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## AN INTRODUCTION TO THE SMALL BUSINESS LIFE

### A Large Contribution to the U.S. Economy

#### ***Starting Point***

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Go to [www.wiley.com/college/hodgetts](http://www.wiley.com/college/hodgetts) to assess your knowledge of the basics of small business in the U.S.

*Determine where you need to concentrate your effort.*

#### ***What You'll Learn in This Chapter***

- ▲ How to determine whether a business is “small” based on government guidelines and other criteria
- ▲ How much small businesses contribute to the American economy
- ▲ The advantages and disadvantages of starting and managing a small business
- ▲ The primary causes of small business failure and how to avoid them
- ▲ The importance of ethics in business management and the value of creating codes of conduct
- ▲ How to identify areas of social responsibility and classify a given business's responsiveness to those issues

#### ***After Studying This Chapter, You'll Be Able To***

- ▲ Assess whether a business is “small” as defined by the federal government
- ▲ Understand the many contributions your small businesses would make to the U.S. economy
- ▲ Determine whether the advantages and disadvantages of owning and running a small business correspond or conflict with your talents, professional goals, and personal needs or lifestyle
- ▲ Develop a plan for business success by accounting for the common management errors leading to small business failures
- ▲ Create a code of conduct that defines the ethical principles a small business will follow
- ▲ Develop a plan for social responsibility that takes into account the areas of social obligation affecting a small business

## INTRODUCTION

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Contrary to popular belief, the amazing economic success of the United States owes more to small businesses than to large corporations. This chapter will define what constitutes a small business, both in terms of formal definitions and other factors that make a business “small,” and consider the many contributions that small businesses add to our economy. The following sections will discuss the many advantages and disadvantages of owning and managing a small business, and review the reasons why some small businesses fail, including common traps into which many managers fall. The final section will consider the important topics of business ethics and social responsibility, offering advice on using codes of conduct to overcome the mixed message society offers businesses about ethics, and providing an analysis of the key areas of social obligation and the various ways a business can respond to these issues.

### 1.1 Defining the Small Business

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The United States is truly a nation of small businesses. Although large corporations dominate newspaper headlines and television news shows, millions of small businesses fuel progress and innovation and represent the American ideal of free enterprise. Over the past decade, changing markets, technologies, ways of living, attitudes toward the environment, and use of leisure time have spawned dozens of entirely new industries. Viewed in terms of process, change, and evolution, small businesses make two essential contributions to the American economy:

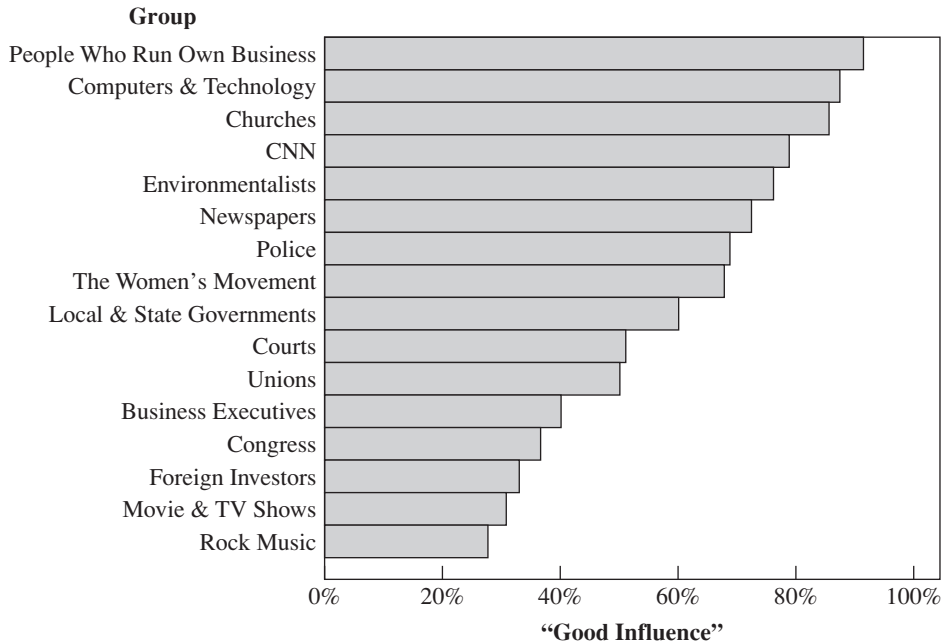
- ▲ They are essential sources of experimentation and innovation. In this role, they drive technological change, spur productivity growth, and help change market structure.
- ▲ They create opportunities for women, minorities, and immigrants. In doing so, they provide an important way for millions of people to enter the economic and social mainstream.<sup>1</sup>

In the United States, owning and operating a small business is a highly respected career. Figure 1-1 illustrates how the general public thinks various groups influence society and people who run their own business rank first. Small business owners achieve ratings ahead of churches, police, and local and state government. Small business owners have become the economic heroes of our modern times.

Studying effective small business management may be the most important way to understand the U.S. economy and to succeed while working in it. And, as the world's nations begin to adopt capitalism, people who understand the initiation, growth, and management of small businesses may hold the key to tomorrow's global economy.

Figure 1-1

**Percent Thinking That Selected Groups Are Having Mainly a Good Influence on the Way Things Are Going**



The influence of small business on society.

### 1.1.1 The U.S. Government Definition

According to the Small Business Act of 1953, a **small business** is one that is independently owned and operated, and is not dominant in its field of operation. The act also authorized the Small Business Administration (SBA) to develop a more detailed definition for most industries in the economy that takes into account criteria such as sales volume and the number of employees in the firm. The SBA has established upper limits for small firms in the following general categories:

- ▲ Manufacturing and mining: 500 employees for most industries
- ▲ Wholesale trade: 100 employees for all industries
- ▲ Retail and service: \$6 million in annual sales for most industries
- ▲ General and heavy constructions: \$28.5 million in annual sales for most industries
- ▲ Special trade contractors: \$12 million in annual sales for all industries
- ▲ Agriculture: \$750,000 in annual sales for most industries<sup>2</sup>

## FOR EXAMPLE

### The Importance of Being Small

Why should a business be concerned if it is defined as “small?” Because that definition could be the key to receiving government-sponsored financing or contracts that, in turn, could mean the difference between success and failure. The Small Business Administration discovered the importance of this issue in 2005 when it proposed simplifying the definition of a small business to one that had 100 or fewer employees, no matter what the industry. In public hearings that followed the announced change, numerous business owners testified that the change might seriously affect their operations, forcing them to lay off employees or even shut their doors. Others said that without SBA loan guarantees they would never have received the financing from venture capitalists necessary for expansion. Ultimately, the SBA came to understand that although the existing definition was complicated, it offered flexibility for different industries. The new definition would have unfairly hurt companies that had more than 100 employees, but were tiny compared to leading firms in their industry. In backing away from its original proposal, the SBA affirmed that defining more firms as small was good for American business.

About one quarter of industries have a size standard that is different from the previous list, although all have employee limits between 100 and 500 or annual sales limits between \$750,000 and \$28.5 million.

An accurate definition of “small” depends on developing limits that are truly appropriate for a given industry. Consider numbers of employees. A retail business may appropriately be defined as small if it has fewer than 100 employees because most retail establishments have few employees, and most retail firms have few establishments. In some industries, such as automobile manufacturing, the typical establishment is often larger than 100 employees, and defining a small business as having fewer than 500 employees accurately recognizes that a firm with 300 or 400 employees may be very small relative to the industry average.

### 1.1.2 Other Factors Making a Business “Small”

The previous section outlines a number of *quantitative* ways to measure the size of a business, but it is also important to consider *qualitative* factors that distinguish a small business from a large one. The Committee for Economic Development has outlined four characteristics that describe a typical small business:

1. Management is independent because the manager usually owns the firm.

2. Capital is supplied by, and ownership is held by, one individual or a few individuals.
3. The area of operations is primarily local, although the market isn't necessarily local.
4. The firm is small when compared to the largest competitors in its own industry.

Taken together, these characteristics provide a qualitative description of small business; however, it is important to consider both the quantitative definitions and the qualitative factors when trying to define small business.

### 1.1.3 Small Business Owners Vs. Entrepreneurs

The terms small business owner and **entrepreneur** are sometimes used interchangeably. Although some situations encompass both terms, it is important to note important differences between the titles. Small business owners usually manage their business with a long-term perspective, aiming for stable sales and profits, and for modest growth. In fact, the business may never grow large—because the owner wants it that way, preferring a more stable and less aggressive approach to running the business, in the process often avoiding innovative practices.

On the other hand, entrepreneurs and their financial backers are usually seeking rapid growth and immediate profits. They often embrace innovation and may even manage their business with an eye on selling it to achieve large capital gains. Thus, entrepreneurs often have a very different perspective from many small business owners. This book will concentrate on the management practices of successful small business owners rather than entrepreneurs, although much of the information will be applicable to both groups.

## SELF-CHECK

1. What two essential contributions do small businesses make to the U.S. economy?
2. In addition to employee or revenue guidelines, what two factors define a small business, according to the SBA?
3. What are the four qualitative characteristics that describe a typical small business?
4. Explain the primary differences between small business owners and entrepreneurs.

## 1.2 The Contributions of Small Businesses

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In terms of sheer numbers, small business dominates the American economy. Consider, for example, data provided by the Small Business Administration regarding the number of new businesses created in 2000–2003. During this three-year span, 1.68 million new small firms (employing fewer than twenty people) were created—an average of more than a half-million new small businesses each year! During this same time period, only 2,093 large businesses (employing more than 500 people) were started.

Small businesses have a similar impact on employment in the U.S. In 2000–2003, firms employing fewer than 20 people were responsible for a net increase of more than 3.5 million jobs. During this same time, businesses employing more than 500 people saw a net *decrease* of 3.4 million jobs. Corporate mega-mergers and the subsequent “downsizing” were largely responsible for this loss of jobs. While this loss of jobs is unfortunate, the situation appears to be creating more opportunities for the smallest businesses—those employing just one person. Self-employment as a primary occupation was expected to increase by almost 50 percent from 1996 to 2006. In 2003, more than 12.2 million people outside of farmers were considered to be self-employed. Much of this growth can be attributed to large corporations making greater use of independent contractors rather than hiring permanent employees.

Consider some of the following facts about small business:

- ▲ About 99 percent of the country’s 23.3 million nonfarm businesses are small as defined by the SBA.
- ▲ Small businesses employ 53 percent of the private nonfarm workforce, contribute 47 percent of all sales in the country, and are responsible for 51 percent of the private gross domestic product.
- ▲ Small businesses provided about 67 percent of initial job opportunities and were responsible for most of the initial on-the-job training in basic skills from 1980 through 1998.
- ▲ In the 1990s, small firms provided 28 percent of the jobs in high-technology industries.
- ▲ Home-based business ownership now represents more than half (52 percent) of all small firms, and provides 10 percent of the total receipts in the economy.
- ▲ Small firms produce 55 percent of innovations. Important innovations by U.S. small firms in the twentieth century include the airplane, audio tape recorder, double-knit fabric, fiber-optic examining equipment, heart valve, optical scanner, pacemaker, personal computer, soft contact lenses, and the zipper.<sup>3</sup>

Small businesses play a major role in the U.S. economy by providing both employment and goods and services. They also complement large businesses by doing what large firms either cannot or will not do, as shown in the following examples:

- ▲ **Small firms play an important role in the introduction of new goods and services to the marketplace.**
- ▲ **Small firms are important suppliers in specialized markets.** Many small firms exist to serve particular demands, as in the case of consumer goods, for which considerable diversity of taste exists. Also, small firms are important suppliers of specialized **intermediate goods**—that is, goods used in the production of other goods.
- ▲ **Small firms purchase, use, and revitalize used capital equipment.** This practice reduces the risk and long-run costs of entry and expansion for all firms. Also, the use of capital equipment that otherwise might lay idle helps to maintain high output levels, which in turn adds jobs to the economy.
- ▲ **Many small firms act as market-demand “shock absorbers.”** By employing flexible technologies, small firms have greater flexibility than large firms in adjusting their production levels and thus are better able to accommodate random, short-term fluctuations in demand. This helps prevent sharp price increases.
- ▲ **Small firms help ensure the mobility of capital resources.** For capital markets to operate efficiently, capital must be free to flow, for example, from industries with low rates of return to industries with higher rates of return. The entry and exit of small businesses facilitate these flows.
- ▲ **Small firms are more likely to employ less-skilled workers and individuals with no prior work experience.** This benefits the economy in two ways. Small firms employ workers who might otherwise have difficulty securing employment. Also, the employment of these workers raises their productivity by giving them on-the-job training and work experience.
- ▲ **Small firms are less likely to encounter problems that can arise from the complex management structures common to large firms.** Smaller businesses are more likely to have a flatter, less-bureaucratic organization in which transferring information is less expensive and more people on all levels can have more impact on important decisions.
- ▲ **A small firm concentrates ownership, and the owner is more likely to be directly involved in management.** Thus, a small firm is less likely to experience problems that arise when a firm’s managers pursue goals that conflict with the owner’s goals.<sup>4</sup>

**FOR EXAMPLE****Small Business Internships**

Small companies provide essential employment and training opportunities for young, inexperienced workers. Some companies hire these people out of financial necessity—they are usually cheaper than older, more experienced workers—but sometimes they provide an essential service. The owner of a small chain of hair salons in Madison, Wisconsin, was disappointed in her ability to attract student customers from the nearby University of Wisconsin. At a friend's suggestion, she worked with the school's employment office to hire two interns—students majoring in marketing and looking for experience—to help her develop a campus customer base. The students ended up doing a variety of valuable jobs for her, including researching competitors and developing a marketing plan aimed at college-age customers. The students helped improve the business in a number of unexpected ways while gaining valuable experience that complemented their classroom studies.<sup>5</sup>

**SELF-CHECK**

1. In recent years, have small businesses or large ones been responsible for creating more new jobs? Why have the numbers of self-employed workers been increasing?
2. What percent of the country's nonfarm businesses are defined as small?
3. List at least five ways that small businesses complement large corporations and in so doing make a major contribution to the U.S. economy.

**1.3 The Advantages and Disadvantages of Small Business**

Small businesses offer tremendous opportunities, but starting one is not for everybody. Before leaping into the small business world, the potential owner should honestly consider their professional goals, personal needs, strengths, and weakness. They should then consider the advantages and disadvantages of owning a small business, which are outlined in the following section. In comparing these various lists, an individual can gain some insight into whether starting a

small business will provide what they are looking for, or expose them to experiences and risks for which they are not prepared.

### 1.3.1 The Advantages of Owning a Small Business

Despite the very real risk of failing, a growing number of people want to own and operate their own small businesses. Numerous benefits can be attained personally as well as professionally by creating and running a small business:

- ▲ **Independence:** Most small business owners enjoy being their own boss. They like the freedom to do things their way, or to establish their own unique business culture. Although often a great deal of responsibility is associated with this independence, they are willing to assume it.
- ▲ **Financial Opportunities:** Another major reason for people going into business for themselves is financial opportunity. Many small business owners make more money running their own company than they would make working for someone else.
- ▲ **Community service:** Sometimes an individual realizes that a particular good or service is not available. If the person has reason to believe the public will pay for such output, he or she can start a company to provide it.
- ▲ **Job security:** When a person owns a business, their job security is ensured. Furthermore, an individual can work as long as he or she wants; there is no mandatory retirement.
- ▲ **Flexibility:** Many small business owners enjoy their ability to schedule their working hours around other commitments in their life, for example, child care or other family-related issues. Others simply relish the ability to take a day off whenever they need to without having to clear things with a supervisor.
- ▲ **Family employment:** Providing family members with a place of employment has several benefits. Many owner-managers want to perpetuate their business, and how better to do so than to get children or relatives to take it over? Too, higher morale and trust usually occur more in family-run businesses than in others. And in times of severe economic downturn, small business owners can provide employment for family members.
- ▲ **Challenge:** Many small business owners are lured by the challenge that accompanies going into business for themselves. Research reveals that most successful small business owners like to feel they have a chance to succeed (they want to know success is possible) and a chance to fail (success is not a sure thing). But one thing is certain: The final outcome depends heavily on them. They want to win or lose on their own abilities. This challenge gives them psychological satisfaction.

### FOR EXAMPLE

#### **Small Business: A Road to Success for New Immigrants**

Aidee Vasquez moved to Boston from Columbia in 1991 with the dream of establishing a new life for herself. Her poor grasp of English initially made it difficult to find a job, but she persevered and found employment cooking and cleaning. Because they paid so poorly, she had to maintain two or more jobs just to pay her bills. She also started selling clothing on the side, enjoyed some success, and realized that a full-time clothing business might be her key to success. A loan from a nonprofit organization supporting low-income business owners provided the start-up funds she needed to open a boutique. Soon her business was growing and she was able to make a living without the stress and uncertainty of working multiple low-paying jobs.<sup>6</sup>

### **1.3.2 The Disadvantages of Owning a Small Business**

It is important to understand that there are some drawbacks to owning a small business. Without proper preparation, an individual may find the career path of business ownership frustrating. The major disadvantages of going into business include:

- ▲ **Sales fluctuations:** Working for a large firm that pays regularly allows an employee to budget food expenditures, plan vacations, and buy clothing. The owner-manager, however, often faces sales fluctuations. In some months sales are very high; in others, they drop off dramatically. The owner must balance cash inflows with cash outflows so that there is always enough money to meet expenses. Sometimes this requires the owner to take a short-term loan to help the business get through a slack period. And virtually every small business has sales fluctuations. For example, retail stores find that their greatest sales volume occurs during the end-of-year holiday season, and construction firms have their best months during the summer when the weather is good.
- ▲ **Competition:** An individual may start a business and prosper for three or four years before meeting insurmountable competition. Or changes in market demand may occur, and the owner will find that this new demand is being satisfied by large competitors. For example, small restaurants and diners may find that they have lost customers to fast-food chains.
- ▲ **Increased responsibilities:** Small businesses face many responsibilities, especially as their operations get larger. For example, owners not only have to make more decisions on major matters, but also have to become

knowledgeable in many different areas. A successful owner is often an accountant, salesperson, personnel manager, and janitor all rolled into one. The individual works long hours and, in many cases, six or seven days per week.

- ▲ **Financial losses:** When the owner makes all major decisions, inevitably some of them will be wrong. On occasion, inventory will be too high or too low; a product line developed at great expense will not sell; a price reduction will not increase product demand, with a resulting decline in total revenue; an advertising campaign will not pay for itself; or an increase in the sales force will prove to be a mistake, and excess personnel will have to be laid off.

In all these cases the owner will face a financial loss, and if enough of them occur, bankruptcy may result; however, this is not what usually happens. Rather, the owner simply ends up making less money, resulting in a small return on investment for a great deal of effort, work, and risk. Additionally, it is important to note that unless the business is incorporated, the owner is personally responsible for all losses. This means the individual could lose everything he or she owns, although in some states the person's home is protected from creditors until the individual chooses to sell it.

- ▲ **Employee relations:** The small business owner also needs to be concerned with employee relations. If the workers are not content, sales will suffer. For example, in many retail stores employees are not allowed to talk or socialize on the job, even though research reveals that if employees feel isolated or alone, their attitudes toward the job will decline. Thus, a balance must be struck regarding how much socializing can be allowed. Solving this problem requires human relations skills.

So do many other problems the owner faces. For example, friction among workers who do not like each other requires the owner to resolve the conflicts by either getting the employees to put aside their personal differences or by firing one or more of them. Another common problem is job assignment. Who will do what? The owner must be careful not to overload one person with work while another does virtually nothing. Financial compensation is also an issue. How much should each person be paid? Should salaries be secret, or should the owner let everyone know how much each person is being paid? As an enterprise grows and more people are hired, more issues arise, including those related to medical insurance, retirement programs, other fringe benefits, and unionization.

- ▲ **Laws and regulations:** Small businesses are subject to a multitude of laws and regulations. For example, federal law requires the owner to pay Social Security taxes for all employees as well as to withhold federal taxes from each person's pay and remit these funds to the government. At the state level, in addition to employee taxes, often a state sales tax

has to be collected and sent to the proper state agency. Also, for some fields the state requires that a license be secured before a business operates; typical examples include restaurants, barbershops, beauty salons, and liquor stores. At the local level, laws often regulate the days of the week and hours of the day during which business can be conducted. In addition, safety and health requirements cover fire prevention and the avoidance of job hazards. Finally, building and zoning regulations limit the type of structures that can be built and where they can be located.

- ▲ **Risk of failure:** The ultimate risk the small business owner-manager faces is failure, usually with a loss of most, if not all, of the money invested in the enterprise. All owners face this risk, and despite experience and business knowledge, many fail because of factors beyond their control—although in most instances, failure is caused by poor management.

### IS SMALL BUSINESS FOR YOU?

Before making the huge commitment to launch a small business, you should honestly evaluate whether this is the right decision for you. The Small Business Administration Web site offers several valuable tools that you can use to assess whether you have what it takes to be a successful entrepreneur. Visit the “Get Ready” section of the site’s Small Business Planner at [www.sba.gov/smallbusinessplanner/plan/getready/index.html](http://www.sba.gov/smallbusinessplanner/plan/getready/index.html). Particularly valuable are the “Do You Have What It Takes?” and “Checklist For Starting A Business” sections. The latter includes an interactive questionnaire that will help you assess your readiness for running a business as well as help you plan your startup.

## SELF-CHECK

1. List at least five advantages of owning a small business.
2. List at least five disadvantages of owning a small business.

### 1.4 Small Business Failure

There are many myths about the high failure rates of small businesses, but research has confirmed a fairly high survival rate for these enterprises. Statistics from the 1990s show an overall 75.5 percent survival rate four years after start-up. Even though the odds for success are pretty good, every year many small

businesses cease operations. It is important for every person considering a career in small business to explore why others have failed. This will allow them to avoid making the same mistakes and to develop a business plan and management philosophy to avoid the most common pitfalls leading to failure.

Most businesses fail when they are unable to pay debts, in which case it is common for the owners to declare bankruptcy and to seek to accommodate the creditors, such as paying them 25 cents on the dollar. In other instances, businesses go out of existence because the owners realize that, although they are currently solvent, if they continue operations they will incur debts they cannot meet. In these instances, **business failure** can be defined as a halt of operations. More important than looking at how businesses meet an untimely end is considering *why* they fail.

### 1.4.1 Some Causes of Failure

Year after year, the major reason that businesses fail is **incompetence**. The owners simply do not know how to run the enterprise. They make major mistakes an experienced, well-trained entrepreneur would see quickly and easily avoid.<sup>7</sup>

The second most common reason businesses fail is **unbalanced experience**. This means owners do not have well-rounded experience in the major activities

#### FOR EXAMPLE

##### Small Problems Can Add up to One Big Failure

Sometimes it is difficult to pinpoint a single reason for a business failure. Consider the story of a bike shop opened in an active, growing community by a first-time business owner. The owner knew and loved bicycles, and he set up a first-class retail establishment that quickly attracted customers. After a strong first couple of years, demand waned and the owner didn't know why or what to do; he knew bikes, not marketing. He panicked and took a part-time job that buoyed his income, but kept him away from the shop at critical times. Sales dropped even more over the next year. To rectify this problem, he hired an assistant manager that had been an enthusiastic customer and offered to work for a low wage, but he did not check out this person's credentials. After six months the assistant quit abruptly and moved out of state—at which point the owner discovered he had been stealing bikes and selling them on the side. The once-promising business was in shambles, and the doors closed. The owner blamed the employee's fraud, but his unbalanced experience, neglect, and lack of managerial experience were probably equally important factors in his failure.

of the business, such as finance, purchasing, selling, and production. Because the owner lacks experience in one or more of these critical areas, the enterprise gradually fails.

A third common cause of business failure is lack of managerial experience. The owners simply do not know how to manage people. A fourth common reason is lack of experience in the line; that is, the owner has entered a business field in which he or she has very little knowledge.

Other common causes of business failure include neglect, fraud, and disaster. **Neglect** occurs whenever an owner does not pay sufficient attention to the enterprise. An owner who has someone else manage the business while he or she goes fishing or plays golf often finds the business failing because of neglect. **Fraud** involves intentional misrepresentation or deception. If one of the people responsible for keeping the business's books begins purchasing materials or goods for himself or herself with the company's money, the business might soon find itself bankrupt. Of course, the owner can sue the individual for recovery of the merchandise and have him or her sent to jail, but that all may happen after the firm's creditors have demanded payment for their merchandise and the owner has had to close the business. **Disaster** refers to some unforeseen happening or "act of God." If a hurricane hits the area and destroys materials sitting in the company's yard, the loss may require the firm to declare bankruptcy. The same is true for fires, burglaries, or extended strikes.<sup>8</sup>

### 1.4.2 Avoiding Management Traps Leading to Failure

In a study reported by the SBA, ten firms that had failed during prosperous years were compared to ten similar companies that had been successful during the same period. An analysis of the two groups revealed a number of avoidable management traps that caused the failure of the small businesses.

- ▲ **Inadequate records:** Nine bankrupt firms had inadequate records. One firm had a good product line, but failed to keep revenue and expense records. The partners never knew where they were in terms of finances. During the bankruptcy proceedings, the accountants admitted they were unable to reconstruct even the simplest form of income statements from the records they had found. In fact, the office records consisted of piles of unsorted papers jammed into an old-fashioned safe.
- ▲ **Expansion beyond resources:** Some of the firms had grown rapidly, and their bookkeeping systems were not designed to handle dramatic growth. In three cases management simply tried to save money on its bookkeeping system by taking shortcuts—all with disastrous effects.
- ▲ **Lack of information about customers:** Half the unsuccessful firms lacked information about their customers. For example, one company

had been shipping goods to customers without making credit investigations. As a result, most of the accounts were 90 days or more in arrears. Additionally, one of its customers was bankrupt and had not made a payment in more than a year, and the company had continued to ship goods to it.

- ▲ **Failure to diversify market:** Three firms failed to diversify their markets and wound up selling their goods to a mere handful of customers. A loss of any one customer would have had a tremendous effect on overall revenue. One company contracted all of its output to one buyer. When that buyer canceled the contract, the company went bankrupt.
- ▲ **Lack of marketing research:** Two firms undertook major ventures without conducting any market research; three adopted a rather simple solution to their marketing problems by contracting their entire plant output to a single buyer. In all cases, changes in market conditions left them in a very poor position.
- ▲ **Legal problems:** One company tried to save money on legal fees; however, when long, drawn-out patent infringement proceedings became necessary, the company was ill prepared to deal with them.
- ▲ **Nepotism:** In three instances favoritism toward family members helped cause the enterprise's failure. One of the most typical examples was the practice of carrying on the payroll family members who received high salaries but contributed little to the overall running of the business.
- ▲ **One-person management:** In three cases, one-person management led to company failure. This occurred in one instance when the individual who had built the firm from nothing began to experience poor health and sold out to a group of investors. The investors did not realize that the man's technical genius was the reason for the company's success. Without that, the business failed within a year.
- ▲ **Lack of technical competence:** Two companies suffered from a lack of technical competence. One had been purchased by a group of investors who had little technical knowledge and lacked the expertise for choosing a technically skilled vice president. The firm's previous reputation carried it for a while, and it had no difficulty landing a contract to supply gun parts; however, the first two shipments were rejected because they did not meet the quality called for by the contract. Eventually, the contract was canceled, and the firm went bankrupt.
- ▲ **Absentee management:** One firm had a long period of profitable operation; then it went through a number of years of absentee management. The owner stayed away for long periods, and operations gradually deteriorated. Financial records were neglected, and the bookkeeper failed to make several years' tax payments. Given such developments, the company failed.

## SELF-CHECK

1. During the 1990s, what was the four-year survival rate for small businesses in the U.S.?
2. Define business failure. What event triggers most business failures?
3. List six common causes of business failure.
4. List at least five management traps that often lead to business failure.

### 1.5 Ethics in Small Business

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Innovation, risk taking, and venture creation form the backbone of the free enterprise system. The qualities of individualism and competition that have emerged from this system have helped to create new jobs and to generate enormous growth in new ventures. These same qualities, however, have also produced complex trade-offs between economic profits and social welfare. On the one hand is the success rate measured in profits, jobs, and efficiency. On the other hand is the quest for personal and social respect, honesty, and integrity. Sadly, several high-profile lapses in corporate ethics (at Enron, WorldCom, Tyco, and other large, once-successful companies) have prompted many Americans to start questioning the integrity of business leaders. Although lumping the vast majority of honest, ethical businesspeople together with the relatively few scoundrels is unfair, it does reinforce the importance of all business owners considering more than just the bottom line when they make management decisions.

Ideally, society would provide one standard for calculating the greatest good for the greatest number and solve various ethical dilemmas for business owners; however, developing one ethical code that suits all people in all situations is nearly impossible. Researchers Longenecker, McKinney, and Moore examined the ethical concerns of small business owners and found many contradictions. The owners surveyed felt they needed to take a strong ethical position with regards to issues such as reporting dangerous design flaws and misleading financial reports. At the same time they were more tolerant of issues that some people might consider serious ethical lapses, including tax evasion, padding expense accounts, and discriminating against women (see Table 1-1).<sup>9</sup> The findings merely proved that ethical decision-making is a complex challenge because of a person's perception of various issues.

In addition to the complexity of ethical decisions, society itself adds to the difficulty by appearing to have a negative opinion about the status of ethics in business. In one study, 65 percent of those surveyed said executives would do everything they could to make a profit, even if it meant ignoring society's needs.<sup>10</sup>

**Table 1-1: Ethical Views of Small Business Owners**

<i>Issues Small Business Owners Believe Require a Strong Ethical Position</i>	<i>Issues Small Business Owners View with Greater Tolerance In Regard to Ethical Position</i>
1. Evaluating faulty investment advice	1. Padded expense accounts
2. Favoritism in promotion	2. Tax evasion
3. Reporting dangerous design flaws	3. Collusion in bidding
4. Misleading financial reporting	4. Insider trading
5. Misleading advertising	5. Discrimination against women
6. Cigarette smoking on the job	6. Copying computer software

Source: Justin G. Longnecker, Joseph A. McKinney, and Carlos W. Moore, "Ethics in Small Business," *Journal of Small Business Management* (Jan. 1989): 30.

Yet the public's perception sometimes is based more on a misunderstanding of the free enterprise system than a condemnation of it. Furthermore, the general public perception stereotypes business ethics as a contradiction in terms. It is a stereotype based on three principal misconceptions that dominate society:

1. Profit and morality are incompatible. In other words, the pursuit of wealth is a barometer of success, yet it is believed wealth tends to corrupt individuals.
2. All ethical problems have simple solutions: They always have a right and wrong answer. This misconception is based on an assumption that an absolute standard exists for judging moral conduct.
3. Ethics is simply a matter of compliance with laws and regulations. Although laws and regulations often emerge from ethical concerns, they are not always considered ethical. (The legal argument versus the ethical argument over abortion is a good example.)<sup>11</sup>

In spite of these misconceptions, the fact remains that unethical behavior in business does take place. Why? A few explanations are possible:

- ▲ Greed
- ▲ An inability to distinguish between activities at work and activities at home
- ▲ A lack of foundation in the study of ethics
- ▲ Survivalist (bottom-line) thinking
- ▲ A reliance on other social institutions (e.g. government or church) to convey and reinforce ethics

Whatever the reasons, ethical decision making is a challenge that every businessperson involved in large or small enterprises confronts.<sup>12</sup>

### 1.5.1 Ethical Practices and Codes of Conduct

**Ethics** provide the basic rules or parameters for conducting any activity in an “acceptable” manner. More specifically, ethics represents a set of principles that explain what is good and right or bad and wrong. Ethics may, in addition, outline moral duties and obligations.<sup>13</sup> The problem with most definitions of ethics is that they are unchanging and they imply that society agrees on certain universal principles. Because society is always changing, however, such a consensus does not exist and there is continual conflict over the ethical nature of decisions. As a result, many businesses turn to a **code of conduct**—a written statement of ethical practices or guidelines to which an enterprise adheres. A variety of such codes exists; some relate to the industry at large, and others directly relate to corporate conduct. These codes cover a multitude of subjects, ranging from misuse of corporate assets, conflict of interest, and use of inside information, to equal employment practices, falsification of books and records, and antitrust violations.

How prevalent are codes of conduct today? The Conference Board, an international consortium of corporate executives, found that 227 out of 300 firms surveyed had codes of conduct.<sup>14</sup> Research into codes of conduct reveals two important things. Codes of conduct are becoming more common in industry. Management is not giving just lip service to ethics and moral behavior; it is putting its ideas into writing and distributing these guidelines for everyone in the organization to read and to follow. Also, recent codes of conduct are proving more meaningful relative to developments in society, offer more comprehensive coverage, and are easier to implement.<sup>15</sup> Students interested in learning more about codes of conduct are encouraged to visit the Web site maintained by the Illinois Institute of Technology Center for the Study of Ethics in the professions (<http://ethics.iit.edu/>). The site includes an online collection of codes of conduct used by various businesses.

The most important question about codes of conduct still remains to be answered: Will management really adhere to a high moral code? Many managers would answer “yes.” They have discovered that high moral conduct results in good business.

A second reason to improve the moral climate of an enterprise is to win back the confidence of the public. A change in the public’s opinion of business would mark a true turnaround because many people today question the moral and ethical integrity of companies and believe businesspeople try to get away with everything they can. Only time will tell whether codes of conduct improve business practices. Current trends indicate, however, that the business community is working hard toward this objective.<sup>16</sup>

### 1.5.2 Ethical Leadership

Even though ethics present complex challenges for small business owners, the entrepreneur-owner’s value system is the key to establishing an ethical organization.

**FOR EXAMPLE****Small Companies Know High Ethical Standards Are Good for Business**

Community Management Associates, Inc., of Plano, Texas, received the prestigious 2006 American Business Ethics Award for small firms. Owner Judi Phares is convinced that you don't have to be a big company to put a corporate ethics policy in place and that there are many good reasons for practicing good corporate citizenship. She said that her company's high ethical standards are a reflection of her personal beliefs, which might be reason enough for an owner to conduct business with the highest standards in mind. But Ms. Phares explains that there is more to it than that: High ethical standards are good for business. "We're in the service business. We don't make widgets. All we have to sell is our reputation."<sup>17</sup>

An owner has the unique opportunity to display honesty, integrity, and ethics in all key decisions. The owner's behavior serves as a model for all employees to follow.

In one study of 282 small business owners, four specific ethical concepts were examined: business development/profit motive; money-related theft; administrative decision making; and giving in to company pressure. The researchers found underlying dimensions of these concepts that were broader than simple adherence to the law. The study refuted the stereotypes of "ethics equating only to law" or "the law is ethics' only guide." In other words, small business owners rely on considerations beyond the law when making decisions. Their value systems were demonstrated to be a critical component in business decisions.<sup>18</sup>

In small businesses, the ethical influence of the owner is more powerful than in larger corporations because his or her leadership is not filtered through layers of management. Owners are identified easily and are observed constantly by employees in a small business. Therefore, small business owners possess a strong potential to establish high ethical standards for all business decisions.<sup>19</sup>

The following list of 12 questions provides a useful tool that leaders can use for examining the ethics of every business decision:

1. Have you defined the problem accurately?
2. How would you define the problem if you stood on the other side of the fence?
3. How did this situation occur in the first place?
4. To whom and to what do you give your loyalty as a person and as a member of the corporation?

5. What is your intention in making this decision?
6. How does this intention compare with the probable results?
7. Whom could your decision or action injure?
8. Can you discuss the problem with the affected parties before you make your decision?
9. Are you confident that your position will be as valid over a long period of time as it seems now?
10. Could you disclose without qualm your decision or action to your boss, your CEO, the board of directors, your family, and society as a whole?
11. What is the symbolic potential of your action if understood? If misunderstood?
12. Under what conditions would you allow exceptions to your stand?<sup>20</sup>

### 1.5.3 Social Responsibility

Over the past three decades, **social responsibility** has emerged as a major issue in the business world. Although it takes different forms for different industries and companies, the basic challenge exists for all.

Social responsibility consists of the obligations a business has to society. As Table 1-2 shows, there are several different areas affected by this societal obligation, including environmental issues, fair business practices, and community involvement. The table offers examples of topics that are important within each area. The diversity of social responsibility opens the door for questions concerning the extent to which corporations should be involved.

Studies have found distinct differences in the stages or levels of socially responsible behavior that corporations exhibit. Some firms simply react to social issues by obeying the laws; others respond more actively, accepting responsibility for various programs; still others are highly proactive and even are willing to be evaluated by the public for various activities. S. Prakash Sethi, a researcher in social responsibility, has established three categories to describe the level of corporate commitment to social concerns:

- ▲ **Social obligation:** Maintains a low public profile and discloses information only when legally required. Denies problems with its business. View contributions as the responsibility of individual employees and gives money only when a direct benefit is shown.
- ▲ **Social responsibility:** Offers information more freely. Willingly admits problems and accepts responsibility to solve them. Contributes to non-controversial and established causes.
- ▲ **Social responsiveness:** Similar to social responsibility with greater openness to public access, scrutiny, and input, and increased willingness to support newer and/or more controversial causes.<sup>21</sup>

**Table 1-2: Areas of Social Responsibility for Small Businesses**

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

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

Only a few studies have examined different features of social responsibility in small firms. For example, an examination of 180 small business owners' perspectives on social responsibility found that 88 percent recognized social responsibility as part of their business role.<sup>22</sup> Another study indicated that small businesses were more critical of their own performance than was the general public.<sup>23</sup> Research also shows differences in the ethical environment between large and small firms. These differences stem from the structure of small firms, which require fewer professional specialists and less formality and whose owners are more closely involved in the actual decision-making.

## SELF-CHECK

1. What are the three general misconceptions of business and ethics held by the general public?
2. List some of the factors explaining unethical behavior in business.
3. Define the terms "ethics" and "codes of conduct," and explain the differences between them.
4. List the six areas of social responsibility that businesses must consider and provide an example of one representative issue from each area.
5. Describe the three categories of corporate commitment to social concern.

## SUMMARY

Small businesses make a significant contribution to the U.S. economy, in many ways overshadowing the impact of large corporations. In particular, small businesses spur innovation and create essential opportunities for women, minorities, and new immigrants. According to the Small Business Act of 1953, a small business is one that is independently owned and operated, and is not dominant in its field of operation. The Small Business Administration offers additional guidelines for annual revenues and number of employees, depending on the industry. Small firms, which represent 99 percent of the nation's nonfarm businesses, provide more than half the jobs in the United States and have been responsible for a majority of innovative products. There are a number of advantages to owning a small business—from independence to financial rewards to job security—but there are also many disadvantages, including increased responsibilities, cumbersome laws and regulations, and the ever-present risk of failure. Research from

the 1990s showed that small businesses have a strong record of success—about 75 percent were still running four years after start-up. Most businesses fail because of owner incompetence, but there are other common causes, including fraud and natural disasters. Many failed small businesses share the same management traps—everything from maintaining inadequate records to expanding beyond available resources—which, if they can be avoided, can help assure long-term success. Because of high-profile cases revealing corporate wrongdoing, businesses of all sizes are coming under greater scrutiny with regards to ethics. Society creates problems by sending mixed signals to business owners and maintaining unfair stereotypes about businesses, but many companies have responded by developing their own written codes of conduct. Small business owners and managers are often able to create an ethical organization through their actions. Social responsibility—with regards to the environment, creating opportunities for women and minority, community involvement, or other issues—has become a hot topic in recent decades. Companies typically fall within one of three categories of responsiveness when facing pressure from society regarding their products or actions.

## KEY TERMS

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<b>Business failure</b>	A halt of business operations. It often occurs when the owners cannot pay debts, or realize that continued operations would lead to that situation.
<b>Code of conduct</b>	A business's written statement of ethical practices or guidelines to which it adheres.
<b>Entrepreneur</b>	Someone who starts and runs a small business with the principal objectives of rapid growth and immediate profits. They are often characterized by their use of innovative practices and a willingness to sell out for large capital gains.
<b>Ethics</b>	The basic rules for conducting any activity in an “acceptable” manner.
<b>Disaster</b>	An unforeseen damaging event or natural calamity.
<b>Fraud</b>	Deception with the intent of misleading another person.
<b>Incompetence</b>	The owner-manager simply does not know how to run an enterprise. The major reason small businesses fail.
<b>Intermediate goods</b>	Goods that are used in the production of other goods.
<b>Neglect</b>	Insufficient attention is paid to a business by its owner.
<b>Nepotism</b>	The practice of a business owner giving jobs or preferential treatment to family members.

<b>Small business</b>	An independently owned and operated company that is not dominant its field of operation.
<b>Social obligation</b>	A business's reaction to social issues by simply obeying the laws and making contributions only when they show a direct economic benefit.
<b>Social responsibility</b>	The obligations a business has to society.
<b>Social responsiveness</b>	A business's proactive support and contribution to new, controversial groups whose needs it sees as unfulfilled and increasingly important.
<b>Unbalanced experience</b>	When an owner or manager lacks experience in one or more of the major activities required for running a business, which can lead to failure of the enterprise.

## ASSESS YOUR UNDERSTANDING

Go to [www.wiley.com/college/hodgetts](http://www.wiley.com/college/hodgetts) to assess your knowledge of the basics of small business in the United States.

*Measure your learning by comparing pre-test and post-test results.*

### Summary Questions

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- Which of the following is not an essential contribution that small businesses make to the U.S. economy?
  - They are sources of experimentation and innovation.
  - They allow their owners an abundance of leisure time.
  - They create opportunities for women, minorities, and recent immigrants.
  - None of the above.
- More Americans think that small business owners are a better influence on society than churches or police departments. True or false?
- Which of the following is not a characteristic of a small business, as defined by the Small Business Act of 1953?
  - They are sources of experimentation and innovation.
  - They are owned by only five or fewer people.
  - They are not dominant in their field of operation.
  - None of the above.
- According to the Council for Economic development, which of the following characterizes a typical small business?
  - Management is independent because the manager usually owns the firm.
  - Capital is supplied by, and ownership is held by, one or a few individuals.
  - The area of operations is primarily local.
  - All of the above.
- An entrepreneur typically manages a small business for the long term, preferring modest growth and profits, and avoiding innovation. True or false?
- There are more large businesses than small businesses in the United States. True or false?
- A majority of the nonfarm workforce in the United States is employed by small businesses. True or false?
- Which of the following is *not* a way that small businesses play an important role in the U.S. economy?
  - They act as market demand “shock absorbers”.
  - They are more likely to employ less-skilled workers.

- (c) They prevent the mobility of capital resources.
  - (d) They purchase, use, and revitalize used capital equipment.
9. Which of the following is *not* an advantage of owning a small business?
- (a) It offers a high level of independence.
  - (b) It appeals to people who prefer minimal flexibility in their schedules.
  - (c) It offers an opportunity to provide jobs to family members.
  - (d) It provides an opportunity to make more money than working for someone else.
10. Sales fluctuations mean that small business owners have to be ready to obtain the cash to keep themselves afloat during slow periods. True or false?
11. Small business owners usually find themselves with fewer responsibilities than when they worked for someone else and can get bored being their own boss. True or false?
12. Human relations problems usually decrease the larger a business grows. True or false?
13. Which of the following is *not* a common cause of small business failure?
- (a) Fraud.
  - (b) Incompetence.
  - (c) Disaster.
  - (d) Communications breakdown.
14. Spending too much time and money on record keeping is often a contributing factor to business failures. True or false?
15. Which of the following is a common management trap that can lead to business failure?
- (a) Failure to diversify market.
  - (b) Absentee management.
  - (c) Lack of information about customers.
  - (d) All of the above.
16. In the twentieth century, the number of business failures fluctuated, often following important economic trends (the Depression) or historic events (World War II). True or false?
17. According to research conducted in the 1990s, 75 percent of small businesses will fail before their fourth year in existence. True or false?
18. Which of the following is a misconception in our society regarding business and ethics?
- (a) Profit and morality are incompatible.
  - (b) All ethical problems have simple solutions.
  - (c) Ethics is simply a matter of complying with laws and regulations.
  - (d) All of the above.

19. Ethics are the basic rules for conducting any activity in an “acceptable” manner. True or false?
20. Which of the following is *not* true about codes of conduct?
  - (a) They are a written statement of ethical guidelines to which an enterprise adheres.
  - (b) They are becoming more common in industry.
  - (c) Recent ones are more meaningful with regards to societal developments.
  - (d) They describe only practices mandated by laws and regulations.
21. The owners and managers of a small business typically have less influence on the ethical behavior of their employees compared to their counterparts in large companies. True or false?
22. Which of the following issues would *not* be described as falling within the realm of social responsibility for a small business?
  - (a) Providing job opportunities for minorities.
  - (b) Delivering a fair profit for its investors.
  - (c) Ensuring a safe workplace for its employees.
  - (d) Contributing money to build a community art center.
23. A “socially responsive” company would probably hire a public relations firm to help convince people that its products were safe rather than seek input on how to improve them. True or false?

### **Applying This Chapter**

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1. The owner of a manufacturing company is interested in obtaining small-business loans to help her expand her operations, but is not sure if her business is still considered “small.” The business was founded in 1978. She bought the company in 2001, and is the primary owner and manager, but has a few investors that own stock in the company. The firm has one plant employing about 200 employees and enjoys sales of \$24 million each year, with products shipping to all of the lower 48 states. The manufacturer is about the fourth largest firm in its industry. Does this firm meet the definition of “small” as established by the Small Business Administration? If yes, does the firm have any “qualitative” factors that further establish its small character?
2. A candidate for Congress discovers that constituents in his district are concerned that not enough is being done to support small business. To help prepare the candidate for an upcoming debate (against an opponent that supports big business), develop two short lists of three items each. One list should quantitatively describe the impact of small businesses;

the other should offer essential contributions that small businesses make to the U.S. economy.

3. A coworker continually talks about quitting his job and starting his own small business. He is talented, but has no experience managing his own business and doesn't seem to be considering the challenges of what he is considering. To help him better evaluate this possible career change, create a list of five disadvantages of being a small business owner, including a sample situation for each that effectively illustrates the challenges he might face.
4. A friend has just started her own business that she is managing herself. She has told you—with total sincerity—that she would really appreciate any advice that you could give her to help her be a better manager. Create a list of five ideas for her to implement that you think will help her business succeed.
5. A young man considering opening his own retail firm is concerned about operating his business in an ethical manner. To that end, he would like to develop a code of conduct to be able to give all his employees. Get him started by suggesting five ethical guidelines that should be included in his retail business's code of conduct.
6. A friend who owns a local business is angry because he has been accused of not being "socially responsible." He doesn't understand the criticism—in part because he diligently follows laws and regulations regarding his business—and is unsure what to do to correct the situation. Help him by explaining the difference between mere social obligation and true social responsibility. Suggest some specific areas in which he could increase his firm's level of social responsibility.

# YOU TRY IT

## **The Politics of Being Small**

Your congressman has just announced that he is considering voting for legislation simplifying the definition of a small business to one that employs no more than 100 people. He thinks this will discourage larger firms from unfairly getting funds from the SBA. Write a brief letter opposing this legislation that explains the contribution small businesses make to the U.S. economy, discusses why it's wrong to apply this single standard to very different industries, and offers some specific ways that deserving small businesses could be hurt by the change.

## **Skills and Traits Leading to Success**

You have been asked to speak to a group of business students at the local community college about what it takes to succeed in running a small business. Consider the many advantages and disadvantages of running a small business, and create a list to share with the students describing the personality traits and business skills that best match the small business environment.

## **Social Responsibility**

Your boss—the owner of the small manufacturing firm you work for—is concerned about some bad publicity

the company has recently received. In response, he just assigned you the job of helping him make the company more socially responsible. Carefully consider and give a brief description of how the company can be more socially responsible in response to the following issues, and explain the possible negative impacts of taking no action:

- The company has been accused of not maintaining a safe workplace by a state worker advocacy organization. The group is demanding access to inspect the facilities and worker-injury records.
- A local fisherman's group is working to clean up the river running past the manufacturing facility. It has suggested that the firm is polluting the river and has threatened to seek the help of a high-profile national environmental group to stop the pollution.
- In a speech on community spirit, the mayor pointedly criticizes the company for not giving its hometown much support—financial or otherwise—and challenges it to change its ways.