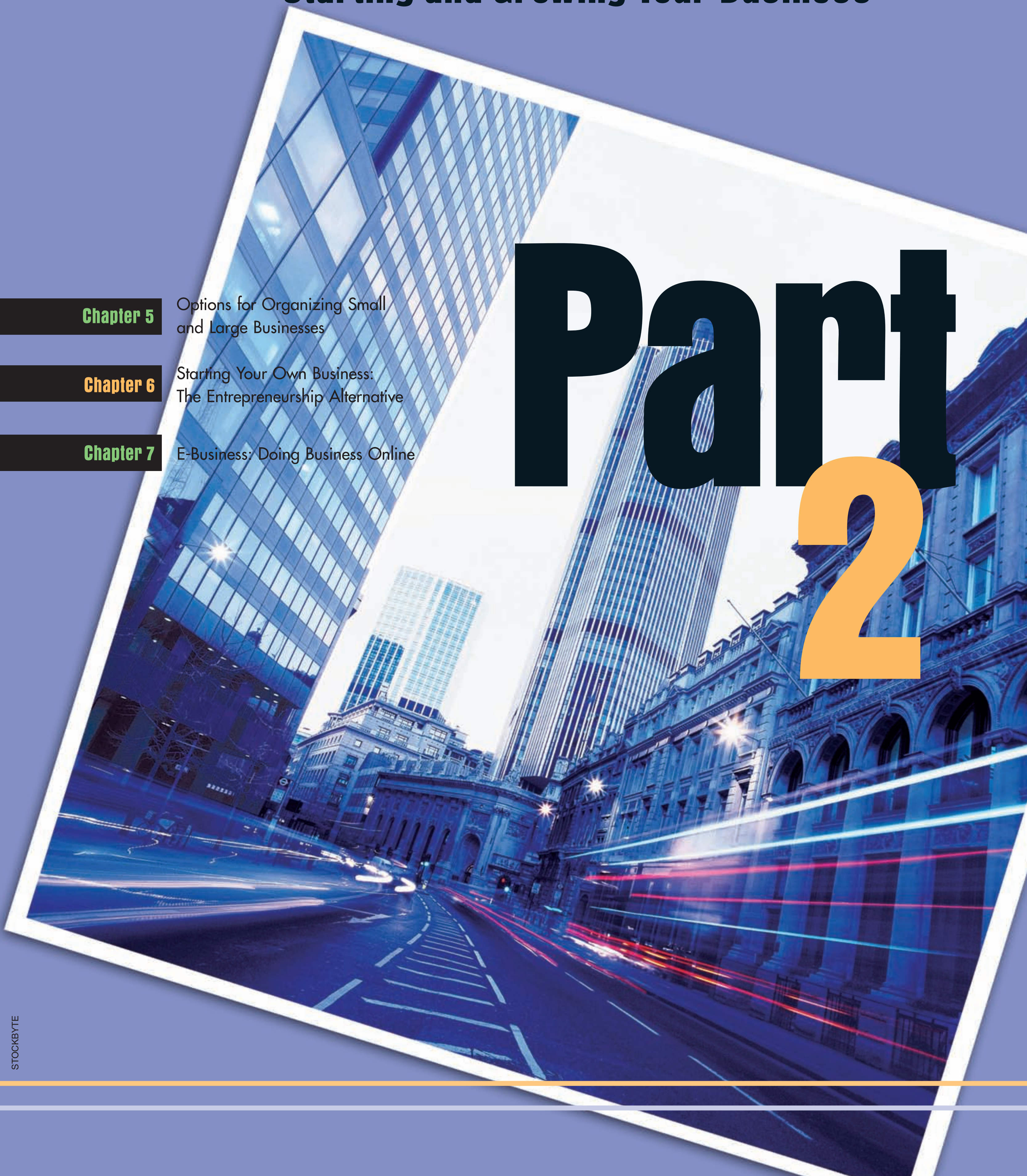
Part 2

Starting and Growing Your Business

Chapter 5 Options for Organizing Small and Large Businesses

Chapter 6 Starting Your Own Business: The Entrepreneurship Alternative

Chapter 7 E-Business: Doing Business Online



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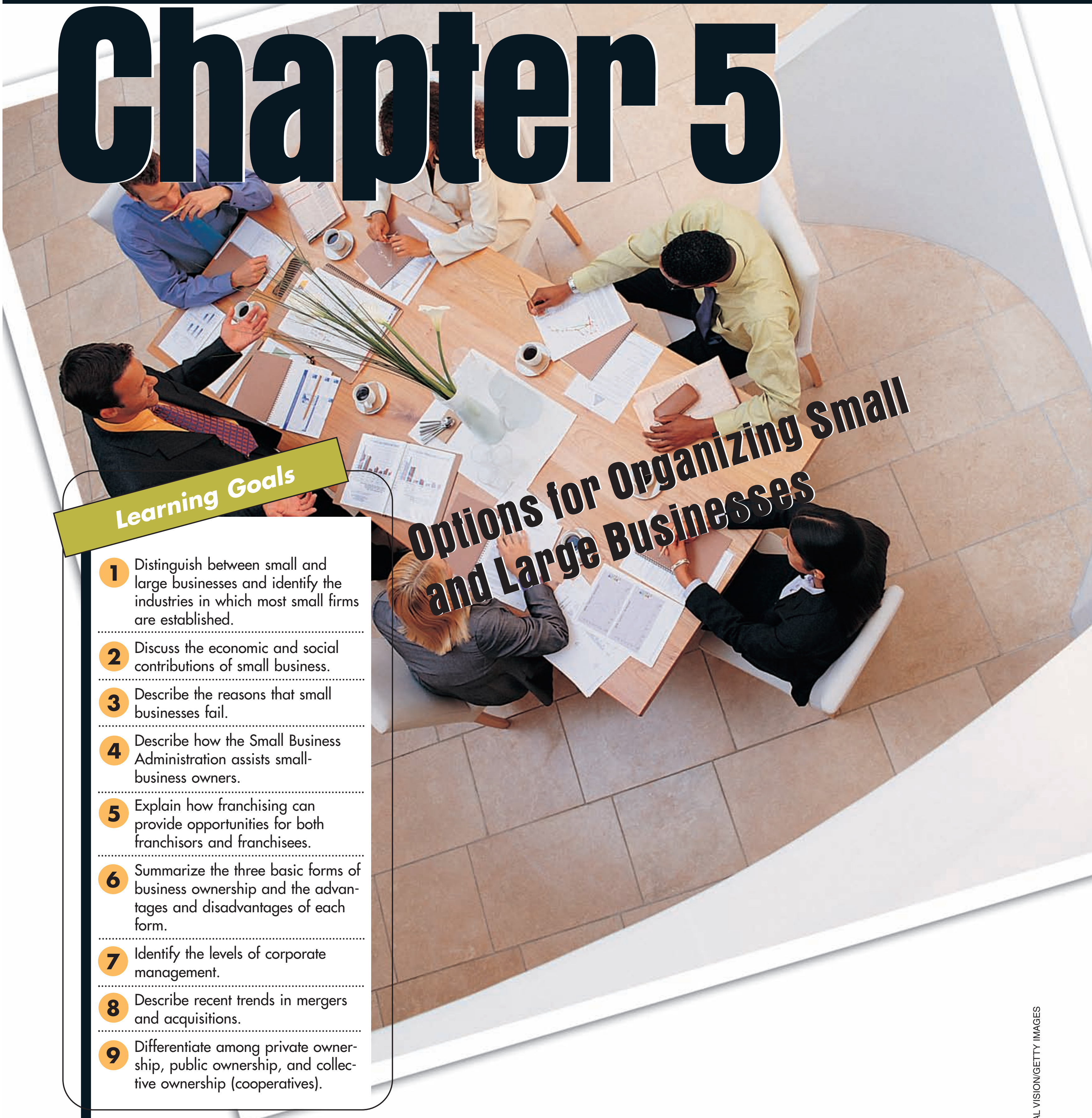
Chapter 5

Options for Organizing Small and Large Businesses



DIGITAL VISION/GETTY IMAGES

Learning Goals

1. Distinguish between small and large businesses and identify the industries in which most small firms are established.
2. Discuss the economic and social contributions of small business.
3. Describe the reasons that small businesses fail.
4. Describe how the Small Business Administration assists small-business owners.
5. Explain how franchising can provide opportunities for both franchisors and franchisees.
6. Summarize the three basic forms of business ownership and the advantages and disadvantages of each form.
7. Identify the levels of corporate management.
8. Describe recent trends in mergers and acquisitions.
9. Differentiate among private ownership, public ownership, and collective ownership (cooperatives).

Pollo Campero Feeds Hungry Fans—and Their Nostalgia for Home

More than 30 years ago, Don Dionisio Gutierrez and his father, Don Juan Bautista Gutierrez, opened the first Pollo Campero restaurant in their native Guatemala. The new owners probably never thought it would grow into a hugely popular worldwide chain. Yet today Pollo Campero's quick-serve chicken restaurants have millions of ardent fans who love the authentic recipes and nostalgic atmosphere enough to wait in line to get in. Each new-store opening is a big event in its community; when the first Pollo Campero opened in New York City, the mayor attended the ribbon-cutting ceremony.

An immediate hit at home in Guatemala, Pollo Campero—meaning, roughly, "country chicken"—soon became the centerpiece of many well-remembered special occasions, such as family gatherings and celebrations for blue-collar workers and business executives alike. "This is something very special," said one U.S. customer who grew up in Guatemala City. "It's part of all of our childhoods. It's a piece of our homelands." Says another native Guatemalan now living in Texas, "Every time we had extra money or it was someone's birthday, we'd head for Pollo Campero." When customers emigrated, they brought their fondness for Pollo Campero with them.

The chain's unique fried chicken specialty, with its spicy secret ingredients, grew popular in other Latin American countries as well, and the chain opened stores in Ecuador, Honduras, El Salvador, Nicaragua, and Mexico. Soon U.S. customers traveling to Latin America became aware of Pollo Campero's unique appeal. After selling about 3 million take-out orders from airports in Central America, which both Americans and nostalgic Guatemalans were taking home on the plane to their family and friends, the company opened its first U.S. restaurant in Los Angeles in 2002.

Today the chain comprises about 200 restaurants. Almost 20 of them are franchises in the United States. "We are very proud to be the first restaurant of our kind in the U.S.," says president and CEO Juan Jose Gutierrez,

AP PHOTO/PAT SULLIVAN

"a brand created and developed in Latin America, featuring the favorite dishes of many Latin American countries and offering top-quality service and product to our loyal customers from home and our new and valued customers in the U.S." Children are always welcome, and the restaurants and service standards are definitely family friendly. Charity events, community involvement, and top employee benefits help strengthen the chain's image wherever it goes.

Although the quick-serve market is nearly saturated, Pollo Campero franchises in the United States are expected to grow. "The number of sites we open next year is limited only by how quickly we can find sites and build restaurants," said Jose Cofiño, CEO of the master franchisor for the western United States. One reason for the high expectations is that black and Asian customers are discovering Pollo Campero, and as one restaurant consultant noted, the public clearly sees the chain as "something different or better" in the crowded fast-food market. Once people taste the menu, they tend to come back, even when advertising and promotion are minimal.

Cofiño defines the competition not just as other chicken outlets but also as all eateries: "Somebody is eating across the street," he says in speaking of competitors. "Why are they eating there and not here?" If Pollo Campero continues to offer the special recipes that have filled countless airplanes with mouth-watering smells, that question won't need to be asked again.[1]

ChapterOverview

If you have ever thought of operating your own business, you are not alone. In fact, on any given day in the United States, more people are trying to start new businesses than are getting married or having children. However, before entering the world of contemporary business, an entrepreneur needs to understand its framework and choose the form the business will take, as Pollo Campero's owners did when they expanded the business to the United States as a series of franchises.

Several variables affect the choice of the best way to organize your business:

- How easily can you set up this type of organization?
- How much financial liability can you afford to accept?
- What financial resources do you have?
- What strengths and weaknesses do you see in other businesses in the industry?
- What are your own strengths and weaknesses?

This chapter begins by focusing on small-business ownership, including the advantages and disadvantages of small-business ventures, the contributions of small business to the economy, and why small businesses succeed and fail. We also look at the services provided by the U.S. government's Small Business Administration. The role of women and minorities in small business is discussed in detail, as well as franchising and global opportunities for small-business owners. We then provide an overview of the three forms of private business ownership—sole proprietorships, partnerships, and corporations. Next, the structures and operations typical of larger companies are explored, followed by a review of mergers, acquisitions, and joint ventures. The chapter concludes with an explanation of public and collective ownership.

MOST BUSINESSES ARE SMALL BUSINESSES

Although many people associate the term *business* with corporate goliaths such as ExxonMobil, Ford, PepsiCo, Pfizer, Microsoft, and Wal-Mart, 89 percent of firms with employees have fewer than 20 people on staff, and 98 percent have fewer than 100 employees.[2] Many U.S. businesses have no payroll at all: more than 15 million people in the United States earn business income without any employees.[3] Almost half the sales in the United States are made by small businesses.[4]

Small business is also the launching pad for entrepreneurs from every sector of the diverse U.S. economy. Thirty-four percent of the nation's 17 million small businesses are owned by women.[5] Hispanic-owned businesses account for 5.8 percent of all U.S. businesses with fewer than 100 employees. Asian Americans own another 4.4 percent, and African Americans own 4 percent.[6]

"They Said It"

"Successful people have control over the time in their life. A shoemaker who owns his own shop gets up one morning and says, 'I'm not opening.' That's a successful guy."
Rod Steiger (1925–2002)
American actor

What Is a Small Business?

How do you distinguish a small business from a large one? Are sales the key indicator? What about market share or number of employees? The Small Business Administration (SBA), the federal agency most directly involved with this sector of the economy, considers a **small business** to be a firm that is independently owned and operated and is not dominant in its field. The SBA also considers annual sales and number of employees to identify small businesses for specific industries.

small business firm that is independently owned and operated, is not dominant in its field, and meets industry-specific size standards for income or number of employees.

- Most manufacturing businesses are considered small if they employ fewer than 500 workers.
- To be considered small, wholesalers must employ no more than 100 workers.
- Most kinds of retailers and other services can generate up to $6 million in annual sales and still be considered a small business.
- An agricultural business is generally considered small if its sales are no more than $750,000 a year.[7]

The SBA has established size standards for specific industries. These standards, which range from $500,000 to $25 million in sales and from 100 to 1,500 for employees, are available at the SBA's "What Is a Small Business" Web page, http://www.sba.gov/size.

An excellent example of a small business—and its owner—is Barbara Kavovit, founder of New York City–based Barbara K! Enterprises, which sells user-friendly tool kits to women who are inexperienced do-it-yourselfers. Kits come in blue-gray cases that contain easy-to-understand instructions plus all the tools and parts needed for household repairs. Roadside safety and dorm survival kits are also available on the company's Web site or at Home Depot and JCPenney stores.[8] Barbara K!—a $5 million company—has an appropriate motto: "If I can do it, so can you."

Because government agencies offer benefits designed to help small businesses compete with larger firms, small-business owners want to determine whether their companies meet the standards for small-business designation. If it qualifies, a company may be eligible for government loans or for government purchasing programs that encourage proposals from smaller suppliers.

AP PHOTO/TAMMIE ARROYO

Barbara Kavovit started her first small business as a general contractor in New York City and worked for corporate clients such as IBM, Carnegie Hall, and Polo Ralph Lauren. She started Barbara K! to make power tools and do-it-yourself kits easier for women to use.

Typical Small-Business Ventures

For decades, small businesses have competed against some of the world's largest organizations, as well as multitudes of other small companies. For example, Shoes for Crews, a 160-employee manufacturer of work shoes in West Palm Beach, Florida, competes against much larger shoe companies, such as Wolverine and Timberland, which have more than 5,000 employees and sales of $1 billion and $1.5 billion, respectively. How can it compete against these big firms? By offering a serious nonslip guarantee. If a worker slips and falls while wearing its shoes, it pays up to $5,000 per claim. That guarantee is why the Cheesecake Factory, which employs 25,000 employees in 97 restaurants, encourages its workers to buy from Shoes for Crews. Vice President Kurt Leisure said, "The warranty is obviously a big incentive for us to get as many employees as possible into their shoes. It's very shrewd on their part."[9]

The past fifteen years have seen a steady erosion of small businesses in many industries as larger firms have bought out small independent businesses and replaced them with larger operations. For example, the number of independent bookstores and hardware stores has fallen dramatically as Borders Books, Barnes & Noble, Home Depot, and Lowe's have dramatically increased their stores over the last decade. But as Table 5.1 reveals, the businesses least likely to be gobbled up and consolidated into larger firms are those that sell services, not things; rely on consumer trust and proximity; and keep their overhead costs low.

For centuries, most nonfarming small businesses have been concentrated in retailing and the service industries. Recently many entrepreneurs have started successful businesses by providing time-starved homeowners with customized services such as housekeeping, lawn care, and home and computer repair. The small size of such a business allows it to cater to customers in ways that big companies can't. See the accompanying "Business Etiquette" feature for some ideas about how to manage an operation that requires working in other people's homes and on their property.

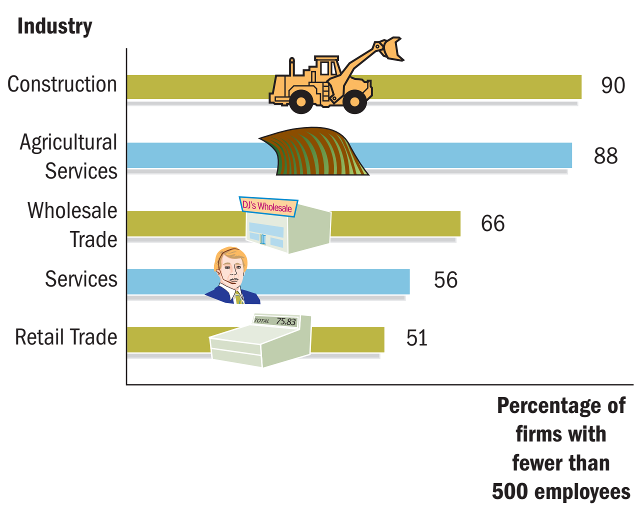
Table 5.1 David vs. Goliath: Business Sectors Most Dominated and Least Dominated by Small Firms

Most Likely to Be a Small Firm	Fewer Than 20 Workers
Home builders	97%
Florists	97%
Hair salons	96%
Auto repair	96%
Funeral homes	94%
Least Likely to Be a Small Firm	**Fewer Than 20 Workers**
Paper mills	25%
Nursing homes	27%
Oil pipelines	33%
Electric utilities	42%
Railroad car makers	42%

Source: U.S. Census Bureau, "Number of Firms, Number of Establishments, Employment, and Annual Payroll by Employment Size of the Enterprise for the United States, All Industries," accessed August 31, 2005, http://www.census.gov.

As Figure 5.1 indicates, small businesses provide most jobs in the construction, agricultural services, wholesale trade, services, and retail trade industries. Retailing is another important industry for today's small businessperson. Merchandising giants such as Target and Wal-Mart may be the best-known retailing firms, but small, privately owned retail stores far outnumber them. Small-business retailing includes stores that sell shoes, jewelry, office supplies and stationery, clothing, flowers, drugs, convenience foods, and thousands of other products. People wishing to form their own business have always been attracted to retailing because of the ability to start a firm with limited funds, rent a store rather than build a facility, create a Web site, and use family members to staff the new business.

Figure 5.1 Major Industries Dominated by Small Businesses



Source: Office of Advocacy, U.S. Small Business Administration, "Small Business Profile: United States," accessed June 17, 2006, http://www.sba.gov/advo.

Powell's Books, based in Portland, Oregon, is one of the most successful retail bookstores in the United States. In contrast to "big box" superstores such as Barnes & Noble and Books-A-Million, which use their huge buying power to secure lower prices for large orders and Amazon.com's well-known high-tech, stock-everything strategy, Powell's competes by specializing in used, sometimes hard-to-find, books. Through its seven bookstores and its Web site (http://www.powells.com), Powell's serves customers who like buying from an independent store instead of one of the larger chains and who don't mind paying extra to find something special to read. Their unique strategies permit Powell's and Amazon to benefit one another. Powell's buys returned books from Amazon.com at a discount and sells them as used books. Amazon fills orders for out-of-print books through Powell's. This strategy will never make Powell's the largest bookseller, but that is just fine with the retailer's founder, Michael Powell.[10]

Small business also plays a significant role in agriculture. Although most farm acreage is in the hands of large corporate farms, most farmers still operate as small businesses. Most U.S. farms are owned by individual farmers or families, not partners or shareholders.[11] The family farm is a classic example of a small-business operation. It is independently owned and operated, with relatively few employees, relying instead on the labor of family members. But today's small farmers must combine savvy business and marketing techniques to thrive, like California-based Earthbound Farm (http://www.ebfarm.com), which grows, packages, and sells organic salads, vegetables, fruits, and dried fruits.

Just over half of small businesses in the United States are **home-based businesses**—firms operated from the residence of the business owner.[12] Between 1960 and 1980, fewer people worked at home, largely because the number of farmers, doctors, and lawyers in home-based practices was declining. But since then, the number of people working at home has more than doubled. A major factor in this growth is the increased availability of personal computers with access to the Internet and other communications devices such as fax machines and cell phones. As computer technology evolves rapidly and more workers prefer the flexibility of working from alternative locations, it is predicted that the number of home-based businesses will grow even faster.[13] Sometimes, however, office space is needed for a meeting or conference or to convey an image of solidity and professionalism. New options for renting such space are springing up in response to the growth of small business, but owners should be wary about projecting an image they can't live up to, as the "Solving an Ethical Controversy" feature discusses.

Lower costs are one of the main reasons that the number of home-based businesses is growing so quickly. Financing a small business is a difficult challenge, so by not leasing or maintaining separate office or warehouse space, a home-based business owner can pour precious

(b)usiness (e)tiquette

Tips for Your Small Business When Working in Customers' Homes

A growing number of entrepreneurs are starting businesses that operate in other people's homes. Housekeeping, handyman, home improvement, lawn care, computer repair, and other service-based businesses are experiencing rapid growth, and their owners and employees need to be considerate about working in customers' private spaces. Here are some tips for in-home services of all kinds.

1. Wear (or have employees wear) a uniform, not only to establish a sense of professionalism but also to identify yourself and your business to the customer.
2. Be on time. Allow yourself extra time for traffic or other problems, and phone if a delay is unavoidable.
3. Take two steps backward after ringing the doorbell, remove your sunglasses if any, and present your business card when the door is opened.
4. If no adults are at home, wait in your car or truck until a parent arrives.
5. If the homeowner needs to prepare for your work by clearing up toys from the floor or yard, confining a dog, or making sure the yard or pool is not in use, call the night before to remind the customer to expect you.
6. Keep your eyes to yourself; never pry into customers' belongings or areas that are off-limits. As one owner of a handyman franchise suggests, "Pretend everything you see is perfectly normal."
7. Never use foul language while working in the client's home.
8. Be considerate. Always advise the customer before using any machinery that's noisy, use tarps or drop cloths, and contain and remove any waste or debris. Take special care not to leave any tools or equipment behind.
9. Avoid becoming involved in any conversations that might be going on in the home, particularly disagreements.
10. Remember that satisfying the customer is what a service business is all about. If the customer isn't happy, make whatever adjustments are needed to satisfy the promises you've made.

Sources: Gwendolyn Bounds, "Handyman Etiquette: Stay Calm, Avert Eyes," *Wall Street Journal Online*, accessed June 17, 2006, http://www.startupjournal.com; Deborah Crawford, "Great Customer Service," Bella Online, accessed June 17, 2006, http://www.bellaonline.com; "Lawn Care Success Tip of the Week," Lawn Care Success, accessed September 16, 2005, http://www.lawncaresuccess.com.

IS IT ETHICAL TO MAKE YOUR BUSINESS APPEAR LARGER THAN IT IS?

What if clients want to visit your office, but you don't have one? Or what if it's damp and dark because it's your basement? Many shoestring entrepreneurs face this problem. A popular new solution is to rent temporary offices equipped with everything from receptionists and bottled water to computers, fax machines, potted plants and paintings, videoconferencing capability, and voice-mail services.

Some "flex spaces" offer technology support, mail delivery, maintenance, security, and even fellow renters to network with. Convenient leases cost a fraction of what permanent space commands, but while flex space helps start-ups appear large and well established, there are dangers.

"There is a fine line between fraud and puffery," says an ethics professor at UCLA. "When you cross the line is when you have a client with a big project and a lot of money at stake and they're fooled into thinking you're much larger and more capable than you really are."

Tricks that edge entrepreneurs toward that line include filling offices with family members, getting friends to follow up with clients to create the illusion of staff, and printing business cards with different job titles for different occasions.

Should small and entrepreneurial companies try to make themselves seem larger?

PRO

1. Making a business appear larger is a competitive strategy, and no one is lying to the client.
2. If clients think you're on a shoestring budget, they may assume you aren't busy, aren't well established, or have financial difficulties.

CON

1. Clients won't worry about size if you project expertise and reliability. Outsourcing is common these days, so there is nothing to hide or disguise.
2. Pretending you are something you are not is inherently dishonest even if no outright lies are told.

SUMMARY

Partnering with larger companies, attending trade shows, and using promotional tools such as press releases to get mentioned in industry publications are alternate ways to project a big image. As one public-relations CEO says, "You can look bigger; you can use strategies that play on people's perceptions; but if confronted with a question, you'd best tell the truth."

Sources: Kortney Stringer, "Temporary Offices Offer the Best of Both Worlds," *StartupJournal*, accessed June 17, 2006, http://www.startupjournal.com; Geoff Williams, "Creative License," *Entrepreneur*, accessed June 17, 2006, http://www.entrepreneur.com; Nicole Gull, "Move-In Ready," *Inc.*, March 2005, pp. 48, 51.

solving an **ETHICAL** controversy

"They Said It"

"Size certainly matters, and not always in a positive way."
Michael Powell (b. 1941)
Founder and owner, Powell's Books

funds into the business itself. Some home-based business owners have even discovered the benefits of selling their goods through eBay, the online auction site. Ron Jones, who helped his wife Jan start their home-based business, Beads, Creativity, and You, on eBay, said, "If you want to be in business for yourself, it's a great way to do it. It keeps the overhead down—you don't have to have a storefront."[14] The cost of operating from home through eBay is far less than the cost of leasing, staffing, and maintaining a retail store at a high-traffic shopping mall, not to mention the far greater number of consumers eBay reaches.

Other benefits of a home-based business include greater flexibility and freedom from the time and expense of commuting. Drawbacks include isolation and less visibility to customers—except, of course, if your customers visit you online. In that case, they don't care where your office is located.

Many small-business start-ups are more competitive because of the Internet. An estimated three of every five small businesses have an online presence. But the Internet does not automatically guarantee success, as illustrated by the thousands of dot-com failures during the early years of e-commerce. Still, setting up a Web site can be relatively inexpensive and enables a business to reach a huge marketplace.

Tiny Salem Five Cents Savings Bank, a Massachusetts firm with only thirteen branches, has a significant presence on the Internet. It established that presence by acting quickly in the mid-1990s, when Internet banking was still an innovation. Consumers liked the new service and low fees, and before long, Salem Five had attracted thousands of new customers. When bigger banks began adding Internet service, Salem Five honed its focus to New England, where the bank already had a good reputation, and then became the first bank to offer every one of its services, from personal and business banking to mortgages and investing, on the Internet, which earned the company recognition as the Internet Bank of the Year. Today, Salem Five continues to innovate and has opened branches with automated-teller machines and Internet kiosks offering videoconferencing with bank representatives. High technology coupled with concern for customer service keeps Salem Five in business even as the biggest banks spend millions of dollars on advertising.[15]

American business history is filled with inspirational stories of great inventors who launched companies in barns, garages, warehouses, and attics. For young visionaries such as Apple Computer founders Steve Jobs and Steve Wozniak, the logical option for transforming their technical idea into a commercial reality was to begin work in a family garage. The impact of today's entrepreneurs, including home-based businesses, is discussed in more depth in Chapter 6.

Home-based businesses have low costs because their owners aren't spending precious startup funds on office or warehouse space. And as this UPS promotion shows, the only thing that home-based businesses need to ship their products worldwide is an Internet connection, or "About 17 inches."

CONTRIBUTIONS OF SMALL BUSINESS TO THE ECONOMY

Small businesses form the core of the U.S. economy. Businesses with fewer than 500 employees generate 39 percent of total U.S. sales and more than half the nation's gross domestic product. Ninety-two of every 100 U.S. businesses are small businesses. In addition, small businesses employ almost half of the nation's private nonfarm workforce.[16]

assessment check

1. What characteristics does the SBA use to determine whether a business is a small business?
2. Identify three industries in which small businesses are common.

Creating New Jobs

Small businesses make tremendous contributions to the U.S. economy and to society as a whole. One impressive contribution is the number of new jobs created each year by small businesses. While it varies from year to year, on average three of every four new jobs are created by companies with fewer than 500 employees.[17] A significant share of these jobs was created by the smallest companies—those with four or fewer employees. Small firms are dominant factors in many of the industries that have added the most jobs: construction trade contractors, wholesale trade, amusement and recreation, service businesses, restaurants, and engineering and management services.[18]

Even if you never plan to start your own business, you will probably work for a small business at some point in your career. Not only do small firms employ about half of all U.S. workers, but they are more likely than large firms to employ the youngest (and oldest) workers. In addition, as detailed in a later section of this chapter, small businesses offer significant opportunities to women and minorities.

Small businesses also contribute to the economy by hiring workers who traditionally have had difficulty finding jobs at larger firms. Compared with large companies, small businesses are more likely to hire former welfare recipients.[19] Driven in part by their limited budgets,

"They Said It"

"You may not think you're going to make it. You may want to quit. But if you keep your eye on the ball, you can accomplish anything."

Hank Aaron (b. 1934)
American baseball legend

small businesses may be more open to locating in economically depressed areas, where they contribute to rehabilitating neighborhoods and reducing unemployment.

Creating New Industries

The small-business sector also gives entrepreneurs an outlet for developing their ideas and perhaps for creating entirely new industries. Many of today's successful high-tech firms—Microsoft, Dell, Cisco Systems, Yahoo!, and Google—began as small businesses. Most high-tech startups are looking for growth, too, sometimes by moving overseas in creative ways. See the "Hit and Miss" feature for just one example of small business on a global scale.

The growth of new businesses and new industries not only provides new goods and services but also fuels local economies. Tucker Technology provides full-service telecommunications and information technology solutions for *Fortune* 500 companies. Tucker, which is based in Oakland, California, has 132 employees, half of whom live in the local neighborhood. Also, 15 percent of its employees got their jobs when founder Frank Tucker went to community-based organizations that help local people learn new job skills. Tucker said, "I'd see all the human resources on the street corner. Clearly, they had no jobs to go to." So he began hiring them at more than $20 an hour to install network and phone cables in office buildings.[20] For more information on the dramatic effects that small businesses can have on local economies, see http://www.theinnercity100.org.

New industries are sometimes created when small businesses adapt to provide needed services to the larger corporate community. The movement toward corporate downsizing that began in the early 1990s created a demand for other businesses to perform activities previously handled by company employees. Outsourcing such activities as security, maintenance, employee benefits management, and transportation services created opportunities that were often filled by small businesses.

Finally, new industries can be created when small businesses adapt to shifts in consumer interests and preferences. Over the last few years the explosion of wireless Internet access in schools, restaurants, airports, hotels, and cities (some of which are installing wireless access to be used by their entire citizenry) has created tremendous growth opportunities. InterDigital Communications of King of Prussia, Pennsylvania, designs wireless technology chips and devices that are used in mobile phones, personal digital assistants, laptop computers, and other wireless digital devices. With the coming shift to 3G wireless capabilities with speeds up to 2 megabits per second, InterDigital's patents and products will enable consumers to quickly and easily download music, video, and other kinds of digital files and services whenever and wherever they want.[21]

Innovation

Small businesses are much better than large businesses at developing new and better goods and services. Although the DVD rental market was dominated by Blockbuster Video, Reed Hastings knew that there just had to be a better way. Perhaps it was that $40 late fee he had to pay Blockbuster when he forgot to return *Apollo 13*, but Hastings recalls asking himself, "How come movie rentals don't work like a health club, where whether you use it a lot or a little, you get the same charge?" And from that question, Netflix.com, the first successful online DVD rental service, was born.

Today, after just a few years in business, the Californian heads a company with more than 3 million subscribers, a DVD library of 50,000 titles, and revenue approaching $1.2 billion.[22] DVDs are mailed to subscribers and returned in prepaid postage envelopes provided by Netflix. Because they can rent several movies at a time without late fees, Netflix customers rent twice as many movies per month. Netflix is so successful that Wal-Mart discontinued its DVD

HIT & MISS

Tacit Networks Builds a Global Alliance

You've got a hot product or service that you're eager to export overseas. But the problem is that your U.S. operation, while successful, is small—efficient, creative, and experienced, but small. There's no easy way to buy the labor or experience needed to launch overseas operations and deal with differences in language, culture, and legal systems.

That's the problem that faced Tacit Networks, a New Jersey–based technology firm whose software lets networks share files instantly, no matter how far apart they are. With 60 employees and revenue of less than $5 million, Tacit had to come up with a way to build a global business from scratch.

The answer was to find partners first instead of clients. Tacit took its first steps into the European market by contacting technology companies interested in selling just the sort of software Tacit makes. Its first such partner, a London-based tech consulting firm called Solution Centre, agreed to a partnership in which Tacit would sell Solution its software at a 30 to 40 percent discount. Solution sells the software to end users, and Tacit provides tech support. The partnership's first client was the firm that introduced the two partners, and Solution Centre has been helping Tacit look for other business.

Similar partnership deals have since been signed, with tech firms acting as Tacit's resellers in Denmark, Ireland, and Germany. Tacit's overseas partners sign a nondisclosure agreement to protect Tacit's intellectual property. Its latest deal is with a California manufacturer of communications equipment that has a big market in Europe and will sell the file-sharing software preinstalled. "With this kind of partner," says CEO Chuck Foley, "they can't be swayed to the competition as easily."

So how have Tacit's partnerships paid off? Sales have doubled to $10 million as international sales have climbed to 20 percent of Tacit's revenue. Meanwhile, the firm continues to expand; it now has its own offices in England and Australia.

Questions for Critical Thinking

1. Can Tacit's strategy for moving overseas apply to other small-business efforts? Why or why not?
2. Has Tacit done enough to ensure that its intellectual property will remain secure? Why or why not? What makes such precautions necessary?

Sources: Tacit Networks Web site, accessed June 17, 2006, http://www.tacitnetworks .com; Lucas Mearian, "Backing Up the Edge," *Computerworld*, accessed June 17, 2006, http://www.computerworld.com; Laura Kolodny, "Building a Global Alliance," *Inc.*, September 2003, p. 48.

rental business, choosing instead to offer Netflix DVD rentals at Wal-Mart.com. Netflix's success has also forced Blockbuster to eliminate the late fees that accounted for most of its profits.[23]

Small businesses are often fertile ground in which to plant innovative ideas for new goods and services. As a chemist in the pharmaceutical industry, Thomas E. D'Ambra saw many exciting ideas neglected because his employer lacked the resources to pursue them. D'Ambra decided that a market existed for a company that would offer research services on a contract basis to firms in the industry. His start-up business, Albany Molecular Research in Albany, New York, focused on obtaining contracts for research and development of new drugs. Today, the company employs 200 chemists and tackles research projects for such industry giants as DuPont Pharmaceuticals and Eli Lilly. With his customers facing a continued shortage of talented chemists, D'Ambra foresees a strong future for Albany Molecular.[24]

In a typical year, small firms develop twice as many product innovations per employee as larger firms. They also obtain more patents per sales dollar than do larger businesses. In addition, the fact that small firms are a richer source of innovations is even more evident than these statistics show because large firms are more likely to patent their discoveries.[25] Key 20th-century innovations that were developed by small businesses include the airplane, the audiotape recorder, double-knit fabrics, the optical scanner, the personal computer, soft contact lenses, and the zipper. One area of innovation that is likely to occupy small businesses

"They Said It"

"When big businesses want to innovate, what do they do? They take a bunch of guys, throw them out, and let them create a small business."

Zach Nelson (b. 1971)
President and CEO, NetSuite

HIT & MISS

Steve Lipscomb, Bluffing His Way to the Top

A lawyer with an entrepreneurial frame of mind, Steve Lipscomb has created a new model of televised poker. After winning a $10,000 prize at a local poker tournament in the World Series of Poker, Lipscomb realized that ESPN, which televised the event, was missing a bet. The broadcasts were "worse than watching paint dry," he says.

The world of high-stakes poker already had several big annual events and tournaments. Lipscomb pulled them all together and created the World Poker Tour (WPT), modeled on the PGA Tour in golf. As Lipscomb says, "I created the only sports league in America where you can come out and play. If you could sell spots for people to suit up and play in the NBA finals for, say, $25,000, many people would do it. But you can't. Here, you can pay your money and compete with the best players in the world. And you can win."

Lipscomb made his dream a debt-free reality by acquiring start-up financing and signing on high-profile casinos that already hosted big events. Next, he created graphics to make viewing exciting. Icons of the cards, the players' names, and the amounts of the bets appear on the TV screen, along with a continual update on each player's odds of winning the game. With everything in place, Lipscomb needed just one more thing—a network partner. He found one in the Travel Channel, an unlikely but happy marriage that has brought the WPT a broad audience. Licensed WPT products completed the picture.

WPT's sponsor-funded prize pools recently passed $10 million, and a celebrity tournament helped bring revenue past $17 million. Although competing shows with similar graphics are springing up on channels such as Bravo and Fox Sports, Lipscomb is confident that "we make the best television." And besides, WPT already has casinos such the Bellagio, Foxwoods, Borgata, Commerce, and the Bicycle Casino on board. Says Lipscomb, "*The New York Times* said that 50 million people were playing poker on a regular basis, and no one had branded it. This became our mission."

Questions for Critical Thinking

1. Which of the steps Lipscomb took to turn an idea into a business would apply to other entrepreneurial ventures? Which were unique to the kind of business he wanted to create?
2. Lipscomb has applied for a patent to protect the graphics he developed for his broadcasts. What else can he do to prevent competitors from adopting too many of his innovations?

Sources: Allyn Jaffrey Shulman, "Steve Lipscomb Changes the Face of Poker," *Card Player,* accessed June 17, 2006, http://www.cardplayer.com; Wendeen Eolis, "Lyle Berman and Steve Lipscomb's Confection: A Poker Tournament Season on National Television," PokerPages.com, accessed September 12, 2005, http://www.pokerpages.com; Larry Olmsted, "How Steve Lipscomb Reinvented Poker and Built the Hottest Business in America," *Inc.*, May 2005, pp. 80–92.

assessment check

1. To what extent do small businesses help create new jobs?
2. In what ways do small businesses contribute to the economy?

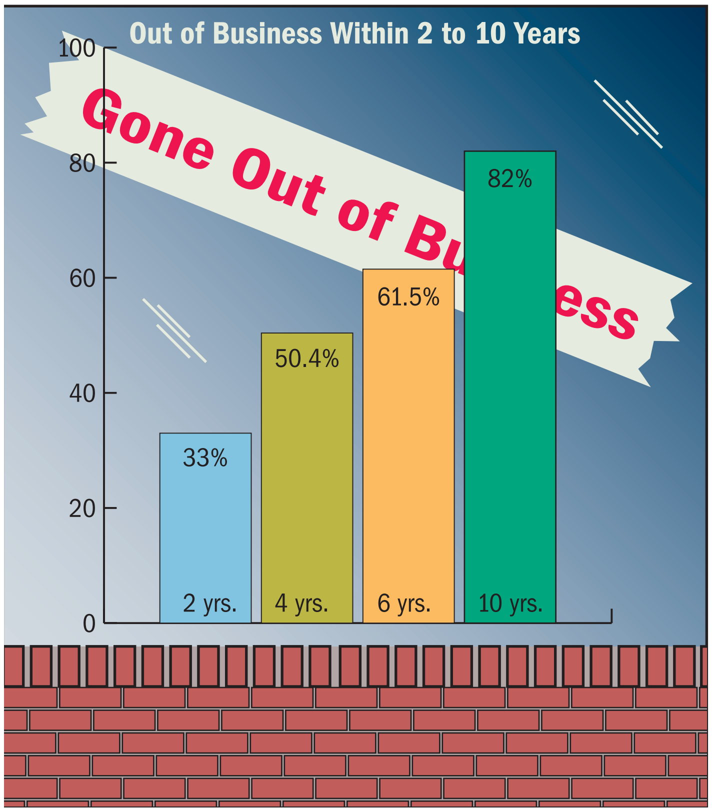
during the early years of the 21st century is security—whether it's the protection of information or people. The "Hit & Miss" feature presents another hot business venture—the entrepreneur who designed the World Poker Tour.

WHY SMALL BUSINESSES FAIL

While small businesses benefit the economy by creating new jobs, new industries, and various innovations, small businesses are much more likely to fail than large businesses, especially during economic downturns. Why? Because of management shortcomings, inadequate financing, and difficulty dealing with government regulations. These issues—quality and depth of management, availability of financing, and ability to wade through government rules and requirements—are so important that small businesses with major deficiencies in one or more of these areas may find themselves in bankruptcy proceedings.

As Figure 5.2 shows, almost one new business in three will permanently close within two years of opening, half will close within four years, and 62 percent will fail within the first six years of operation. By the tenth year, 82 of every 100 businesses will have failed. Although highly motivated and well-trained business owner-managers can overcome these potential problems, they should thoroughly analyze whether one or more of these problems may threaten the business before deciding to launch the new company.

Figure 5.2 Rate of Business Failures



Source: Office of Advocacy, U.S. Small Business Administration, "Frequently Asked Questions: Advocacy Small Business Statistics and Research," accessed June 17, 2006, http://app1.sba.gov/faqs; Amy Knaup, "Survival and Longevity in the Business Employment Dynamics Data," *Monthly Labor Review* (Bureau of Labor Statistics), May 2005, p. 50.

Management Shortcomings

Among the most common discoveries at a postmortem examination of a small-business failure is inadequate management. Business founders often possess great strengths in specific areas such as marketing or interpersonal relations, but they may suffer from hopeless deficiencies in others such as finance or order fulfillment. Large firms recruit specialists trained to manage individual functions; small businesses frequently rely on small staffs who must be adept at a variety of skills.

An even worse result occurs when people go into business with little, if any, business training. Some new businesses are begun almost entirely on the basis of what seems like a great idea for a new product. Managers assume that they will acquire needed business expertise on the job. All too often, the result is business bankruptcy.

If you are contemplating starting a new business, heed some words of warning. First, learn the basics of business. Second, recognize your own limitations. Although most small-business owners recognize the need to seek out the specialized skills of accountants and attorneys for financial and legal assistance, they often hesitate to turn to consultants and advisors for assistance in areas such as marketing, where they may lack knowledge or experience.

Founders of new businesses are typically excited about the potential of newly designed products, so they may neglect important details such as marketing research to determine whether potential customers share their excitement. Individuals considering launching a new business should first determine whether the proposed product meets the needs of a large enough market and whether they can convince the public of its superiority over competing offerings.

Inadequate Financing

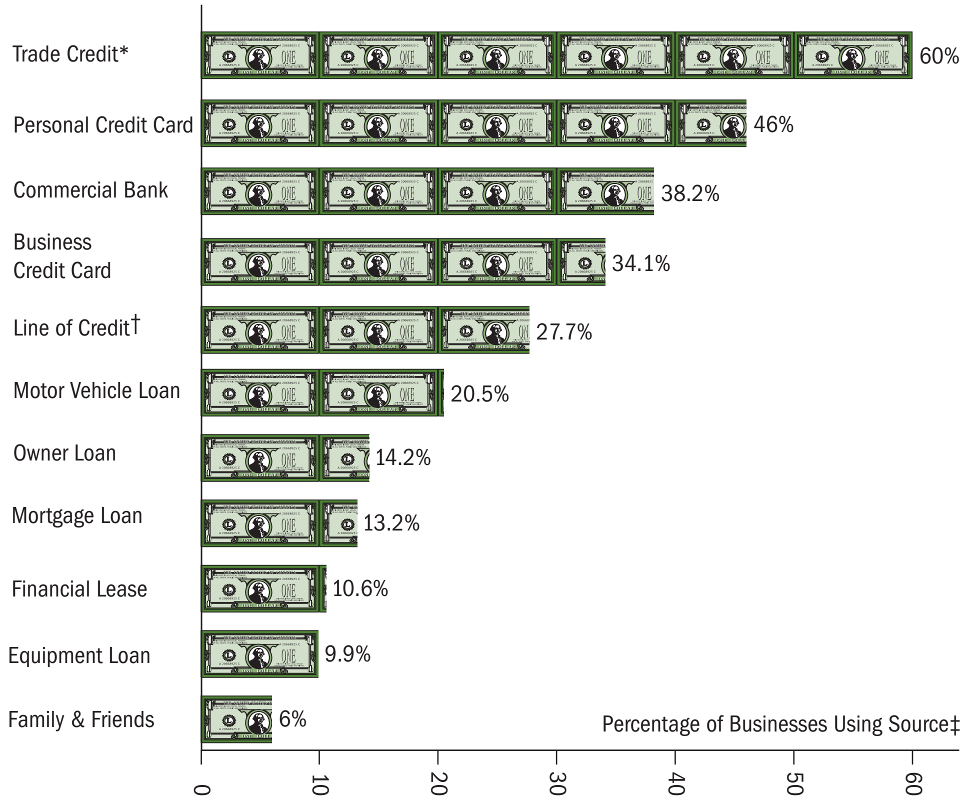
Another leading cause of small-business problems is inadequate financing. First-time business owners often assume that their firms will generate enough funds from the first month's sales to finance continuing operations. Building a business takes time, though. Employees must be trained, equipment purchased, deposits paid for rent and utilities, and marketing dollars spent to inform potential customers about the new firm and its product offerings. Even a one-person, home-based business has start-up expenses—such as a new computer or additional phone lines. Unless the owner has set aside enough funds to cover cash shortfalls during the first several months while the business is being established, the venture may collapse at an early stage.

After surviving the cash crunch that often accompanies the first months of operation, a business must confront another major financial problem: uneven cash flows. For most small and large businesses, cash inflows and outflows fluctuate greatly at different times of the year. Small retail outlets generate much of their annual sales revenues during the December holiday period. Florists make most of their deliveries during three holidays: Valentine's Day, Easter, and Mother's Day. Large firms may build sufficient cash reserves to weather periods of below-average sales, or they can turn to banks and other lenders for short-term loans. By contrast, small business start-ups often lack both cash reserves and access to sources of additional funds.

Another reason that small businesses are inadequately financed is that they rely less on debt for financing than large businesses do; 47 percent of small businesses have no outstanding loans at all, and another 25 percent have just one loan to pay off.[26] But when small firms need loans, the most frequent source of funding, as shown in Figure 5.3, is trade credit, that is, buying goods and agreeing to pay for them later, usually within 30 to 60 days. The next most commonly used sources of financing are personal credit cards, loans from commercial banks,

Figure 5.3

Sources of Small-Business Financing



*Trade credit is purchasing goods or equipment from a supplier who finances the purchase by delaying the date of payment for those goods.

†A line of credit is an agreement between a bank and a borrower, indicating the maximum amount of credit the bank will extend to the borrower.

Note: Total exceeds 100 percent because businesses typically use more than one source of financing.

Source: Small Business Administration, Office of Advocacy, "Financing Patterns of Small Firms," accessed June 17, 2006, http://www.sba.gov/advo; Susan Coleman, "Free and Costly Trade Credit: A Comparison of Small Firms," Academy of Entrepreneurial Finance, accessed June 17, 2006, http://www.aoef.org/papers.

business credit cards, lines of credit from a bank, motor vehicle loans, owner loans in which the owner lends the business money, and then mortgage loans. Figure 5.3 shows that despite their relatively high interest rates, credit cards are an important source of financing for small businesses. The heaviest users of credit cards for business financing are tiny firms with fewer than ten employees. A small-business owner who has a good credit record with a consumer credit card will have relatively easy approval for a corporate credit card. Even a business owner who doesn't have the best credit history will be more apt to win approval on a credit card than on a traditional business loan.[27] As discussed later in this chapter, small-business owners may have other sources of financing as well.

Inadequate financing can compound management shortcomings by making it more difficult for small businesses to attract and keep talented people. Typically, a big company can offer a more attractive benefits package and a higher salary. During the wave of dot-com start-ups, many people decided to take a chance and work for these companies, which often offered stock options—the right to buy stock in a firm at a lower price—in place of higher salaries or better benefits. If a company succeeded, its employees could become rich. If it failed, its workers were left not only without profits but often without jobs.

With less money to spend on employees, successful small companies need to be more creative. Ronald Richey, who runs Precision Plastics, an injection-molding plant in Columbia City, Indiana, watched one-fifth of his employees quit each year. Lacking sufficient employees to operate the factory, he had to keep some of his machinery idle every week. Richey tried better communication and hiring temporary workers, but nothing worked. Then he thought of an innovative arrangement: If employees would work five 6-hour shifts without lunch breaks, he would pay them 40 hours' wages each week for 30 hours of work. Two weeks into the new plan, turnover plummeted—and quality improved. Even with what is effectively a higher pay scale, Precision's profits have grown.[28]

Government Regulation

Small-business owners often complain bitterly about excessive government regulation and red tape. Paperwork costs alone account for billions of small-business dollars each year. A large company can better cope with requirements for forms and reports. Larger firms often find that it makes economic sense to hire or contract with specialists in specific types of regulation, such as employment law and workplace safety regulations. By contrast, small businesses often struggle to absorb the costs of government paperwork because of their more limited staff and budgets. Some small firms close for this reason alone.

Recognizing the burden of regulation on small businesses, Congress sometimes exempts the smallest companies from certain regulations. For example, small businesses with 49 or fewer employees are exempt from the Family and Medical Leave Act, which gives employees up to twelve weeks of unpaid leave each year to take care of a newborn child, adopt a child, or care for a family member who has serious health problems.[29] Most small-business owners comply with employment and other laws, believing that such compliance is ethically correct and fosters better employee relations than trying to determine which regulations don't apply to a small business. To help small businesses obey employment laws, the U.S. Department of Labor provides forms and guidelines at its "elaws Advisors" Web page (http://www .dol.gov/elaws/). Employers can also file these forms online.

Taxes are another burdensome expense for a small business. In addition to local, state, and federal income taxes, employers must pay taxes covering workers' compensation insurance, Social Security payments, and unemployment benefits. Although large companies have similar expenses, they generally have more resources to cover them.

assessment check

1. What percentage of small businesses will still be in business two, four, six, and ten years after starting?
2. How do management shortcomings, inadequate financing, and government regulation make small businesses more likely to fail?

INCREASING THE LIKELIHOOD OF SMALL-BUSINESS SUCCESS

In spite of the challenges just discussed, many small businesses do succeed. How can a prospective owner gain the many advantages of running a smaller firm while also overcoming the disadvantages? Most successful entrepreneurs believe that two recommendations are critical:

- Develop a business plan.
- Use the resources provided by such agencies as the Small Business Administration, local business incubators, and other sources for advice, funding, and networking opportunities.

Creating a Business Plan

Perhaps the most important task a would-be business owner faces is creating a business plan. An effective business plan can mean the difference between a company that succeeds and one that fails. A **business plan** is a written document that provides an orderly statement of a company's goals, the methods by which it intends to achieve these goals, and the standards by which it will measure achievements.

business plan written document that provides an orderly statement of a company's goals, the methods by which it intends to achieve those goals, and the standards by which it will measure achievements.

Business plans give the organization a sense of purpose. They provide guidance, influence, and leadership, as well as communicate ideas about goals and the means of achieving them to associates, employees, lenders, and others. In addition, they set standards against which achievements can be measured. Although no single format best suits all situations, a good small-business plan includes the methods and time frames for achieving specific goals (sales, profits, or changes in market share), as well as cash flow projections (both income received by the business and funds disbursed to pay expenses). Because business plans are essential tools for securing funding, the financial section should be thorough, professional, and based on sound assumptions. A business plan also includes the following components:

- An *executive summary* that briefly answers the who, what, why, when, where, and how questions for the business
- An *introduction* that includes a general statement of the concept, purpose, and objectives of the proposed business
- Separate *financial* and *marketing sections* that describe the firm's target market and marketing plan as well as detailed financial forecasts of the need for funds and when the firm is expected to break even—the level of sales at which revenues equal costs
- *Résumés of principals*—especially in plans written to obtain financing

Business plans are discussed in more detail in Appendix C, "Developing a Business Plan," and on the *Contemporary Business* Web site.

"They Said It"

"Rich people plan for four generations. Poor people plan for Saturday night."
Gloria Steinem (b. 1934)
American feminist and journalist

Small Business Administration

Small businesses can benefit from using the resources provided by the **Small Business Administration (SBA).** The SBA is the principal government agency concerned with helping small U.S. firms, and it is the advocate for small businesses within the federal government. Over 3,000 employees staff the SBA's Washington headquarters and its regional and field offices. The primary operating functions of the SBA include providing financial assistance, aiding in government procurement matters, and providing management training and consulting.

Small Business Administration (SBA) federal agency that aids small businesses by providing management training and consulting, financial assistance, and support in securing government contracts.

Financial Assistance from the SBA Contrary to popular belief, the SBA seldom provides direct business loans. Its major financing contributions are the guarantees it provides for small-business loans made by private lenders, including banks and other institutions. Direct SBA loans are available in only a few special situations, such as natural disaster recovery and energy conservation or development programs. For example, after Hurricane Katrina destroyed homes and businesses in New Orleans and the southern coastal regions of Louisiana, Mississippi, and Alabama, the SBA offered small businesses disaster loans up to $1.5 million to repair or replace damaged buildings, equipment, inventory, and supplies.[30] Even in these special instances, a business applicant must contribute a portion of the proposed project's total cost in cash, home equity, or stocks to qualify. However, in the case of Hurricane Katrina, if everything associated with a small business was destroyed, the SBA used the business's real estate as collateral.

The SBA also guarantees **microloans** of up to $35,000 to start-ups and other very small firms.[31] Microloans may be used to buy equipment or operate a business but not to buy real estate or pay off other loans. These loans are available from nonprofit organizations located in most states. Other sources of microloans include the federal Economic Development Administration, some state governments, and certain private lenders, such as credit unions and community development groups.

AP PHOTO/CHARLIE RIEDEL

C. Ray Bergeron salvages his tire inventory as he cleans out the flood-damaged office of his service station in the lakeside area of New Orleans. Bergeron's business was under eight feet of floodwater after Hurricane Katrina hit. Bergeron managed to salvage about $15,000 worth of tires, but the rest of his business was a total loss.

Small-business loans are also available through SBA-licensed organizations called **Small Business Investment Companies (SBICs),** which are run by experienced venture capitalists. SBICs use their own capital, supplemented with government loans, to invest in small businesses. Like banks, SBICs are profit-making enterprises, but they are likely to be more flexible than banks in their lending decisions. Well-known companies that used SBIC financing when they were start-ups include Apple Computer, Callaway Golf, America Online, Federal Express, Intel, Staples, and Outback Steakhouse.

Another financial resource underwritten by the SBA is *Active Capital*, which matches entrepreneurs looking for start-up capital with potential investors willing to exchange their money and advice for partial ownership of the company. Entrepreneurs post information about their businesses on the Active Capital Web site, where potential investors can review it. Interested parties contact the firms. The goal is to help businesses seeking smaller amounts of capital than those typically handled by bigger investment firms. However, small businesses can raise up to $5 million via Active Capital. Why use Active Capital? Because, as a nonprofit organization sanctioned by the SBA, Active Capital charges a small annual fee of $1,000 but no commissions, which makes it a cheap, safe, and secure way for entrepreneurs and investors to exchange information and do business.[32]

Other Specialized Assistance Although government purchases represent a huge market, small companies have difficulty competing for this business with giant firms, which employ specialists to handle the volumes of paperwork involved in preparing proposals and completing bid applications. Today, many government procurement programs set aside portions of government spending for small companies; an additional SBA role is to help small firms secure these contracts. With **set-aside programs** for small businesses, up to 23 percent of certain government contracts are designated for small businesses.[33] Every federal agency with buying authority must maintain an Office of Small and Disadvantaged Business Utilization to ensure that small businesses receive a reasonable portion of government procurement contracts. To help connect small businesses with government agencies, the SBA's Web site offers Central Contractor Registration, which includes a search engine for finding business opportunities as well as a chance for small businesses to provide information about themselves.[34] Set-aside programs are also common in the private sector, particularly among major corporations.

In addition to help with financing and government procurement, the SBA delivers a variety of other services to small businesses. It provides information and advice through toll-free telephone numbers and its Web site, http://www.sba.gov, where you can find detailed information about starting, financing, and managing a small business, along with further information about businesses opportunities and disaster recovery. Finally, through its Small Business Training Network, the SBA offers free online courses; sponsors inexpensive training courses on topics such as taxes, networking, and start-ups in cities and small towns throughout the country; and provides a free online library of more than 200 SBA publications and additional business resources.

business incubator organization that provides temporary low-cost, shared facilities to small start-up ventures.

Business Incubators

Some local community agencies interested in encouraging business development have implemented a concept called a **business incubator** to provide low-cost shared business facilities to small start-up ventures. A typical incubator might section off space in an abandoned plant and rent it to various small firms. Tenants often share clerical staff, computers, and other business services. The objective is that, after a few months or years, the fledgling business will be ready to move out and operate on its own.

Hundreds of business incubator programs operate nationwide. About half are run by not-for-profit organizations, including industrial development authorities. The remainder are divided between college- and university-sponsored incubators and business-run incubators.[35] These facilities offer management support services and valuable management advice from in-house mentors. Operating in an incubator gives entrepreneurs easy access to such basic needs as telephones and human resources experts. They also can trade ideas with one another.

assessment check

1. What components should be part of a good business plan?
2. What are the various ways and methods by which the SBA helps small businesses with financing and getting government contracts?

SMALL-BUSINESS OPPORTUNITIES FOR WOMEN AND MINORITIES

The thousands of new business start-ups each year include growing numbers of women-owned firms as well as new businesses launched by African Americans, Hispanics, and members of other minority groups. The numbers of women-owned and minority-owned businesses are growing much faster than the overall growth in U.S. businesses. The people who start these companies see small-business ownership and operation as an attractive and lucrative alternative to working for someone else.

Women-Owned Businesses

In the United States today, more than 10.6 million women-owned firms provide jobs for almost 19.1 million people. Forty-eight percent of U.S. businesses are owned by women, compared with one-fourth to one-third of businesses worldwide. One of every five of these businesses is owned by minority women.[36]

Women, like men, have a variety of reasons for starting their own companies. Some are driven by an idea that they believe can help others. Some have a unique business idea that they want to bring to life, such as Kimberly See, an African American business woman who founded Arlington, Texas–based kemse & company, which offers a line of multicultural stationery and invitations designed for women of color.[37] Others decide to strike out on their own when they lose their jobs or become frustrated with the bureaucracies in large companies. In other cases, women leave large corporations when they feel blocked from opportunities for advancement. Sometimes this occurs because they hit the so-called glass ceiling, discussed in Chapter 8. Because women are more likely than men to be the primary caregivers in their families, some may seek self-employment as a way to achieve flexible working hours so they can spend more time with their families.

NATALIE CAUDILL/THE DALLAS MORNING NEWS

After being unable to find stationery, invitations, or greeting cards showing people of color, Kim See started her own business, kemse & company. "I decided to take matters into my own hands and create a line of paper products, in particular, invitations, to fill that void." Her products have been featured in the *Dallas Morning News* and *Essence* and *O* magazines.

The fastest growth among women-owned firms is occurring in construction, transportation and communications, and agricultural services.[38] One woman who created a successful manufacturing business is Karen Alvarez of Dublin, California. She got her original product idea when she was grocery shopping with her children and one child fell from the shopping cart. To prevent such accidents, which occur to thousands of children every year, Alvarez developed the Baby Comfort Strap, a simple padded strap that parents use to buckle a small child to a cart or stroller. She consulted experienced retailers and manufacturers for help in developing packaging, pricing, and testing. When the Baby Comfort Strap proved to be a reliable seller, Alvarez began a successful strategy to generate publicity about the frequency of shopping carts' resulting in injuries to small children. This led to widespread awareness of the problem—and about how the Baby Comfort Strap could resolve it. This publicity worked, and Alvarez was able to set up distribution throughout the United States.[39]

"They Said It"

"Whatever women do, they must do twice as well as men to be thought half as good. Luckily, this is not difficult."
Charlotte Whitton (1896–1975) Mayor of Ottawa

As the number of female small-business owners has grown, they have also been able to establish powerful support networks in a relatively short time. Many nationwide business assistance programs serve women exclusively. Among the programs offered by the Small Business Administration are the Contract Assistance for Women Business Owners program, which teaches women how to market to the federal government; the Women's Network for Entrepreneurial Training, which matches experienced female entrepreneurs with women trying to get started; and dozens of Women's Business Centers, which offer training and counseling in operating a business.

Springboard Enterprises is a nonprofit organization based in Washington, D.C., that promotes entrepreneurship and acquisition of capital for women entrepreneurs. Amy Millman, president of Springboard, assesses the small-business environment for women this way: "If you are an entrepreneur, it is always the right time to launch a business. There is great opportunity [if you] focus on the fundamentals. Remember, there is no free lunch."[40] In addition, women can find encouragement, advice, and mentors by joining organizations such as Women Entrepreneurs and the Forum for Women Entrepreneurs and Executives, both of which support women who want to start high-growth companies.[41]

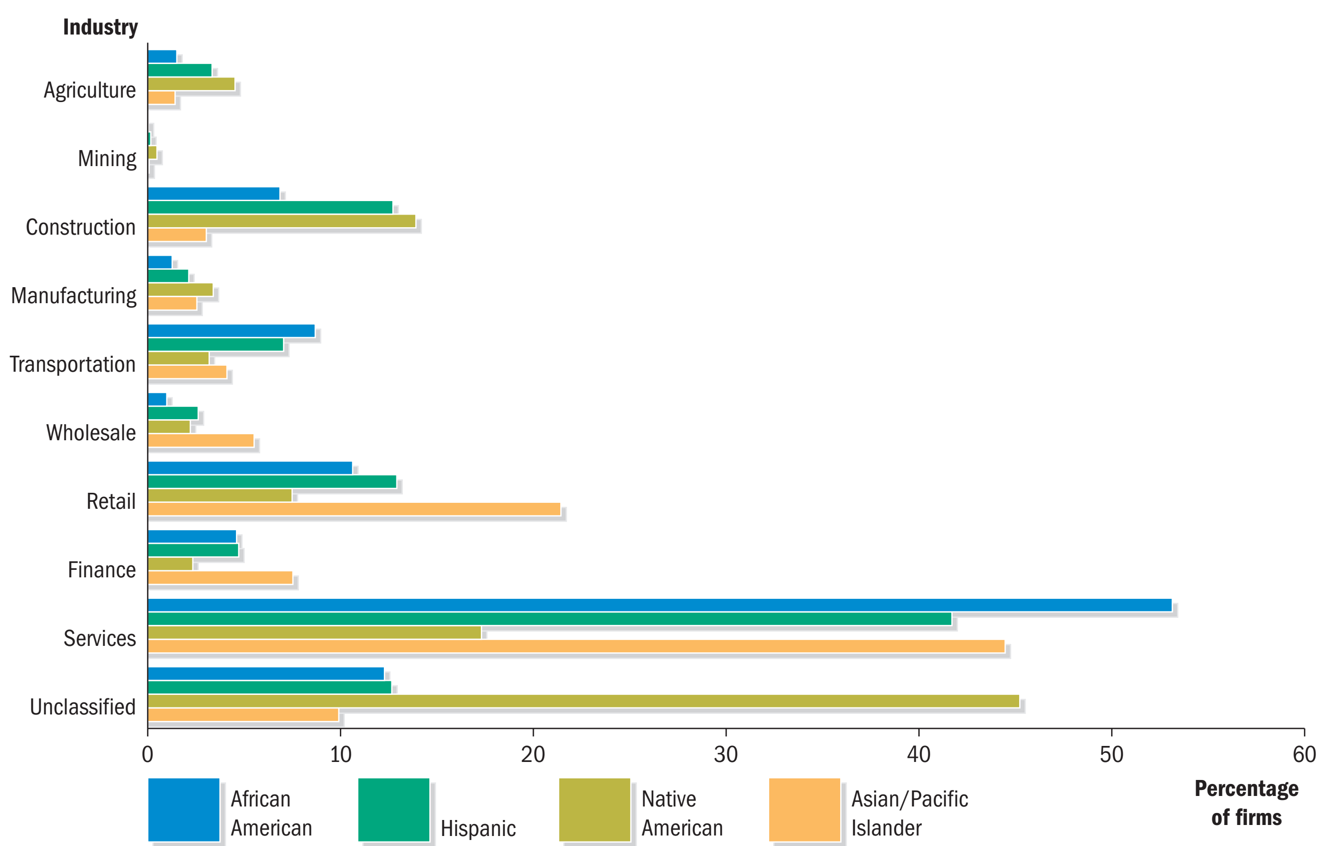
Minority-Owned Businesses

Business ownership is also an important opportunity for America's racial and ethnic minorities. In recent years, the growth in the number of businesses owned by African Americans, Hispanics, and Asian Americans has far outpaced the growth in the number of U.S. businesses overall. Figure 5.4 shows the percentages of minority ownership in major industries. The relatively strong presence of minorities in the services and retail industries is especially significant because these industries contain the greatest number of businesses.

Hispanics are the nation's largest group of minority business owners, followed by Asian American, African American, and Native American owners.[42] The Small Business Administration attributes some of this pattern to strong population growth among Hispanics, whose disposable income is also growing at twice the rate of non-Hispanics.[43] Even more growth lies ahead for Hispanic-owned businesses during this decade, especially as trade between the United States and Latin America increases under NAFTA and CAFTA (see Chapter 4 for more information on NAFTA and CAFTA).

Historically, large numbers of U.S. immigrants have started businesses. In fact, immigrants own nearly 15 percent of all small businesses.[44] In addition, both male and female immigrants are more likely to own small businesses than are native-born Americans. For example, 8 percent of female immigrants own small businesses compared with 6 percent of women born in

Figure 5.4 Types of Businesses Owned by Racial and Ethnic Minorities



Source: Data from Office of Advocacy, U.S. Small Business Administration, "Minorities in Business," p. 17, accessed June 17, 2006, http://www.sba.gov/advo.

the United States.[45] Susana Cook, originally from Peru, who with her husband owns Cook's Natural Foods and Universal Medical Supply in Little Rock, Arkansas, said, "In our countries owning your own business is a struggle; here it's like a dream come true. Here they do not put so many obstacles or red tape in your way."[46]

Despite their progress, minority business owners still face considerable obstacles. Minority entrepreneurs tend to start businesses on a smaller scale and have more difficulty finding investors than other entrepreneurs. They rely less on bank credit than do other business owners, possibly because they have a harder time getting loans from banks. According to the Federal Reserve, bank loan applications of Hispanic- and African American–owned businesses are rejected at twice the rate of white-owned businesses. Not surprisingly, other research finds that roughly half of minority small-business owners don't even apply for bank loans, presumably because they believe their loan requests will be turned down.[47]

THE FRANCHISING ALTERNATIVE

Franchising is a major factor in the growth of small businesses. **Franchising** is a contractual business arrangement between a manufacturer or another supplier and a dealer. The contract specifies the methods by which the dealer markets the good or service of the supplier. Franchises can involve both goods and services; some well-known franchises are Burger King, KFC, McDonald's, Jiffy Lube, Domino's Pizza, Coldwell Banker Real Estate, and Supercuts.

franchising contractual agreement that specifies the methods by which a dealer can produce and market a supplier's good or service.

Starting a small, independent company can be a risky, time-consuming endeavor, but franchising can reduce the amount of time and effort needed to expand. The franchisor has already developed and tested the concept, and the brand may already be familiar to prospective customers.

"They Said It"

"The road to success is dotted with many tempting parking spaces."
Anonymous

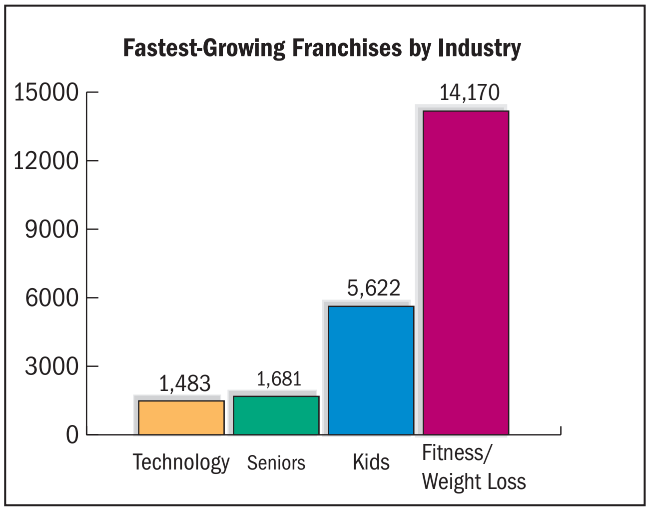
The Franchising Sector

Franchising started just after the U.S. Civil War, when the Singer Company decided to build its business by franchising retail sewing machine outlets. The concept became increasingly popular after 1900 in the automobile industry. Automobile travel led to demand for local auto sales and service outlets, as well as gasoline, oil, and tire retailers. Auto manufacturers created systems of franchised distributors and then set up local retailers in each retail location—auto dealers, gas stations, tire stores, and auto parts retailers. Dunkin Donuts, Meineke Muffler, and Super 8 Motels also set up their distribution systems through a network of local and regional franchises.

Today, the franchising concept continues its rapid growth. U.S. franchises generate sales of $1.53 trillion annually and employ more than 18 million people.[48] According to *Entrepreneur,* the Number one franchise is Subway, with Curves (exercise centers for women) coming in second. Quizno's Subs, the Jackson Hewitt Tax Service, UPS Stores, Sonic Drive-In, Jani-King (janitorial services), 7-Eleven, Dunkin' Donuts, and RE/MAX real estate complete the rest of *Entrepreneur*'s top ten list.[49] Areas in which strong growth is likely to continue include technology consulting; products for seniors and kids, both of which are growing population segments; and anything having to do with fitness or weight loss. With weight problems at epidemic proportions, Curves, whose slogan is "No men, no mirrors, no makeup," is growing 37 percent per year, has 4 million members and 9,000 centers after ten years in business, and is planning to open another 8,000 centers in Asia and Europe in the near future. Figure 5.5 shows four of the hottest industries in which franchising growth is currently occurring.

Franchising overseas is also a growing trend for franchisors and franchisees who want to expand into foreign markets. It seems that anywhere you go in the world, you can get a

Figure 5.5 The Fastest-Growing Franchises by Industry



Source: Sara Wilson, "All the Rage: Wondering What Everyone Will Be Crazy About in the Coming Year? Take a Sneak Peek at the Hottest Franchising Trends for 2005," *Entrepreneur*, accessed June 17, 2006, http://www.entrepreneur.com.

McDonald's burger. But other international franchises, such as Best Western, Pak Mail, Pizza Hut, KFC, Subway, and 7-Eleven, are almost as common.

Some people get into franchising because they can operate their business from home, another continuing trend. Examples of these franchises include ServiceMaster Clean, Chem-Dry Carpet Drapery & Upholstery Cleaning, Snap-On Tools, and Lawn Doctor.[50]

Franchising Agreements

The two principals in a franchising agreement are the franchisee and the franchisor. The individual or business firm purchasing the franchise is called the **franchisee,** while the small-business owner who contracts to sell the good or service of the supplier is called the **franchisor.** In exchange for some payment (usually a fee plus a percentage of franchise sales) from the franchisee, the franchisor typically provides building plans, site selection help, managerial and accounting systems, and other services to assist the franchisee. Franchisees' total costs can vary over a wide range. The initial fee paid by a franchisee to McDonald's for a new McDonald's franchise is $45,000, but the total start-up costs can run anywhere from $500,000 to $1.6 million. In contrast, the initial fee for a Subway franchise is $12,500, but the total start-up costs range from $70,000 to $220,000.[51] The franchisor also provides name recognition for the small-business owner who becomes a franchisee. This public image is created by their familiarity with the franchise in other geographical areas and by advertising campaigns, all or part of which is paid for by contributions by the franchisees.

AP PHOTO/PAT WELLENBACH

Curves, the second-fastest-growing franchise in the United States, uses weightlifting and diet management to help its customers lose weight. For 30 minutes, three times a week, customers build muscles, strengthen joints, and increase flexibility by working their way around a circuit of weight-bearing machines.

Franchise agreements often specify that the franchisee will receive materials, equipment, and training from the franchisor. Charmain and Charles Smith bought a Fruitfull Frozen Fruit Bars franchise from Happy & Healthy Products for $28,000, financing much of the purchase price with an SBA-backed loan. Charmain, with a decade of experience in the food service business, runs the franchise. Her husband, who also has a full-time job as a corporate financial executive, provides accounting and other services. The basic agreement with Happy & Healthy Products provides the franchisees with ten freezers, two pallets of frozen fruit and yogurt bars, and a week of training, which covers sales and the company's products and equipment. The franchisee then sells the product to retailers to be stocked in either Fruitfull freezers or the retailer's own freezers. The Smiths' franchise has accounts in Georgia, including Kroger supermarkets, a chain of health clubs, and school cafeterias.[52]

Benefits and Problems of Franchising

As with any other business, a franchise purchaser bears the responsibility for researching what he or she is buying. Poorly financed or poorly managed franchise systems offer opportunities no better than those in poorly financed or poorly managed independent businesses. Although franchises are more likely than independent businesses to succeed, many franchises do go out of business. The franchising concept does not eliminate the risks of a potential small-business investment; it simply adds alternatives.

Advantages of franchises include a prior performance record, a recognizable company name, a business model that has proven successful in other locations, a tested management program, and business training for the franchisee. An existing franchise has posted a performance record on which the prospective buyer can base comparisons and judgments. Earlier results can indicate the likelihood of success in a proposed venture. In addition, a widely recognized name gives the franchisee a tremendous advantage; auto dealers, for instance, know that their brand-name products will attract particular segments of the market.

A tested management program usually allows the prospective franchisee to avoid worrying about setting up an accounting system, establishing quality-control standards, or designing employment application forms. In addition, most franchisors offer valuable business training. McDonald's teaches the basics of operating a franchise at its Hamburger University in Oak Brook, Illinois. Franchise operators quickly learn to meet customer expectations by following strict guidelines for how many seconds to cook the french fries and what words to use when serving customers. By following the franchisor's standards and building on an existing brand name, franchise operators typically can generate profits faster than an independent business owner. That was the case for Joe Grimand 25 years ago. After serving as a pilot in the Air Force, he knew he wanted to run his own business, but he had no business experience. So he bought into a Precision Tune Auto Care franchise, worked long hours, followed the company's advice, and adhered to its management system. Today he owns eight Precision stores, which together generate nearly $5 million in annual revenues. Says Grimand, "Looking back, I never thought it would grow to what it is now."[53]

On the negative side, franchise fees and future payments can be very expensive. As with any business, a franchise may well be unprofitable during its first months and at times thereafter. Payments to the franchisor can add to the burden of keeping the business afloat until the owner begins to earn a profit.

Another potential drawback stems from the fact that the franchisee is linked to the reputation and management of the franchise. If customers are unhappy with their experience at one franchised sandwich shop, they might avoid stopping at another one several miles away, even if the second one is owned and operated by someone else. So a strong, effective program of managerial control is essential to maintain a franchise brand's effectiveness. Before signing on with a franchisor, potential franchisees should carefully study its financial performance and reputation and talk with current franchise owners. Sources of information include the franchisor as well as state consumer protection agencies, the Better Business Bureau, and the Federal Trade Commission. The FTC's Web site includes advice for franchisees and reports of complaints against franchisors. Potential franchisees also should study the franchise agreement carefully to make sure they can succeed within the limitations of the agreement. In some instances, franchisors pursue additional sales by establishing new distribution outlets, which may compete directly with established franchisees. In today's online business environment, it is important to ask whether the franchisor retains the right to sell the same products online that the franchisee is trying to sell through a local outlet.

Even well-known, previously successful franchises can suffer from problems. Most people don't realize it, but auto dealers, just like McDonald's and Burger King stores, are franchises with the exclusive right to resell an auto manufacturer's cars. So when a franchisor like GM suffers, its dealers, that is, its franchises, suffer right along with it. And with its U.S. market share at half of what it was 25 years ago, GM has been suffering a lot, and so have its franchises.[54] For example, 20 years ago, Jeff Wooley's Pontiac dealership in Tampa, Florida, was selling 300 cars a month. Today, however, it's about 50 cars a month.[55] By contrast, since his Nissan dealership, which once sold 100 cars a month, now sells twice that many and will likely sell 300 cars a month within a few years, Wooley tore down his large Pontiac showroom, replacing it with a new $4.5 million showroom for Nissans.

Finally, some people are more suited to the demands of operating a franchise than others. Any person who is considering buying a franchise must think first about whether he or she has the right personality for the endeavor. Chapter 6 features an in-depth discussion of the basic characteristics that entrepreneurs should bring to their new endeavors.

assessment check

1. Distinguish between a franchisor and a franchisee.
2. Name some of the largest franchises.
3. What are the benefits and problems of franchising?

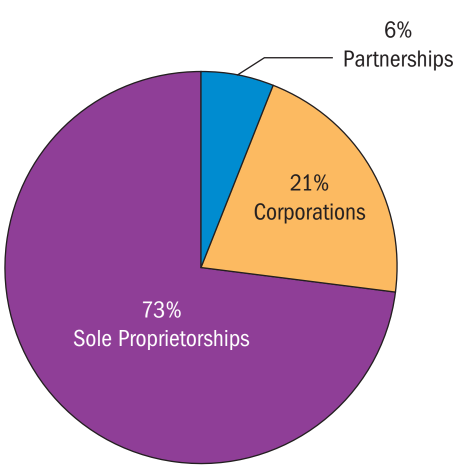
ALTERNATIVES FOR ORGANIZING A BUSINESS

Whether small or large, every business fits one of three categories of legal ownership: sole proprietorships, partnerships, and corporations. As Figure 5.6 shows, sole proprietorships are the most common form of business ownership. Although a much smaller percentage of firms are organized as corporations, corporate revenues are nineteen times as large as the revenues earned by all sole proprietorships. After all, a corporate giant such as Wal-Mart, with annual sales of nearly $320 billion, has a huge impact on the nation's economy.

sole proprietorship form of business ownership in which the company is owned and operated by one person.

Each form offers unique advantages and disadvantages, as outlined in Table 5.2. To overcome certain limitations of the traditional ownership structures, owners may also use three specialized organizational forms: S corporations, limited-liability partnerships, and limited-liability companies. Along with the basic forms, this section also briefly examines each of these alternatives.

Figure 5.6 Forms of Business Ownership



Source: Data from U.S. Census Bureau, "Statistics about Business Size (Including Small Business) from the U.S. Census Bureau," http://www.census.gov.

Sole Proprietorships

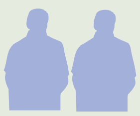
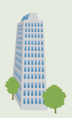
The most common form of business ownership, the **sole proprietorship** is also the oldest and the simplest because no legal distinction separates the sole proprietor's status as an individual from his or her status as a business owner. Although sole proprietorships are common in a variety of industries, they are concentrated primarily among small businesses such as repair shops, small retail outlets, and service providers, such as painters, plumbers, and lawn care operations.

Sole proprietorships offer advantages that other business entities cannot. For one, they are easy to form and dissolve. (Partnerships are also easy to form, but difficult to dissolve.) A sole proprietorship offers management flexibility for the owner, along with the right to retain all profits after payment of personal income taxes. Retention of all profits and responsibility for all losses give sole proprietors the incentive to maximize efficiency in their operations.

Minimal legal requirements simplify entering and exiting a sole proprietorship. Usually, the owner must meet only a few legal requirements for starting one, including registering the business or trade name—to guarantee that two firms do not use the same name—and taking out any necessary licenses. Local

Table 5.2

Comparing the Three Major Forms of Private Ownership

Form of Ownership	Number of Owners	Liability	Advantages	Disadvantages
Sole proprietorship 	One owner	Unlimited personal liability for business debt	1. Owner retains all profits 2. Easy to form and dissolve 3. Owner has flexibility	1. Unlimited financial liability 2. Financing limitations 3. Management deficiencies 4. Lack of continuity
Partnership 	Two or more owners	Personal assets of any operating partner at risk from business creditors	1. Easy to form 2. Can benefit from complementary management skills 3. Expanded financial capacity	1. Unlimited financial liability 2. Interpersonal conflicts 3. Lack of continuity 4. Difficult to dissolve
Corporation 	Unlimited number of shareholders; up to 75 share-holders for S corporations	Limited	1. Limited financial liability 2. Specialized management skills 3. Expanded financial capacity 4. Economies of large-scale operations	1. Difficult and costly to form and dissolve 2. Tax disadvantages 3. Legal restrictions

governments require that certain kinds of licenses be obtained before opening restaurants, motels, and retail stores. Some occupational licenses require firms to carry specific types of insurance, such as liability coverage.

The ease of dissolving a sole proprietorship is an attractive feature for certain types of enterprises. This advantage is particularly important for temporary businesses set up to handle just a few transactions. Ownership flexibility is another advantage of a sole proprietorship. The owner can make management decisions without consulting others, take prompt action when needed, and keep trade secrets. You've probably heard people say, "I like being my own boss." This flexibility leads many business owners to prefer the sole proprietorship organization form.

A disadvantage of the sole proprietorship form is the owner's personal financial liability for all debts of the business. Also, the business must operate with financial resources limited to the owner's personal funds and money that he or she can borrow. Such financing limitations can keep the business from expanding. Another disadvantage is that the owner must handle a wide range of management and operational tasks; as the firm grows, the owner may not be able to perform all duties with equal effectiveness. Finally, a sole proprietorship lacks long-term continuity, because death, bankruptcy, retirement, or a change in personal interests can terminate it.

These limitations can make potential customers nervous about buying major goods or services from a sole proprietorship. When they know the form of organization being used by their supplier, they may worry that the sole proprietor will not be around long enough or have the resources to fulfill the agreement. Paulette Thomas, who writes the Startup Q&A column for the *Wall Street Journal*, says that because of that risk, "It makes no sense for such behemoths as BellSouth [or any other large corporation] with its $22.6 billion in annual revenue to parcel out that work to solo operators."[56]

Partnerships

partnership form of business ownership in which the company is operated by two or more people who are co-owners by voluntary legal agreement.

Another option for organizing a business is to form a partnership. The Uniform Partnership Act, which regulates this ownership form in most states, defines a **partnership** as an association of two or more persons who operate a business as co-owners by voluntary legal agreement. The partnership was the traditional form of ownership for professionals offering services, such as physicians, lawyers, and dentists. Today, most of these service providers have switched to other organizational forms to limit personal liability.

Like sole proprietorships, partnerships are easy to form. The legal requirements consist of registering the business name and taking out the necessary licenses. Partnerships also offer expanded financial capabilities when each partner invests money. They also usually increase access to borrowed funds compared with sole proprietorships. Another advantage is the opportunity for professionals to combine complementary skills and knowledge. In the earlier example of Charmain and Charles Smith's Fruitfull Frozen Fruit Bars franchise, the two franchise owners each contribute important skills. Charmain has experience as a manager in the food service business, and Charles has a financial background.

Like sole proprietorships, most partnerships have the disadvantage of unlimited financial liability. Each partner bears full responsibility for the debts of the firm, and each is legally liable for the actions of the other partners. Partners must pay the partnership's debts from their personal funds if it ceases operations and its debts exceed its assets. Breaking up a partnership is also a much more complicated undertaking than dissolving a sole proprietorship. Rather than simply withdrawing funds from the bank, the partner who wants out may need to find someone to buy his or her interest in the firm.

In many states, partners can minimize some of these risks by organizing as a limited liability partnership. In many respects, such a partnership resembles a general partnership, but laws limit the liability of the partners to the value of their investments in the company.

The death of a partner also threatens the survival of a partnership. A new partnership must be formed, and the estate of the deceased is entitled to a share of the firm's value. To ease the financial strains of such events, business planners recommend life insurance coverage for each partner, combined with a buy-sell agreement. The insurance proceeds can be used to repay the deceased partner's heirs and allow the surviving partner to retain control of the business.

Because partnerships are vulnerable to personal conflicts that can quickly escalate into business battles, you should carefully choose your business partners. Scott Stewart, whose former business partner spent extravagantly, said, "People told me a business partnership is like a marriage. I didn't understand it until now. You have to go through a dating period to find out if you're compatible."[57] Good communication is the key to resolving conflicts before they damage a partnership's chances for success or even destroy it.

Corporations

corporation business that stands as a legal entity with assets and liabilities separate from those of its owner(s).

A **corporation** is a legal organization with assets and liabilities separate from those of its owner(s). Although even the smallest business can choose the corporate form of organization, most people think of large companies when they hear the term *corporation*. In truth, many corporations are extremely large businesses.

Recently, ExxonMobil, whose annual worldwide sales are nearly $340 billion, passed longtime number one–ranked Wal-Mart to become the largest U.S.-based corporation in terms of sales. ExxonMobil has been ranked third for a number of years, so its move to the number one slot pushed General Motors to number three on the list, ahead of Chevron and Ford Motor Company. The list of the ten largest U.S. corporations contains another manufacturer, General

Electric, as well as banking firm Citigroup, insurance and financial firm AIG, information technology solution provider IBM, and international petroleum giants.[58]

The corporate ownership form offers considerable advantages. First, because a corporation acquires the status of a separate legal entity, its stockholders have only limited financial risk. If the firm fails, they lose only the money they have invested. Protection also applies to legal risk. Class-action suits filed against automakers, cigarette makers, and drug manufacturers are filed against the companies, not the owners of those companies. The limited risk of corporate ownership is clearly reflected in corporate names throughout the world. While many U.S. and Canadian corporations include the designation *Inc.* in their names, British firms use the abbreviation *Ltd.* to identify their limited liability. In Australia, the abbreviation for *proprietary limited*—Pty. Ltd.—is frequently included in corporate names.

Corporations offer other advantages. They can draw on the specialized skills of many employees, unlike the typical sole proprietorship or partnership, for which managerial skills are usually confined to the abilities of their owners and a small number of employees. Corporations gain access to expanded financial capabilities based on the opportunity to offer direct outside investments such as stock sales.

The large-scale operation permitted by corporate ownership also results in a number of advantages for this legal form of organization. Employees can specialize in their most effective tasks. A large firm can generate internal financing for many projects by transferring money from one part of the corporation to another. Long manufacturing runs usually promote efficient production and allow the firm to charge highly competitive prices that attract customers.

One major disadvantage for a corporation is the double taxation of corporate earnings. After a corporation pays federal, state, and local income taxes on its profits, its owners (stockholders) also pay personal taxes on any distributions of those profits they receive from the corporation in the form of dividends. One of the key components of the 2003 U.S. tax cut was the reduction of federal taxes on corporate dividends to 15 percent. Prior to passage of the economic stimulus legislation, people in the highest income bracket would pay more than 38 percent of any dividends received in federal taxes.

Corporate ownership also involves some legal issues that sole proprietorships and partnerships do not encounter. The number of laws and regulations that affect corporations has increased dramatically in recent years.

To avoid double taxation of business income while achieving or retaining limited financial liability for their owners, some firms have modified the traditional corporate and partnership structures. Businesses that meet certain size requirements, including ownership by no more than 75 shareholders, may organize as **S corporations,** also called *subchapter S corporations*. These firms can elect to pay federal income taxes as partnerships while retaining the liability limitations typical of corporations. The tax advantage of S corporations over typical corporations, which incur double taxation, is that S corporations are only taxed once. Unlike regular corporations, S corporations do not pay corporate taxes on their profits. Instead, the untaxed profits of S corporations are paid directly as dividends to shareholders, who then pay the lower 15 percent corporate dividend tax rate. This tax advantage has induced a fivefold increase in the number of S corporations. Consequently, the IRS is closely auditing S corporations for abuse because some businesses that don't meet the legal requirements have formed S corporations to illegally take advantage of the S corporation's lower taxes.[59]

Business owners may also form **limited liability companies (LLCs)** to secure the corporate advantage of limited liability while avoiding the double taxation characteristic of corporations. An LLC is governed by an operating agreement that resembles a partnership agreement, except that it reduces each partner's liability for the actions of the other owners. Professional corporations—such as law offices, accounting firms, and physicians—use a similar approach, with the abbreviation *PC* shown at the end of the name of the business.

Changing Legal Structures to Meet Changing Needs

Before deciding on an appropriate legal form, someone planning to launch a new business must consider dozens of factors, such as these:

- Personal financial situations and the need for additional funds for the business's start-up and continued operation
- Management skills and limitations
- Management styles and capabilities of working with partners and other members of top management
- Concerns about exposure to personal liability

assessment check

1. What are the key differences between sole proprietorships, partnerships, and corporations?
2. What are the advantages and disadvantages of sole proprietorships, partnerships, and corporations?

Although the legal form of organization is a major decision, new business owners need not treat it as a permanent decision. Over time, changing conditions such as business growth may prompt the owner of a sole proprietorship or a group of partners to switch to a more appropriate form. For example, if you have a successful business organized as a limited liability company, but you want to give your children or other family members partial ownership, you can give them shares of the company by switching to a corporation. And you can do this without giving up control of the company or paying a gift tax.[60]

ORGANIZING AND OPERATING A CORPORATION

One of the first decisions in forming a corporation is determining where to locate its headquarters and where it will do business. This section describes the various types of corporations and considers the options and procedures involved in incorporating a business.

Types of Corporations

Corporations fall into three categories: domestic, foreign, or alien. A firm is considered a **domestic corporation** in the state where it is incorporated. When a company does business in states other than the one where it has filed incorporation papers, it is registered as a **foreign corporation** in each of those states. A firm incorporated in one nation that operates in another is known as an **alien corporation** where it operates. Some firms—particularly large corporations with operations scattered around the world—may operate under all three of these designations.

The Incorporation Process

Suppose that you decide to start a business, and you believe that the corporate form offers the best way to organize it. Where should you set up shop? How do you establish a corporate charter? The following paragraphs discuss the procedures for creating a new corporation.

Where to Incorporate Location is one of the most important considerations for any small-business owner. Although most small and medium-sized businesses are incorporated in the states where they do most of their business, a U.S. firm can actually incorporate in any state it chooses. The founders of large corporations, or of those that will do business nationwide, often compare the benefits provided in various states' laws to firms in various industries.

The favorable legal climate in Delaware and the speed and simplicity of incorporating there have prompted more than half of the companies in *Fortune* magazine's list of the top

500 companies to set up operations there. Because of this popularity, incorporation has become a $400 million government-run industry in Delaware.

The Corporate Charter

Each state mandates a specific procedure for incorporating a business. Most states require at least three *incorporators*—the individuals who create the corporation—which opens incorporation possibilities to small businesses. Another requirement demands that a new corporation adopt a name dissimilar from those of other businesses; most states require that the name must end with the word *Company*, *Corporation*, *Incorporated*, or *Limited* to show that the owners have limited liability. Figure 5.7 lists ten elements of the articles of incorporation that most states require for chartering a corporation.

The information provided in the articles of incorporation forms the basis on which a state grants a **corporate charter**, a legal document that formally establishes a corporation. After securing the charter, the owners prepare the company's bylaws, which describe the rules and procedures for its operation.

Figure 5.7 Traditional Articles of Incorporation

- Name and Address of the Corporation
- Corporate Objectives
- Type and Amount of Stock to Issue
- Expected Life of the Corporation
- Financial Capital at the Time of Incorporation
- Provisions for Transferring Shares of Stock among Owners
- Provisions for Regulating Internal Corporate Affairs
- Address of the Business Office Registered with the State of Incorporation
- Names and Addresses of the Initial Board of Directors
- Names and Addresses of the Incorporators

Corporate Management

Depending on its size, a corporation has some or all of the ownership and management levels illustrated in Figure 5.8. At the top of the figure are **stockholders.** They acquire shares of stock in the corporation and so become part owners of it. Some companies, such as family businesses, are owned by relatively few stockholders, and the stock is generally unavailable to outsiders. In such a firm, known as a *closed* or *closely held corporation*, the stockholders also control and manage all activities. In contrast, an open corporation, sometimes called a *publicly held corporation*, sells stock to the general public, establishing diversified ownership and often leading to larger operations than those of a closed corporation.

stockholder person or organization who owns shares of stock in a corporation.

Stock Ownership and Stockholder Rights

Publicly held corporations usually hold annual stockholders' meetings. During these meetings, managers report on corporate activities, and stockholders vote on any decisions that require their approval, including elections of officers. Wal-Mart holds the nation's largest stockholder meeting in a university's basketball arena. Approximately 18,000 people attend. In addition to standard shareholder business, the Wal-Mart meeting has featured celebrities and entertainers such as Jessica Simpson, Jimmy Buffett, and Will Smith.[61]

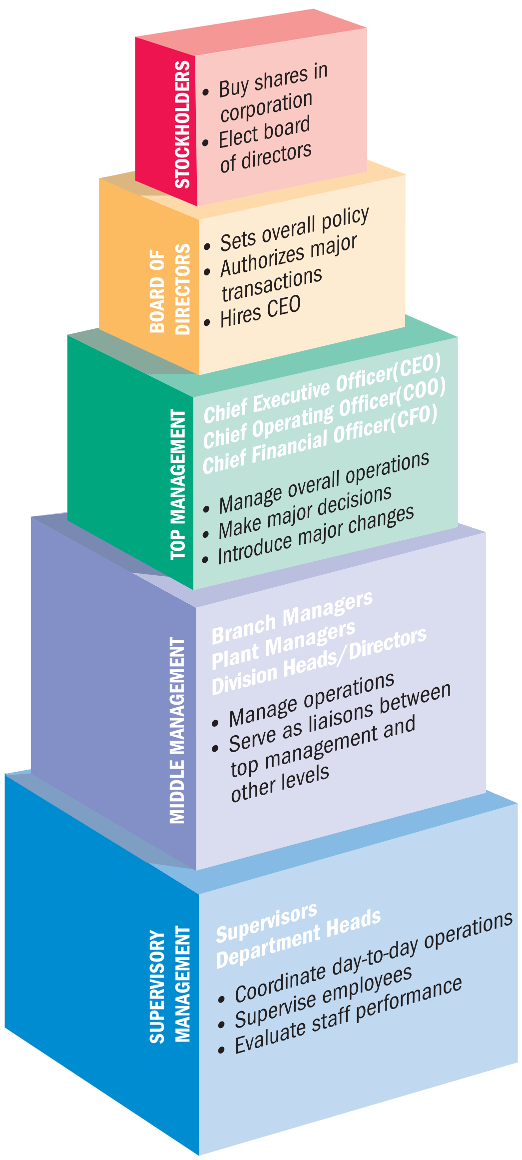
Stockholders' role in the corporation depends on the class of stock they own. Shares are usually classified as common or preferred stock. Although owners of **preferred stock** have limited voting rights, they are entitled to receive dividends before common-stock holders. If the corporation is dissolved, they have first claims on assets, once debtors are repaid. Owners of **common stock** have voting rights but only residual claims on the firm's assets, which means they are last to receive any income distributions. Because one share is typically worth only one vote, small stockholders generally have little influence on corporate management actions.

Board of Directors

Stockholders elect a **board of directors**—the governing body of a corporation. The board sets overall policy, authorizes major transactions involving the corporation, and hires the chief executive officer (CEO). Most boards include both inside directors (corporate executives) and outside directors—people who are not employed by the organization.

board of directors elected governing body of a corporation.

Figure 5.8 Levels of Management in a Corporation



Sometimes the corporation's top executive also chairs the board. Generally, outside directors are also stockholders.

Corporate Officers and Managers

The CEO and other members of top management, such as the chief operating officer (COO) and chief financial officer (CFO), make most major corporate decisions. Managers at the next level down the hierarchy, middle management, handle the ongoing operational functions of the company. At the first tier of management, supervisory personnel coordinate day-to-day operations, assign specific tasks to employees, and evaluate job performance. The activities and responsibilities of managers at various levels in the organization are described in detail in Chapter 8.

In the past, top managers of corporations have had nearly free rein to guide their companies. The firm's CEO has traditionally played a major role in nominating candidates for board membership and often served jointly as board chairperson and CEO. Recent corporate and accounting scandals were traced to a lack of business ethics, coupled with illegal acts of members of top management and failure of the corporate boards to fulfill their obligations to the firm's investors in providing adequate oversight. These failings among a number of large corporations prompted Congress to pass the Sarbanes-Oxley Act of 2002, which tightened requirements of corporate boards and required CEOs and CFOs of major corporations to certify in writing the accuracy of the firm's financial statements. New criminal penalties were established for corporate wrongdoers. This far-reaching legislation, which focuses on improving corporate governance and increasing the accountability of corporate boards, top executives, and accounting firms, was introduced in the appendix titled "A Legal Framework for Business" following Chapter 4. Its impact on business will be also be discussed in the management, accounting, and finance chapters later in the text.

Employee-Owned Corporations

Another alternative in creating a corporation is **employee ownership,** in which workers buy shares of stock in the company that employs them. The corporate organization stays the same, but most stockholders are also employees.

The popularity of this form of corporation is growing. Since the mid-1970s, the number of employee ownership plans has grown sevenfold—to approximately 11,400. But the number of employees participating in such plans today is nearly 34 times as many—nearly 10 million people.[62] Several trends underlie the growth in employee ownership. One is that employees want to share in whatever wealth their company earns. Another is that managers want employees to care deeply about the company's success so that they will contribute their best effort. Because human resources are so essential to the success of a modern business, employers want to build their employees' commitment to the organization. Some of the country's most successful public corporations, including Procter & Gamble, Lowe's, and Southwest Airlines, have embraced employee ownership and watched their stock values hold up better than other companies; sales of employee-owned companies are 2.3 to 2.4 percent larger than nonemployee-owned firms.[63] Employee-owned firms are discussed in more detail in Chapter 9.

assessment check

1. What is the role of stockholders, the board of directors, and corporate officers and management?
2. Identify all the levels of corporate management.

Not-for-Profit Corporations

The same business concepts that apply to organizations whose objectives include earning profits also apply to **not-for-profit corporations**—firms pursuing objectives other than returning profits to owners. About 1.5 million not-for-profits operate in the United States, including charitable groups, social-welfare organizations, and religious congregations. This sector includes museums, libraries, religious and human-service organizations, private secondary schools, healthcare facilities, symphony orchestras, zoos, and thousands of other groups such as government agencies, political parties, and labor unions.

A good example of a not-for-profit corporation is the San Francisco Ballet, which has been at the forefront of dance in America since its founding in 1933 as America's first professional ballet company. It is widely regarded as one of the premier ballet companies in the nation. Visitors to its Web site, http://www.sfballet.org, can learn about upcoming performances, purchase tickets, buy gift certificates, and shop online at the gift shop.[64]

UPI PHOTO/WILLIAM ALIX/LANDOV

The San Francisco Ballet company was founded in 1933 to train dancers to appear in full-length operas. Today, though, the not-for-profit company is the third-largest ballet company in the United States, and it stages more than 100 performances annually. It also trains approximately 325 ballet dancers per year.

Most states set out separate legal provisions for organizational structures and operations of not-for-profit corporations. These organizations do not issue stock certificates, because they pay no dividends to owners, and ownership rarely changes. They are also exempt from paying income taxes.

WHEN BUSINESSES JOIN FORCES

Today's corporate world features many complex unions of companies, not always in the same industry or even in the same country. Many well-known firms have changed owners, become parts of other corporations, split into smaller units, or experienced financial bankruptcy. Current trends in corporate ownership include mergers and acquisitions, and joint ventures.

Mergers and Acquisitions (M&A)

In recent years, merger mania has hit U.S. corporations. Procter & Gamble paid $54 billion in stock to acquire Gillette. Cingular Wireless paid $41 billion to acquire AT&T Wireless. Sprint paid $35 billion to merge with Nextel Communications. SBC paid $16 billion to acquire AT&T.[65] Typically, 7,000 to 9,000 mergers and acquisitions take place annually.[66]

The terms *merger* and *acquisition* are often used interchangeably, but their meanings differ. In a **merger,** two or more firms combine to form one company; in an **acquisition,** one firm purchases the property and assumes the obligations of another. Acquisitions also occur when one firm buys a division or subsidiary from another firm. Many mergers and acquisitions cross national borders, as managers attempt to enter new markets and improve global competitiveness for their companies. Bermuda-based Bacardi International, one of the world's largest producers of alcoholic beverages, paid $2.29 billion to acquire Grey Goose, a maker of premium vodka ($30+ a bottle) in Cognac, France, from Sidney Frank Importing of New Rochelle, New York. Bacardi not only aims to increase sales of Grey Goose vodka in the United States but wants to double the number of countries around the world in which it is sold.[67]

merger combination of two or more firms to form one company.

acquisition procedure in which one firm purchases the property and assumes the obligations of another.

Mergers can be classified as vertical, horizontal, or conglomerate. A **vertical merger** combines firms operating at different levels in the production and marketing process—the combination of a manufacturer and a large retailer, for instance. A vertical merger pursues one of two primary goals: (1) to ensure adequate flows of raw materials and supplies needed for a firm's products, or (2) to increase distribution. Software giant Microsoft is well known for acquiring small firms that have developed products with strong market potential, such as Teleo, a provider of voice over Internet protocol (VoIP) software and services that can be used to make phone calls via the Internet.[68] Likewise, large petroleum companies often try to reduce the uncertainty of their future petroleum supplies by acquiring successful oil and gas exploration firms.

A **horizontal merger** joins firms in the same industry that wish to diversify, increase their customer bases, cut costs, or offer expanded product lines. While P&G and Gillette are both in the global consumer goods business, Gillette was strong in shaving, men's grooming, and oral care and toothbrushes, while P&G excelled in beauty care, laundry and household cleaners, baby products, drugs, and pet care. The combined company features 21 brands with annual sales of $1 billion or more.[69]

A **conglomerate merger** combines unrelated firms. The most common reasons for a conglomerate merger are to diversify, spur sales growth, or spend a cash surplus that might otherwise make the firm a tempting target for a takeover effort. Conglomerate mergers may join firms in totally unrelated industries. A company well known for its conglomerate mergers is GE, which owns television broadcaster NBC and cable programmers CNBC and MSNBC, along with its manufacturing businesses such as appliances, aircraft engines, and industrial products. Experts debate whether conglomerate mergers are beneficial. The usual argument in favor of such mergers is that a company can use its management expertise to succeed in a variety of industries. However, the stock of an acquiring company often falls in price when it makes an acquisition, suggesting that investors doubt the value of this strategy.

Joint Ventures: Specialized Partnerships

A **joint venture** is a partnership between companies formed for a specific undertaking. Sometimes a company enters into a joint venture with a local firm or government, sharing the operation's costs, risks, management, and profits with its local partner. A joint venture also may enable companies to solve a mutual problem. Four U.S. pipeline companies entered into a joint venture to provide better service to the oil refineries that use their services. Their venture, called Transport4, created an online resource at which 430 oil companies can schedule use of the pipelines and track the delivery of 4.5 million barrels of petroleum per day, which often must pass through more than one company's pipelines to reach its destination. Transport4 collects orders and schedules petroleum shipments for more than 150,000 oil transactions per day through the four pipeline companies' systems. It frees customers from calling each company to negotiate and renegotiate schedules.[70] As discussed in the previous chapter, joint ventures also offer particularly attractive ways for small firms to conduct international business, because they bring substantial benefits from partners already operating inside the host countries.

assessment check

1. Distinguish between a merger and an acquisition.
2. What are the different kinds of mergers?
3. What is a joint venture?

PUBLIC AND COLLECTIVE OWNERSHIP

Most business organizations are owned privately by individuals or groups of people, but municipal, state, and national governments own some firms. In addition, groups of people collectively own some companies. Public ownership is common in many industries, both in the United States and abroad. In the United States, more than 350 municipalities offer Internet or cable TV services, competing with private firms that offer those same services.[71]

Public Ownership

One alternative to private ownership is some form of **public ownership,** in which a unit or agency of government owns and operates an organization. In the United States, local governments often own parking structures and water systems. The Pennsylvania Turnpike Authority operates a vital highway link across the Keystone State. The federal government operates Hoover Dam in Nevada to provide electricity over a large region.

Government-Owned Corporations

Sometimes public ownership results when private investors are unwilling to invest in a high-risk project. This situation occurred with the rural electrification programs of the 1930s, which expanded utility lines in sparsely populated areas. At other times, public ownership has replaced private ownership of failed organizations. Certain functions, such as municipal water systems, are considered so important to public welfare that government often implements public ownership to protect its citizens from problems. Finally, some nations use public business ownership to foster competition by operating public companies as competitive business enterprises. In Bogota, Colombia, the government runs a TV and radio network, Instituto Nacional de Radio & Television, that broadcasts both educational and commercial programs. Public ownership remains common abroad, despite a general trend toward privatization.

Customer-Owned Businesses: Cooperatives

Another alternative to traditional private business ownership is collective ownership of a production, storage, transportation, or marketing organization. Such collective ownership establishes an organization referred to as a **cooperative** (or **co-op**), whose owners join forces to collectively operate all or part of the functions in their industry.

Cooperatives allow small businesses to obtain quantity discounts on purchases, reducing costs and enabling the co-op to pass on the savings to its members. Marketing and advertising expenses are shared among members, and the co-op's facilities can also serve as a distribution center.

Cooperatives are frequently found in small farming communities, but they also serve large growers of specific crops. For instance, Blue Diamond Growers is a cooperative that represents California almond growers. Retailers have also established co-ops. Ace Hardware is a cooperative of independently owned hardware stores. Financial co-ops, such as credit unions, offer members higher interest rates on deposits and lower interest rates on loans than other profit-seeking institutions could provide.

assessment check

1. What is private ownership? What is public ownership? What is government ownership?
2. Where are cooperatives typically found and what benefits do they provide small businesses?

WHAT'S AHEAD

The next chapter shifts the book's focus to the driving forces behind new-business formation: entrepreneurs. It examines the differences between a small-business owner and an entrepreneur and identifies certain personality traits typical of entrepreneurs. The chapter also details the process of launching a new venture, including identifying opportunities, locating needed financing, and turning good ideas into successful businesses. Finally, the chapter explores a method for infusing the entrepreneurial spirit into established businesses—intrapreneurship.

Summary of Learning Goals

1 Distinguish between small and large businesses and identify the industries in which most small firms are established.

Small businesses can adopt many profiles, from part-time, home-based businesses to firms with several hundred employees. A small business is a firm that is independently owned and operated, is not dominant in its field, and meets industry-specific size standards for income or number of employees. Small businesses operate in every industry, but retailing, services, and construction feature the highest proportions of small enterprises.

Assessment Check Answers

1.1 What characteristics does the SBA use to determine whether a business is a small business?
The SBA looks at the number of employees, annual sales, and whether a firm is independently owned and not dominant in its field.

1.2 Identify three industries in which small businesses are common.
Construction, wholesale, retail, and service industries are common for small businesses.

2 Discuss the economic and social contributions of small business.

Small businesses create 75 percent of the new jobs in the U.S. economy and employ half of U.S. workers. They provide valuable outlets for entrepreneurial activity and often contribute to the creation of new industries or development of new business processes. Women, minorities, and immigrants find small-business ownership to be an attractive alternative to working in large firms and are starting new companies at a much faster rate than the overall growth in U.S. businesses. Small firms may also offer enhanced lifestyle flexibility and opportunities to gain personal satisfaction.

Assessment Check Answers

2.1 To what extent do small businesses help create new jobs?
On average, three of every four new jobs are created by small businesses.

2.2 In what ways do small businesses contribute to the economy?
Small businesses create new jobs, new industries, and better products and services through innovation.

3 Describe the reasons that small businesses fail.

Because of management shortcomings, inadequate financing, and difficulty dealing with government regulations, small businesses are much more likely to fail than large businesses, especially during economic downturns.

Assessment Check Answers

3.1 What percentage of small businesses will still be in business two, four, six, and ten years after starting?
One-third, 50 percent, 62 percent, and 82 percent of small businesses will have failed within two, four, six, and ten years, respectively.

3.2 How do management shortcomings, inadequate financing, and government regulation make small businesses more likely to fail?
Founders of new businesses often lack the business expertise and experience needed to grow a small business. Inadequate financing prevents small businesses from handling the inevitable cash shortfalls they face and from attracting and keeping talented people. Government regulation burdens small businesses that have limited staff and budgets with expensive, time-consuming red tape and paperwork.

4 Describe how the Small Business Administration assists small-business owners.

The U.S. Small Business Administration helps small-business owners obtain financing through programs that guarantee repayment of their bank loans or match small-business owners with potential investors. The SBA also helps women and minority business owners obtain government purchasing contracts. It offers training and information resources, so business owners can improve their odds of success. Finally, the SBA advocates small-business interests within the federal government.

Assessment Check Answers

4.1 What components should be part of a good business plan?
A good business plan contains an executive summary, an introduction, separate financial and marketing sections, and the résumés of the principals.

4.2 What are the various ways and methods by which the SBA helps small businesses with financing and getting government contracts?
The SBA guarantees business loans, helps small businesses compete for government set-aside programs, and provides business information, advice, and training.

5 Explain how franchising can provide opportunities for both franchisors and franchisees.

A franchisor is a company that sells the rights to use its brand name, operating procedures, and other intellectual property to franchisees. Franchising helps business owners expand their companies' operations with limited financial investments. Franchisees, the individuals who buy the right to operate a business using the franchisor's intellectual property, gain a proven business system, brand recognition, and training and other support from the franchisor.

Assessment Check Answers

5.1 Distinguish between a franchisor and a franchisee.
Franchisors permit franchisees to use their business name and to sell their business's goods and services. Franchisors also provide franchisees a variety of marketing, management, and other services in return for various fees and a percentage of the franchisee's sales.

5.2 Name some of the largest franchises.
McDonald's, Burger King, KFC, Pizza Hut, Taco Bell, Subway, Curves, Quizno's, Jackson Hewitt Tax Services, UPS, Sonic Drive-In, Jani-King, 7-Eleven, Dunkin' Donuts, and RE/MAX are some of the largest franchises.

5.3 What are the benefits and problems of franchising?
Advantages include a prior performance record, a recognizable company name, a business model that has proven successful in other locations, a tested management program, and business training for the franchisee. On the negative side, franchise fee payments can be very expensive, the franchisee is linked to the reputation and management of the franchise, and new franchise outlets may compete directly with established franchises.

6 Summarize the three basic forms of business ownership and the advantages and disadvantages of each form.

A sole proprietorship is owned and operated by one person. While sole proprietorships are easy to set up and offer great operating flexibility, the owner remains personally liable for all of the firm's debts and legal settlements. In a partnership, two or more individuals share responsibility for owning and running the business. Partnerships are relatively easy to set up, but they do not offer protection from liability. Also, partnerships may experience problems by the death of a partner or when partners fail to communicate or establish effective working relationships. When a business is set up as a corporation, it becomes a separate legal entity. Investors receive shares of stock in the firm. Owners have no legal and financial liability beyond their individual investments.

Assessment Check Answers

6.1 What are the key differences between sole proprietorships, partnerships, and corporations?
Sole proprietorships expose their owners to unlimited financial liability from their businesses. Corporations shield business owners from financial liability by separating an organization's assets and liabilities from its business owners' assets and liabilities.

6.2 What are the advantages and disadvantages of sole proprietorships, partnerships, and corporations?
Sole proprietorships are easy to form and dissolve, and they allow owners to retain all business profits. But they lack long-term continuity, and their owners are personally liable for all business debts and must be capable of handling a wide range of business tasks. Partnerships are easy to form and offer expanded financial capabilities and complementary skills and knowledge. But they are difficult to dissolve, are vulnerable to personal conflicts, and make their owners personally liable for all business debts. Corporations shield owners from financial and legal risks, draw on specialized skills of employees, and can expand financial capabilities by selling stock. However, corporations are more difficult to establish, face double taxation of corporate earnings, and are subject to numerous state and federal laws and regulations.

7 Identify the levels of corporate management.

Stockholders, or shareholders, own a corporation. In return for their financial investments, they receive shares of stock in the company. The number of stockholders in a firm can vary widely, depending on whether the firm is privately owned or makes its stock available to the public. Shareholders elect the firm's board of directors, the individuals responsible for overall corporate management. The board has legal authority to change or create the firm's policies. A company's officers are the top managers who oversee its operating decisions.

Assessment Check Answers

7.1 What is the role of stockholders, the board of directors, and corporate officers and management?
Stockholders acquire shares of stock and become corporate owners. At the annual stockholders' meeting, managers report on corporate activities and stockholders vote on any decisions that require their approval, including elections of officers. The board of directors sets overall policy, authorizes major transactions involving the corporation, and hires the chief executive officer (CEO). The CEO and other members of top management make most major corporate decisions and are accountable to the board and shareholders.

7.2 Identify all the levels of corporate management.
The levels of corporate management include top management, middle management, and supervisory management.

8 Describe recent trends in mergers and acquisitions.

Typically, 7,000 to 9,000 corporate mergers and acquisitions occur each year. U.S. corporations are spending record amounts on mergers and acquisitions. These business combinations occur worldwide, and companies often merge with or acquire other companies to aid their operations across national boundaries. Vertical mergers help a firm ensure access to adequate raw materials and supplies for production or improve its distribution outlets. Horizontal mergers occur when firms in the same industry join to diversify or offer expanded product lines. Conglomerate mergers combine unrelated firms, often to help spend cash surpluses that might otherwise make a firm a takeover target.

Assessment Check Answers

8.1 Distinguish between a merger and an acquisition.
In a merger, two or more firms combine to form one company. In an acquisition, one firm purchases the property and assumes the obligations of another. Acquisitions also occur when one firm buys a division or subsidiary from another firm.

8.2 What are the different kinds of mergers?
Mergers can be classified as vertical, horizontal, or conglomerate.

8.3 What is a joint venture?
A joint venture is a partnership between companies formed for a specific undertaking.

9 Differentiate among private ownership, public ownership, and collective ownership (cooperatives).

Managers or a group of major stockholders sometimes buy all of a firm's stock. The firm then becomes a privately owned company, and its stock is no longer publicly traded. Some firms allow workers to buy large blocks of stock, so the employees gain ownership stakes. Municipal, state, and national governments also own and operate some businesses. This public business ownership has declined, however, through a recent trend toward privatization of publicly run organizations. In a cooperative, individuals or companies band together to collectively operate all or part of an industry's functions. The cooperative's owners control its activities by electing a board of directors from its members. Cooperatives are usually set up to provide for collective ownership of a production, storage, transportation, or marketing organization that is important to an industry.

Assessment Check Answers

9.1 What is private ownership? What is public ownership? What is collective ownership?
Most business organizations are owned privately by individuals or groups of people. Public ownership occurs when a government unit or agency owns and operates an organization. In a cooperative, individuals or companies band together to collectively operate all or part of an industry's functions. The cooperative's owners control its activities by electing a board of directors from their members.

9.2 Where are cooperatives typically found and what benefits do they provide small businesses?
Cooperatives are usually set up to provide for collective ownership of a production, storage, transportation, or marketing organization that is important to an industry.

Business Terms You Need to Know

small business 146
business plan 158
Small Business Administration (SBA) 158
business incubator 160
franchising 163
sole proprietorship 166
partnership 168
corporation 168
stockholder 171
board of directors 171
merger 173
acquisition 173

Other Important Business Terms

home-based business 149
microloans 159
Small Business Investment Company (SBIC) 159
set-aside program 159
franchisee 164
franchisor 164
S corporation 169
limited liability company (LLC) 169
domestic corporation 170
foreign corporation 170
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corporate charter 171
preferred stock 171
common stock 171
employee ownership 172
not-for-profit corporation 173
vertical merger 173
horizontal merger 174
conglomerate merger 174
joint venture 174
public ownership 175
cooperative (co-op) 175

Review Questions

1. What is meant by the term *small business?* What business sectors are most and least likely to be dominated by small firms?
2. What are the most common industries for small businesses? What opportunities do home-based companies and the Internet provide for small business? How do small businesses contribute to a nation's economy in terms of job creation and new industries and innovation?
3. What percentage of small businesses is likely to fail two, four, six, and ten years after starting? Why are small businesses more likely to fail? Explain how poor management, inadequate financing, and government regulations put small businesses at a disadvantage.
4. What are the benefits of a good business plan? Identify the major components of a business plan.
5. What is the Small Business Administration? How does it assist small companies, financially and in other specialized ways? What are business incubators?
6. To what extent are small businesses creating opportunities for women today? Why have Hispanics become the nation's largest group of minority business owners? To what extent are other minority groups, including immigrants, taking advantage of opportunities to start and run their own businesses?
7. What are the top franchises and the latest trends in franchising? Describe a typical franchising agreement. What are the advantages and disadvantages of a franchising agreement?
8. What are a sole proprietorship, a partnership, and a corporation? How are they different? What are the advantages and disadvantages of each organizational form?
9. What are the three categories of corporations? What are the steps for creating a new corporation? Why does location matter? What is a corporate charter?
10. What are the levels of management in a corporation? What is the difference between employee-owned and not-for-profit corporations?
11. How are mergers and acquisitions different? What are the three kinds of mergers? What is a joint venture?
12. Distinguish among public ownership, government-owned corporations, and customer-owned businesses (cooperatives).

Projects and Teamwork Applications

1. Go to Entrepreneur.com and look for information on home-based business franchises. Choose three that interest you. Compare their company backgrounds, the costs and fees of becoming a franchisee, the training and support provided by the franchisor, and Entrepreneur.com's ratings for each franchisor. Also, visit the franchisors' Web sites. Which of the three home-based business franchises would represent the best opportunity for you? Why?
2. Read the business page of your local newspaper and choose a small business that has been profiled or mentioned in the paper. What do you think makes this business successful?
3. Propose an idea for a business incubator in an industry that interests you. Describe where the incubator would be located, how it would function, and what it is intended to accomplish.
4. Livewire International, http://www.livewirekiosk.com, a York, Pennsylvania, firm that provides electronic kiosks for ski lift tickets, has made alliances with businesses such as ski resorts and sports retailers. Describe another type of company that Livewire might make an alliance with. How might this alliance benefit Livewire? What precautions should Livewire take in entering into the alliance?
5. Do you think that consumers benefit from public ownership of such functions as municipal water systems and the postal service? Why or why not?

Case 5.1

Armstrong's Supply Rebuilds in the Wake of Hurricane Katrina

Scott Armstrong's family has been in New Orleans since the 1840s, only a generation less than his wife's ancestors. His electrical and lighting supply business, Armstrong's Supply, was founded by a great-uncle there in 1924. So leaving the city after the flooding and other damage wrought by Hurricane Katrina was simply not an option for him.

President and part owner of the electrical services and lighting firm, Armstrong faced numerous problems as New Orleans struggled to dry, clean, and rebuild thousands of ruined homes and businesses. His first priority was to find or account for all of his 32 longtime employees, which included rowing back to the flooded city to check the home of a missing worker. While Armstrong tackled that job, his wife and four other employees raced to every Home Depot and Lowe's in Houston and southern Louisiana to stock up on the electrical service equipment Armstrong's small-business customers and emergency repair crews would soon be asking him for. "I'm trying to make sure that not a single one of my customers has to go to another supplier because we don't have it," he explained. To ensure he could meet demand, Armstrong also asked his regular wholesale suppliers to rush him shipments of wiring, circuit-breaker panels, and other supplies on credit and to give him six months to pay.

Armstrong then negotiated leases on two buildings, one in a heavily damaged area of the city where he guessed most of the rebuilding would begin. He rented another building near his branch office to take the place of his ruined headquarters, which was inches deep in the flood's toxic mud. Without any means to write a lease, he and the landlord sealed the deal with a handshake. Armstrong had estimated that about 80 percent of his inventory was unsalvageable, along with the company's trucks, computers, and new phone system. So he spent hours on the phone getting the credit limits extended on his personal credit cards to cover necessary business purchases, including $11,000 for new computer equipment.

The next step was rebuilding financial security for the company by taking out short-term loans and wrangling with the insurance company that had protected

Armstrong's business against work stoppages by covering the payroll for up to 90 days. When the insurer explained that his policy didn't cover flooding, Armstrong argued that the government-mandated evacuation had caused the stoppage, along with the city's traumatic power loss and other factors. While waiting for a decision about his insurance settlement, Armstrong struggled to reduce his $25,000 weekly payroll. He contacted suppliers and business acquaintances and asked them to try to give some of his workers jobs. He and two other company executives took an immediate 25 percent pay cut, and workers who returned and whom the firm could still employ were given 10 percent pay cuts. Those who weren't essential for the short term, such as workers in the temporarily defunct retail arm of the business, were being paid half their salaries until further notice. Darren Sixkiller, operations and customer service manager, lost his home in the hurricane and his family was displaced. "Armstrong's Supply is my lifeline right now," he said, "because I have nothing to go back to."

Just days after the storm, Armstrong's Supply had updated its Web site with emergency information for customers and employees and was already selling thousands of devices to connect power lines to individual homes. Because his business computers were down and his records were presumed destroyed, Armstrong asked buyers what they had most recently paid for the same item, and that's what he charged them. Though such sales were encouraging, "It's just not fueling the engine that we have to have fueled," said Armstrong. But on the other hand, he concluded, "If we can survive a month, a month, a month, a month, maybe we will be around."

Questions for Critical Thinking

1. What do you think accounts for Scott Armstrong's dedication to his business in the face of such adversity? List as many factors as you can.
2. No business can truly plan for the kind of emergency Armstrong's Supply faced. What effect do you think its size had on its ability to take the first steps to recovery? Are there other actions it could take?

Sources: Armstrong's SupplyWeb site, accessed June 17, 2006, http://www.armstrongssupply.com; Sarah Rubenstein, "A New Orleans Man Struggles to Rebuild His Small Business," *Wall Street Journal Online*, accessed June 17, 2006, http://online.wsj.com; "Special Report: Katrina Update, Part 3," *Ted Magazine,* accessed September 19, 2005, http://www.tedmag.com.

VIDEO

Case 5.2 The UL Mark of Approval

This video case appears on page 612. A recently filmed video, designed to expand and highlight the written case, is available for class use by instructors.