasonable best efforts to cause its capital stock to constitute Qualified Small Business Stock unless the Board determines that such qualification is inconsistent with the best interests of the Company.]
Termination:	All rights under the Investor Rights Agreement, other than registration rights, shall terminate upon the earlier of an IPO, a Deemed Liquidation Event, or a transfer of more than 50% of Company's voting power.
Right of First Refusal/Co-Sale Agreement and Voting Agreement	
Right of First Refusal/ Right of Co-Sale (Take-Me-Along):	Company first and Investors second (to the extent assigned by the Board of Directors) have a right of first refusal with respect to any shares of capital stock of the Company proposed to be sold by Founders [and employees holding greater than [1]% of Company Common Stock (assuming conversion of Preferred Stock)], with a right of oversubscription for Investors of shares unsubscribed by the other Investors. Before any such person may sell Common Stock, he will give the Investors an opportunity to participate in such sale on a basis proportionate to the amount of securities held by the seller and those held by the participating Investors.[19]
Board of Directors:	At the initial Closing, the Board shall consist of [_____] members comprised of (i) [*Name*] as [the representative designated by [_____], as the lead Investor, (ii) [*Name*] as the representative designated by the remaining Investors, (iii) [*Name*] as the representative designated by the Founders, (iv) the person then serving as the Chief Executive Officer of the Company, and (v) [_____] person (s) who are not employed by the Company and who are mutually acceptable [to the Founders and Investors][to the other directors].
Drag Along:	Holders of Preferred Stock and the Founders [and all current and future holders of greater than [1]% of Common Stock (assuming conversion of Preferred Stock and whether then held or subject to the exercise of options)] shall be required to enter into an agreement with the Investors that provides that such stockholders will vote their shares in favor of a Deemed Liquidation Event or transaction in which 50% or more of the voting power of the Company is transferred, approved by [the Board of Directors] [and the holders of a [majority][super majority] of the outstanding shares of Preferred Stock, on an as-converted basis].
Termination:	All rights under the Right of First Refusal/Co-Sale and Voting Agreements shall terminate upon an IPO, a Deemed Liquidation Event, or a transfer of more than 50% of Company's voting power.
Other Matters	
Founders' Stock:	All Founders to own stock outright subject to Company right to buy-back at cost. Buyback right for [_____]% for first [12 months] after Closing; thereafter, right lapses in equal [monthly] increments over following [_____] months.
[Existing Preferred Stock:[20]	The terms set forth below for the Series [_____] Stock are subject to a review of the rights, preferences and restrictions for the existing Preferred Stock. Any changes necessary to conform the existing Preferred Stock to this term sheet will be made at the Closing.]

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No Shop/ Confidentiality:	The Company agrees to work in good faith expeditiously toward a closing. The Company and the Founders agree that they will not, for a period of [six] weeks from the date these terms are accepted, take any action to solicit, initiate, encourage, or assist the submission of any proposal, negotiation, or offer from any person or entity other than the Investors relating to the sale or issuance, of any of the capital stock of the Company [or the acquisition, sale, lease, license, or other disposition of the Company or any material part of the stock or assets of the Company] and shall notify the Investors promptly of any inquiries by any third parties in regards to the foregoing. [In the event that the Company breaches this no-shop obligation and, prior to [_____], closes any of the above-referenced transactions [without providing the Investors the opportunity to invest on the same terms as the other parties to such transaction], then the Company shall pay to the Investors $[_____] upon the closing of any such transaction as liquidated damages.][21] The Company will not disclose the terms of this Term Sheet to any person other than officers, members of the Board of Directors, and the Company's accountants and attorneys and other potential Investors acceptable to [_____], as lead Investor, without the written consent of the Investors.
Expiration:	This Term Sheet expires on [_____, 200] if not accepted by the Company by that date.

EXECUTED THIS [_____] DAY OF [_____], 200[_____].

[SIGNATURE BLOCKS]

Notes

1. Modify this provision to account for staged investments or investments dependent on the achievement of milestones by the Company.
2. The Charter is a public document, filed with the [Delaware] Secretary of State, that establishes all of the rights, preferences, privileges, and restrictions of the Preferred Stock. Note that if the Preferred Stock does not have rights, preferences, and privileges materially superior to the Common Stock, then (after Closing) the Company cannot defensibly grant Common Stock options priced at a discount to the Preferred Stock.
3. In some cases, accrued and unpaid dividends are payable on conversion as well as upon a liquidation event. Most typically, however, dividends are not paid if the preferred is converted. Another alternative is to give the Company the option to pay accrued and unpaid dividends in cash or in common shares valued at fair market value. The latter are referred to as "PIK" (payment-in-kind) dividends.
4. For California corporations, one cannot "opt out" of the statutory requirement of a separate class vote by Common Stockholders to authorize shares of Common Stock.
5. Note that, as a matter of background law, Section 242(b)(2) of the Delaware General Corporation Law provides that if any proposed charter amendment would adversely alter the rights, preferences, and powers of one series of Preferred Stock but not similarly adversely alter the entire class of all Preferred Stock, then the holders of that series are entitled to a separate series vote on the amendment.
6. Note that additional exclusions are frequently negotiated, such as issuances in connection with equipment leasing and commercial borrowing.
7. The per-share test ensures that the investor achieves a significant return on investment before the Company can go public. Also consider allowing a non-QPO to become a QPO if an adjustment is made to the Conversion Price for the benefit of the investor, so that the investor does not have the power to block a public offering.
8. Alternatively, this provision could apply on a proportionate basis (e.g., if Investor plays for ½ of pro rata share, receives ½ of antidilution adjustment).
9. If the punishment for failure to participate is losing some but not all rights of the Preferred (e.g., anything other than a forced conversion to common), the Charter will need to have so-called "blank check preferred" provisions at least to the extent necessary to enable the Board to issue a "shadow" class of preferred with diminished rights in the event an investor fails to participate. Note that, as a drafting matter, it is far easier to simply have (some or all of) the preferred convert to common.
10. Redemption rights allow Investors to force the Company to redeem their shares at cost (plus a small guaranteed rate of return [e.g., dividends]). In practice, redemption rights are not often used; however, they do provide a form of exit and some possible leverage over the Company. While it is possible that the right to receive dividends on redemption could give rise to a Code Section 305 "deemed dividend" problem, many tax practitioners take the view that if the liquidation preference provisions in the Charter are drafted to provide that, on conversion, the holder receives the greater of its liquidation preference or its as-converted amount (as provided in the NVCA model Certificate of Incorporation), then there is no Section 305 issue.
11. Due to statutory restrictions, it is unlikely that the Company will be legally permitted to redeem in the very circumstances where investors most want it (the so-called "sideways situation"), investors will sometimes request that certain penalty provisions take effect where redemption has been requested but the Company's available cash flow does not permit such redemption—for example, the

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redemption amount shall be paid in the form of a one-year note to each unredeemed holder of Series A Preferred, and the holders of a majority of the Series A Preferred shall be entitled to elect a majority of the Company's Board of Directors until such amounts are paid in full.

12. Note that, while it is not at all uncommon in East Coast deals to require the Founders to personally rep and warrant (at least as to certain key matters, and usually only in the Series A round), such Founders reps are rarely found in West Coast deals.
13. The bracketed text should be deleted if this section is not designated in the introductory paragraph as one of the sections that is binding on the Company regardless of whether the financing is consummated.
14. Note that Founders/management sometimes also seek registration rights.
15. See commentary in introduction to NVCA model Managements Rights Letter, explaining purpose of such letter.
16. Note that Section 402 of the Sarbanes-Oxley Act of 2003 would require repayment of any loans in full prior to the Company filing a registration statement for an IPO.
17. Note that noncompete restrictions (other than in connection with the sale of a business) are prohibited in California and may not be enforceable in other jurisdictions as well. In addition, some investors do not require such agreements for fear that employees will request additional consideration in exchange for signing a Noncompete/Nonsolicit (and indeed the agreement may arguably be invalid absent such additional consideration—although having an employee sign a noncompete contemporaneous with hiring constitutes adequate consideration). Others take the view that it should be up to the Board on a case-by-case basis to determine whether any particular key employee is required to sign such an agreement. Noncompetes typically have a one-year duration, although state law may permit up to two years.
18. SEC Staff examiners have taken position that, if contractual right to friends and family shares was granted less than 12 months prior to filing of registration statement, this will be considered an "offer" made prematurely before filing of IPO prospectus. So investors need to agree to drop shares from offering if that would hold up the IPO. While some documents provide for alternative parallel private placement where the IPO does occur within 12 months, such a parallel private placement could raise integration issues and negatively impact the IPO. Hence, such an alternative is not provided for here.
19. Certain exceptions are typically negotiated, for example, estate planning or *de minimis* transfers.
20. Necessary only if this is a later round of financing and not the initial Series A round.
21. It is unusual to provide for such "breakup" fees in connection with a venture capital financing but might be something to consider where there is a substantial possibility the Company may be sold prior to consummation of the financing (e.g., a later-stage deal).

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Chapter 15

Harvesting the Entrepreneurial Venture

Learning Objectives

15.1. Discuss the concept of "harvest" as a plan for the future
15.2. Explain the key factors in the management succession of a venture
15.3. Identify some of the most important sources of succession
15.4. Explain the potential impact of regulations on family business succession
15.5. Outline the ways to develop a succession strategy
15.6. Describe the specifics of an initial public offering (IPO) as a potential harvest strategy
15.7. Discuss "selling out" as a final alternative in the harvest strategy

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Entrepreneurial Thought

In the agrarian mindset there is an ideal and defined window to bring a harvest to the marketplace. If you do it too soon, the product will not yet be ripe. Nobody will buy it. If you're too late, then there will be rotting, spoilage, and waste. Why can't we take that same approach with today's entrepreneurial ventures?

—Andrew J. Sherman, *Harvesting Intangible Assets*

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15-1 Harvesting the Venture: A Focus on the Future

LO15.1 Discuss the concept of "harvest" as a plan for the future

Entrepreneurs must realize that the eventual success of their venture will lead them to a decision concerning the future operation and management of the business. A *harvest plan* defines how and when owners and investors will realize an actual cash return on their investment. Note that "harvest" does not mean that the challenges and responsibility of the entrepreneur are over. There are challenging decisions to be made. It may be a decision regarding managerial control and succession for successful continued operations as a privately held firm.[1] It may be a desire to initiate a liquidity event through which the venture is able to generate a significant amount of cash for investors. It may be that the venture has grown to a stage at which the possibility of an initial public offering (IPO), which we discussed in Chapter 8, is a reality. Or it may be that the most realistic opportunity is selling the business. In any of these situations, the entrepreneur is confronted with myriad choices and possibilities. Although it is impossible for this chapter to answer all of the questions that an entrepreneur faces at this point because each venture presents a unique set of circumstances, it is the goal of this final chapter to review some of the more common challenges that confront entrepreneurs during this stage. Thus, we examine the challenge of a management succession strategy and the two most notable harvest strategies for ventures: the IPO and the sale of the venture.

15-2 The Management Succession Strategy

LO15.2 Examine the key factors in the management succession of a venture

Research shows that many privately held firms go out of existence after 10 years; only 3 of 10 survive into a second generation. More significantly, only 16 percent of all privately held enterprises make it to a third generation.[2] The average life expectancy for a privately held business is 24 years, which is also the average tenure for the founders of a business.[3] One of the major problems most privately held businesses face is the lack of preparation for passing managerial control to the next generation. The cruel fact is that one generation succeeds the other with biological inevitability, yet most privately held firms never formulate succession plans.

Management succession, which involves the transition of managerial decision making in a firm, is one of the greatest challenges confronting owners and entrepreneurs in privately held businesses. At first glance, succession would not seem to be a major problem. All an owner has to do is designate which heir will inherit the operation or, better yet, train one (or more) of them to take over the business during the founder's lifetime. Unfortunately, this is easier said than done—a number of problems exist. One of the major ones is the owner. To a large degree, the owner is the business; the individual's personality and talents make the operation what it is. If this person were to be removed from the picture, the company might be unable to continue. Additionally, this individual may not want to be removed. So, if the owner/manager begins to have health problems or is unable to manage effectively, they may still hang on. The owner often views any outside attempt to get them to step aside as greedy efforts to plunder the operation for personal gain. What's more, the owner and family members may feel anxiety about death because discussing the topic of death conjures up a negative image in everyone's mind.

Other barriers to succession include sibling rivalry, family members' fear of losing status, or a complete aversion to death for fear of loss or abandonment.[4] Table 15.1 provides a list of barriers to succession attributed to the owner and to the family.

The basic rule for privately held businesses is this: the owner should develop a succession plan. Because many people want to keep the business in their families, decisions have to be made regarding heirs. This is often psychologically difficult. Choosing an heir can be like buying a cemetery plot—it is an admission of one's mortality. Owners who refuse to face the succession issue, however, place an unnecessary burden on those whom they leave behind. Successor problems are not insurmountable. For our consideration of these problems, the best place to begin is with an identification of the key factors in succession.

15-3 Key Factors in Succession

It has been said that the concept of "smooth succession" in a privately held business is a contradiction of terms. This contradiction is because succession is a highly charged emotional issue that requires not only structural changes but cultural changes as well.[5] Family succession includes the transfer of ethics, values, and traditions, along with the actual business itself. The "family business" and the "business family" are two distinct components that must be dealt with and disentangled if progress toward succession is to be made.[6]

A number of considerations affect the succession issue.[7] One way to examine them is in terms of pressures

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Table 15.1 Barriers to Succession Planning in Privately Held Businesses

Founder/Owner	Family
Death anxiety	Death as taboo
Company as symbol	• Discussion is a hostile act
• Loss of identity	• Fear of loss/abandonment
• Concern about legacy	Fear of sibling rivalry
Dilemma of choice	Change of spouse's position
• Fiction of equality	
Generational envy	
• Loss of power	

Source: Manfred F. R. Kets de Vries, "The Dynamics of Family-Controlled Firms: The Good News and the Bad News," *Organizational Dynamics*, Winter 1993, 68.

and interests inside the firm and outside the firm. Another way is to examine forcing events. A third way is to examine the sources of succession. Finally, we will discuss the legal restrictions that may affect succession decisions.

15-3a Succession Pressures and Interests inside the Firm

Two types of succession pressures originate within privately held businesses (see Figure 15.1). One comes from family members; the other comes from nonfamily employees.[8]

Family Members

When members of the family are also employees, a number of succession-type problems can arise. One is that the family members may want to keep the business in existence so that they and their families will be able to manage it. Sometimes this results in the members wanting to get or increase control over operations. Another common development is pressure on the owner/manager to designate an heir. A third possible development is rivalry among the various branches of the family. For example, each of the owner's children may feel that the owner should put them (or one of their children) in charge of the operation. Given that only one of the family branches can win this fight, the rivalry can lead to the sale or bankruptcy of the business.[9]

Nonfamily Employees

Nonfamily employees sometimes put pressure on the owner/manager in an effort to protect their personal interests. For example, long-term employees often think that the owner should give them an opportunity to buy a stake in the company, or they believe that they should be given a percentage of the business in the owner's will. Such hopes and expectations are often conveyed to the owner and can result in pressure for some form of succession plan. Moreover, to the extent that the nonfamily employees are critical to the enterprise's success, these demands cannot be ignored. The owner must reach some accommodation with these people if the business is to survive.

15-3b Succession Pressures and Interests outside the Firm

Outside the firm, both family members and nonfamily elements exert pressure on and hold interest in the firm's succession.

Family Members

Even when family members do not play an active role in the business, they can apply pressure. Quite often, these individuals are interested in ensuring that they inherit part of the operation, and they will put pressure on the owner/manager toward achieving that end. In some cases, they pressure to get involved in the business. Some family members will pressure the owner/manager to hire them. Quite often, these appeals are resisted on the grounds of the firm not needing additional personnel or needing someone with specific expertise (sales ability or technical skills), and thus the owner sidesteps the request.

Nonfamily Elements

Another major source of pressure comes from external environmental factors. One of these is competitors who continually change strategy and force the owner/

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Figure 15.1 Pressures and Interests in a Family Business



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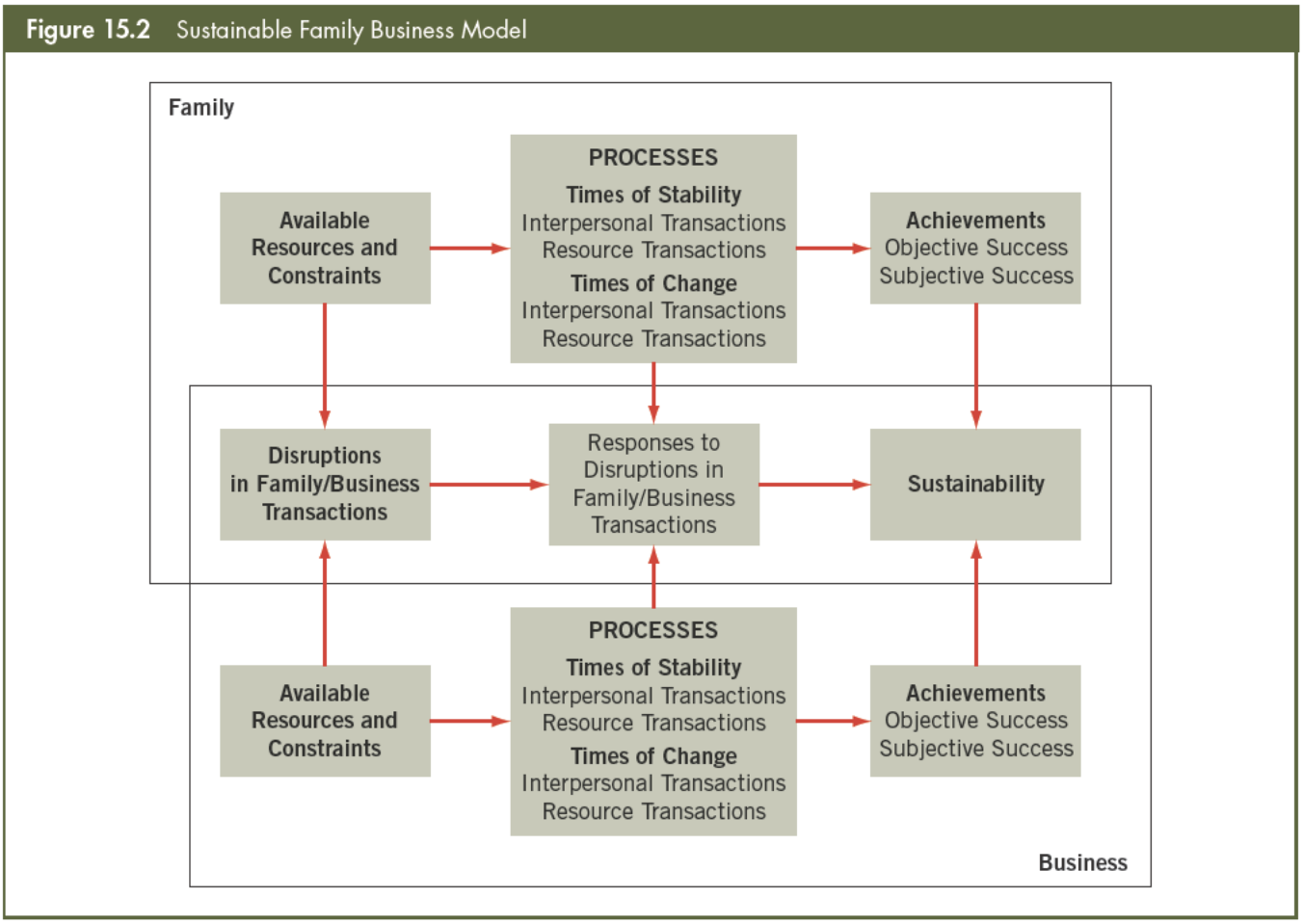
manager to adjust to new market considerations. Other factors include customers, technology, and new-product development. These forces continually change, and the entrepreneur must respond to them. Tax laws, regulatory agencies, and trends in management practices constitute still other elements with which the owner/manager must contend.[10] Depending on the situation, any of these sources of pressure can prove troublesome.

Figure 15.2 illustrates the distinction of family and business issues in a systems model. At the interface of the family and business systems, both the family and the business respond to disruptions in their regular transaction patterns. These disruptions may come from outside the family and business or from within them. Outside sources of disruption include public policy changes, economic upheavals, and technological innovation. Inside sources of disruption include marriage, birth, death, and divorce of family members. These disruptions may be either good or bad. In either case, they require a response from both the family and the business.

The extent of overlap between the family and business systems will vary from family business to family business. In privately held businesses, where the prevailing orientation is to keep the family and the business separate, there is little overlap—diagrammatically, this

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Figure 15.2 Sustainable Family Business Model



Source: Kathryn Stafford, Karen A. Duncan, Sharon Dane, and Mary Winter, "A Research Model of Sustainable Family Business," *Family Business Review* 12, no. 3 (September 1999): 197–208.

case is illustrated by a small area of interface between the two systems. Conversely, in privately held businesses characterized by great overlap, the area of interface between the family and business systems is considerable.

Sustainability results from the confluence of family success, business success, and appropriate responses to disruptions. In other words, sustainability requires consideration of the family as well as the business. It also requires consideration of the ability of the family and business to cooperate in responding to disruptions in a way that does not impede the success of either.[11]

15-3c Forcing Events

Forcing events are those happenings that cause the replacement of the owner/manager. These events require the entrepreneur to step aside and let someone else direct the operation. The following are typical examples:

- Death, resulting in the heirs immediately having to find a successor to run the operation
- Illness or some other form of nonterminal physical incapacitation
- Mental or psychological breakdown, resulting in the individual having to withdraw from the business
- Abrupt departure, such as when an entrepreneur decides, with no advance warning, to retire immediately
- Legal problems, such as incarceration for violation of the law (if this period of confinement is for more than a few weeks, succession usually becomes necessary, if in name only)
- Severe business decline, resulting in the owner/manager deciding to leave the helm
- Financial difficulties, resulting in lenders demanding the removal of the owner/manager before lending the necessary funds to the enterprise

These types of events often are unforeseen, and the family seldom has a contingency plan for dealing with them. As a result, when they occur, they often create a major problem for the business.

These considerations influence the environment within which the successor will operate. Unless that individual and the environment fit well, the successor will be less than maximally effective.

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15-3d Sources of Succession

LO15.3 Identify some of the most important sources of succession

An entrepreneurial successor is someone who is high in ingenuity, creativity, and drive. This person often provides the critical ideas for new-product development and future ventures. The managerial successor is someone who is interested in efficiency, internal control, and the effective use of resources. This individual often provides the stability and day-to-day direction needed to keep the enterprise going.

When looking for an inside successor, the entrepreneur usually focuses on a son, daughter, nephew, or niece, with the intent of gradually giving the person operational responsibilities followed by strategic power and ownership. An important factor in the venture's success is whether the founder and the heir can get along. The entrepreneur must be able to turn from being a leader to being a coach, from being a doer to being an adviser. The heir must respect the founder's attachment to the venture and be sensitive to this person's possessive feelings. At the same time, the heir must be able to use their entrepreneurial flair to initiate necessary changes.[12] When looking ahead toward choosing a successor from inside the organization, the founder often trains a team of executive managers that consists of both family and nonfamily members. This enables the individual to build an experienced management team capable of producing a successor. The founder assumes that, in time, a natural leader will emerge from the group.[13]

Two key strategies center on the entry of the inside younger generation and when the "power" actually changes hands. Table 15.2 illustrates the advantages and disadvantages of the early entry strategy versus the delayed entry strategy. The main question is the ability of the successor to gain credibility with the firm's employees. The actual transfer of power is a critical issue in the implementation of any succession plan.[14]

If the founder looks for a family member outside the firm, they usually prefer to have the heir first work for someone else. The hope is that the individual will make their initial mistakes early on before assuming the family business reins.

Sometimes the founder will look for a nonfamily outsider to be the successor, perhaps only temporarily. The entrepreneur may not see an immediate successor inside the firm and may decide to hire a professional manager, at least on an interim basis, while waiting for an heir to mature and take over.

Table 15.2 Comparison of Entry Strategies for Succession in Privately Held Businesses

	Advantages	Disadvantages
Early entry strategy	Intimate familiarity with the nature of the business and employees is acquired.	Conflict results when the owner has difficulty with teaching or relinquishing control to the successor.
	Skills specifically required by the business are developed.	Normal mistakes tend to be viewed as incompetence in the successor.
	Exposure to others in the business facilitates acceptance and the achievement of credibility.	Knowledge of the environment is limited, and risks of inbreeding are incurred.
	Strong relationships with constituents are readily established.	
Delayed entry strategy	The successor's skills are judged with greater objectivity.	Specific expertise and understanding of the organization's key success factors and culture may be lacking.
	The development of self-confidence and growth independent of familial influence are achieved.	Set patterns of outside activity may conflict with those prevailing in the family firm.
	Outside success establishes credibility and serves as a basis for accepting the successor as a competent executive.	Resentment may result when successors are advanced ahead of long-term employees.
	Perspective of the business environment is broadened.	

Source: Jeffrey A. Barach, Joseph Ganitsky, James A. Carson, and Benjamin A. Doochin, "Entry of the Next Generation: Strategic Challenge for Family Firms," *Journal of Small Business Management* 26, no. 2 (April 1988): 53.

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The Entrepreneurial Process

Harvesting a Business Online

Selling a business, also known as harvesting a business, is normally a time-consuming, stressful experience for entrepreneurs. Between the due diligence performed by the buyer and the emotional distress felt by the entrepreneur as a result of leaving the business, the sales process is far more involved than selling a car or even a house. Employees have to be considered, financial statements have to be organized and analyzed, and the entrepreneur has to figure out what to do after the business is sold.

Purchasing a business is a complex procedure that is difficult to simplify; however, companies looking to facilitate the buying and selling of businesses are gaining in popularity. These companies are offering online services designed to match entrepreneurs with potential buyers. The objective is to provide greater visibility for businesses to eliminate much of the anxiety felt by entrepreneurs, which results from completing the most difficult part of the process: locating an interested party.

Business brokers have been around for decades. Most (if not all) brokers now have websites with directories of businesses currently for sale, not unlike those provided by real estate agents. These brokers usually keep their lists private and limit their scope to a given region. The new services are planning to differentiate themselves by providing global listings to maximize exposure for entrepreneurs and to entice buyers to frequent their sites. In addition, these sites will offer the added functionality of broadcasting their listings to popular search services, such as Craigslist and Google.

BizTrader.com, one such company, is an all-inclusive provider for anyone looking to buy, sell, or value a small business. The company has received positive feedback from existing brokerage agencies, a fact that it attributes to hiring a chief operating officer with experience running operations for online real estate services. Many similarities exist between the tasks of brokering businesses and selling real estate—a fact that BizTrader.com has successfully exploited.

Another similar site is BizBuySell.com, which has been in business since 1996. The company boasts that it has 45,000 companies listed at any given time. Its first-mover advantage has positioned it as the industry leader. Although the site does not offer the same global exposure that BizTrader.com is promoting, the size of BizBuySell.com allows it to provide greater value than any new service could.

Both BizTrader.com and BizBuySell.com provide valuable functionality for entrepreneurs. The fees are variable, depending on the services provided. The primary purpose of each of these websites is to provide small business with a platform to list their businesses for sale. Both websites also provide ancillary services, such as helping entrepreneurs find financing opportunities and assisting with business valuations. The broker fee for BizTrader.com is $49 per month with free membership. It also provides two pricing options for selling business ads. The standard option is free for 30 days with limited capabilities. However, a valuation is included. BizTrader.com's premium option for advertising requires a one-time fee of $59 and is available until the business is sold. It has increased capabilities and will publish the ad on 10 different websites. The broker plans for BizBuySell.com start at $59.95 per month. Purchasing an ad to sell a business has a starting price of $49.95 per month with free distribution on 150 or more partner websites. BizBuySell.com provides valuation reports ranging from $19.95 to $59.95, contingent on how many businesses are being analyzed in the report.

As online advertising becomes increasingly important to businesses, newspaper classified ads are waning in popularity. The success of the Internet as a forum to promote businesses is attributed largely to the opportunity it provides for entrepreneurs to more effectively promote their businesses at a reduced cost.

Although some experts strongly encourage entrepreneurs to focus their resources on Internet postings, entrepreneurs who have sold their businesses tend to utilize all available channels. The notion that more is better certainly applies when selling a business, and online services such as BizBuySell.com and BizTrader.com serve to increase the resources at entrepreneurs' disposal.

Source: Adapted from Konstantin Shishkin, "Selling Your Business? Click Here," *Fortune Small Business*, April 14, 2008, http://money.cnn.com/2008/04/14/smbusiness/biztrader.fsb/index.htm, accessed April 17, 2008), and the company websites http://www.biztrader.com and http://www.bizbuysell.com, accessed January 30, 2015.

Another form of nonfamily outsider is the specialist who is experienced in getting ventures out of financial difficulty. The founder usually gives the specialist total control, and this person later hands the rejuvenated venture to another leader.

Still another nonfamily approach is for the founder to find a person with the right talents and to bring this individual into the venture as an assistant with the understanding that they will eventually become president and owner of the venture. No heirs may exist, or perhaps no eligible family member is interested.

15-3e Legal Restrictions

LO15.4 Discuss the potential impact of regulations on family business succession

The first source for succession often is family and in-house personnel prospects. However, such traditions of succession practices in privately held businesses were challenged in the *Oakland Scavenger Company* case.

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This suit was brought in 1984 by a group of Black and Hispanic workers at the California-based **Oakland Scavenger Company** (a garbage collection firm) who complained of employment discrimination because of their race. The U.S. District Court of Northern California dismissed the suit on the basis that it had no relation to antidiscrimination laws. However, the U.S. Court of Appeals for the Ninth Circuit reviewed the decision and held that "nepotistic concerns cannot supersede the nation's paramount goal of equal economic opportunity for all."[15]

According to Oakland Scavenger's legal brief, the question focused on the Fifth Amendment versus Title VII of the 1964 Civil Rights Act: if discrimination overrides the protection of life, liberty, and property from unreasonable interference from the state, then the rights of parents to leave their property and business to anyone can be abolished. This decision can have a major effect on the management succession plans of privately held businesses.

The case was appealed to the U.S. Supreme Court. However, before the Court could make a ruling, the Oakland Scavenger Company was purchased by Waste Management Corporation, and an out-of-court $8 million settlement was reached. The settlement allocated sums of at least $50,000 to 16 Black and Hispanic plaintiffs, depending on their length of service, and also provided for payments to a class of more than 400 Black and Hispanic workers Oakland Scavenger employed after January 10, 1972.[16]

As K. Peter Stalland, legal representative for the National Family Business Council, has stated, "The effect this case can have on small business is tremendous. It means, conceivably, that almost any small business can be sued by an employee of a different ethnic origin than the owner, based upon not being accorded the same treatment as a son or daughter. The precedent is dangerous."[17] Thus, **nepotism** is something that now must be considered seriously in light of the legal ramifications.

Always remember that Title VII discrimination provisions apply in most states when a business has 15 or more employees. Here are some helpful hints that will assist a family-controlled firm to maintain proper legal practices:

1. Hold relatives to the same standard as all other employees.
2. Require relatives to train and work their way up your corporate hierarchy.
3. Compensation and benefits should be the same for family as other employees.
4. Have written job descriptions. Steer clear of favoritism.
5. Keep careful statistics on the employment of family and nonfamily members and the representation of minorities.

15-4 Developing a Succession Strategy

LO15.5 Outline the ways to develop a succession strategy

Developing a succession strategy involves several important steps: (1) understanding the contextual aspects, (2) identifying successor qualities, and (3) developing a written succession plan.[18]

15-4a Understanding Contextual Aspects of Succession

The five key aspects that must be considered for an effective succession follow.

Time

The earlier the entrepreneur begins to plan for a successor, the better the chances of finding the right person. The biggest problem the owner faces is the prospect of events that force immediate action and result in inadequate time to find the best replacement.

Type of Venture

Some entrepreneurs are easy to replace; some cannot be replaced. To a large degree, this is determined by the type of venture. An entrepreneur who is the idea person in a high-tech operation is going to be difficult to replace. The same is true for an entrepreneur whose personal business contacts throughout the industry are the key factors for the venture's success. On the other hand, a person running an operation that requires a minimum of knowledge or expertise usually can be replaced without much trouble.

Capabilities of Managers

The skills, desires, and abilities of the replacement will dictate the future potential and direction of the enterprise. As the industry matures, the demands made on the entrepreneur also may change. Industries where high tech is the name of the game often go through a change in which marketing becomes increasingly important. A technologically skilled entrepreneur with an understanding of marketing or with the ability to develop an orientation in this direction will be more valuable to the enterprise than will a technologically skilled entrepreneur with no marketing interest or background.

Entrepreneur's Vision

Most entrepreneurs have expectations, hopes, and desires for their organization. A successor—it is hoped—will share this vision except, of course, in cases where the entrepreneur's plans have gotten the organization in trouble and a new vision is needed. Examples are plentiful today because of the huge increase in life sciences ventures,

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high-technology ventures, and other emerging technologies in which the founding entrepreneur possesses the initial vision to launch the company but lacks the managerial experience to grow the venture. Outside executive experience is sought because the board of directors may feel that a more managerial, day-to-day entrepreneurial manager is needed to replace the highly conceptual, analytical entrepreneur who founded the company.

Environmental Factors

Sometimes a successor is needed because the business environment changes and a parallel change is needed at the top. An example is Edwin Land of Polaroid. Although his technological creativity had made the venture successful, Land eventually had to step aside for someone with more marketing skills. In some cases, owners have had to allow financial types to assume control of the venture because internal efficiency was more critical to short-run survival than was market effectiveness.

15-4b Identifying Successor Qualities

Successors should possess many qualities or characteristics. Depending on the situation, some will be more important than others. In most cases, however, all will have some degree of importance. Some of the most common of these successor qualities are sufficient knowledge of the business or a good position (especially marketing or finance) from which to acquire this knowledge within an acceptable time frame; fundamental honesty and capability; good health; energy, alertness, and perception; enthusiasm about the enterprise; personality compatible with the business; a high degree of perseverance; stability and maturity; a reasonable amount of aggressiveness; thoroughness and a proper respect for detail; problem-solving ability; resourcefulness; the ability to plan and organize; the talent to develop people; the personality of a starter and a finisher; and appropriate agreement with the owner's philosophy about the business.[19]

15-4c Writing a Succession Strategy

These elements prepare the entrepreneur to develop a management continuity strategy and policy. A written policy can be established using one of the following strategies:

1. The owner controls the *management continuity strategy* entirely. This is very common, yet legal advice is still needed and recommended.
2. The owner consults with selected family members. Here, the legal adviser helps to establish a *liaison* between family and owner in constructing the succession mechanism.
3. The owner works with professional advisers. This is an actual board of advisers from various professional disciplines and industries that works with the owner to establish the mechanism for succession (sometimes referred to as a "quasi board").[20]
4. The owner works with family involvement. This alternative allows the core family (blood members and spouses) to actively participate in and influence the decisions regarding succession.

If the owner is still reasonably healthy and the firm is in a viable condition, the following additional actions should be considered:

5. The owner formulates **buy/sell agreements** at the very outset of the company (or soon thereafter) and whenever a major change occurs. This is also the time to consider an appropriate insurance policy on key individuals that would provide the cash needed to acquire the equity of the deceased.
6. The owner considers **employee stock ownership plans (ESOPs)**. If the owner has no immediate successor in mind and respects the loyalty and competence of their employees, then an appropriate ESOP might be the best solution for passing control of the enterprise. After the owner's death, the employees could decide on the management hierarchy.
7. The owner sells or liquidates the business when losing enthusiasm for it but is still physically able to go on. This could provide the capital to launch another business. Whatever the owner's plans, the firm would be sold before it fails due to disinterest.
8. The owner sells or liquidates after discovering a terminal illness but still has time for the orderly transfer of management or ownership.[21]

Legal advice is beneficial for all of these strategies, but of greater benefit is having advisers (legal or otherwise) who understand the succession issues and are able to recommend a course of action.

Entrepreneurial founders of privately held businesses often reject thoughts of succession. However, neither ignorance nor denial will change the inevitable. It is therefore crucial for entrepreneurs to design a plan for succession very carefully. Such plans prevent today's flourishing privately held businesses from becoming a statistic of diminishing family dynasties.

Consider Outside Help

Promotion from within is a morale-building philosophy. Sometimes, however, it is a mistake. When the top person does a poor job, does promoting the next individual in line solve the problem? The latter may be the owner/manager's clone. Conversely, consider family-owned businesses that start to outgrow the managerial ability of the top person. Does anyone in the firm *really* have the requisite skills to manage the operation? The questions that must be answered are the following: How can the business be effectively run, and who has the ability to do it? Sometimes answering these questions calls for

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an outside person. Privately held businesses also face the ever-present ego factor. Does the owner/manager have the wisdom to step aside and the courage to let someone else make strategic decisions? Or is the desire for control so great that the owner prefers to run the risks associated with personally managing the operation? The lesson is clear to the dispassionate observer; unfortunately, it is one that many owners have had to learn the hard way.[22]

15-5 The Exit Strategy: Liquidity Events

It is true that most entrepreneurs are focused on launching and growing their ventures rather than the plan for exiting the venture in the years to come. However, an exit strategy is always of prime importance to outside investors. Investors' commitment to capital will always reside in the confidence that they will recover their initial investment with a healthy profit. Entrepreneurs need to be aware that an exit strategy *for* the venture may mean the entrepreneur's exit *from* the venture as well.[23]

An exit strategy is defined as that component of the business plan where an entrepreneur describes a method by which investors can realize a tangible return on their investment. The questions of "how much," "when," and "how" need to be addressed. Investors always want to convert their share of the investment into a more "liquid" form, known as a liquidity event, which refers to the positioning of the venture for the realization of a cash return for the owners and the investors. This "event" is most often achieved through an IPO or complete sale of the venture. In either scenario, the entrepreneur must seek professional advice and legal counsel due to the significant regulations and legal parameters involved. For our purposes, we delve into the basic concepts involved with each of these liquidity events.

15-5a The Initial Public Offering (IPO)

LO15.6 Describe the specifics of an initial public offering (IPO) as a potential harvest strategy

As we covered in Chapter 8, many entrepreneurs have sought capital through the public markets. Just to reiterate, the term initial public offering (IPO) is used to represent the registered public offering of a company's

The Entrepreneurial Process

Using Buy/Sell Agreements

Many entrepreneurs owe their continued success to the combined skills of two or more owners. But did any owner, at the inception of the venture, contemplate involuntarily continuing the business with a co-owner's children? With a co-owner's ex-spouse? With a co-owner's creditors? Probably not. But smart entrepreneurs plan ahead in order to deal with issues of control that may unpredictably arise by virtue of one of the four *D*s: disability, death, dissolution, and debtorship. Should a co-owner become disabled, die, be involved in a marital dissolution, or have assets seized by their creditors, ownership of their interest in the business may be in jeopardy of transfer to one or more third parties. Fortunately, it is possible (and imperative) that the parties take the steps necessary to ensure that the transfer of any ownership interest in the business is carried out in a way that protects the future of the business, the ownership interests of remaining shareholders, and the financial security of the departing owner's family. A buy/sell agreement can provide just such protection. It ensures that, in the event of one of these "triggering events," interest in a closely held business is transferred in a manner that is advantageous to all involved parties. This type of agreement can be designed to make certain the following:

1. The remaining shareholder(s) has (have) the first right to retain the ownership interest.
2. The departing owner (or beneficiaries) receives a fair market price for the ownership interest.
3. Lawsuits and disputes that could threaten the company's existence are avoided.
4. Funds are available to purchase the ownership interest.

Legal counsel is necessary to ensure that a buy/sell agreement addresses all of the unique circumstances of a particular company.

The two basic types of agreements are the cross-purchase agreement, in which the shareholders are obligated to purchase the departing owner's stock, and the redemption agreement, in which the company is obligated to purchase the departing owner's stock. Each case has certain advantages, disadvantages, and tax implications that need to be considered, and some agreements include "blended" options and obligations for such purchases. Thus, both a lawyer and a tax accountant should be consulted.

Source: Thomas Owens, "Buy–Sell Agreements," *Small Business Reports*, January 1991): 57–61, and Mark E. Need, director of the Elmore Entrepreneurship Law Clinic, Indiana University Bloomington, 2015.

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securities for the first time. As we illustrated in Chapter 8, there is tremendous volatility that exists within the stock market, and entrepreneurs should be aware of the concerns that confront them when they pursue the IPO market. Many entrepreneurs already have begun to recognize some of the complex requirements involved with going public.[24] Table 15.3 provides a complete illustration of the steps involved with an IPO.

Table 15.3 The IPO Process

The entire initial public offering process is at once fast moving and highly structured, governed by an interlocking set of federal and state laws and regulations and self-regulatory organization rules. Each member of the IPO team has specific responsibilities to fulfill; however, the company ultimately calls the plays for the team.
The following steps in the IPO process apply to both U.S. and non-U.S. companies.
Present proposal to the board. The IPO process begins with management making a presentation to the company's board of directors, complete with business plan and financial projections, proposing their company enter the public market. The board should consider the proposal carefully.
Restate financial statements and refocus the company *(applies only to companies not in compliance with U.S. GAAP).* If the board approves the proposal to go public, the company's books and records should be reviewed for the past two to three years. Financial statements should be restated to adhere to GAAP in order for them to be certified. Any intracompany transactions, compensation arrangements, and relationships involving management or the board that are customary to a private enterprise—but improper for a public company—must be eliminated and the statements appropriately restated. Also, companies should consider whether any outside affiliations (operations tangential to the company's core business) will be perceived negatively by the market.
Find an underwriter and execute a "letter of intent." At this point, a company should select an underwriter if it has not already engaged one. A company's relationship with an underwriter should then be formalized through a mutual "letter of intent," outlining fees, ranges for stock price and number of shares, and certain other conditions.
Draft prospectus. After a letter of intent is executed, the IPO attorneys can begin work on the prospectus.
Respond to due diligence. The next step is to ask your investment banker and accountant to begin an elaborate investigation of your company (the due diligence process). Your underwriter will examine your company's management, operations, financial conditions, performance, competitive position, and business plan. Other factors open to scrutiny are your labor force, suppliers, customers, creditors, and any other parties that have a bearing on the viability of the company as a public entity and could affect the proper, truthful, adequate disclosure of its condition in the prospectus. The accounting firm will examine financial information and such specific documents as contracts, billings, and receipts to ensure the accuracy and adequacy of financial statements.
Select a financial printer. Your company should select an experienced financial printer—one that is familiar with SEC regulations governing the graphic presentation of a prospectus and that has the facilities to print sufficient quantities under severe time constraints.
Assemble the syndicate. After the preliminary prospectus has been filed with the SEC and is available for circulation among potential investors, your underwriter should assemble the "syndicate," consisting of additional investment bankers who will place portions of the offering to achieve the desired distribution. Your underwriter should also accumulate "indications of interest"—solicited through its efforts as well as those of the syndicate—from institutions and brokers that have approached their clients. These indications give assurance that the IPO is viable and help to determine the final number of shares to be offered and the allocations to investors.
Perform the road show. Next, your company and your investment banker should design and perform the "road show," a series of meetings held with potential investors and analysts in key cities across the country and, if appropriate, overseas. The road show has become increasingly important not only to communicate key information to investors but also to display the managerial talent and expertise that will be leading the company.
Prepare, revise, and print the prospectus. In the meantime, the preliminary prospectus should have been prepared and revised according to SEC and National Association of Securities Dealers Regulations (NASDR) comments. On completion of these revisions, the company can expect NASDR to issue a letter stating that it has no objections to the underwriting compensation, terms, and arrangements and the SEC to indicate its intent to declare their registration effective. The preliminary prospectus should be circulated to potential investors at least two days before the effective date; then the final version of the prospectus can be printed.

(*Continued*)

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Table 15.3 The IPO Process (*Continued*)

Price the offering. Just before the underwriting agreement is signed, on the day before the registration becomes effective and sales begin, the offering is priced. The investment banker should recommend a price per share for management's approval, taking into account the company's financial performance and competitive prospects, the stock price of comparable companies, general stock market conditions, and the success of the road show and ensuing expressions of interest. While the company will want to price the offering as high as possible, an offering that does not sell or sell completely will not be in its best interest or in the interest of the investors who find the share price declining in the market immediately after their initial purchase. In fact, investors look for at least a modest increase in the market price to reassure them about their investment decision.
Determine the offering size. The investment banking team should also consult with management regarding the offering size, taking into consideration how much capital the company needs to raise, the desired degree of corporate control, and investor demand. Often, the more shares outstanding, the greater the liquidity of the stock, which will increase institutional interest.

Source: Adapted from *Going Public* (New York: The NASDAQ Stock Market, Inc., 2005), 5–9; updated for accuracy February 2015.

The Securities and Exchange Commission (SEC) requires the filing of a registration statement that includes a complete prospectus on the company. The SEC then reviews the registration, ensuring that full disclosure is made before giving permission to proceed. (See Table 15.4 for a presentation of the registration process.)

The prospectus must disclose fully all pertinent information about a company and must present a fair representation of the firm's true prospects. All negative information must be clearly highlighted and explained. Some of the specific, detailed information that must be presented follows:

- History and nature of the company
- Capital structure
- Description of any material contracts
- Description of securities being registered
- Salaries and security holdings of major officers and directors and the price they paid for holdings
- Underwriting arrangements
- Estimate and use of net proceeds
- Audited financial statements
- Information about the competition with an estimation of the chances of the company's survival

Some of the more important disclosure requirements for annual reports follow:

- Audited financial statements that include the balance sheets for the past two years and income and funds statements for the past three years
- Five years of selected financial data
- Management's discussion and analysis of financial conditions and results of operations
- A brief description of the business
- Line-of-business disclosures for the past three fiscal years
- Identification of directors and executive officers, with the principal occupation and employer of each
- Identification of the principal market in which the firm's securities are traded

Table 15.4 The Registration Process

Event	Participants	Agenda	Timetable
Preliminary meeting to discuss issue	President, vice president of finance, independent accountants, underwriters, counsel	Discuss financial needs; introduce and select type of issue to meet needs	July 1 (begin)
Form selection	Management, counsel	Select appropriate form for use in registration statement	July 3 (3 days)
Initial meeting of working group	President, vice president of finance, independent accountants, underwriter, counsel for underwriter, company counsel	Assign specific duties to each person in the working group; discuss underwriting problems with this issue; discuss accounting problems with the issue	July 8 (8 days)

(*Continued*)

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Table 15.4 The Registration Process (*Continued*)

Event	Participants	Agenda	Timetable
Second meeting of working group	Same as for initial meeting	Review work assignments; prepare presentation to board of directors	July 22 (22 days)
Meeting of board of directors	Board of directors, members of working group	Approve proposed issue and increase of debt or equity; authorize preparation of materials	July 26 (26 days)
Meeting of company counsel with underwriters	Company counsel, counsel for underwriters, underwriters	Discuss underwriting terms and blue-sky problems	July 30 (30 days)
Meeting of working group	Members of working group review collected material and examine discrepancies		August 6 (37 days)
Prefiling conference with SEC staff	Working group members, SEC staff, other experts as needed	Review proposed registration and associated problems: legal, financial, operative	August 9 (40 days)
Additional meetings of working group	Members of working group	Prepare final registration statement and prospectuses	August 12–30 (61 days)
Meeting with board of directors	Board of directors, members of working group	Approve registration statement and prospectuses; discuss related topics and problems	September 6 (68 days)
Meeting of working group	Members of working group	Draft final corrected registration statement	September 10 (72 days)
Filing registration statement with SEC	Company counsel or representative and SEC staff	File registration statement and pay fee	September 12 (74 days)
Distribution of "red herring" prospectus	Underwriters	Publicize offering	September 16 (78 days)
Receipt of letter of comments	Members of working group	Relate deficiencies in registration statement	October 15 (107 days)
Meeting of working group	Members of working group	Correct deficiencies and submit amendments	October 21 (113 days)
Due diligence meeting	Management representatives, independent accountants, company counsel, underwriter's counsel, underwriters, other professionals as needed	Exchange final information and discuss pertinent problems relating to underwriting and issue	October 24 (116 days)
Pricing amendment	Management, underwriters	Add the amounts for the actual price, underwriter's discount or commission, and net proceeds to company to the amended registration statement	October 25 (117 days)
Notice of acceptance	SEC staff	Report from SEC staff on acceptance status of price-amended registration statement	October 28 (120 days)
Statement becomes effective			October 30 (122 days)

Source: From K. Fred Skousen, *An Introduction to the SEC*, 5th ed. © 1991 Cengage Learning; see also. K Fred Skousen, Steven Glover, and Douglas Prawitt, *An Introduction to Corporate Governance and the SEC* (Mason, OH: Cengage Learning, 2004).

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- Range of market prices and dividends for each quarter of the two most recent fiscal years
- An offer to provide a free copy of the 10-K report to shareholders on written request unless the annual report complies with Form 10-K disclosure requirements[25]

Some of the forms the SEC requires follow:

- Form S-1 (information contained in the prospectus and other additional financial data)
- Form 10-Q (quarterly financial statements and a summary of all important events that took place during the three-month period)
- Form 8-K (a report of unscheduled material events or corporate changes deemed important to the shareholder and filed with the SEC within 15 days of the end of a month in which a significant material event transpired)
- Proxy statements (information given in connection with proxy solicitation)[26]

Entrepreneurs who pursue the public securities route should be prepared for these reporting requirements, disclosure statements, and the shared control and ownership with outside shareholders.

15-6 Complete Sale of the Venture

LO15.7 Discuss "selling out" as a final alternative in the harvest strategy

After considering the various succession ideas presented in this chapter, as well as the potential for an IPO, many privately held business entrepreneurs choose a **harvest strategy** that involves complete sale of the venture. If this becomes the proper choice for an entrepreneur (keep in mind that it may be the best decision for an entrepreneur who has no interested family members or key employees), then the owner needs to review some important considerations. The idea of "selling out" actually should be viewed in the positive sense of "harvesting the investment."

Entrepreneurs consider selling their venture for numerous reasons. Based on 1,000 business owners surveyed, some of the motivations are (1) boredom and burnout, (2) lack of operating and growth capital, (3) no heirs to leave the business to, (4) desire for liquidity, (5) aging and health problems, and (6) desire to pursue other interests.[27]

Whether it is due to a career shift, poor health, a desire to start another venture, or retirement, many entrepreneurs face the sellout option during their entrepreneurial lifetime. This harvesting strategy needs to be carefully prepared in order to obtain the adequate financial rewards.[28]

15-6a Steps for Selling a Business

There are generally eight recommended steps for the proper preparation, development, and realization of the sale of a venture.[29]

Step 1: Prepare a Financial Analysis

The purpose of such an analysis is to define priorities and forecast the next few years of the business. These fundamental questions must be answered:

- What will executive and other workforce requirements be, and how will we pay for them?
- If the market potential is so limited that goals cannot be attained, should we plan an acquisition or develop new products to meet targets for sales and profits?
- Must we raise outside capital for continued growth? How much and when?

Step 2: Segregate Assets

Tax accountants and lawyers may suggest the following steps to reduce taxes:

- Place real estate in a separate corporation, owned individually or by members of the family.
- Establish a leasing subsidiary with title to machinery and rolling stock. You can then lease this property to the operating company.
- Give some or all of the owner's shares to heirs when values are low but have the owner retain voting rights. Thus, when a sale is made, part or all of the proceeds can go directly to another generation without double taxation.
- Hold management's salaries and fringe benefits at reasonable levels to maximize profits.

Step 3: Value the Business

The various methods used to valuate a venture were discussed in Chapter 14. Obviously, establishing the valuation of a company constitutes a most important step in its sale.

Step 4: Identify the Appropriate Timing

Knowing when to offer a business for sale is a critical factor. Timing can be everything. A few suggestions follow:

- Sell when business profits show a strong upward trend.
- Sell when the management team is complete and experienced.
- Sell when the business cycle is on the upswing, with potential buyers in the right mood and holding excess capital or credit for acquisitions.
- Sell when you are convinced that your company's future will be bright.

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Step 5: Publicize the Offer to Sell

A short prospectus on the company that provides enough information to interest potential investors should be prepared. This prospectus should be circulated through the proper professional channels: bankers, accountants, lawyers, consultants, and business brokers.

Step 6: Finalize the Prospective Buyers

Inquiries need to be made in the trade concerning the prospective buyers. Characters and managerial reputation should be assessed to find the best buyer.

Step 7: Remain Involved through the Closing

Meeting with the final potential buyers helps to eliminate areas of misunderstanding and to negotiate the major requirements more effectively. Also, the involvement of professionals such as attorneys and accountants usually precludes any major problems arising at the closing.

Step 8: Communicate after the Sale

Problems between the new owner and the remaining management team need to be resolved to build a solid transition. Communication between the seller and the

Diversity in Entrepreneurship

Metaverse: Challenges to Diversity

The intensified pace in the division between innovation and regulation is raising questions about the potential negative social, economic, and health effects of modern technologies. While technologies are changing on a daily basis and becoming increasingly complex, regulators are struggling to keep up. Metaverse is looking to be the next revolutionary technology that is projected to significantly shape our lives with a new immersive virtual world where we will shop, socialize, and work via our new virtual avatars. While the opportunities of metaverse are exciting, this new world will not be without its challenges. Concerns have been raised around personal data, especially privacy issues, as well as the effects of metaverse on our personal well-being with everyone seemingly perfect yet not real.

A completely virtual world would produce an immense amount of new data not only on the whole environment around you but also on yourself. Everything, from your personal expressions, temperature, or heart rate, could be recorded. You would no longer be able to hide your nervousness from your manager, for example. Or, if eye tracking is enabled, even small things like rolling your eyes would not be hidden from your manager's view. Your manager could use this data to have real-time information on who is paying attention, which could be useful to find new ways to motivate workers. However, such technology is vulnerable to misuse, or it could be misread. In a simpler sense, not everybody wants to constantly share how they are feeling, and neither should they be forced to do so.

As with many modern technologies, the metaverse is sparking fears that it will disconnect individuals from reality, isolate them, or make them violent. The exciting promises of the metaverse to enable people to be whomever they want to be could create a world where everything is perfect. Jeremy Bailenson, the founding director of Stanford University's Virtual Human Interaction Lab, says that nobody knows how spending time in a world in which everyone is perfect and everything is beautiful and ideal will affect one's own self-esteem.

Indeed, there are some fundamental building blocks of mental health that are well established—these include positive relationships, social support, healthy sleep, and physical activity. However, whether we talk about the metaverse or any other technology, the question to ask is not how much time we are spending on it but rather whether we are using technology in a way that fosters those fundamental building blocks or inhibits them. Will diversity be promoted in a positive way, or will it be negatively exacerbated? You may find that the virtual world provides you with an online community that identifies with your values and can provide the essential social support that you might not find in the real world. In this case, we would assume that your mental health would benefit from this virtual interaction. On the other hand, if spending time in the metaverse replaces non-online behaviors, such as exercise or healthy sleep that are essential for your mental health, then the metaverse can be harmful. The ease of accessing the virtual world may accelerate both good and harmful effects on mental health.

With revolutionary technology like the metaverse, consequences can be profound. It is important that technology companies take a thoughtful and ethical approach as they proceed to develop metaverse technologies and ask themselves about what can go wrong and how harmful interactions and content can proliferate. While we should not focus only on the negatives, it is important to understand the risks early in order to develop a metaverse environment that we can all positively benefit from.

Source: Adapted from: Benoit Morenne, "The Metaverse's Effects on Mental Health: Trivial or Troubling?," *Wall Street Journal*, January 9, 2022, and Sarah E. Needleman and Kathryn Dill, "How We'll Work in the Metaverse," *Wall Street Journal*, February 7, 2022.

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buyer and between the buyer and the current management personnel is a key step.

In addition to these eight steps, an entrepreneur must be aware of the tax implications that arise from the sale of a business. For professional advice, a tax accountant specializing in business valuations and sales should be consulted.

The eight steps outlined here, combined with the information on valuation in Chapter 14, will help entrepreneurs harvest their ventures. The steps provide a clear framework within which entrepreneurs can structure a fair negotiation leading to a sale. If the purpose of a valuation is to sell the business, then the entrepreneur must plan ahead and follow through with each step.

Summary

This chapter focused on the harvesting of the venture. Beginning with the issue of management succession as one of the greatest challenges for entrepreneurs, a number of considerations that affect succession were discussed. Using privately held firms as the focal point in this chapter, key issues such as family and nonfamily members—both within and outside the firm—were identified to show the unique pressures on the entrepreneur. Some family members will want to be put in charge of the operation; others simply want a stake in the enterprise.

Two types of successors exist: an entrepreneurial successor provides innovative ideas for new-product development, whereas a managerial successor provides stability for day-to-day operations. An entrepreneur may search inside or outside the family as well as inside or outside the business. The actual transfer of power is a critical issue, and the timing of entry for a successor can be strategic.

The *Oakland Scavenger Company* case revealed how legal concerns now exist about the hiring of only family members. Nepotism has been challenged in the courts on the basis of discrimination.

Developing a succession plan involves understanding these important contextual aspects: time, type of venture, capabilities of managers, the entrepreneur's vision, and environmental factors. Also, forcing events may require the implementation of a succession plan regardless of whether the firm is ready to implement one. This is why it is so important to identify successor qualities and carry out the succession plan.

The chapter closed with a discussion of the entrepreneur's decision to sell out. The process was viewed as a method to "harvest" the investment, and eight specific steps were presented for entrepreneurs to follow.

Key Terms

buy/sell agreements
delayed entry strategy
early entry strategy
employee stock ownership plans (ESOPs)
entrepreneurial successor
exit strategy
forcing events
harvest strategy
initial public offering (IPO)
liquidity event
management succession
managerial successor
nepotism
Oakland Scavenger Company

Review and Discussion Questions

1. What are the potential choices for an entrepreneur to examine as the venture matures?
2. A number of barriers to succession in privately held businesses exist. Using Table 15.1, identify some of the key barriers.
3. What pressures do entrepreneurs sometimes face from inside the family? (Use Figure 15.1 in your answer.)
4. What pressures do entrepreneurs sometimes face from outside the family? (Use Figure 15.1 in your answer.)
5. An entrepreneur can make a number of choices regarding a successor. Using Table 15.2 as a guide, discuss each of these choices.
6. How might the *Oakland Scavenger Company* case affect succession decisions in small businesses?
7. What are three of the contextual aspects that must be considered in an effective succession plan?
8. In what way can forcing events cause the replacement of an owner/manager? Cite three examples.
9. What are five qualities or characteristics successors should possess?
10. Why do entrepreneurs look forward to the day when they can take their company public?
11. What eight steps should be followed to harvest a business? Discuss each of these steps.

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Glossary

A

Abandonment Nonuse of a trademark for two consecutive years without justification or a statement regarding abandonment of the trademark.

Accounts payable Liabilities incurred by a business when goods or supplies are purchased on credit.

Accounts receivable Claims of a business against its customers for unpaid balances from the sale of merchandise or the performance of services.

Accounts receivable financing Short-term financing that involves either the pledge of receivables as collateral for a loan or the outright sale of receivables. (See also Factoring.)

Accredited purchaser A category used in Regulation D that includes institutional investors; any person who buys at least $150,000 of the offered security and whose net worth is in excess of $1 million; a person whose individual income was greater than $200,000 in each of the last two years; directors, partners, or executive officers selling securities; and certain tax-exempt organizations with more than $500,000 in assets.

Adjusted tangible book value A common method of valuing a business by computing its net worth as the difference between total assets and total liabilities.

Administrative expenses Operating expenses not directly related to selling or borrowing.

Advertising model Generates revenue by selling advertisements against the traffic of the site.

Affiliate model Generates revenue by driving traffic, leads, or sales to another, affiliated company's website.

Aggressive growth venture Referred to as a gazelle (fast growing), unicorn (market value at $1 billion), or decacorn (market value at $10 billion), these are often technology based ventures with strong innovation capabilities that seek exponential growth and are funded by venture capital.

Angel capital Investments in new ventures that come from wealthy individuals referred to as "business angels."

Antidilution protection The conversion price of the preferred stock is subject to adjustment for certain diluting events, such as stock splits or stock dividends. The conversion price is typically subject to "price protection," which is an adjustment based on future sales of stock at prices below the conversion price.

Appositional relationship A relationship among things and people existing in the world in relation to other things and other people.

B

B corporation A legal structure that expands corporate accountability to make decisions that are good for society, not just shareholders. B corporations' performance standards enable consumers to support businesses that align with their values.

Balance sheet A financial statement that reports the assets, liabilities, and owner's equity in the venture at a particular point in time.

Bankruptcy A legal process for insolvent debtors who are unable to pay debts as they become due. For business, this includes Chapters 7, 11, and 13 of the federal bankruptcy code.

Bankruptcy Act Federal law that provides for specific procedures in handling insolvent debtors.

Benefit corporation It is exactly the same as traditional corporations except for a few specific elements that make them more socially sustainable enterprises: purpose, accountability, and transparency.

Better widget strategies Innovation that encompasses new or existing markets.

Blitzscaling Accelerating the venture growth faster by prioritizing speed over efficiency in an environment of uncertainty.

Blog monitoring Analyzing blog content to identify prominent terms or themes.

Bootlegging Secretly working on new ideas on company time as well as on personal time.

Bootstrapping The art of doing more with less.

Break-even analysis A technique commonly used to assess expected product profitability, which helps to determine how many units must be sold to break even at a particular selling price.

Budget A statement of estimated income and expenses over a specified period of time.

Business accelerators Organizations that offer mentorship, office space, a range of support services, and funding opportunities for new ventures. One of the most important elements of accelerators is their ability to offer access to capital and investment in return for start-up equity.

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Business angel Wealthy people in the United States looking for investment opportunities.

Business broker Professionals specializing in business opportunities often can provide leads and assistance in finding a venture for sale.

Business incubator An entity that helps new ventures to develop by providing services such as management training and office space so that entrepreneurs enjoy a collaborative work environment with invaluable mentoring and networking opportunities, funding support, and shared equipment.

Business model How a venture is designed to make money, demonstrating a clear method of getting to the market for sales.

Business model canvas A structured brainstorming tool for entrepreneurs to use to define and understand the strategic focus and the questions that need to be answered for each of the nine business building blocks.

Business plan The written document that details a proposed venture. It must illustrate current status, expected needs, and projected results of the new business.

Business valuation The calculated value of the business, used to track its increases or decreases.

Buy/sell agreements Agreements designed to handle situations in which one (or more) of the entrepreneurs wants to sell their interest in the venture.

C

Cancellation proceedings A third party's challenge to the trademark's distinctiveness within five years of its issuance.

Capital budgeting A budgeting process used to determine investment decisions. It relies heavily on an evaluation of cash inflows.

Career risk Whether an entrepreneur will be able to find a job or go back to an old job if their venture fails.

Cash Coins, currency, and checks on hand. It also includes money the business has in its checking and savings accounts.

Cash-flow budget A budget that provides an overview of inflows and outflows of cash during a specified period of time.

Cash-flow statement A financial statement that sets forth the amount and timing of actual and/or expected cash inflows and outflows.

Champion Within the context of corporate entrepreneurship, this is a person with an innovative vision and the ability to share it.

Claims A series of short paragraphs, each of which identifies a particular feature or combination of features, protected by a patent.

Cleaning-out procedure The failure of a trademark owner to file an affidavit stating that it is in use or justifying its lack of use within six years of registration.

Coachability is the willingness to take feedback, be corrected, and act on that correction. *See* Entrepreneurial coachability.

Code of conduct A statement of ethical practices or guidelines to which an enterprise adheres.

Cognition It refers to mental processes. These processes include attention, remembering, producing and understanding language, solving problems, and making decisions.

Cognitive adaptability The ability to be dynamic, flexible, and self-regulating in one's cognitions given dynamic and uncertain task environments.

Collective entrepreneurship Individual skills integrated into a group wherein the collective capacity to innovate becomes something greater than the sum of its parts.

Company's profitability The amount of net profit a company produces after expenses.

Comprehensive feasibility approach A systematic analysis incorporating external factors.

Conformance A new venture does not question, change, or violate the social structure but rather "follows the rules."

Consumer pricing Combining penetration and competitive pricing to gain market share.

Consumer-driven philosophy A marketing philosophy that relies on research to discover consumer preferences, desires, and needs before production actually begins. (See also Production-driven philosophy and Sales-driven philosophy.)

Contribution margin approach A common approach to break-even analysis, determined by calculating the difference between the selling price and the variable cost per unit.

Control factor The degree of control an owner legally has over the firm can affect its valuation.

Copyright A legal protection that provides exclusive rights to creative individuals for the protection of their literary or artistic productions.

Corporate entrepreneurship A new "corporate revolution" taking place due to the infusion of entrepreneurial thinking into bureaucratic structures.

Corporate Entrepreneurship Assessment Instrument (CEAI) A questionnaire designed to measure the key entrepreneurial climate factors.

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Corporate venturing The adding of new businesses (or portions of new businesses via equity investments) to the corporation. This can be accomplished through three implementation modes: internal corporate venturing, cooperative corporate venturing, and external corporate venturing.

Corporation An entity legally separate from the individuals who own it, created by the authority of state laws, and usually formed when a transfer of money or property by prospective shareholders takes place in exchange for capital stock in the corporation.

Corridor principle States that with every venture launched, new and unintended opportunities arise.

Creation A new social context developed by an entrepreneur with new rules, norms, values, scripts beliefs, or models.

Creative process The four phases of creative development: background or knowledge accumulation, incubation process, idea experience, and evaluation or implementation.

Creativity The generation of ideas that results in an improvement in the efficiency or effectiveness of a system.

Critical factors Important new-venture assessments.

Crowdfunding It is a twenty-first-century phenomenon. Commercial lenders are not always willing to make loans to unproven enterprises, leaving entrepreneurs desperate for funding to seek new loan options.

Customer availability Having customers available before a venture starts.

D

Dark side of entrepreneurship A destructive side that exists within the energetic drive of successful entrepreneurs.

Debt financing Borrowing money for short- or long-term periods for working capital or for purchasing property and equipment.

Debtor-in-possession When a debtor involved in a Chapter 11 proceeding continues to operate the business.

Decacorn A firm with a $10 billion market value.

Delayed entry strategy A succession strategy that encourages the younger generation to enter the business at a later age to gain experience outside the family held firm.

Demand-oriented pricing A flexible strategy that bases pricing decisions on the demand level for the product.

Design methodology Takes an initial concept idea and develops a proof of concept that elicits feedback from relevant stakeholders.

Design-centered entrepreneurship In essence, the entrepreneur applies design methods in three action stages of developing an opportunity: ideation, market engagement, and business model.

Diaspora networks They are relationships among ethnic groups that share cultural and social norms.

Direct public offering (DPO) It eases the regulations for the reports and statements required for selling stock to private parties—friends, employees, customers, relatives, and local professionals.

Discounted earnings method A method that determines the true value of the firm with a pricing formula that includes earning power as well as adjusted tangible book value.

Displacement school of thought A school of entrepreneurial thought that focuses on group phenomena, such as the political, cultural, and economic environments.

Divergent goals When the entrepreneur has a vision for the venture that differs from the investors' goals or stockholders' desires, thus causing internal conflicts in the firm.

Due diligence A thorough analysis of every facet of the existing business.

Duplication A basic type of innovation that involves the replication of an already existing product, service, or process.

Dynamic states model A network of relationships and systems that convert opportunity tension into value for a venture's customers, generating new resources that maintain the dynamic state.

E

Early entry strategy A succession strategy that encourages the younger generation to enter the business at an early age to gain experience.

Ecopreneurship Environmental entrepreneurship with entrepreneurial actions contributing to preserving the natural environment, including the Earth, biodiversity, and ecosystems.

Ecovision Leadership style for innovative organizations. Encourages open and flexible structures that encompass the employees, the organization, and the environment, with attention to evolving social demands.

Either/or thinking People often get bogged down with striving for an unreasonable amount of certainty in their lives. But the creative person learns to accept a reasonable amount of ambiguity in their work and life.

Elevator pitch The brief oral presentation for selling a business plan to potential investors (named for the analogy of riding an elevator and having only two minutes to get your story told to another person in the elevator).

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Emotional bias The tendency to believe an enterprise is worth a great deal more than outsiders believe it is worth.

Employee stock ownership plans (ESOPs) Passing control of the enterprise to the employees if the owner has no immediate successor in mind.

Entrepreneur An innovator or developer who recognizes and seizes opportunities; converts these opportunities into workable/marketable ideas; adds value through time, effort, money, or skills; assumes the risks of the competitive marketplace to implement these ideas; and realizes the rewards from these efforts.

Entrepreneurial behavior An entrepreneur's decision to initiate the new-venture formation process.

Entrepreneurial coachability Mentorship/coaching from other experienced individuals provided to an entrepreneur.

Entrepreneurial cognition The knowledge structures that people use to make assessments, judgments, or decisions involving opportunity evaluation, venture creation, and growth.

Entrepreneurial discipline Entrepreneurship is based on the same principles, whether the entrepreneur is an existing large institution or an individual starting their new venture single-handed.

Entrepreneurial ecosystem The social and economic environment affecting the local and regional entrepreneurship. It usually consists of six general domains: a conducive culture, enabling policies and leadership, availability of appropriate finance, quality human capital, venture-friendly markets for products, and a range of institutional and infrastructural supports.

Entrepreneurial experience Entrepreneurs emerge as a function of the novel, idiosyncratic, and experiential nature of the venture creation process involving three parallel, interactive phenomena: emergence of the opportunity, emergence of the venture, and emergence of the entrepreneur.

Entrepreneurial firm It increases opportunity for its employees, initiates change, and instills a desire to be innovative.

Entrepreneurial hustle An entrepreneur's urgent, unorthodox actions that are intended to be useful in addressing immediate challenges and opportunities under conditions of uncertainty.

Entrepreneurial leadership An entrepreneur's ability to anticipate, envision, maintain flexibility, think strategically, and work with others to initiate changes that will create a viable future for the organization.

Entrepreneurial mindset All the characteristics and elements that compose the entrepreneurial potential in every individual.

Entrepreneurial motivation The willingness of an entrepreneur to sustain their entrepreneurial behavior.

Entrepreneurial persistence An entrepreneur's choice to continue with an entrepreneurial opportunity regardless of counterinfluences or other enticing alternatives.

Entrepreneurial Revolution The tremendous increase in entrepreneurial business and entrepreneurial thinking that has developed during the past 20 years. This revolution will be as powerful to the twenty- first century as the Industrial Revolution was to the twentieth century (if not more!).

Entrepreneurial strategy matrix Measures risk and innovation.

Entrepreneurial successor A successor to a venture who is highly gifted with ingenuity, creativity, and drive.

Entrepreneurial teams Two or more individuals who pursue a new business idea, are involved in its subsequent management, and share ownership.

Entrepreneurial trait school of thought A school of entrepreneurial thought that focuses on identifying traits that appear common to successful entrepreneurs.

Entrepreneurship A dynamic process of vision, change, and creation. It requires an application of energy and passion toward the creation and implementation of new ideas and creative solutions. Essential ingredients include the willingness to take calculated risks—in terms of time, equity, or career; the ability to formulate an effective venture team; the creative skill to marshal needed resources; the fundamental skill of building a solid business plan; and, finally, the vision to recognize opportunity where others see chaos, contradiction, and confusion.

Environmental school of thought A school of entrepreneurial thought that focuses on the external factors and forces—values, mores, and institutions—that surround a potential entrepreneur's lifestyle.

Equity financing The sale of some ownership in a venture in order to gain capital for start-up.

Ethics A set of principles prescribing a behavioral code that explains what is good and right or bad and wrong.

European Union (EU) The EU is an economic and political union of 27 member states that are located primarily in Europe.

Exit strategy That component of the business plan where an entrepreneur describes a method by which investors can realize a tangible return on their investment.

Expenses An expired cost, any item or class of cost of (or loss from) carrying on an activity, a present or past expenditure defraying a present operating cost or representing an irrecoverable cost or loss, an item

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of capital expenditures written down or off, or a term often used with some qualifying expression denoting function, organization, or time, such as a selling expense, factory expense, or monthly expense.

Exporting It is the shipping of a domestically produced good to a foreign destination for consumption. Exporting is important for entrepreneurs because it often means increased market potential.

Extension A basic type of innovation that involves extending the life of a product, service, or process already in existence.

External locus of control A point of view in which external processes are sometimes beyond the control of the individual entrepreneur.

External problems Related to customer contact, market knowledge, marketing planning, location, pricing, product considerations, competitors, and expansion.

F

Factoring The sale of accounts receivable.

Failure A venture not being able to survive as caused by inexperience or incompetent management.

Failure prediction model Based on financial data from newly founded ventures; assumes the financial failure process is characterized by too much initial indebtedness and too little revenue financing.

Fair use doctrine An exception to copyright protection that allows limited use of copyrighted materials.

Family and social risk Starting a new venture uses much of the entrepreneur's energy and time. Entrepreneurs who are married, especially those with children, expose their families to the risks of an incomplete family experience and the possibility of permanent emotional scars. In addition, old friends may vanish slowly because of missed get togethers.

Feasibility criteria approach A criteria selection list from which entrepreneurs can gain insights into the viability of their venture.

Finance companies Asset-based lenders that lend money against assets such as receivables, inventory, and equipment.

Financial expense The interest expense on long-term loans. Many companies also include their interest expense on short-term obligations as part of their financial expense.

Financial risk The money or resources at stake for a new venture.

Financial/capital school of thought A school of entrepreneurial thought that focuses on the ways entrepreneurs seek seed capital and growth funds.

Five-minute reading A six-step process that venture capitalists use when they are reviewing a business plan for potential investment.

Fixed assets Land, building, equipment, and other assets expected to remain with the firm for an extended period.

Fixed cost A cost that does not change in response to changes in activity for a given period of time.

Forcing events Happenings that cause the replacement of the owner/ manager.

Framework of frameworks Allows for the entrepreneurship theory to move forward identifying the static and dynamic elements of new theories, typologies, or frameworks.

Franchise Any arrangement in which the owner of a trademark, trade name, or copyright has licensed others to use it to sell goods or services.

Franchise disclosure document (FDD) A legal disclosure document that must now be presented to prospective buyers of franchises in the presale disclosure process in the United States. It was originally known as the Uniform Franchise Offering Circular (UFOC).

Franchise fee The initial amount of money needed to purchase a franchise.

Franchisee An individual who purchases and operates a franchise.

Franchisor An individual (or company) who offers to sell or license his operation in the form of a franchise.

Franchisor control The franchisor generally exercises a fair amount of control over the operation in order to achieve a degree of uniformity.

Freemium model Generates revenue by offering a basic service for free while charging for a premium service with advanced features to paying members.

Fully diluted All securities—including preferred stock, options, and warrants—that can result in additional common shares are counted in determining the total amount of shares outstanding for the purposes of determining ownership or valuation.

Functional perspective Viewing things and people in terms of how they can be used to satisfy one's needs and to help complete a project.

G

Gazelle A business establishment with at least 20 percent sales growth every year, starting with a base of at least $100,000.

Generic meaning Allowance of a trademark to represent a general grouping of products or services (e.g., Kleenex has come to represent tissue).

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Global entrepreneurs An entrepreneur who relies on global (international) networks for resources, design, and distribution.

Goodwill The amount of value created by an owner of a business in terms of their time, effort, and public image with the business itself.

Great chef strategies The skills or special talents of one or more individuals around whom a venture is built.

Grief recovery The traditional process of recovering from grief involves focusing on the particular loss to construct an account that explains why the loss occurred.

Growth hacking A combination of creative marketing, data analysis, and coding with the focus being on growth.

Growth of sales The growth pattern anticipated for new-venture sales and profits.

Growth stage The third stage of a new venture life cycle, typically involving activities related to reformulating strategy in the light of competition.

Growth wall A psychological wall against change that prevents entrepreneurs from developing a managerial ability to deal with venture growth.

Guerrilla marketing plan Applying nonconventional tactics and unorthodox practices to marketing research.

H

Harvest strategy A strategy of how and when the owners and investors will realize an actual cash return on their investment in a venture.

Hectacorn A firm with a $100 billion market value.

High-growth venture When sales and profit growth are expected to be significant enough to attract venture capital money and funds raised through public or private placements.

Horizontal analysis Looks at financial statements and ratios over time.

Hustle See Entrepreneurial hustle.

I

Importing It is buying and shipping foreign-produced goods for domestic consumption.

Income statement A financial document that reports the sales, expenses, and profits of the enterprise over a specified period (usually one year).

Incongruities Whenever a gap or difference exists between expectations and reality.

Incremental innovation The systematic evolution of a product or service into newer or larger markets.

Individualize An aspect of global social media strategy directing customized messages to different users based on location, taste preferences, and shopping habits.

Informal risk capitalist Wealthy people in the United States are looking for investment opportunities; they are referred to as business angels or informal risk capitalists.

Infringement budget A realistic budget for prosecuting violations of the patent.

Initial public offering (IPO) A corporation's raising of capital through the sale of securities on the public markets.

Initiate An aspect of global social media strategy creating user-generated content in order to start a meaningful dialogue between different consumers as they communicate online.

Innovation team (I-team) An internal corporate team formulated for the purpose of creating new innovations for the organization.

Innovation The process by which entrepreneurs convert opportunities into marketable ideas.

Insolvent debtor Those who are unable to pay debts as they become due.

Institutional logics Socially constructed, historical patterns of practices, assumptions, values, beliefs, and rules by which individuals provide meaning,

Integrate An aspect of global social media strategy inserting the application into the daily life of the user by offering incentives, prizes, or discounts.

Intellectual property right Provides protection such as patents, trademarks, or copyrights against infringement by others.

Interactive learning Learning ideas within an innovative environment that cut across traditional, functional lines in the organization.

Internal locus of control The viewpoint in which the potential entrepreneur has the ability or control to direct or adjust the outcome of each major influence.

Internal problems Involve adequate capital, cash flow, facilities/equipment, inventory control, human resources, leadership, organizational structure, and accounting systems.

Internal rate of return (IRR) method A capital-budgeting technique that involves discounting future cash flows to the present at a rate that makes the net present value of the project equal to zero.

International alliances Another alternative available to the entrepreneur in the international arena. There are three main types of these strategic alliances: informal international cooperative alliances, formal international cooperative alliances (ICAs), and international joint ventures.

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Intracapital Special capital set aside for the corporate entrepreneur to use whenever investment money is needed for further research ideas.

Intrapreneurship Entrepreneurial activities that receive organizational sanction and resource commitments for the purpose of innovative results within an established corporation. (See also Corporate entrepreneurship.)

Invention A basic type of innovation that involves the creation of a new product, service, or process that is often novel or untried.

Inventory Merchandise held by the company for resale to customers.

Involve An aspect of global social media strategy engaging the user interactively with a type of story or game.

J

Joint venture Occurs when two or more firms analyze the benefits of creating a relationship, pool their resources, and create a new entity to undertake productive economic activity.

L

L3C A low-profit, limited liability company that facilitates investments in socially beneficial, for-profit ventures. L3C has an explicit primary charitable mission and only a secondary profit concern. Unlike a charity, an L3C is free to distribute the profits, after taxes, to owners or investors.

Lack of expertise/skills When small-business managers lack the specialized expertise/skills necessary for the planning process.

Lack of knowledge Small-firm owners'/managers' uncertainty about the components of the planning process and their sequence due to minimal exposure to and knowledge of the process itself.

Lack of trust and openness When small-firm owners/managers are highly sensitive and guarded about their businesses and the decisions that affect them.

Lean Startup methodology Provides a scientific approach to creating early venture concepts and delivers a desired product to customers' hands faster. It is hypothesis driven, and entrepreneurs must work to gather and incorporate customer feedback early and often.

Learning curve concept The time needed for new methods or procedures to be learned and mastered.

Left brain The part of the brain that helps an individual analyze, verbalize, and use rational approaches to problem solving. (See also Right brain.)

Legal restraint of trade A legal document signed by the seller of a business that restricts them from operating in the same business for a reasonable amount of time and within a reasonable geographic jurisdiction.

Legitimacy A resource that enables new ventures to overcome the "liability of newness," allowing for the acquisition of other resources, such as financial capital, human resources, and strategic relationships.

Letter of intent (LOI) Nonbinding document meant to record two or more parties' intentions to enter into a future agreement based on specified (but incomplete or preliminary) terms. Many LOIs contain provisions that are binding, such as nondisclosure agreements, a covenant to negotiate in good faith, or a "stand-still" provision promising exclusive rights to negotiate.

Liabilities The debts of a business, incurred either through normal operations or through the process of obtaining funds to finance operations. (See also Short-term liabilities and Long-term liabilities.)

Liability of poorness The potential for failure of a new venture that is associated with problems that the entrepreneur struggles to adequately address because of characteristics and influences deriving from a poverty background.

Licensing A business arrangement in which the manufacturer of a product (or a firm with proprietary rights over technology or trademarks) grants permission to a group or an individual to manufacture that product in return for specified royalties or other payments.

Life cycle stages The typical life cycle through which a venture progresses, including venture development, start-up, growth, stabilization, and innovation or decline.

Lifestyle venture A venture that provides a relatively stable income stream for owners based on a workable business model and a maintenance approach to management.

Limited liability company (LLC) A hybrid form of business enterprise that offers the limited liability of a corporation but the tax advantages of a partnership.

Limited liability limited partnership (LLLP) A variant of the limited partnership. An LLLP has elected limited liability status for all of its partners, including general partners.

Limited liability partnership (LLP) A form of partnership that allows professionals the tax benefits of a partnership while avoiding personal liability for the malpractice of other partners. If a professional group organizes as an LLP, innocent partners are not personally liable for the wrongdoing of the other partners.

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Limited partnership A form of company organization that permits capital investment without responsibility for management and without liability for losses beyond the initial investment.

Liquidation See Bankruptcy.

Liquidation preference When the company is sold or liquidated, the preferred stockholders will receive a certain fixed amount before any assets are distributed to the common stockholders.

Liquidity event The positioning of the venture for the realization of a cash return for the owners and the investors. This "event" is most often achieved through an initial public offering or complete sale of the venture.

Loan payable The current installment on a long-term debt that must be paid this year.

Long-term liabilities Business debts that are not due and payable within the next 12 months.

Loss leader pricing Pricing the product below cost in an attempt to attract customers to other products.

M

Macro view of entrepreneurship A broad array of factors that relate to success or failure in contemporary entrepreneurial ventures.

Macroiteration In design-centered entrepreneurship, it is moving from one particular action stage back to a previous stage for further development.

Managed growth venture A venture with a workable business model that seeks stable growth over time with occasional launches of new products and a steady expansion of facilities to establish a strong local or regional brand.

Management succession The transition of managerial decision making in a firm, one of the greatest challenges that confronts owners and entrepreneurs in family businesses.

Management team The founders of a new venture who plan on managing the company as well as any advisers, consultants, or members of the board.

Managerial successor A successor to a venture who is interested in efficiency, internal control, and the effective use of resources.

Manipulation An entrepreneur attempts to make changes in the external environment to achieve consistency between an organization and its environment.

Market A group of consumers (potential customers) who have purchasing power and unsatisfied needs. (See also Market niche and Niche.)

Market niche A homogeneous group of consumers with common characteristics.

Market segmentation The segment of a business plan that describes aspects of the market, such as the target market, the market size and trends, the competition, estimated market share, market strategy, pricing, and advertising and promotion.

Marketability Assembling and analyzing relevant information about a new venture to judge its potential success.

Marketing research A gathering of information about a particular market, followed by an analysis of that information.

Marketing segment The segment of a business plan that describes aspects of the market, such as the target market, the market size and trends, the competition, estimated market share, market strategy, pricing, and advertising and promotion.

Marketing strategy The general marketing philosophy of the company should be outlined to include the kinds of customer groups to be targeted by the initial intensive selling effort, the customer groups to be targeted for later selling efforts, methods of identifying and contracting potential customers in these groups, the features of the product or service (quality, price, delivery, and warranty) to be emphasized to generate sales, and innovative or unusual marketing concepts that will enhance customer acceptance.

Market-rich countries Countries have something that others need, thus forming the basis of an interdependent international trade system.

Metacognitive model Integrates the combined effects of entrepreneurial motivation and context toward the development of metacognitive strategies applied to information processing within an entrepreneurial environment.

Metrics Assumptions and calculations used for any revenue projections.

Micro view of entrepreneurship Examines the factors specific to entrepreneurship and part of the internal locus of control.

Microiteration In design-centered entrepreneurship, it is iterating within each action stage to improve the outcome.

Milestone schedule segment The section of a business plan that provides investors with timetables for the accomplishment of various activities, such as completion of prototypes, hiring of sales representatives, receipt of first orders, initial deliveries, and receipt of first accounts receivable payments.

Minimum viable product (MVP) This is the early version of the product that enables a full turn on the feedback loop with a minimum of effort.

Mixed costs A blend of fixed and variable costs.

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Mobile marketing It allows for an even higher level of individualized company-to-consumer communication by directing customized messages to different users based on location, taste preferences, and shopping habits.

Moral failure This form of failure is a violation of internal trust.

Mountain gap strategies Identifying major market segments as well as interstice (in-between) markets that arise from larger markets.

Muddling mindsets When creative thinking is blocked or impeded.

N

Nepotism The hiring of relatives in preference to other, more qualified candidates.

Net income The excess of revenue over expenses during a particular period.

Net present value (NPV) method A capital-budgeting technique used to evaluate an investment that involves a determination of future cash flows and a discounting of these flows to arrive at a present value of these future dollars.

New-new approach A start-up approach to business in which the concept is a brand-new idea to the marketplace.

New-old approach A start-up approach to business in which the concept provides a new angle to something that already exists in the marketplace.

New-venture development The first stage of a venture's life cycle that involves activities such as creativity and venture assessment.

Noncompete agreement An agreement that the previous owner will refrain from conducting the same business within a reasonable distance for a period of at least five years.

Note payable Promissory notes given as tangible recognition of a supplier's claim or notes given in connection with an acquisition of funds, such as for a bank loan.

O

Oakland Scavenger Company A garbage collection firm based in California that was involved in a legal dispute over nepotism in a family business.

One-person-band syndrome Exists when an entrepreneur fails to delegate responsibility to employees, thereby retaining all decision-making authority.

Operating budget A budget that sets forth the projected sales forecast and expenses for an upcoming period.

Operating expenses The major expenses, exclusive of costs of goods sold, in generating revenue.

Opportunity identification The ability to recognize a viable business opportunity within a variety of good ideas.

Owners' equity What remains after the firm's liabilities are subtracted from its assets.

P

Pain The nickname that venture capitalists use for exactly what problem is being solved by your venture.

Partnership An association of two or more persons acting as co-owners of a business for profit.

Patent An intellectual property right granted to an inventor, giving them the exclusive right to make, use, or sell an invention for a limited time period (usually 20 years).

Patent and Trademark Office An office of the federal government through which all patent and trademark applications are filed.

Payback method A capital-budgeting technique used to determine the length of time required to pay back an original investment.

Peer-to-peer (P2P) lending Commonly abbreviated as P2PL, this is the practice of lending money to unrelated individuals, or "peers," without going through a bank or other traditional financial institution. Also known as "debt-based crowdfunding," this lending takes place online on peer-to-peer lending companies' websites using various lending platforms.

Penetration Setting prices at such a low level that products are sold at a loss. Allows quick gains in market share by setting a price below competitors' prices.

Perception of high cost When small-business owners perceive the cost associated with planning to be very high.

Personal failure A form of failure brought about by a lack of skill or application.

Pivot A structured course correction designed to test a new fundamental hypothesis about the product, strategy, and engine of growth.

Political risks They include unstable governments, disruptions caused by territorial conflicts, wars, regionalism, illegal occupation, and political ideological differences.

Potential market The entire size of the market for a product at a specific time. It represents the upper limits of the market for a product.

Prepaid expenses Expenses that the firm already has paid but that have not yet been used.

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Price/earnings ratio (P/E) A method of valuing a business that divides the price of the common stock in the market by the earnings per share and multiplies the result by the number of shares of stock issued.

Primary data New data that are often collected using observational or questioning methods.

Private placement A method of raising capital through securities; often used by small ventures.

Pro forma statements Projection of a firm's financial position during a future period (pro forma income statement) or on a future date (pro forma balance sheet).

Probability thinking Relying on probability to make decisions in the struggle to achieve security.

Product availability The availability of a salable good or service at the time the venture opens its doors.

Production-driven philosophy A market philosophy based on the principle of producing efficiently and letting sales take care of themselves. (See also Consumer-driven philosophy and Sales-driven philosophy.)

Profit trend A venture's ability to generate a profit over a sustained period.

Prototyping A physical representation of the venture that captures the essence of an idea in a form that can be shared with others for communication and feedback that closes the gap between concept and reality.

Psychic risk The great psychological impact on and the well-being of the entrepreneur who creates a new venture.

Q

Qualitative research It needs far less sample size as it involves the researcher into the process and is able to delve deeper into the questions with the respondents.

Quantitative research It involves empirical assessments that work from numerical measurements and analytical approaches to compare the results in some way.

R

Radical innovation The inaugural breakthroughs launched from experimentation and determined vision that are not necessarily managed but must be recognized and nurtured.

Rationalizations What managers use to justify questionable conduct.

Ratios Designed to show relationships among financial statement accounts.

Reachable market The immediate reachable group of customers that will be targeted by a new venture.

Regulation D Regulation and exemption for reports and statements required for selling stock to private parties based on the amount of money being raised.

Resource-rich countries Countries have something that others need, thus forming the basis of an interdependent international trade system.

Retained earnings The accumulated net income over the life of the corporation to date.

Revenues The gross sales made by a business during a particular period under review.

Revised Uniform Limited Partnership Act (RULPA) An act that governs limited partnerships and contains 11 articles and 64 sections of guidelines covering areas such as (1) general provisions, (2) formation, (3) limited partners, (4) general partners, (5) finance, (6) distributions and withdrawals, (7) assignment of partnership interest, (8) dissolution, (9) foreign limited partnerships, (10) derivative actions, and (11) miscellaneous.

Revised Uniform Partnership Act (RUPA) A model statute that dictates how partnerships should be set up and organized as well as what the rights and duties of each of the partners should be. It is, as the name suggests, a revision of the Uniform Partnership Act (UPA) and has been adopted by almost every state.

Right brain The part of the brain that helps an individual understand analogies, imagine things, and synthesize information. (See also Left brain.)

Risk Involves uncertain outcomes or events. The higher the rewards, the greater the risk entrepreneurs usually face.

Risk versus reward Examine overall gains and losses to point out the importance of getting an adequate return on the amount of money risked.

Role assertion Unethical acts involving managers/entrepreneurs who represent the firm and who rationalize that they are in a position to help the firm's long-run interests.

Role distortion Unethical acts committed on the basis that they are "for the firm" even though they are not and involving managers/entrepreneurs who commit individual acts and rationalize that they are in the firm's long-run interests.

Role failure Unethical acts against the firm involving a person failing to perform their managerial role, including superficial performance appraisals (not being totally honest) and not confronting someone who is cheating on expense accounts.

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S

S corporation Formerly termed a Subchapter S corporation, an **S corporation** takes its name from Subchapter S of the Internal Revenue Code, under which a business can seek to avoid the imposition of income taxes at the corporate level yet retain some of the benefits of a corporate form (especially the limited liability).

Sales forecast The process of projecting future sales by applying statistical techniques to historical sales figures.

Sales-driven philosophy A marketing philosophy that focuses on personal selling and advertising to persuade customers to buy the company's output. (See also Consumer-driven philosophy and Product-driven philosophy.)

Secondary data Data that have already been compiled. Examples are periodicals, articles, trade association information, governmental publications, and company records.

Security hunting Common mental habit that inhibits creativity and innovation by hindering creative thought processes.

Selection A new venture locating in a favorable environment.

Shared value It is a transformation of business thinking recognizing societal weaknesses that create internal costs for firms (e.g., wasted energy, accidents, and inadequacies in education).

Short-term liabilities (current liabilities) Business debts that must be paid during the coming 12 months (also called current liabilities).

Simple linear regression A technique in which a linear equation states the relationship among three variables used to estimate the sales forecast.

Skimming Deliberately setting a high price to maximize short-term profits.

Skunk Works A highly innovative enterprise that uses groups functioning outside traditional lines of authority.

Small profitable venture A venture in which the entrepreneur does not want venture sales to become so large that they must relinquish equity or ownership position and thus give up control over cash flows and profits, which it is hoped will be substantial.

Social cognition theory Cognition is used to refer to the mental functions, mental processes (thoughts), and mental states of intelligent humans. Social cognition theory introduces the idea of knowledge structures—mental models (cognitions) that are ordered in such a way as to optimize personal effectiveness within given situations—to the study of entrepreneurship.

Social entrepreneurship A new form of entrepreneurship that exhibits characteristics of nonprofits, government, and businesses; it applies traditional (private-sector) entrepreneurship's focus on innovation, risk taking, and large-scale transformation to social problem solving.

Social impact investing Raising funds for socially motivated causes.

Social media marketing It describes the use of these tools for marketing purposes. The most common social media marketing tools include Twitter, blogs, LinkedIn, Facebook, Flickr, and YouTube.

Social value Contribution to the welfare or well-being in a given community.

Sole proprietorship A business that is owned and operated by one person. The enterprise has no existence apart from its owner. This individual has a right to all of the profits and bears all of the liability for the debts and obligations of the business.

Sophisticated investor Wealthy individuals who invest more or less regularly in new and early- and late-stage ventures. They are knowledgeable about the technical and commercial opportunities and risks of the businesses in which they invest.

Special purpose acquisition company (SPAC) A company that has no commercial operations and is formed strictly to raise capital through an IPO for the purpose of acquiring or merging with an existing company (also known as "blank check companies").

Specification The text of a patent; it may include any accompanying illustrations.

Stabilization stage The fourth stage of a new-venture life cycle, typified by increased competition, consumer indifference to the entrepreneur's good(s) or service(s), and saturation of the market with a host of "me too" lookalikes. During this stage, the entrepreneur begins planning the venture's direction for the next three to five years.

Start-up activities The second stage of a new-venture life cycle, encompassing the foundation work needed to create a formal business plan, search for capital, carry out marketing activities, and develop an effective entrepreneurial team.

Start-up problems A perceived problem area in the start-up phase of a new venture, such as lack of business training, difficulty obtaining lines of credit, and inexperience in financial planning.

Stereotyping Refers to averages that people fabricate and then, ironically, base decisions on as if they were entities existing in the real world.

Strategic entrepreneurship The exhibition of large-scale or otherwise highly consequential innovations that are adopted in the firm's pursuit of competitive advantage.

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Using strategic entrepreneurship approaches, innovation can be in any of five areas: the firm's strategy, product offerings, served markets, internal organization (i.e., structure, processes, and capabilities), or business model.

Strategic formulation school of thought A school of entrepreneurial thought that focuses on the planning process used in successful venture formulation.

Strategic planning The primary step in determining the future direction of a business influenced by the abilities of the entrepreneur, the complexity of the venture, and the nature of the industry.

Strategic positioning The process of perceiving new positions that attract customers from established positions or draw new customers into the market.

Stress A function of discrepancies between a person's expectations and ability to meet demands as well as discrepancies between the individual's expectations and personality. If a person is unable to fulfill role demands, then stress occurs.

Subscription model Generates revenue by requiring users to pay a fee (generally monthly or yearly) to access a product or service.

Survival venture A venture that provides basic subsistence for the entrepreneur and their family.

Sustainable entrepreneurship It focused on the preservation of nature, life support, and community in the pursuit of perceived opportunities to bring into existence future products, processes, and services for gain, where gain is broadly construed to include economic and noneconomic gains to individuals, the economy, and society.

SWOT analysis A strategic analysis that refers to strengths, weaknesses, opportunities, and threats.

Synthesis A basic type of innovation that involves combining existing concepts and factors into a new formulation.

T

Taxes payable Liabilities owed to the government—federal, state, and local.

Technical feasibility Producing a product or service that will satisfy the expectations of potential customers.

Term sheet Document that outlines the material terms and conditions of a venture agreement and lists deal terms in bullet-point format.

Time scarcity Lack of time and the difficulty of allocating time for planning in the face of continual day-to-day operating problems.

Top-management support When upper-level managers in a corporation can concentrate on helping individuals within the system develop more entrepreneurial behavior.

Trade credit Credit given by a supplier who sells goods on account. A common arrangement calls for the bill to be settled within 30 to 90 days.

Trade secrets Customer lists, plans, research and development, pricing information, marketing techniques, and production techniques. Generally, anything that makes an individual company unique and has value to a competitor could be a trade secret.

Trademark A distinctive name, mark, symbol, or motto identified with a company's product(s).

Triple bottom line (TBL) An accounting framework that goes beyond the traditional measures of profit, return on investment, and shareholder value to include environmental and social dimensions.

U

Uncontrollable failure Form of failure caused by external factors that are outside the control of employees, such as resource limitations, strategic direction, and market changes.

Undercapitalization The amount of equity investment is usually low (often indicating a high level of debt).

Unicorn A start-up with a $1 billion market value.

Uniqueness The special characteristics and design concepts that draw the customer to the venture, which should provide performance or service that is superior to that of competitive offerings.

Unlimited liability The individual proprietor is personally responsible for all business debts. This liability extends to all of the proprietor's assets.

Unscrupulous practices Business practices that are devoid of ethics and seek personal gain at any cost.

Upside gain and downside loss Within the financial capital domain, this is the best possible gain weighed against the worst loss possible. (See also Risk versus reward.)

USMCA The United States–Mexico–Canada Agreement (formerly known as the North American Free Trade Agreement) increased the imports and exports as well as intellectual property protections for the trading among all three nations.

V

Validated learning A process in which one learns by trying out an initial idea and then measuring it to substantiate the effect.

Variable cost A cost that changes in the same direction as and in direct proportion to changes in operating activity.

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Venture capitalist Individuals who provide a full range of financial services for new or growing ventures, such as capital for start-ups and expansions, marketing research, management consulting, assistance with negotiating technical agreements, and assistance with employee recruitment and development of employee agreements.

Venture opportunity school of thought A school of entrepreneurial thought that focuses on the search for idea sources, on concept development, and on implementation of venture opportunities.

Vertical analysis The application of ratio analysis to one set of financial statements.

Virtual goods model Generates revenue by charging users for virtual goods, such as upgrades, points, or gifts, on a website or in a game.

W

Water well strategies The ability to gather or harness special resources (land, labor, capital, and raw materials) over the long term.

World Trade Organization (WTO) The umbrella organization governing the international trading system. Its job is to oversee international trade arrangements, but, contrary to popular belief, the WTO does not replace the General Agreement on Tariffs and Trade (GATT).

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