4. How to organize and lead an entrepreneurial venture

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Learning objectives

- differentiate between the growth stages of business organizations
- understand how businesses can organize their tasks and responsibilities
- compare the advantages and disadvantages of tall versus flat organization structures
- distinguish between the various types of business legal entities (see skill head, US legal issues)

Introduction

This chapter discusses organizational issues owners face while operating and attempting to grow their businesses. We examine four stages of organizational growth and the choices business owners face when deciding how to manage tasks and responsibilities. Those management decisions shape an organization's structure, which in turn influences lines of communication and decision-making processes.

The end of the chapter includes a short description of business legal entities. Also, you will find exercises to help you better grasp these concepts and to determine what type of organizational structure and legal entity might best suit your venture.

Moving from a one-person band to an orchestra

Most businesses start like a one-person band. The owner plays all the instruments, some better than others, but all out of necessity.

Like any musical ensemble, a small business includes many roles. In the beginning, the owners are often the best at making or delivering the product or service. Since they have the most at stake, they often assume a wide variety of roles, including sales, accounting, and much more.

Through a combination of skill, planning, talent, and perhaps luck, some businesses manage to grow. This growth leads to new and changing roles in the business for everyone, including the owner. Of all the roles an owner has in the business, perhaps the most important one is to be the *designer* for the business.

In the role of chief designer, business owners have three critical duties:

- **Provide the vision and direction for the company.** Owners set the direction for the values of the company, develop its product and service strategies, and set the tone for its relationships with customers.
- **Develop and refine processes and procedures.** Owners design the "business model", or the big picture formulas and processes of doing business. Then, they must fill in the details by analyzing processes and finding bottlenecks.
- **Create the organization's human resource structure.** Owners identify the positions and types of people the business needs, and then they find the people to fill those roles. In the words of Jim Collins, author of the bestseller *Good to Great*, "Get the right people on the bus, the wrong people off the bus, and get everyone in the right seats."

The payoff for a well-designed business is immense. With clarity of vision, expectations and processes, and with the right people pulling together, there is a strong foundation for growth. Instead of a grim "never take a day off" grind, the business owner can now enjoy the ride—and maybe take a day off from time to time. It is also now possible for the owner to think about a profitable exit, because a business that can run without the owner is worth a lot more than one that falls apart when he or she is not at the controls.

Owners of a growing business eventually have to decide how to organize employees and delegate authority. Doing so can be a frustrating task for many entrepreneurs. Most would rather concentrate on closing sales, producing product, or managing cash. However, they do so at the peril of putting off planning for the future needs of their enterprise.

Organizational issues

Entrepreneurs typically know when their company needs a structural overhaul. The owner can no longer juggle all the critical day-to-day activities. Important decisions are delayed, customer contact suffers, employees feel overwhelmed and confused about their and others' roles in the organization. As the employee count rises, someone other than the owner has to manage and be empowered to make critical decisions. The stress generated by these various dysfunctional symptoms eventually reaches a point where the owner has to decide to either continue growing the business (but in a more managed way) or to restrict its growth to effectively manage the firm single-handedly.

Acme Security Company's (the name has been changed to maintain its anonymity) original organizational structure caused many problems for the company, especially as its customer base began to expand.

The company provides security and fire alarm systems for high rise buildings and large corporate and government customers. It had grown to more than 40 employees in a short time, but was finding it increasingly difficult to provide the service customers expected. The company's organizational structure had evolved to meet the needs of the many family members that worked in the company, but not the needs of the customers.

The company had a product-based structure. The departments included Inspection, Maintenance, and Alarm Installation. Each department had a manager, a sales manager, field crews and administrative support. Even though most customers needed and purchased all of the company's services, no one was responsible for meeting the total needs of the customer. Each department focused on getting its work done. The lack of communication and coordination resulted in scheduling snafus and invoicing problems. A growing number of petty details quickly buried the CEO and prevented her from focusing on the important strategic and financial issues facing the company. She was also a bottleneck that contributed to customer service problems. No wonder she kept a candy dish filled with antacids on her desk!

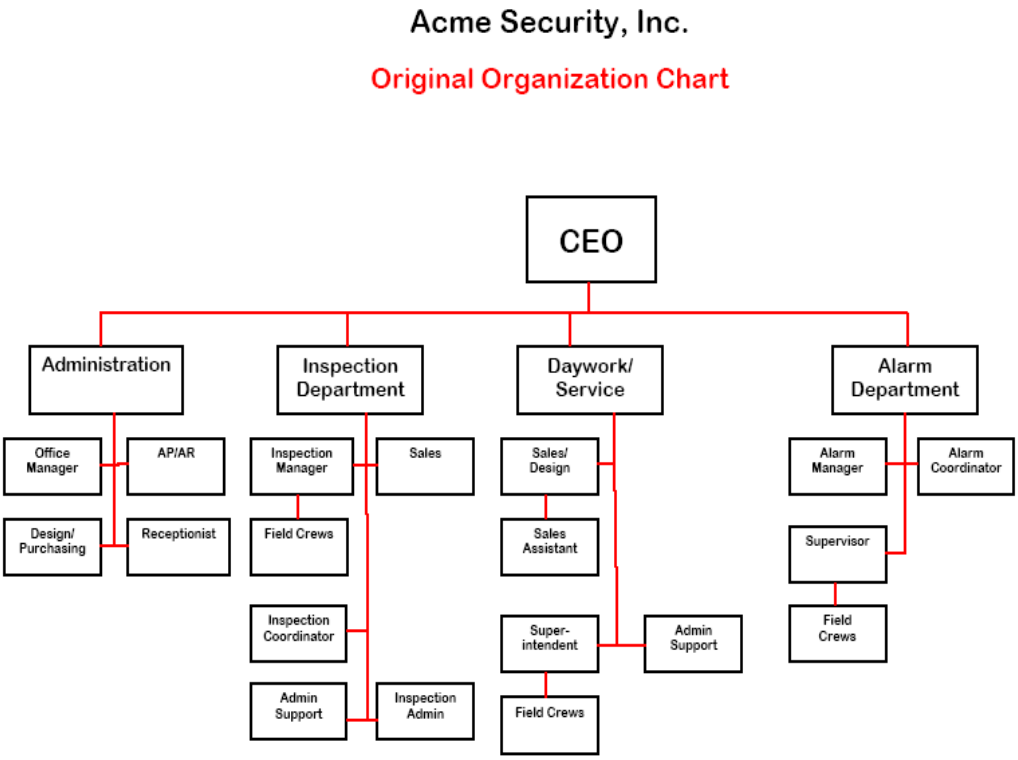

Exhibit 18: A Product-based organization

From the customer's point of view, working with Acme Security was akin to entering a restaurant and having to order the appetizer from the appetizer waiter, entrée from the entrée waiter, and dessert from the dessert waiter. In this scenario, each waiter is only concerned with getting his or her order complete and delivered. The dessert might arrive before the entrée or appetizer. And if the entrée is delivered cold, the other waiters cannot help. Finally, once the meal is over, all the waiters have to get together to figure out the bill. Like Acme Security, the restaurant's structure made it difficult, if not impossible, to deliver quality service.

With the ultimate goal of improving customer service, what should the new and improved Acme Security organizational structure look like? For this company, a function-based rather than a product-based structure was more appropriate. The most important change was to assign one person as the primary contact for each Acme Security customer. This Account Manager would report to the Sales Manager. The new company structure features two other key management positions, an Operations Manager and an Office Manager. These three key managers report to the CEO. The challenge for the CEO was to delegate responsibility and authority to these three managers. Below we will discuss the composition and responsibilities of these three functional departments:

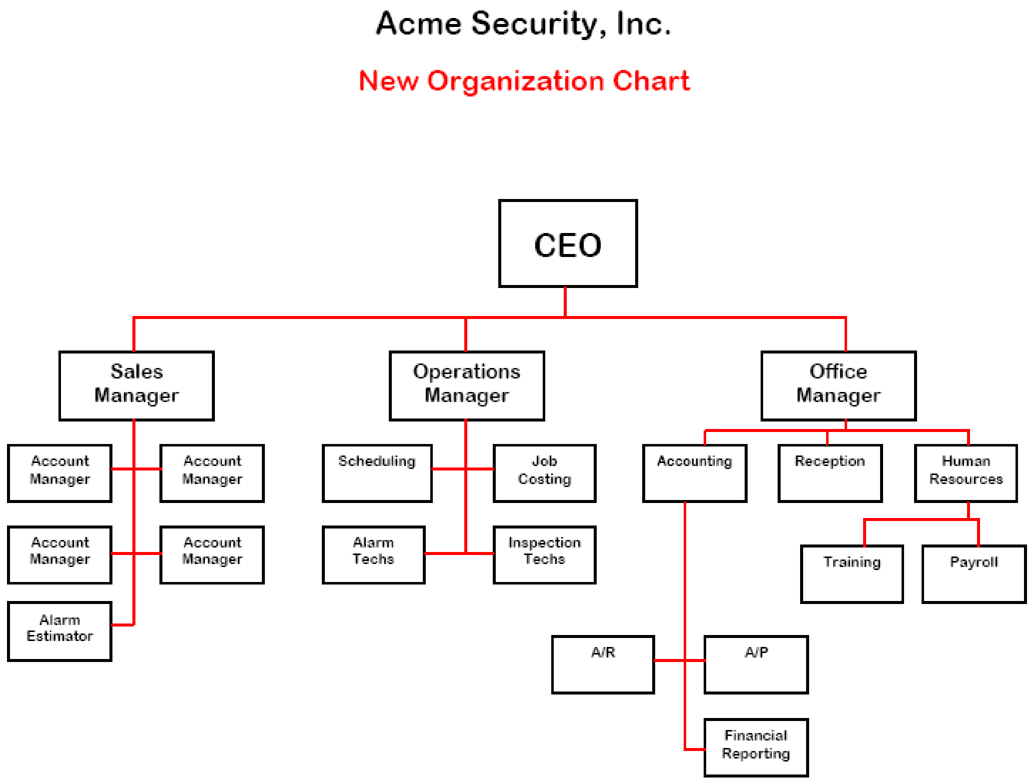

Exhibit 19: A Function-based organization

Sales: *includes the Sales Manager, the account managers and estimators. Account Managers are assigned by building or a major corporate account. This way everyone in the company, and more importantly the customer, knows who is responsible for a question or problem. The Account Manager's primary task is to meet the customer's total needs, and to make sure the invoices for work performed are issued in a timely manner.*

Operations: *includes the operations manager and the field crews. This department includes a position responsible for scheduling all operations work and a position responsible for collecting and entering all job cost information. Operations' primary task is to meet the needs of the Account Manager and the needs of the Office Manager with respect to information required to process invoices and payroll. The department maintains a centralized scheduling system that is accessible to everyone. They notify the Account Manager that a job is complete, provide the necessary job costing and billing information so that the Account Manager can notify accounting that an invoice should be issued.*

Administration *is led by the Office Manager. This department includes the receptionist, Accounting Manager, and Human Resources. This department's primary task is to issue invoices and manage payables, receivables, and to provide management with timely financial reports.*

With improved structure and communication, the CEO of Acme Security can focus on more strategic issues and replace the bowl of antacids with chocolate!

Organizational stages of growth

As an organization grows, it generally progresses through four stages of increasingly formal management structures.[27]

Stage 1: In a one-person operation, the owner does everything: sales, bookkeeping, marketing, production and so on. Many firms remain one-person operations indefinitely due to the owner's family obligations, financial constraints, or contentment with the status quo.

Stage 2: As more people join an organization, the business owner becomes a player-coach. The entrepreneur continues to perform day-to-day tasks, but along with other employees. So the owner assumes additional employee management duties such as hiring, scheduling, supervising, and payroll.

Stage 3: Firms reach a major milestone in organizational development when they add an additional level of supervision. The owner relinquishes some direct control and begins working through an intermediary layer of professional managers.

Stage 4: As a company adds more layers of management and processes, it also adopts written policies, budgets, standardized personnel practices, organizational charts, job descriptions, and control protocols.

Departmentation

New business owners do not ask themselves how they should organize their business. Rather, they organize by objective: what does it take to get a job done, meet a goal or create wealth. How owners organize a company depends on a multitude of factors: for example, are certain tasks performed in-house or out-sourced? Are people (staff and management) with the necessary skills available?

Business scholars have categorized various organizational structures as described below. However, do not assume that a growing business must at one point or another assume one of these structures. Rather, smart entrepreneurs constantly tweak their organizations to remain agile to take advantage of new opportunities or respond to new challenges. Sometimes the changes necessary to move from a small to larger business require gut wrenching decisions: for example, personnel that might have played key roles in establishing a new business might not be the right fit for a larger, more structured organization.

As the business grows, its organizational structure is heavily influenced by function (people grouped with similar responsibilities), process (people involved in similar processes), product (people building a specific product) or projects (members of a project).[28] A firm's structure might be influenced by some or all of these types of departmentation. Large firms usually employ a variety of departmentation styles, selecting the most appropriate form for each subsystem.

27 Longenecker, Justin Gooderl, Moore, Carlos W.; Petty, J. William; Palich, Leslie. (1991). Small Business Management: An Entrepreneurial Emphasis. South-Western College Publishing. Mason, OH.

28 “Entrepreneurial Firms: An Examination of Organizational Structure and Management Roles Across Life Cycle Stages,” Watson, Kathleen M., Plascha, Gerhard R., paper presented at U.S. Association for Small Business and Entrepreneurship annual conference, Baltimore, Maryland, October 1993)

Departmentation by function

Grouping activities by function is the most widely used form of departmentation. Similar activities are housed in a department or under a single chain of command. For example, sales, advertising, public relations, and promotion might be grouped in a marketing department; employee benefits, employee training and employee regulatory compliance may be housed in the human relations department and so on.

Functional departmentation takes advantage of employees' specialization. Employees with similar training, education, skills, or equipment work together and under a supervisor responsible for that department's activities. Because one supervisor typically oversees a major area of activity, functional departmentation also facilitates coordination. For instance in a larger retail operation, one marketing department supervisor would control and coordinate the work of buyers, merchandisers and the sales force so that information and activities of each function would be more efficient and productive.

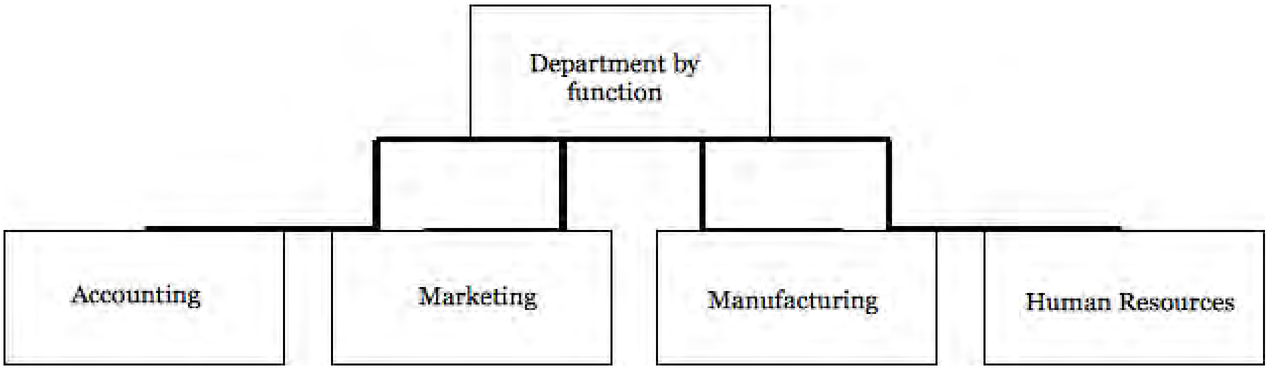

Exhibit 20: Departmentation by function

The process or equipment used in producing a product or service may be the basis for determining departmental units. Since a certain amount of expertise or training is required to handle complicated processes or complex machinery, activities that involve the use of specialized equipment may be grouped into a separate department.

This form of departmentation is similar to functional departmentation. The grouping of all milling machines into one department or the placing of lathes in another department is illustrative of departmentation by equipment or process. As a further example, a large food products firm may be departmentalized by processes such as manufacturing, package design, distribution, and shipping.77

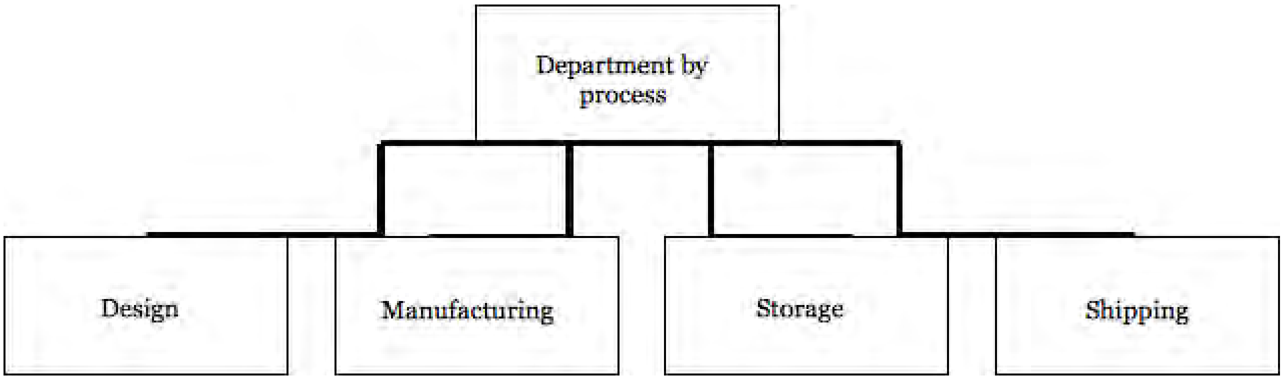

Exhibit 21: Departmentation by process

Departmentation by products

Companies with diversified product lines frequently create departmental units based on the product. To departmentalize on a product basis means to establish each major product in a product line as an independent unit within the overall structure of the company. For instance, retail stores may organize their operations to meet the needs of specific customer groups by forming special departments to cater to house wares, menswear, children's clothing and so forth. Product departmentation can be a useful guide for grouping activities in service businesses as well. Many banks have separate departments for mortgages, checking accounts and commercial loans.

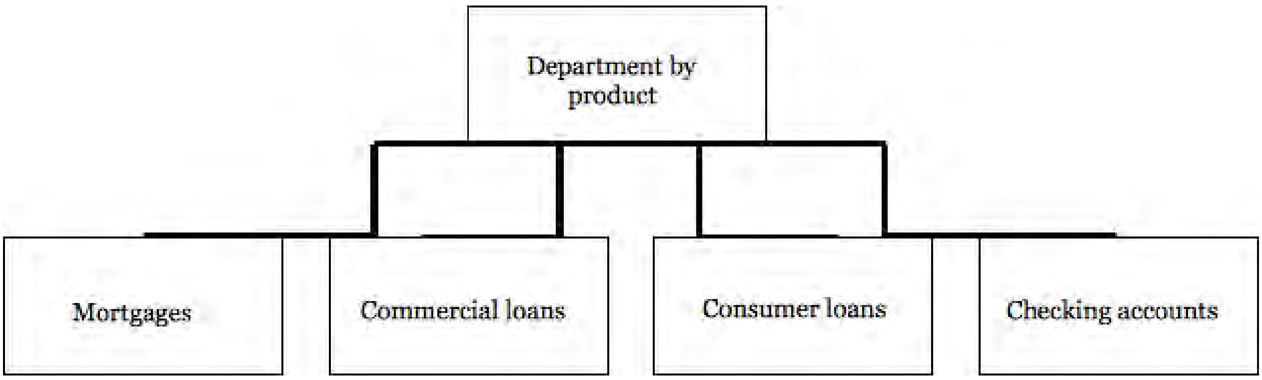

Exhibit 22: Departmentation by product

Departmentation by projects

Project organizations are specifically designed to deal with changing environments. A project in this sense is a series of related activities required to accomplish a work outcome, such as the development of a new product. Projects and task forces or teams are generally unique—designed to work on a nonrecurring project. They are tightly organized units under the direction of a manager with broad powers of authority.

A team is given a project with specific tasks or operational concerns. This team is composed of employees from the firm who have expertise or skills that can be applied directly to the project. The members of the team manage the project without direct supervision and assume responsibility for the results. When work teams function well, the need for a large number of supervisors decreases.

Departmentation by matrix

Some firms are organized by using a mix of departmentation types (matrix organization). It is not unusual to see firms that utilize the function and project organization combination. The same is true for process and project as well as other combinations. For instance, a large hospital could have an accounting department, surgery department, marketing department, and a satellite center project team that make up its organizational structure.

- Once the bases for departmentation are determined, another problem of structure immediately arises concerning how many departments or how many individual workers should be placed under the direction of one manager. This is referred to as a span of management or span of control issue. A number of factors should be considered when deciding upon a span of control:
  - the complexity of the subordinates' jobs and need for interaction with management
  - the complexity of the supervisors' jobs
  - the competence of the supervisors and subordinates
  - the number and nature of the supervisors' other interactions with non-subordinates
  - the extent to which staff assistants provide support.

Flat versus tall organizations

By definition, a small business is typically a flat, centralized organization. The founder/owner is the boss and makes all the critical decisions. However, as the personnel count grows, the firm's structure typically expands either horizontally (flat) or vertically (tall). Again, various factors including the owner's management style, might affect what type of structure a business assumes.

Flat organizations

Flat organizations follow the decentralized approach, or organic system. There are fewer levels of management which creates an environment for faster growth and response between all levels. Organizations that follow this type of structure have wider spans of supervisory control and have more horizontal communication. This type of structure promotes task interdependence with less attention to formal procedures.

More decisions are made at the middle levels of the organization. They are less bureaucratic and less structured. Externally, the organization as a whole becomes more adaptable to its market and can quickly react to changes. Internally, the organization as a whole encourages more participation between all levels of the organization. As a result, all levels have the potential of working more closely together which enhances a closer working environment with better communication and creativity.

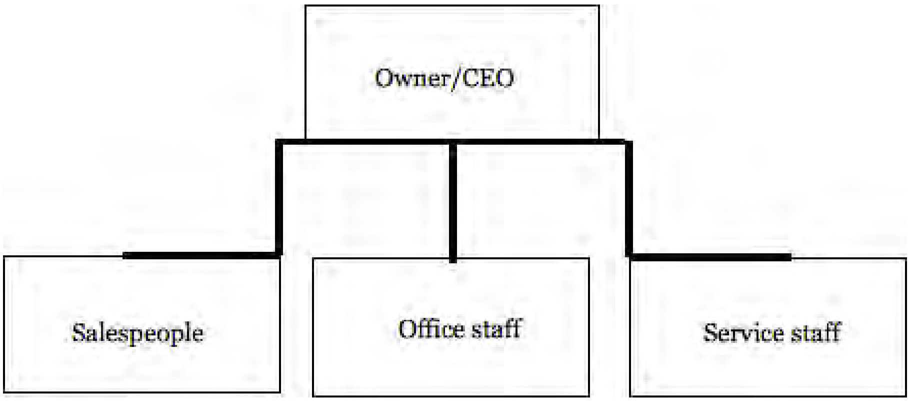

Exhibit 23: Flat organization

Tall organizations

A tall structure is a more formal, bureaucratic organization or mechanistic system. In this environment, multiple levels of management control decision making processes and employees within the organization. When numerous levels become involved in daily operations, decision-making tends to be more impersonal. Since this type of structure has more levels, the division of labor is much more specialized. Departments can become more compartmentalized, which increases the communication within them, but does not lend itself to communication with other departments.

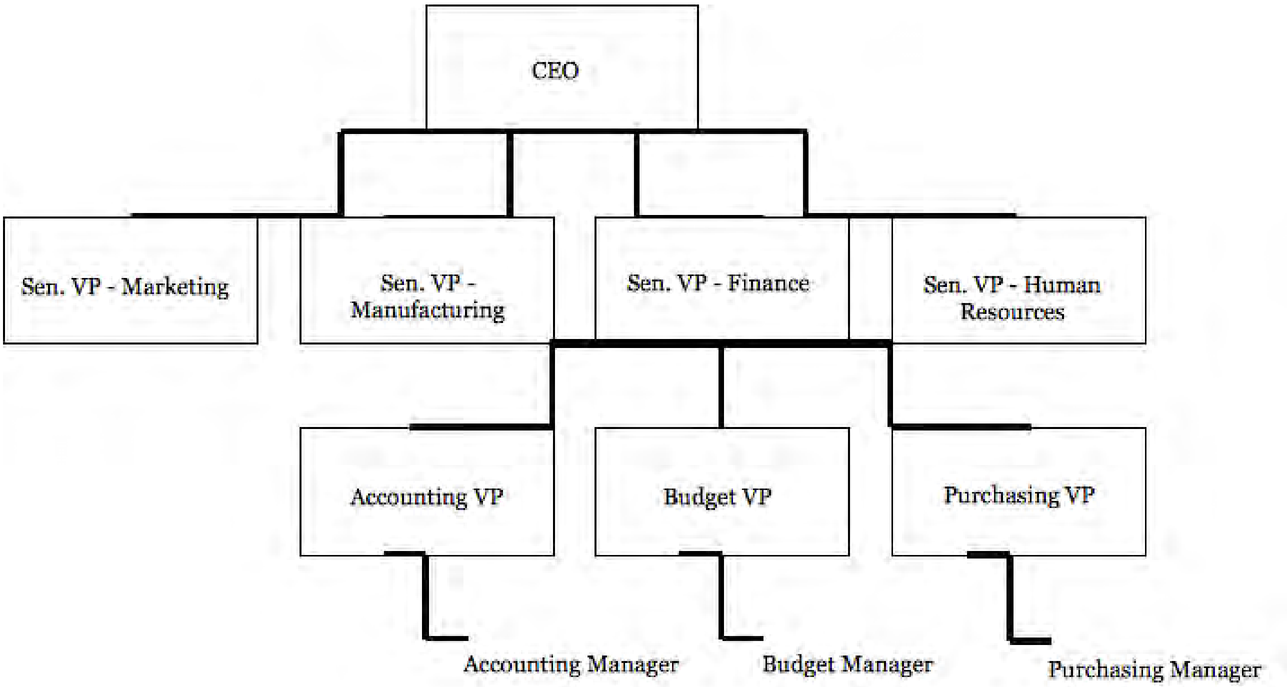

Exhibit 24: Tall organization

Centralized versus decentralized organizations

Communication is essential to disseminate information throughout organizations and can take place at many levels. There are two communication models that are utilized—centralized and decentralized. Again, each style can be effective depending on the environment and each has its advantages and disadvantages, as are outlined below.

Centralized

Centralized organizations require communications flow through a central person or location. Single leaders are prominent and have a great deal of decision-making power. These persons have access to more information and can therefore exercise a great deal of influence over group members by controlling the flow of critical information.

One disadvantage to centralized communication is that as the organization grows, the amount of information can overwhelm the central hub (person or department) that processes this information. One advantage to the centralized approach is that it encourages standardized processes that typically result in cost savings and better quality control.

Decentralized

Decentralized organizations tend to utilize many channels of information flow, allowing for more open communication between group members. This model is more conducive to solving complex problems.

One of the major advantages to decentralized communication is that problems and processes can be solved and changed in a timely manner. Also, the needs of customers and employees are more easily and quickly met because fewer levels of management are involved.

A major disadvantage to a decentralized organization is that departments can easily lose sight of the organization's common mission. To ensure organizations stay on task, upper management should maintain open lines of communication with local management.

Chapter summary

So how does an owner begin to digest and pick between all the choices (function, product, process, project or matrix structure, flat versus tall, centralized versus decentralized) available when it comes to organizing a business?

To design a better business, owners should take these steps:

- Schedule time to work on the business. This applies to start-ups and established businesses. There is an old saying, "If you are chopping wood, you need to take some time to sharpen the axe".
- Write everything down. Document all job descriptions, processes, and procedures, and then refine the processes so the result is reliable and high quality output. In his book *The E-Myth*, Michael Gerber makes the case that entrepreneurs should build and document their business as if it were the first of 5,000 locations, even if they never plan to expand.
- Try to become unimportant to the day-to-day operations. A business that would cease if something happened to the owner has very little value to a potential buyer. If the business is a turn-key operation with documented and reliable processes, it has much greater value to the current owner and future buyers.

- Be prepared to change roles as the business grows. As time goes on, the amount of time an owner spends working in the business should decrease. He or she should embrace the role of a CEO who is working on the business.

In the introduction of this chapter we likened the business owners' role to a musician. In the early stages of the business, the owner had to play every instrument. But if the business is to grow and prosper, the owner must become the conductor of an evolving orchestra. If an orchestra has good musicians, excellent sheet music, and a talented conductor, the result is beautiful music.

US legal issues

Because laws regulating business vary greatly by country and locale, entrepreneurs should pick a legal entity for their business in consultation with a local attorney that specializes in business law. The legal issues discussed below reflect general practices in the United States where laws governing business vary not only by state, but by local jurisdictions within states.

Businesses activities are organized either by individuals, couples or groups of people.

Businesses with one owner (the most common and referred to as sole proprietorships in the United States) can be launched without any legal assistance, and depending on the location, with or without certain permits.

Businesses with multiple owners typically write out explicit guidelines regarding investment and management issues using one of several types of legal agreements designed specifically for business organizations. Thus, one of the first decisions facing new business owners is deciding what legal entity to use for their business. That decision-making process typically weighs the following issues:

(a) how much time or involvement in the business is required

(b) what skills are required

(c) degree of risk associated with the business

(d) amount of capital needed

(e) tax regulations on labor and income earned by the business

In the United States, there are four basic types of business operations:

1. Sole proprietorships

A sole proprietorship is an individual owner of a business (with or without employees). This type of operation is the simplest to form, and the single owner, or sole proprietor, may work as much or as little time as desired. The sole proprietor is generally held accountable for all products and/or services produced by the business, as well as debts and liabilities of the business. Since the owner's personal liability extends well beyond amounts invested in the business or even beyond assets purchased by the business, this type of operation is considered high risk.

The amount of capital required to start a sole proprietorship is generally minimal.

In addition to sole ownership of all assets and liabilities, the proprietor benefits by receiving all profits, which in the United States are taxed as part of the owner's total personal income. The sole proprietor may employ workers or engage independent contractors to increase skills available, but the business ceases to exist upon the owner's death.

A sole proprietor business can be organized at any time into a different legal entity. The owner often decides to reorganize when profits substantially increase the individual's tax liability.

2. Partnerships

When two or more family members or people join together in a business operation, they may choose to establish a partnership which can take the form of a general or limited liability partnership. General partnerships are similar to the combination of a group of sole proprietorships in that the partners share workloads, profits, and liabilities. Limited Liability Partnerships, however, usually include one or more partners who manage daily operations and are generally liable for the debts of the business while other limited partners risk their investment in anticipation of profits.

Initial agreement is essential concerning how the partnership will operate, who will manage daily operations, how profits will be disbursed, and who assumes liabilities and debts. Such an agreement is normally formalized in writing and is known as a "Partnership Agreement".

Partnerships, like sole proprietorships, are generally dissolved upon the death of a partner. Profits are shared in accordance with terms of the Partnership Agreement and reported to taxing authorities on personal tax returns of the partners.

3. Corporations

In the United States, corporations are considered separate legal entities that are chartered and regulated by an authority in each state, such as the Secretary of State. Additionally, a separate agent who acts on behalf of the corporate entity is identified in the initial application process to receive legal notifications. Corporations must also submit identification and governing documents such as Articles of Incorporation and By-Laws. Corporate entities are generally required to be kept in active status through annual updates to a regulatory authority. As a result, this type of entity is deemed slightly more complex to form and manage.

Corporations require investment by one of more owners who are known as "shareholders" or "stockholders", and the amount of investment varies depending on the needs of the business. Since this form of entity provides protection (widely known as the "corporate veil") for the personal assets of owners against certain types of claims, it is generally of lower risk. Corporate entities may vary in numbers of owners from a single shareholder to an unlimited number. States and federal agencies regulate financial activities and reporting requirements that are categorized by the number of shareholders and whether their shares are available to purchase and sell on public stock exchanges. For example, US corporations with publicly traded shares are regulated by the US Securities and Exchange Commission.

The corporation may employ workers and engage independent contractors as needed to increase skills available. Corporations are required, however, to acknowledge formally (in a written document) the individuals who are approved to engage in financial transactions on behalf of the entity.

In the United States, the Internal Revenue Service regulates federal tax codes. There are two taxing options for earnings of corporations: a progressive structure on profits for the traditional corporation and another that allows owners to "flow-through" profits to their personal tax returns.

4. The Limited Liability Company (LLC)

In the United States, the Limited Liability Company (LLC) is the entity of choice for the owner or owners who prefer the limited liability afforded by a corporation and a tax treatment that allows profits to flow from the business to the owner or owners. The LLC must also be registered with a State authority, but requires less documented structure. Ownership is acknowledged by percentage as opposed to number of shares and protection for the owners is similar to that of a corporation.

Discussion questions

- Describe the characteristics of each of the four stages of growth a business organization might experience?
- Describe the advantages and disadvantages of a flat versus tall organizational structure.
- Given your personality and past experience, do you prefer working in a flat or tall organization and why?
- What are the characteristics of the four types of business legal entities?

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Gerber, Michel E. (1995). *E-Myth Revisited: Why Most Small Businesses Don't Work and What to Do About It*. HarperCollins Publishers, Inc. New York, NY.