Where are we headed?
After completing this chapter, you should be able to:

- define a small business
- list the reasons for owning a small business
- identify the alternatives to establishing a small business
- identify the resources required to establish a small business
- identify the personal qualities of a successful small business owner
- distinguish between businesses based on the nature of their operations
- identify and explain the advantages and disadvantages of various ownership structures
- identify and explain the advantages and disadvantages of establishing a small business or buying an existing business or a franchise
- explain why some small businesses succeed where others fail
- identify sources of assistance for small business owners.

KEY TERMS
After completing this chapter, you should be familiar with the following terms:

- small business
- term deposit
- negative gearing
- share
- dividend
- franking credit
- cost price
- sole proprietorship
- unlimited liability
- partnership
- proprietary company
- limited liability
- goodwill
- franchise
- franchisee
- franchisor
3.1 SMALL BUSINESS

Small businesses can be identified by the following characteristics:

- They are independently owned and operated.
- They are closely controlled by the owner/manager who also contributes most, if not all, of the operating capital.
- The principal decision-making is made by the owner/manager.

A simple definition of a small business is any business in which the owner and manager is the same person (or people), and which employs fewer than fifteen people. The number of employees is a useful distinguishing feature to determine a small business from a medium or large business. A medium business would employ 15 or more people but less than 200, while a large business would employ over 200 people.

However, with the exception of a ‘sole proprietorship’, which has one owner, the size of the business should not be taken as evidence of its business structure. Small, medium and large businesses can all be sole proprietorships, partnerships or companies. (This will be covered in detail later in this chapter).

The small business sector

Politicians and economists frequently cite small businesses as the engine room of the Australian economy, but just how important are they? In Australia there are approximately 2.1 million private sector small businesses, and this represents roughly 96% of all private sector businesses.

Small businesses play a vital role in the Australian economy as they employ almost 5 million people, which is almost half of all private sector employment. They also contribute strongly to Australia’s level of economic activity and production, and exports, which (most importantly from the government’s perspective) are a major source of tax revenue.
3.2 BECOMING A SMALL BUSINESS OWNER

Unfortunately, the list of successful small business owners is dwarfed by those that fail (see later in this chapter). The decision to become a small business owner should thus not be taken lightly, but rather be the product of a careful assessment of the prospective owner’s motivation, strengths and weaknesses, and the costs and benefits of ownership itself.

Reasons for becoming a small business owner

The reasons why people choose to own their own business are as many and varied as the businesses they operate. Some of the more common reasons are:

**Profit motive**

Rightly or wrongly, many people think that owning a small business is a gateway to financial riches and see becoming an owner as the best way to improve their income. Although wealth and security are by no means guaranteed, the profit motive is a powerful factor in the decision to purchase or start a business.

**A desire for greater freedom/independence – to be your own boss**

Many people become frustrated as employees, either because they think they have a better way of doing things, or because they feel that their efforts are under-recognised. By owning their own business, small business owners gain their independence as well as all the financial rewards that their hard work has gained. This extends to being able to choose the hours they work, and the way that work is done.

**Identifying a market opportunity**

A business opportunity can sometimes present itself in a way that an ambitious or creative person cannot ignore. An idea for a new or cheaper/better quality product, or a service that is not currently being provided can be a strong incentive to go into business for yourself so that the market demand is satisfied (not to mention the recognition – and hopefully profits – that will eventuate).

**Unemployment**

Due to retrenchment or other factors some individuals may discover that self-employment is their only option. The old saying about one door closing and another one opening is apt for those who are forced into what can turn out to be a highly rewarding small business.

While there are certainly benefits to be gained from owning a small business, there are also costs and risks involved. The independence that comes with being the owner is accompanied by extra responsibilities, meaning many hours of hard work and periods of stress. The loss of a secure income and other benefits (like paid holidays, sick pay and employer-funded superannuation) that go with salaried employment must be considered, as must the risk owners are taking by investing their own funds in the business – if the business fails, this investment will be lost.
3.3 ALTERNATIVES TO SMALL BUSINESS OWNERSHIP

As stated above, the potential small business owner accepts a large financial risk if he or she commences their own small business. The individual has their savings at risk so it would not be unreasonable for that person to explore alternatives. Later in Chapter 3, we explore a profitability indicator called Return on Owner’s Investment (ROI). ROI measures the return (profit) generated for the owner on the capital they have invested. Specifically, it shows the profit earned per dollar invested by the owner, so it is useful in assessing how profitable the business is as an investment. This also allows a direct comparison with other alternative investments.

Alternative investments

The difficulty is that, given the number of alternatives, it can be difficult to choose an investment option. Each investment has its own specific levels of risk, achievable rates of return for the owner, and advantages and disadvantages, and all these factors must be taken into account. Risky investments are likely to offer a higher rate of return. Investing carries not only the risk that a return will not be earned, but also the risk that the initial investment may be lost. Some investors would rather play it safe and achieve a moderate return on their funds, whereas others want to achieve a greater return on their funds and are willing to take the risks associated to achieve that return.

Another factor that an investor must take into account is the term (length) of the investment. For investment options subject to business cycles and other fluctuations, a long-term investment may be required to generate an adequate return.

Similarly, the investor also has to consider the liquidity of the investment: how easily it can be converted back into cash if the individual needed their funds urgently.

There are three main asset groups that can be used as investment options:

- cash
- property
- shares.

Within each asset grouping, there are many different individual investment options, each with its own advantages and disadvantages. This list is by no means exhaustive and only highlights a number of investment options available to investors.

Investment option 1: Cash

Bank accounts

The most basic and common form of cash investment is to put money in the bank or a similar institution such as a building society or credit union. It has the advantage that the cash is readily accessible and that there is virtually no risk of the business losing its investment as the government guarantees all bank deposits. However, basic on-call business bank accounts pay a very low return, with interest on deposits earned at only half a percent to one-and-a-half per cent. (It is highly possible that when account-keeping fees are factored in, the return on a bank account could actually be negative.)
The property market

Term deposits

Term deposits are an investment option available from banks that does provide a higher rate of interest in return for agreeing to invest for a set term. The term can vary, ranging from three months to five years. If the investor requires the funds before the end of the term, they may be available but this would be at the cost of any interest that would have been earned, plus additional costs for early termination of the investment.

Investment option 2: Property

Investing in property essentially means buying real estate of some type, which can provide both a capital gain and an income stream in the form of rent. Some investors actually borrow to invest in property in order to earn a capital gain from the increase in its market value. In addition, as long as the rental income is less than the cost of the property (including the interest payments on the loan), the investor will make a ‘loss’, thus reducing their taxable income. This is known as negative gearing.

Risks

Given the dual returns available from property, it can seem like a very attractive option. However, there are some factors that can make property a risky investment.

The property market

The general wisdom has it that property prices double every seven years, but this is not guaranteed. The property market is subject to fluctuations, meaning that timing is crucial: purchasing at the height of the market (when prices have peaked) may mean that the investor suffers a short-term loss, or a smaller capital gain. Also, growth rates can vary dramatically according to the location of the property, meaning that investors must conduct careful and thorough research before making their investments.

Interest rates

Property prices are dependent on the ability of buyers to pay, which is in turn dependent on the cost of borrowing. If interest rates rise, buyers are less willing to pay high prices meaning the market value of the property may fall. This will reduce any capital gain the investor may make. Further, the costs associated with paying loans may become unmanageable for the investor who may then be forced to sell in unfavourable circumstances or market conditions.

Rent

Unfortunately rental income is not guaranteed. Some investors can find it difficult to find a tenant for their property or to achieve their desired rental income. Bad tenants can create costs ranging from a loss of rental income to the cost of fixing damage or neglect.

Liquidity

Property must be viewed as a medium to long-term investment, because disposal is not only costly, but also time-consuming. Once a buyer is found and the property is sold (which can take time), it can then take up to 120 days for settlement.

Although property can provide good returns in the form of capital gains, this gain can only be realised if the property is sold, and any profit is then subject to capital gains tax. On its own, the rental income from property is unlikely to match the return on other less risky investments. However, the combination of the two forms of return makes it a good investment tool, especially as a long-term investment.
Investment option 3: Shares

When an investor buys shares they are buying part-ownership of a business, giving the shareholder some say in the running of the company. In terms of a return, it gives the shareholder access to an income stream in the form of dividends (a share of the firm’s profit). In addition, the ability to trade shares through the stock exchange gives the shareholder a potential for capital gains if the market value of the shares increases.

Owning shares can bring a variety of benefits, including:

**Greater returns**

Various studies have shown that Australian shares have out-performed other forms of investment. Many investments taken with a long-term perspective tend to provide higher and more consistent returns, and shares happen to top this list.

**Tax benefits**

Many dividends are paid to investors from profits that have already had company tax deducted from them, reducing the tax that must be paid by the investor. This is referred to as a franking credit. Only if the investor is in a tax bracket higher than the company tax rate of 30%, will they have to pay any tax on the dividend income. In addition, if the shares have been held for more than 12 months, they can qualify for a 50% reduction in capital gains tax. (Any shares sold at a capital loss can be used to offset any other capital gains.)

**Diversification**

There are over 2,200 different companies’ shares listed on the stock exchange, allowing an investment in a variety of markets and industry areas all at the one time. This means that if one segment of the market is under-performing, it may be offset by strong performance in another. Similarly, a risky investment in one company that promises a high return can be offset by a safer investment in a company offering a less lucrative return.

**Flexibility**

Shares themselves are quite liquid and can be sold quickly to return cash to the investor if it is required.

**Risks**

Investing in shares carries risks similar to those involved with property, with the dividend return dependent on the profitability of the company, and the capital gain dependent on the share market. An investor who holds shares in an unprofitable company will see little or no return in terms of dividends, and is also likely to suffer a capital loss as the market value of their shares falls below their purchase price.

Fluctuations in the market value of shares are a daily occurrence. Speculative or short-term investors attempt to predict these fluctuations by purchasing shares in new industries and businesses and then selling them when the market price is high. Investors who take this approach are more interested in a capital gain than dividends. Long-term investors on the other hand are more likely to purchase shares in companies that have a history of earning good profits, and distributing them as dividends.
REVIEW QUESTIONS 3.3
1 Explain the main difference between a bank account and a term deposit.
2 List the main returns to be gained from investing in property.
3 Explain the main benefit of negative gearing.
4 Explain the factors that can make property a risky investment.
5 List the benefits of becoming a shareholder.
6 Explain the benefits of investing in shares rather than other investment options.
7 Explain the risks associated with owning shares.
8 Explain why an individual should explore alternative investments when considering starting their own small business.

3.4 RESOURCES REQUIRED TO ESTABLISH A SMALL BUSINESS

Having explored all alternatives an individual may still come to the decision that commencing their own small business is their best option. The individual then needs to identify the resources required to commence their own small business. These will consist of:

- **personal resources** – the qualities and traits the individual can bring to the business
- **financial resources** – how the business is to be financed. This will be discussed in detail in Chapter 4: Sources of Finance.
- **external support resources** – how professionals such as accountants and solicitors, the Government, and professional organisations provide advice to assist small business owners to succeed.

**Personal qualities of successful small business owners**

Even amongst those who are prepared to accept the risks, not all people are suited to being small business owners. Successful small business owners share certain personal attributes, including:

- **expertise** – a detailed knowledge of their product or service and the market into which it is being sold, as well as a range of other management issues including marketing, management, human resources, finance, the law and accounting
- **entrepreneurship** – the ability to recognise a business idea, accept the risk and transform it into an actual functioning and successful business
- **determination** – a willingness to persevere in the face of hardships and setbacks
- **confidence** – the self-belief to make decisions and then accept the consequences
- **cordiality and patience** – an ability to develop good relationships with customers and employees and resolve disputes in a pleasant manner
- **humility** – a willingness to recognise their own limitations and seek expert assistance in areas in which their knowledge is lacking.

This may seem like a daunting list, and not all business owners possess all these qualities when they start. However, a willingness and desire to develop these qualities will allow the owner, and therefore their business, the best chance of success.
External support resources

As shown later, one of the main reasons for small business failure is a lack of managerial experience and an unwillingness to seek assistance. It is those owners who can identify their shortfalls or lack of expertise and seek professional assistance who will ensure their small business survives. There are many professionals who can provide assistance to small businesses, including:

Accountants
Accountants are no longer simply bookkeepers (recorders of financial information); they are experts in providing advice and direction on ownership structures, pricing policies, tax minimisation, superannuation obligations, tax obligations regarding PAYG and GST, and strategies for improving business performance.

Lawyers
A small business owner can contact a solicitor or the Law Institute to assist them in any form of legal matter. This could involve the establishment of an ownership structure such as a partnership or proprietary company, representation in civil cases, or assistance with the lodging of a registered trademark.

Bank managers
A bank manager can provide specific advice regarding business finance and suggest alternatives in terms of financing options.

Sponsored assistance programs
In addition to these traditional sources of assistance, there are many private and government sponsored programs to assist small businesses to survive and thrive, including:

- **TAFE courses** – courses which address specific aspects of running a small business, from food handling and Occupational Health and Safety (OHS), to cash management and budgeting
- **Industry associations** – groups whose members operate in a particular industry, and so are well placed to provide advice and assistance specific to that industry; for example, Retail Traders Association.
- **AusIndustry** – an Australian Government agency delivering services and information that supports small business, research and innovation: www.ausindustry.gov.au. This agency provides access to the Small Business Entrepreneurship Program (SBEP) – a general skills development and mentoring program to help small business owners maximise business performance.
- **Business Victoria** – a state government initiative that provides a comprehensive online resource that is designed to help prospective owners to start, operate and develop their business: www.business.vic.gov.au
- **Small Business Counselling Service (SBCS)** – an independent, non-profit organisation providing experienced volunteer business counsellors, mentors and coaches to Victorian businesses: www.sbcs.org.au
- **The Australian Business Funding Centre** – provides information and support on how to secure grants, loans or financial aid to finance your small business idea: www.australiangovernmentgrants.org
- **Greater Victoria Economic Development Commission (GVEDC)** also known as Business Victoria – an independent, non-profit organisation that focuses on supporting the small business community: www.bizvic.com
REVIEW QUESTIONS 3.4

1. Explain the personal qualities shared by successful small business owners.
2. List five areas in which a small business owner must have detailed knowledge.
3. Explain the importance of seeking additional advice to ensure the successful running of a small business.
4. List and describe four sources that small business owners may turn to for advice.

3.5 PLANNING

One of the most important steps before venturing into a business is to formulate a business plan. The more information that is gathered before the business commences operations, the greater its chances of success. (In particular, a business plan may make it easier to convince a financial institution to provide finance.)

A comprehensive business plan should include:

- a description of the business and the most appropriate business structure (this will be covered in detail later in this chapter)
- a description of the product or service; that is, exactly what the business will be selling or providing as a service to its customers
- a market analysis that would include marketing strategies. This would also assist in finding a target market and help to determine the best business location.
- an analysis of the personal strengths and weaknesses of the owner that would allow for the identification of areas where assistance or expert help will be required
- a detailed list of establishment costs and the expected sources of finance (this will be covered in Chapter 4)
- projected sales figures and estimated running costs. These costs should be further broken down into fixed and variable costs. This would allow for the forecasting of the firm’s cash and profit/loss to determine when the business can support itself from its own operations. (This will be covered in Chapter 5.)

REVIEW QUESTIONS 3.5

List the issues that must be addressed in a comprehensive business plan.

3.6 NATURE OF BUSINESS OPERATIONS

The market and type of products or services offered by a business determines the nature of its operations.

Retail/trading

This type of business purchases finished goods for the sole purpose of resale. Stock is purchased from wholesalers/manufacturers at a cost price, and then sold to consumers through a retail outlet at a marked-up selling price. Trading businesses sell just about everything including clothing, hardware, CDs and hi-fi equipment, groceries, and books, and may be well-known like certain supermarket chains and clothing stores, or local businesses in shopping centres.
Service

This type of business performs a service for the customer so in fact what is being sold is the time, labour and expertise of the business. There is no physical exchange of goods. The service industry is the fastest growing sector and can include services such as cleaning, gardening and other home maintenance, and services supplied by plumbers, electricians, carpenters and mechanics.

Manufacturing

This type of business actually produces the goods it sells, using a production process (which could be on an assembly line) to transform raw materials into a finished product. This would include the makers of goods such as cars, biscuits, clothing and toys. Many of these manufacturers sell predominantly to trading businesses, but an increasing number of factory outlets sell direct to the public.

Mixed businesses

In certain cases, a business will combine one or more types of operation. For example, hairdressers not only perform a service (cutting your hair) but also sell a variety of hair-care products, and car dealerships not only sell cars but also provide service centres for tune-ups.

There are also other ways of classifying operations, including mining, agriculture and hospitality, but for our purposes the ability to distinguish between trading, service and manufacturing firms, or those which combine more than one of these operations, is sufficient.

**REVIEW QUESTIONS 3.6**

1. **Explain** how a trading firm earns profit. **State** two examples of trading firms in your area.
2. **Explain** how a service firm earns profit.
3. **Suggest** two reasons why manufacturing firms sell predominantly to trading firms rather than to the general public.
4. **Suggest** one reason why manufacturing firms may open a factory outlet to sell direct to the public.

**3.7 OWNERSHIP STRUCTURES**

Once a potential small business owner has determined the nature of their business venture and is satisfied that they have the personal qualities, there is still more to consider. One of the most important decisions facing an individual who wishes to commence a small business is which ownership structure to adopt. This choice can have an impact on:

- the owner’s personal accountability for the debts of the business
- the owner’s tax liability
- the firm’s ability to raise capital
- the costs of establishing the business and compliance with government regulations
- the ability to shut down the business
- control over decision-making in the business.
Sole proprietorship

A **sole proprietorship** is owned by a single individual, operating the business in their own right under their own name (Peter Romer) or a registered business name (Romer’s Roof Repairs). It is the most straightforward and inexpensive way of structuring a business. A sole trader is not a separate legal entity, so the owner would be taxed as an individual and would have to declare all income earned from the business in his or her personal tax return and face personal income tax rates. Examples of a sole trader business could be a milk bar, fish and chip shop or a plumber.

**Advantages**

- It is easy and cheap to set up. At the time of writing, to register a business name in Victoria for three years costs only $83.70.
- The owner has full control over decision-making within the business.
- The owner receives all profits and has full access to the capital of the business.
- It is simple to sell or wind up. There is no charge to deregister a business name.

**Disadvantages**

- The owner has **unlimited liability** and is thus personally responsible for all debts and liabilities incurred by the business. This can also extend to personal assets jointly owned with another person: for example, the family home.
- The business has a limited life; the continuity of the business is in danger if the owner should die.
- There is limited access to capital, as all start-up capital must come from one person. This may limit the finance available to the business as it has to rely on the owner’s financial resources and their credit rating if they wish to borrow funds.
- Since there is essentially only one person running the business, these skills may be limited and may not cover every area that is required to run a successful business.
- The owner may have to endure personal hardship as they have to work excessively long hours to ensure the continued operation and success of the business. Since they are operating on an individual basis, finding time for a holiday or taking time off may be difficult and detrimental to the business.

**Partnership**

Sole proprietorship a business owned by a single individual, operating their business in their own right under their own name or a registered business name

Unlimited liability

the legal status of sole proprietorships and partnerships is that they are not recognised as separate legal entities, so the owner(s) is personally liable for the debts of the business
A partnership is two or more persons in business together operating under their own names (Sue Dorman and Barry Pratt) or a registered business name (Dorman and Pratt Consultancy Services) with a view to making a profit. Partnerships are generally made up of 2 to 20 legal persons but can extend beyond this number under special circumstances. (For example, accountancy firms have many partners, at least partly to spread the liability.) A partnership is not a separate legal entity and the partners would be taxed as individuals on the profit from the business that they received in their personal tax return and face personal income tax rates. Examples of partnerships could include doctors, lawyers and accountants. Although not legally necessary, it is strongly recommended that a partnership be set out in writing as a legal document by a solicitor in the form of a partnership agreement. The agreement should cover all aspects of the operation of the partnership and include things such as the role of each partner, the proportion of ownership and the resolution of disputes.

**Advantages**
- It is relatively cheap to set up. To register a business name in Victoria for three years costs only $83.70 (at the time of writing) and a partnership agreement would attach a solicitor’s fee.
- It is relatively simple to wind up and reclaim an individual’s investment in the business.
- There is greater access to capital and skills. With more partners there is a greater source of financial resources to fund the business’s start up costs and future expansion. Also there is greater access to expertise and knowledge to ensure the smooth running of the business.
- Tax advantages can exist where the partners are married, as the profits can be split between them, effectively giving them two tax-free thresholds. This reduces their tax debt, but not their household income.

**Disadvantages**
- Control over decision-making is shared among the partners. This may lead to disagreements and personality clashes.
- The owners have unlimited liability and are thus personally responsible for all debts and liabilities incurred by the business. This liability extends to debts incurred by the other partners in the business’s name, meaning each partner is personally responsible for all debts and liabilities incurred by the other partners.
- The partnership has a limited life – if one of the partners should die, be declared insane or decide to leave the business, the partnership is dissolved.
- Profits are shared among the partners. This is normally set out in the partnership agreement but if not could be another reason for a dispute between the partners.

**Proprietary company (Pty Ltd)**

A proprietary company is a registered legal entity with the right to do business in its own right. It comes into existence by incorporation under the *Corporations Act 2001*. A solicitor normally prepares the necessary documents required for incorporation. It can be owned and operated by one person being both shareholder and director; however, it can have no more than 50 non-employee shareholders. It has its own separate legal entity and so can sue and be sued, and is subject to taxation in its own right. Examples of proprietary companies are Musical Inspiration Pty Ltd and Don Smallgoods Co. Pty Ltd.
Establishment

Advantages

• **Limited liability** means the owners (shareholders) have no further responsibility for any liabilities incurred by the business unless they signed personal guarantees. Also directors have no personal responsibility for any debts unless they caused the debts recklessly, negligently or fraudulently.
• There is a greater ability to attract capital to the business as there is limited liability.
• The life of the business is ongoing due to its being a separate legal entity. It does not cease to exist even if a director/shareholder decides to leave or dies. It exists until it is wound up.
• The firm can conduct business Australia-wide using the company name as the name is registered on a national basis.

Disadvantages

• Establishment costs are high. To register a proprietary company can cost anywhere from $462 to about $1,000.
• There may be difficulty attracting additional capital because a proprietary company cannot publicly advertise for funds. This also can make it difficult for shareholders to sell their shares and recover their investment in the company, as there may be limitations on who can purchase the shares.
• There are higher compliance costs as a result of the need to comply with tax laws. This can include fees paid to external tax advisers, time spent by personnel within the business dealing with tax matters and other related costs.
• Because it is regulated by the Australian Securities and Investments Commission (ASIC) as well as the Australian Taxation Office (ATO) and a separate tax return is required by both these bodies each year, the degree of regulation is much higher than that imposed on sole proprietorships or partnerships.

Proprietary companies (Pty Ltd) are also referred to as ‘private companies’ (family companies). Because their ownership tends to be of a smaller nature, their ownership is more difficult to transfer and they do not have to make their financial reports available to the public. A Public Company (Ltd) is a large business structure that is also incorporated so it also has its own legal existence, but derives the ‘Public’ name because it can publicly raise funds by advertising and selling shares through the Australian Securities Exchange (ASX). It is also open to the scrutiny of the public by being listed on the stock exchange and has to make its financial reports public. It is for this reason the regulations and compliance surrounding a public company are more stringent than those under which a proprietary company operates.

**REVIEW QUESTIONS 3.7**

1. **Define** the following types of ownership structure:
   - sole proprietorship
   - partnership
   - proprietary company.

2. **List** the advantages and disadvantages of each type of ownership structure.

3. **Distinguish** between a private company and a public company.

4. **Distinguish** between limited and unlimited liability.

5. Referring to one Accounting Principle, **explain** the effect of unlimited liability on the recording of transactions for a sole proprietorship or partnership.
3.8 STARTING VERSUS BUYING

Once a prospective owner decides to go into business for themselves, three options exist:

- starting a new business
- buying an existing business
- buying a franchise.

Starting a new business

As the title suggests, this involves starting a brand new business from scratch, and if there is no business for sale, may very well be the only option for a prospective business owner. Its great advantage is also its main disadvantage – there will be nothing in place, meaning the owner has to decide on a location and ownership structure, purchase assets, hire staff and develop business practices before trading can begin.

Advantages

- Almost total freedom in determining how the business operates.
- Freedom to set customer expectations.
- No need to pay for goodwill.
- Rewarding for the owner knowing they have created the entire business.

Disadvantages

- No track record, so greater risk of failure.
- No customer base – could mean low cash inflows in first months of operation.
- Large start up capital required that will essentially have to be provided by the owner.
- More difficult to obtain finance.

Buying an existing business

In order to overcome the uncertainties of starting a new business, another option is to buy a business that already exists. A potential buyer would need to conduct careful research into the history of the business, its future potential and the reasons the owners are selling.

Advantages

- A proven track record can increase the chances of success.
- All assets, practices, suppliers and customers are already established.
- An immediate income stream is available.
- Previous owner(s) and current employees can assist in the change of ownership as they can provide helpful advice.

Disadvantages

- Previous success may have been dependent on the skills of the previous owner(s) and their relationship with customers.
- Difficult to change existing procedures, staff and customer expectations.
- Must pay for goodwill (which is difficult to value accurately).
- Existing assets may require major renovation, repair or even replacement.

Buying a franchise

Buying a franchise is an increasingly popular way of entering the world of small business, as it offers the support and advice of a large financial corporation that has a vested interest in ensuring the success of the franchisee. Under a franchise arrangement, the small business owner (the franchisee) purchases the right to use the name and business systems of a larger business (the franchisor) in return for a certain fee. Some popular and successful franchises operate in the fast food and home gardening industries.
Like any small business venture the potential buyer must do their homework to ensure that the franchise operation is sound and that the company is reputable. The franchise agreement will set out the terms and conditions relating to franchise fees, operating arrangements, territory in which the franchisee can operate, and the life of the agreement.

**Advantages**
- Recognised brand name/national advertising.
- Established (and proven) reputation and business practices.
- All equipment necessary to commence operations.
- Bulk buying power through the franchise group.

**Disadvantages**
- High purchase price, ranging from $15,000 for a lawn-mowing business to upwards of a million dollars for a fast-food restaurant.
- Ongoing franchise fees (frequently based on sales) to cover expenses such as advertising and administration.
- Rigid guidelines for operations.
- Competition from fellow franchisees.
- Dependence on the operations of the franchisor.

### REVIEW QUESTIONS 3.8

1. **List** the advantages and disadvantages of starting a business from scratch.
2. **Define** the term ‘goodwill’.
3. **Explain** how goodwill can bring both benefits and costs for the purchaser of an existing small business.
4. **List** the advantages and disadvantages of buying an established business.
5. **Define** the term ‘franchise’.
6. **Suggest** two reasons for the growth in the popularity of franchising.
7. **List** the advantages and disadvantages of buying a franchise.

### 3.9 REASONS FOR SUCCESS AND FAILURE

Given that so many small businesses fail, a prospective small business owner must be aware of the factors on which small business success are likely to depend. Successful small businesses have:
- high demand for their product or service
- a location that is visible and easily accessible for customers
- a thorough business plan that details all aspects of the firm’s operations
- sufficient starting capital that can support the business and the owner until it is functioning in a profitable manner
- an owner that exhibits the following qualities:
  - a strong knowledge of the good or service that they are selling
  - business acumen – insight or good judgement when it comes to business dealings and decisions
  - humility – not being afraid to seek assistance for any areas that they feel they don’t have the required level of expertise; for example, legal or financial matters
  - friendly and fair – when dealing with the public whether employees or customers
  - resilience – the ability to withstand failures, learn from mistakes and resolve issues and move on.
Unfortunately, approximately 80% of all small businesses fail within their first five years of operation, due to factors such as:

- **competition from other small and large businesses** – some businesses will purposely cut prices to drive out new competitors because they can afford to endure small margins or losses for a period of time whereas new businesses cannot. It can also be difficult for new businesses to attract customers away from established businesses especially larger ones that could offer a wider range of goods or services.

- **a poor location** – could be represented by poor visibility or poor access in terms of parking. It could also be in the wrong demographic area for the customers you are trying to reach. For example, you would not establish a shop selling children’s play equipment in a demographic area where the average age of the population is 60!

- **insufficient start up capital to support the business or the owner(s) until sales are established** – initial capital not only needs to cover setting up the business in terms of its premises, fixtures and fittings, signage and stock but it also needs to cover the operating and ongoing expenses such as electricity, telephone, wages and advertising. Starting small business owners may also have unrealistic expectations of their initial sales figures.

- **poor marketing, targeting either the wrong people, or no one at all** – in an ever competitive market, getting your business to be known by the right people is all important. The significance of modern technology highlights the need of a website and being linked to a good search engine, otherwise no one will know of your business’s existence.

- **poor management skills and a lack of willingness to seek professional advice** – there are very few, if any, that are experts in all fields covered by business. However, there are those that think they can do it all themselves that soon discover, to their own detriment, that they cannot.

- **poor customer relations** – there is an old saying in business that the ‘customer is always right’; however, there are small business owners who obviously disagree and can treat customers in ways that can be seen as aggressive, unhelpful or rude. Customers will not return to a business for poor treatment.

**STUDY TIP**

Use opposites here – the reasons for success are the opposite of the reasons for failure and vice versa.

**REVIEW QUESTIONS 3.9**

1. **List** the common characteristics of successful small businesses.
2. **List** the reasons why 80% of small businesses fail in the first five years of operation.
WHERE HAVE WE BEEN?

- Small businesses are owned and managed by the same person, and employ fewer than 15 people.
- Small businesses represent roughly 96% of all private sector businesses, employ almost 5 million people and contribute strongly to Australia’s level of economic activity and production, exports and tax revenue.
- Reasons for owning a business include the profit motive, a desire for greater independence, the identification of a market opportunity and employment.
- Investors must take into account the correlation between the level of risk and the rate of return, the term, and the liquidity of any alternative investment.
- There are three main asset groups that can be used as alternative investment options to starting a small business: cash, property and shares.
- Most successful business owners are experts in their field, entrepreneurial, determined, confident, cordial, patient and willing to recognise their own limitations and seek assistance.
- A detailed business plan is essential before operations commence.
- Business can be classified by the nature of their operations as trading, service or manufacturing businesses.
- The choice of ownership structure will have consequences for a whole host of issues, including the owner’s personal accountability for the debts of the business.
- Sole proprietorships and partnerships have unlimited liability; companies have limited liability.
- A prospective business owner can start a new business, buy an existing business or buy a franchise.
- Successful small businesses have a high demand for their product or service, a good location, a thorough business plan, sufficient starting capital and a knowledgeable and resilient owner.
- Small businesses can gain assistance from a variety of sources.

EXERCISE 3.1

SMALL BUSINESS

In 2012, Travis Sands left his job at a call centre to start his own landscape design business called Environ Landscape. Before commencing operations, Travis drafted a detailed business plan, and as a sole proprietor, Travis has been handling the business records and reports since the business started in 2012.

Required

a State two features that would distinguish Environ Landscapes from a large business.
b Suggest two reasons why Travis may have decided to become a small business owner.
c State two personal qualities Travis would need to be a successful small business owner.
d List four issues Travis would have addressed in his business plan.
EXERCISE 3.2
NATURE OF OPERATIONS
For each of the following businesses, identify the nature of its operations as one of trading, service or manufacturing.

a  Q-Mart Clothing Emporium
b  Ken Farthington, accountant
c  Mac Walter Textiles Factory
d  First Rate Plumbing
e  The Book Store
f  Digby Recording Studios.

EXERCISE 3.3
PARTNERSHIPS
Maxine Smart is the owner and operator of Ninety Nights, a small business that makes and sells designer pyjamas. Maxine started the business in March 2015 after leaving her position as a fashion designer with a major international clothing retailer. Maxine and her husband, Nigel, each contributed $20 000 of their own funds to start the business. However, Nigel was concerned that if the firm was established as a partnership, it would mean that all their personal assets, including their house and belongings, would be listed in the firm’s Balance Sheet. As a result, they decided that a sole proprietorship, in Maxine’s name, was the most appropriate business structure.

Required
a  State one reason why Maxine may be willing to accept less in profit than she earned as a salary in her previous job.
b  Identify the nature of operations of Ninety Nights.
c  Referring to one accounting principle, explain how Maxine and Nigel’s personal assets will be treated in the firm’s Balance Sheet.
d  Explain one benefit Maxine and Nigel would derive by registering their business as a partnership rather than a sole proprietorship.
e  Explain how Maxine and Nigel could ensure that in the event of bankruptcy, their personal assets will not be seized to pay business debts.

EXERCISE 3.4
PARTNERSHIPS
Marco Costa and Vince Carello are cousins who own and operate Ponte Vecchio Jewellers. Vince is a jeweller by trade, so Marco looks after most of the management issues. Because Marco and Vince are cousins, they have established their business as a partnership. Vince said, ‘We don’t need a formal partnership agreement – we are family.’ Marco added, ‘And when we die, our kids will take over.’

Required
a  State two benefits that Marco and Vince derive from operating their business together as a partnership.
b  State one benefit that Marco and Vince would derive from having a formal partnership agreement.
c  State one reason why Marco’s statement is incorrect.
d  On 1 May 2016, Marco left the partnership to take up a new job. Vince decided to continue trading as a sole proprietor. State one reason why Vince’s small business may still fail.
EXERCISE 3.5
COMPANIES

Lucas George has decided to go into business creating and selling his own space-based computer games. His girlfriend Sky is very keen to enter into the business with him, and Lucas is unsure about what type of ownership structure to adopt.

Required
a Identify the nature of operations for this new business.
b State three personal qualities Lucas will require to run his business successfully.
c State one advantage and one disadvantage of establishing the business as a private company rather than a partnership.
d Assuming that the business is structured as a company, explain the effect on the business should the relationship between Lucas and Sky end.
e State two arguments to support Lucas’s decision to start his own business rather than buy an existing business.

EXERCISE 3.6
SMALL BUSINESS ISSUES

Piece of Cake sells cakes from a shop in Hawthorn. For the past three years it has been owned and operated as a sole proprietorship by Elena St Clair, who left her job as an analyst for a large computer company in search of greater independence. Elena has frequently called on her sister (who is an accountant) for assistance and recently her sister expressed a desire to join Elena as a joint owner of the business.

Required
a State two reasons (other than a desire for independence) why people leave paid employment to own a small business.
b State two costs to Elena of leaving paid employment to start her own business.
c Explain the difference between a sole proprietorship and a proprietary company in terms of their legal status.
d State one disadvantage of establishing the business as a proprietary company.
e State one benefit Elena would derive from entering into a partnership with her sister.
f State two benefits Elena derived by buying an existing business rather than starting her own.
g Explain one reason (other than insufficient professional advice) why this business may still fail.
h State two sources from which Elena can seek alternative professional advice.

EXERCISE 3.7
SMALL BUSINESS ISSUES

Until 2012, Jane Bronte was employed as a journalist with a local broadsheet newspaper. Although she was quite happy with her job, on 1 December 2012 she left this position to start her own bookshop called Bronte’s Books. At the time, a friend had suggested that it would be wise to join a franchise group.

Required
a Explain one risk Jane was taking by becoming a small business owner.
b Explain why the establishment costs for a new business would be less than the purchase price of an existing business.
c Explain one benefit of being a member of a franchise group.
d State one financial and one non-financial cost of joining a franchise group.

During December 2015, Jane decided that in addition to selling a range of classic books, the shop would also provide a small library service that would allow customers to borrow rare and antique books. The library was due to commence operations in January 2016. On 1 January 2016, the business purchased $500 worth of books for the library service.

Required

e Explain the nature of the operations of Bronte's Books in January 2016.

f Explain why the books purchased on 1 January 2016 should be reported as an asset of Bronte's Books.

g Explain one circumstance in which the books should be reported as a current asset as at 31 January 2016.

h Explain one circumstance in which the books should be reported as a non-current asset as at 31 January 2016.