# THE ENTREPRENEURIAL EXECUTIVE

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# LETTER FROM THE EDITORS

**Welcome to the second issue of the *Entrepreneurial Executive.* As you know, the mission of the *EE* is to publish articles with practical applications for entrepreneurs or the practice of entrepreneurship. In keeping with the tradition of excellence which the *EE* has established, the articles in this issue will be of interest to entrepreneurs and entrepreneurial scholars, alike.**

**Throughout Volume 1, and continuing with the present issue, the Editorial Board has maintained an acceptance rate for manuscripts of approximately 25%. We think that you will recognize the high standards which the Board preserves in the contents of this issue.**

**We have edited some of the manuscripts in this issue due to space limitations. In every instance, we have attempted to preserve the flavor of the article. When we have failed in that attempt, the authors bear no responsibility.**

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**We invite readers to submit manuscripts for consideration by the *EE.* We also hope that you will join us at the National Conference of the Academy which is scheduled for April 1 through 4, 1997, in Las Vegas, and the International Conference, which is scheduled for October 14 through 17, 1997, in Maui, Hawaii. For information about the conferences, check our WEB page at:**

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# BLACK ENTREPRENEURSHIP: IT HAS A PAST AND IT CAN HAVE A FUTURE

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## ABSTRACT

***This study compares two groups that fall on opposite ends of many scales: mainstream, white business owners in mid-size cities and suburban areas and aspiring Black entrepreneurs from inner city neighborhoods in New York City. One group consists of established, well-off, mostly male, business owners with an average of thirteen years experience owning their own businesses. The other is poor, over 40% unemployed, with little or no business experience. We wanted to know just how large the gap was between these two groups on their motivations and goals for starting or operating a business. Could differences in motivations be part of the reason that Blacks lag so badly in entrepreneurial activity? What we found surprised us: with few exceptions, aspiring Black entrepreneurs have the same motivations and goals as established, white, business owners.***

***Of course, this sample may not be representative of Blacks in general. We surveyed aspiring Black entrepreneurs who were motivated enough to participate in a program designed to put them in business. Even if this group is only a vanguard, leading the way for others, it augers well for the future of Black entrepreneurship and private and public policies that can foster it. As with other racial and ethnic groups, Blacks may use entrepreneurship as their entrance into the economic mainstream.***

## INTRODUCTION

**By the time Thelma Lewis (not her real name) showed up at the Baruch College Small Business Lab, she had been in business for six months. Her gift shop with products aimed at the Black community was growing, but she was facing a cash crunch brought on by collection problems from vendors to whom she rented booth space in her store. She had begun to believe that the lease she had negotiated was onerous. She had not been able to advertise because the radio station she wanted charged $400 per commercial: ten times more than she expected. Thelma had never produced a budget, a cash flow projection, or dealt with real estate issues. At the Small Business Lab, she took classes in planning, computers, and business law, and she was coached through the process of creating a business plan and dealing with specific issues that were threatening her gift shop. Thelma was able to renegotiate her lease, make more financially secure arrangements with her vendors, and develop a marketing plan that fit her new budget. Today, Thelma's business is still growing and her confidence has returned.**

**On the other hand, Richard Lewis (not his real name), who was working part-time as a security guard, came to the Small Business Lab with a vision of building a real estate empire. He said he was inspired by Donald Trump and his life style and deduced that real estate was a good business. He also thought it would be good for the Black community to have a role model who was a successful entrepreneur in the real estate business. Richard wanted to know what he had to do to make that happen for him. When told that Trump's endeavors were the culmination of fifty years of real estate ventures begun by his father, and that Donald Trump had actually flirted with bankruptcy in the recent past, Richard's enthusiasm began to wane. After taking a few classes on accounting and finance, and having some counseling sessions with a professor to focus his efforts on aspects of real estate that was more realistic, Richard stopped showing up at the Lab.**

**As different as they are, the examples of Thelma and Richard reveal some of the issues faced by Black entrepreneurs. Lack of training, experience, and resources make the task of initiating a new venture a daunting one. Some react by becoming discouraged even before they begin; others, like Richard, are simply unrealistic.**

**It is widely accepted that entrepreneurship is the engine of economic growth. Between 1987 and 1992, 90% of new jobs were added by companies with fewer than 500 employees. Firms with fewer than 20 employees added more jobs during the period between 1985 and 1995 than did firms with more than 500 employees. Today there are 13 million sole proprietors in the U.S. and their ranks have been growing at 3% yearly for more than twenty years. This trend has largely bypassed Blacks. Light and Rosenstein studied rates of entrepreneurship as measured by self-employment in 167 metropolitan areas and concluded that Blacks are at the bottom of the scale. Neither the causes of this phenomenon nor its cures are obvious.**

**This study compares two groups: white business owners in mid-size cities and suburban areas and aspiring Black entrepreneurs from inner city neighborhoods in New York City. One group consists of established, well-off, mostly male, business owners with an average of 13 years experience in business ownership. The other is poor, over 40% unemployed, with little or no business experience. We wanted to know just how large the gap was between these two groups on their motivations and goals for starting or operating a business. Could differences in motivations be part of the reason that Blacks lagged so badly in entrepreneurial activity?**

## HISTORY OF BLACK ENTREPRENEURSHIP

**Throughout history, Blacks have been subjected to factors unique among ethnic groups, including forced migration and a century of slavery. Despite these negative factors, there has been a long tradition of Black entrepreneurship. An evaluation of the current state of Black entrepreneurship begins by looking at this tradition. The history of Black entrepreneurship is a history of efforts to suppress it. Butler, in his detailed review of Black entrepreneurship published in 1991, shows how prevalent entrepreneurship was among the 10% of American Blacks that were free prior to emancipation. For example, an 1838 pamphlet, *A Register of Trades of Colored People in the City of Philadelphia,* listed 656 Blacks running businesses in 57 areas including banking, carpentry, blacksmithing, hairdressing, and sail making.**

**In his 1936 book, *The Negro as Capitalist,* Abram Harris detailed the development of mutual-aid societies throughout the 18th and 19th centuries that provided financing and insurance for Black entrepreneurs. Some of these grew to be quite large. By the 1930s, for example, the North Carolina Mutual Insurance Company had an annual revenue in excess of $25 million and was the largest Black-owned business in the world (Butler, p.189). In states that permitted slavery, free Blacks were also slaveholders. In 1830, there were 3,777 Black slaveholders running businesses from farms to manufacturing (Butler p.43).**

**But the barriers faced by Black entrepreneurs were quite unlike anything faced by any other group. In addition to slavery and segregation, Jim Crow laws existed in almost every slave state prohibiting Blacks from locating businesses outside the Black area and from doing business with whites. While other ethnic groups, such as the Irish, Asians, and Jews, certainly suffered discrimination, there were no laws explicitly limiting the markets in which they could operate their businesses.**

**One of the major responses to these barriers against Blacks was the reliance on self-help groups at all levels. The first and largest example of this is churches, many of which served various economic functions by organizing mutual aid groups, sponsoring insurance companies, and supporting schools. Du Bois (1967) detailed 107 schools that were supported financially by the Afro-American Baptist Church in 1907. The large parallel system of Black higher education that developed during the post Civil War period, including the founding of Tuskegee Institute, Grambling College, Hampton Institute, Fisk University, and Howard University, is a clear example of the Black community's self-help efforts.**

## PREVIOUS RESEARCH FINDINGS

**Despite this history of entrepreneurship and self-help, rates of entrepreneurship in the Black community lag behind other groups. Research by Light and Rosenstein and others has recently begun to explain this issue and its origins.**

***Education and training.*** **Light and Rosenstein have found that each additional year of formal education increases an individual's likelihood of becoming an entrepreneur by 0.8%. While this effect is somewhat lower for Blacks and Hispanics, it is nonetheless largely true. Other research, using different methodologies, has found approximately the same effect.**

***Discrimination*. Blacks and other minorities have long focused their economic activities in certain areas. For example, Asian-owned businesses have tended to be concentrated in laundries, food stores, and restaurants. Historically, Black entrepreneurship has been oriented around food businesses and construction. But, even after accounting for all the factors that correlate with entrepreneurship among the entire population, such as education, age, and percentage of the population that is male, Black entrepreneurship is still lower than should be expected. This discrepancy is thought to be the result of discrimination and other cultural factors.**

***Ethnic and racial cultural factors*. Cultural factors are often pointed to as an explanation for the high rates of entrepreneurship among Jews and Koreans, whose entrepreneurship rates are higher than their education levels alone would predict. So too, it is with Blacks, but in the opposite direction: the low rate of Black entrepreneurship is not fully explained by the overall low education level of Blacks.**

This issue of culture, and the values that underlie it, is critical if Blacks are to join the mainstream economic community through the path of entrepreneurship. To examine this issue, this study compares a sample of aspiring Black entrepreneurs who have begun programs at the Small Business Lab, with a sample of business owners in four eastern and midwestern cities, none of whom are Black. The question we sought to answer is how, if at all, aspiring Black entrepreneurs are different from the mainstream, non-minority, business owners they seek to emulate. In fact, the samples were chosen because large differences were expected.

## THEORY AND POLICY ISSUES

If members of minority groups have different goals than the entrepreneurial mainstream, then one can reasonably expect the outcomes of their entrepreneurial efforts to differ as well. For example, if minority entrepreneurs rate the goal of earning money lower than members of other groups, then they could be reasonably expected to operate their businesses in ways that do not maximize financial returns. Their ventures should attract less capital, produce fewer jobs, and contribute less to overall economic activity.

If members of a minority group see entrepreneurship as attractive primarily as a means of avoiding discrimination at their current jobs, then the traditional notions of entrepreneurs driven to bring the vision of a new product or service to market might not apply. Similarly, if members of one group did not see entrepreneurship and business ownership as attractive for the control that it gives the business owner, or the freedom it offers in his or her personal life, then the traditional notions of what motivates entrepreneurs would have to be changed.

From a public policy perspective, the goals of minority entrepreneurs are a critical link in the process of minority business development. If minority entrepreneurs hold different goals or find business ownership and entrepreneurship less attractive than the mainstream of non-minority entrepreneurs and small business owners, it might make scant difference how much training and education were offered or how many discrimination barriers were removed. The public policy of supporting minority entrepreneurs with training and education is useless unless the attractiveness of business ownership and the goals of minority entrepreneurs are similar enough to the non-minority business owner and entrepreneur.

As with the diffusion of any value or behavior, it is important for a vanguard group to adopt an attitude, be rewarded for that attitude through reinforcement, such as recognition or financial benefit, and then spread that value to others within the specified population. This paper sets out to test whether the vanguard group of minority entrepreneurs holds similar attitudes towards entrepreneurship as non-minority entrepreneurs. The importance of this rests within the diffusion model: if the vanguard group does not embrace the same values, then the chances of their being spread to the rest of the minority population is greatly reduced.

## DESCRIPTION OF THE SAMPLES

Table 1 shows the characteristics of the samples. The differences between the samples are mostly what one would expect. The Black sample is more heavily female, 51.9%, compared

**to only 27% female for the sample of non-minority business owners. While the mean ages of the Black and non-minority samples are within one year of each other, at approximately 35 years old, the median age of the Black sample is 32 and the median age of the non-minority sample is 40.**

**Table 1: Demographic Comparison of the Two Samples**

| Characteristic | | Non-Minority Business Owners (n=222) | Non-Minority Percent of Total | Aspiring Black Entrepreneurs (n=82) | Aspiring Black Entrepreneurs Percent of Total |
|---|---|---|---|---|---|
| Gender: | Male | 162 | 73.0 | 39 | 48.1 |
| | Female | 59 | 27.0 | 42 | 51.9 |
| Age: | Under 20 | 2 | 0.9 | 1 | 1.2 |
| | 21 - 30 | 22 | 9.9 | 7 | 8.6 |
| | 31 - 40 | 87 | 39.2 | 30 | 37.0 |
| | 41 - 50 | 72 | 32.4 | 25 | 30.9 |
| | 51 - 60 | 27 | 12.2 | 17 | 21.0 |
| | 61 and over | 12 | 5.4 | 1 | 1.2 |
| Income: | Under $30,000 | 18 | 8.1 | 60 | 77.9 |
| | $30,001-$50,000 | 44 | 19.8 | 17 | 22.1 |
| | $50,001-$70,000 | 42 | 18.9 | - | - |
| | $70,001-$90,000 | 36 | 16.2 | - | - |
| | $90,001-$110,000 | 29 | 13.1 | - | - |
| | $110,001-$130,000 | 13 | 5.9 | - | - |
| | $130,001-$150,000 | 8 | 3.6 | - | - |
| | $150,001-$170,000 | 5 | 2.3 | - | - |
| | $170,001 and over | 22 | 9.5 | - | - |
| Education: | | | | | |
| 1-8th Grade | | 3 | 1.4 | 1 | 1.2 |
| Some High School | | 5 | 2.3 | 4 | 4.9 |
| High School Graduate | | 47 | 21.2 | 11 | 13.4 |
| Some College | | 67 | 30.2 | 30 | 36.6 |
| College Graduate | | 77 | 34.7 | 23 | 28.0 |
| Graduate Degree | | 23 | 10.4 | 13 | 15.9 |

**Income, as presented in Table 1, shows a large difference between the samples. Whereas the non-minority sample has a long tail going to the higher income cells, with 9.5% of the sample earning over $170,000 per year, none of the Black sample earns over $50,000 annually. The mean income for the non-minority sample is $72,000 per year and $31,100 for the Black sample. Given the fact that 41.4% of the Black sample reported that they are currently unemployed, it is surprising that the differences are not greater.**

**On the measure of education level completed, the samples match quite closely. Of the non-minority sample, 45% completed college, compared to 44% of the Black sample.**

## ANALYSIS AND FINDINGS

All participants in the study were asked to rate twelve goals on a seven-point scale. The list of goals was developed from interviews and focus groups with business owners. In general, the aspiring Black entrepreneurs tended to have a stronger response to the goals. This is probably due to the fact that the aspiring Black entrepreneurs are at that exciting stage of bringing their dream into reality. But when the goals are ranked, and the rankings compared, a very close similarity is seen between the business owners and the aspiring Black entrepreneurs. The list of goals and the relevant scores are presented in Table 2.

**Table 2**
**Goals of Non-Minority Business Owners Compared to Goals of Aspiring Black Entrepreneurs on a Seven-Point Scale and by Rank**

| Goal | Non-Minority Business Owners Mean (Sample=222) | Non-Minority Business Owners Goal Rank | Aspiring Black Entrepreneurs Mean (Sample=82) | Aspiring Black Entrepreneurs Goal Rank |
|---|---|---|---|---|
| Utilizing my skills and abilities | 5.86 | 1 | 6.51 | 1 |
| Supporting my family | 5.53 | 2 | 4.96 | 9 |
| Gaining maximum control over my life | 5.30 | 3 | 6.07 | 3 |
| Building something for my family | 5.25 | 4 | 5.62 | 6 |
| Living how and where I like | 5.18 | 5 | 6.00 | 4 |
| Earning lots of money | 5.17 | 6 | 5.61 | 7 |
| Creating a new venture | 5.05 | 7 | 6.09 | 2 |
| Gaining respect and recognition | 4.61 | 8 | 4.99 | 8 |
| Contributing to society | 4.45 | 9 | 5.89 | 5 |
| Replacing my current job | 3.98 | 10 | 3.05 | 11 |
| Fulfilling others' expectations | 3.52 | 11 | 2.95 | 12 |
| Accepting the best alternative available | 3.43 | 12 | 4.60 | 10 |

Seven of the goals were ranked equally or very closely by both groups. "Utilizing my skills and abilities" was ranked first by both groups. "Gaining maximum control over my life" was ranked third in importance by both. Owning a business as a means of "Living how and where I like" was ranked 4th by the Black sample and 5th by the non-minority business owners. "Earning lots of money" was ranked 6th by the business owners and 7th by Black sample, showing that, overall, money was not their main motivation for entrepreneurship. "Gaining respect and recognition" was ranked 8th by both groups. Starting a business as a means of "Replacing my current job" was ranked 10th by the non-minority sample and 11th by the Black sample. "Fulfilling others' expectations" was ranked 11th by the non-minority

**sample and 12th, or last, by the Black sample. Similarly, beginning a business because it was the best alternative available was ranked near the bottom by both groups. The Black sample rated it 10th and the non-minority sample ranked it 12th.**

**Four goals showed significant differences between the groups. “Creating a new venture” was ranked 2nd by the aspiring Black entrepreneurs, but only 7th by the non-minority business owners. There are several possible reasons for this. The aspiring entrepreneurs are caught up in the excitement of trying to create something new, a feeling that is, on average, thirteen years in the past for the non-minority business owners. Also, about 25% of the business-owners sample have, in fact, inherited their businesses and never experienced this as a goal.**

**There was relatively great divergence between the samples on the goals of "Supporting my family" and the similar, but longer term goal of "Building something for my family." The non-minority business owners scored the former 5.53 and ranked it 2nd, while scoring the latter 5.25 and ranking it 4th. The sample of aspiring Black entrepreneurs scored "Supporting my family" 4.96 and ranked it 9th, and scored "Building something for my family" 5.89 and ranked it 5th.**

**There are some important differences between the samples relative to family status. The non-minority sample is 73% men, while the Black sample is 48% men. The median age of the non-minority sample is 40, while it is 32 for the Black sample. Also 60% of the non-minority sample is married, compared to 28% of the Black sample. In general, Blacks have lower marriage rates than whites, although many unmarried Blacks live in otherwise traditional family units.**

**To see if these demographic differences might explain the discrepancies between the two samples regarding the goal of “Supporting my family,” Tables 3 breaks out responses to this goal based on marital status. Table 3 shows that by comparing only single respondents, that the non-minority sample scored "Supporting my family" 4.57 and single members of the Black sample scored it 4.90, which represents a rank of 8 for the non-minority sample and 9 for the Black sample. The more long term goal of "Building something for my family," showed less difference among the full samples, but also showed much greater similarity when marital status was controlled.**

**Table 3**
**Rating and Ranking of Goal “Supporting my Family” Based on Marital Status**

| Group | Rank Among 12 Goals | Mean Response |
|---|---|---|
| Single Non-Minority Business Owners | 8 | 4.57 |
| Single Aspiring Black Entrepreneurs | 9 | 4.90 |
| Married Non-Minority Business Owners | 2 | 5.74 |
| Married Aspiring Black Entrepreneurs | 8 | 5.00 |

**Married members of the non-minority business owners sample scored "Supporting my family" a 5.76 and ranked it 2nd overall, while married members of the aspiring Black**

**entrepreneur sample scored it 5.00 and ranked it 8th. Married members of the non-minority sample scored "Building something for my family" a 5.52 and ranked it 3rd, compared to a score of 5.86 and a ranking of 4th for the Black sample.**

**The analysis of these two goals by marital status shows a much reduced level of difference between the samples. In fact, the married respondents only indicated a great difference on the rankings in response to the goal of "Supporting my family." This might be explained by at least two possible phenomena. First, it could be due to the number of wage earners in the families of aspiring Black entrepreneurs compared to the number of wage earners in the families of non-minority business owners. As pointed out above, the mean income of the samples differs by more than a factor of two. The non-minority sample's mean income is $72,000 per year, while the Black sample's mean income is $31,100 per year. Perhaps the Black sample's households have more second or even third breadwinners, making family support a relatively lower priority goal for the respondents. Second, there might be a difference in household size, which was not measured during this study. The non-minority business owners, being older, may have more children and thus might be weighing family support as a more important personal goal.**

**The goal of "Contributing to society" was scored 4.45 or 9th by the non-minority sample and 5.89 or 5th by the Black sample. The differences here remain even when controlling for age, sex, and marital status. In fact, in every stage of the research process, including focus group interviews and the survey, this factor showed up very strongly among the Black sample, and very weakly among the non-minority respondents. It is clear that the aspiring Black entrepreneur sees several important societal roles for their entrepreneurship. First, they see themselves as role models for their communities, fulfilling that role as members of the vanguard group in the diffusion model outlined above. Second, they see themselves as providing goods and services within their communities that are currently not offered, or not offered in sufficient quantity. As such, minority communities often represent strong potential markets. Third, the aspiring Black entrepreneurs see their anticipated success as a way to keep economic gains within their communities. These roles mirror the political protests that have accompanied non-minority and Asian business ownership within Black and Hispanic communities. This finding substantiates Butler's (1991) work outlining the close relationship that has existed since the 19th century between Black entrepreneurship and self-help.**

**Several alternative explanations were also examined and rejected. The variables of income and gender were investigated to see if there were significant differences within the two samples caused by these variables. Neither was found to make a significant difference on any goal's rankings. Thus, there is much less difference on the ranking of the twelve goals than even first appears. Controlling for marital status, to a large degree, brings the two samples nearly into perfect agreement on both family support goals. Indeed, taking both family support goals out of the ranking presented in Table 2, and removing the "Contributing to society" goal, on which there is a broad difference, produces a ranking of nine goals that have nearly perfect agreement. Therefore, with the exception of "Contributing to society," which is ranked much higher by the sample of aspiring Black entrepreneurs, the hypothesis is**

**confirmed that there is no difference in goals and motivation for entering business ownership between the two samples.**

## CONCLUSION

**The thread of Black entrepreneurship, frayed by slavery, economic restrictions, and discrimination, remains. There is a group of Blacks who want to join the economic mainstream with the same goals and motivations as those members of other groups who have preceded them. Like Thelma Lewis and Richard Jones, many Blacks lack the skills and experience to make the transition easily. But research and experience have shown that Blacks, like all other groups, significantly increase their rate of entrepreneurship with more education and training. In this era of shrinking social programs, it is important that those programs which add this missing ingredient to the entrepreneurial ambitions of Blacks be retained, if not enhanced. Ultimately, for Blacks, as well as for other ethnic and racial groups, entrepreneurship will be a major path to reaping the rewards of American society.**

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# REASONS WHY SMALL BUSINESSES FAIL: AND HOW TO AVOID FAILURE

**Robert N. Lussier, Springfield College**

**ABSTRACT**

***The purpose of this article was to better understand why small businesses fail and how entrepreneurs can avoid failure. Another way of looking at this study is to say that the author has saved the entrepreneur the time, cost, and energy of contacting 100 owners of failed small businesses and asking them why they failed. The article begins with an introduction which is followed by the commonly believed reasons why businesses succeed and fail. It then presents the survey methods and profile of the 100 entrepreneurs who completed the questionnaire for this study, which is followed by the identification of the 10 most common reasons why the sampled entrepreneurs failed (Table 3), and ends with a discussion of practical things entrepreneurs can do to help avoid failure.***

## INTRODUCTION

**The increase in entrepreneurial activity is a significant trend in the US economy. Unfortunately, small business owners often face the reality of failure. The important role of small business suggests that an understanding of why firms fail and succeed is crucial to the stability and health of economy (Gaskill, Van Auken & Manning, 1993). Of major concern to any would-be entrepreneur is the chance of success or failure of the proposed business. It appears critical for researchers and business owners and managers to better understand the factors contributing to the failure of small business. Success versus failure research benefits entrepreneurs, those who assist, train and advise them, those who provide capital for their ventures, suppliers, and public policy makers (Lussier, 1995a: 1995b).**

## REASONS WHY BUSINESSES SUCCEED AND FAIL: LITERATURE REVIEW

**There are many studies to better understand business success versus failure. However, as Gaskill, Van Auken and Manning (1993) stated: there are many questions still to be resolved and warrant additional exploration...previous studies do not provide a comprehensive or unified explanation for small firm failure.**

**There is no generally accepted list of variables distinguishing business success from failure. Prior researchers have created discrepancies within the literature by reporting different variables as contributing factors to success or failure. The two most commonly stated distinguishing variables are capital and management experience. However, in 22 journal articles only 14 (64%) specifically state that these two variables contribute to success versus**

failure; while 5 (20%) other studies claim they do not, with 3 (14%) not identifying the variable as a contributing factor. The literature list of success versus failure variables in this study was developed by including the fifteen major variables, identified in 22 journal articles as contributing to success versus failure. See Table 1 for an explanation of the 15 variables, and Table 2 for a comparison of the 22 studies that support, do not support, or do not mention each variable.

**Table 1: Explanations of Success versus Failure Variables**

*Capital* (capt): Businesses that start undercapitalized have a greater chance of failure than firms that start with adequate capital.

*Record Keeping and Financial Control* (rkfc): Businesses that do not keep updated and accurate records and do not use adequate financial controls have a greater chance of failure than firms that do.

*Industry Experience* (inex): Businesses managed by people without prior industry experience have a greater chance of failure than firms managed by people with prior industry experience.

*Management Experience* (maex): Businesses managed by people without prior management experience have a greater chance of failure than firms that are managed by people with prior management experience.

*Planning* (plan): Businesses that do not develop specific business plans have a greater chance of failure than firms that do.

*Professional Advisor* (prad): Businesses that do not use professional advisors have a greater chance of failure than firms using professional advisors.

*Education* (educ): People without any college education who start a business have a greater chance of failure than people with one or more years of college education.

*Staffing* (staff): Businesses that cannot attract and retain quality employees have a greater chance of failure than firms that can.

*Product/Service Timing* (psti): Businesses that select products/services that are too new or too old have a greater chance of failure than firms that select products/services that are in the growth stage.

*Economic Timing* (ecti): Businesses that start during a recession have a greater chance of failure than firms that start during expansion periods.

*Age* (age): Younger people who start a business have a greater chance of failure than older people starting a business.

*Partners* (part): A business started by one person has a greater chance of failure than a firm started by more than one person.

*Parents* (pent): Business owners whose parents did not own a business have a greater chance of failure than owners whose parents did not own a business.

*Minority* (mior): Minorities have a greater chance of failure than nonminorities.

*Marketing* (mrkt): Business owners without marketing skills have a greater chance of failure than owners with marketing skills.

As shown in Table 2, there are discrepancies among several studies. Clearly, there is no generally accepted set of reasons why businesses fail or succeed. Based on a lack of agreement on why businesses fail, the reasons given by 100 entrepreneurs may have significant value in helping to understand, explain, predict, and control small business failure.

| Table 2: Comparison of Variables Identified in the Literature as Contributing to Business Failure | | | | | | | | | | | | | | | |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| Senior Author | c a p t | r k f c | i n e x | m a e x | p l a n | p r a d | e d u c | s t a f | p s t i | e c t i | a g e | p a r t | p e n t | m i o r | m r k t |
| Barsley | F | -- | F | F | F | F | -- | -- | -- | -- | -- | -- | -- | -- | -- |
| Bruno | F | F | -- | F | F | -- | -- | F | F | F | -- | -- | -- | -- | F |
| Cooper 90 | F | -- | N | N | F | F | N | -- | F | F | F | F | -- | F | -- |
| Cooper 91 | F | -- | F | N | -- | F | F | -- | N | N | N | N | F | F | -- |
| Crawford | -- | -- | F | -- | -- | F | F | -- | -- | N | N | -- | -- | -- | -- |
| D&B | F | F | F | F | -- | -- | -- | -- | -- | F | -- | -- | -- | -- | -- |
| Flahvin | F | F | F | F | -- | F | -- | F | -- | -- | -- | -- | -- | -- | -- |
| Gaskill | N | F | F | F | F | F | N | -- | -- | N | -- | -- | -- | -- | F |
| Hoad | -- | -- | F | N | N | F | F | -- | -- | -- | -- | -- | -- | -- | -- |
| Kennedy | F | -- | -- | F | F | -- | -- | -- | -- | F | -- | -- | -- | -- | -- |
| Lauzen | F | F | -- | F | F | -- | -- | F | -- | -- | -- | -- | -- | -- | -- |
| Lussier 95a | N | N | N | N | F | F | F | F | N | N | N | N | F | N | N |
| Lussier 95b | N | N | N | N | N | N | N | F | N | N | N | N | F | N | N |
| McQueen | F | -- | F | F | -- | -- | -- | -- | -- | -- | -- | -- | -- | -- | F |
| Reynolds 87 | F | F | -- | -- | F | -- | -- | N | F | -- | -- | -- | -- | -- | N |
| Reynolds 89 | F | F | -- | -- | F | -- | N | N | F | -- | N | F | -- | -- | -- |
| Sage | F | -- | -- | F | -- | -- | F | -- | -- | -- | -- | -- | -- | -- | -- |
| Sommers | -- | -- | -- | F | F | -- | -- | F | -- | -- | -- | -- | -- | -- | -- |
| Thompson | N | -- | -- | F | F | -- | -- | F | F | -- | -- | -- | -- | -- | F |
| Vesper | F | F | F | F | N | F | F | -- | F | F | -- | F | -- | -- | F |
| Wight | F | F | -- | F | -- | F | -- | -- | -- | -- | -- | -- | -- | -- | -- |
| Wood | -- | F | F | F | F | -- | F | -- | -- | -- | -- | -- | -- | -- | -- |
| Total F | 14 | 10 | 10 | 14 | 12 | 11 | 7 | 7 | 6 | 5 | 3 | 3 | 3 | 2 | 5 |
| Total N | 4 | 2 | 3 | 5 | 3 | 0 | 4 | 2 | 3 | 5 | 3 | 3 | 0 | 2 | 3 |
| Total -- | 4 | 10 | 9 | 3 | 7 | 11 | 11 | 13 | 13 | 12 | 16 | 16 | 19 | 18 | 14 |

F supports the variable as a contributing factor in business failure
N does not support the variable as a contributing factor in business failure
— does not mention variable as a contributing factor in business failure

## SURVEY METHODOLOGY

The population from which the sample was selected for this study was limited to the six New England states (Connecticut, Maine, Massachusetts, New Hampshire, Rhode Island, and Vermont). According to Dun & Bradstreet (1995), the population of failed business includes both Chapter 7 (liquidated) and Chapter 11 (restructuring debts to stay in business) companies. Firms that go out of business without loss to creditors are not considered failures: they are discontinued businesses.

**The population of failed businesses includes both Chapter 7 and Chapter 11 companies. However, once a business has liquidated under Chapter 7, its owner is very difficult to locate to answer the questionnaire. Based on a cost-benefit analysis, the questionnaire was only sent to Chapter 11 companies. Chapter 11 firms are early representatives of closed businesses. Wood (1990) reported that less than 5 percent of Chapter 11 companies survive whereas Flynn (1989) reported a 10 to 12 percent survival rate. In previous business failure studies, Corman and Lussier (1991), Lussier and Corman (1995) and Lussier (1995a; 1995b) used a sample of Chapter 11 firms.**

**Based on bankruptcy court records, the questionnaire was mailed to the owner/CEO of each company filing Chapter 11 during the most recent year. There were 100 usable questionnaires returned yielding a 38 percent response rate. Even though the questionnaire was mailed to Chapter 11 companies, most businesses eventually convert to Chapter 7. The sample was made up of 72 Chapter 11 companies and 28 Chapter 7 companies. This response rate is high, and the sample size is large for a study that surveys failed small business (Lussier, 1995a).**

## FAILED SMALL BUSINESS PROFILE

**To ensure that the sample represents the population, a comparison was made of the sample failure frequency distributions to the failure population by state and industry. The population figures include Chapter 7 and Chapter 11 failures (Dun & Bradsteet, 1995). Using the Chi-square test, there is no significant difference ($p<.05$). In other words, businesses in all six states, and all types of businesses, are represented by about the same percentage in the sample as the population of which they represent. The sample representation by state includes approximately 20% from Connecticut, 5% from Maine, 44% from Massachusetts, 19% from New Hampshire, 9% from Rhode Island, and 6% from Vermont. Using Dun & Bradstreet's (1995) eight industry classifications, approximately 2% of the failure firms in this study are from agriculture, 15% from construction, 18% from finance, insurance, and real estate, 10% from manufacturing, 22% from retail, 3% from wholesale, 6% from transportation and communications, and 25% from services.**

**Based on size, approximately 27% employ 0-5 workers, 25% employ 6-15 workers, 20% employ 16-25 workers, 19% employ 26-50, 7% employ 51-99, and 4% employ 100-300 workers. The mean, median, mode and standard deviation are 25, 15, 5, and 38. These results are consistent with Dun & Bradstreet's (1995) findings that the majority of business failures are among the businesses employing under 100 people.**

**The average business owner completed 3 1/3 years of college, had 10 years of industry experience and 9 years of management experience, was 37 years old, and operated the business for 5 ½ years. Sixty-two were sole proprietors and eight were minorities.**

## REASONS WHY SMALL BUSINESS FAIL

**Because the research question is open-ended, results are reported using descriptive statistics only. Without forced choices, the percentages of respondents repeating the same reason for failure is relatively low, compared to traditional multiple choice statistical testing (Lussier, 1995b). Entrepreneurs were asked to state the major reason for failure: most listed more than one reason. Therefore, results are recorded using multiple responses. Due to the sample size being exactly 100, the numbers reported represent both the number of business owners and the percentage of the sample responses. See Table 3 for a summary of the ten most commonly stated reasons for failure.**

**Table 3: Reasons Small Businesses Fail**

| Rank Order of Reason Given | Percentage Response |
|---|---|
| Undercapitalization and High Fixed Cost | 32% |
| Slow Economic Activity/recession | 30% |
| Creditor Problems | 23% |
| Slow Accounts Receivable | 8% |
| Tax Problems | 8% |
| Loss of a Major Customer | 6% |
| Poor Management | 5% |
| Partners | 3% |
| Overexpansion | 3% |
| Theft | 3% |

## SURVEY RESULTS COMPARED TO THE LITERATURE

**There are discrepancies in the literature about which variables do in fact cause failure (Table 2), and between the literature and the findings of this study. In other words, there is no valid and reliable list of variables that explain failure. Of the fifteen variables identified in the literature as contributing factors of success versus failure, only two were strongly supported by this study: economic timing (30%) and undercapitalization (9% when separated from high fixed costs). Poor management was not strongly supported because only 5 percent of entrepreneurs identified it as a reason for their failure; however, it is not uncommon for people to blame external factors for their failure rather than themselves. The relationship between not planning and failure was only supported by 2 percent of respondents as a cause of failure. Recordkeeping and financial control were only supported by 1 business owner as a cause of failure. Although partners and staffing were discussed (3% and 2%), they did not support the literature reasons for failure. Respondents stated that a partner was the reason for failure. Entrepreneurs of failed businesses did not say that they had a problem getting good employees, they stated that they were too slow to layoff employees who were no longer needed. Industry experience, professional advisors, education, product/service timing, age,**

**minority, and marketing skills were not listed as reasons for business failure by any of the small business owners.**

## HOW TO AVOID SMALL BUSINESS FAILURES

**The study results identify the reasons for business failure that imply implementation strategies for would-be entrepreneurs to avoid failure in ten areas:**

1. **Before starting the business, the entrepreneurs should attain adequate capital and keep fixed costs low. A rule of thumb to define adequate, is to get the best estimate available of all costs, then double it. As the business begins to earn money, the owner should avoid the temptation to increase fixed costs. Without some extra financing a small business has no margin for the other factors of failure.**
2. **During slow economic activity/recession, consider waiting to start the business until the economy turns around, if the product/service is economic sensitive.**
3. **Starting with adequate capital and developing a close relationship with creditors can help eliminate creditor problems.**
4. **Following good accounts receivable practices, particularly aging of accounts receivable and continuous contact, can help to avoid slow accounts receivable.**
5. **Good recordkeeping with the help of a good accountant, and having adequate capital and good credit relations can help overcome tax problems.**
6. **Having a diversified customer base can help eliminate the problems of the loss of a major customer.**
7. **Entrepreneurs who lack management experience and skill can work for someone else to gain these skills before starting their own business.**
8. **Partners can be an advantage or disadvantage to the entrepreneur. On the positive side, partners increase capital and skills, but on the other hand, a bad partner can be the cause of business failure. This is understandable, but can be counterargued by the many successful entrepreneurs who recommend having a partner. The implication is to be careful when selecting a partner and to have a clear understanding exactly what each partners' responsibilities and share of the profits will be.**
9. **Small businesses should expand slowly with adequate capital to support growth; especially if business activity may not be as high as projected. Keeping the fixed costs low can also help.**
10. **Good recordkeeping and financial control can help minimize theft.**

**These same reasons for failure have implications for small business owners and mangers, those who assist, train and advise entrepreneurs, those who provide capital for their ventures, suppliers, and public policy makers. Those who assist, train and advise entrepreneurs should make them aware of the reasons business fail and how to avoid failure. Those who provide capital and supplies to entrepreneurs can be aware of the reasons for failure. They should realize the importance of providing adequate capital and supplies. It may be wise to deal with entrepreneurs with a good chance of success, and to back them adequately. Public policy makers should realize the effects their policies have on business, and to be supportive of small business. For example, the IRS should try to avoid tax changes that are going to cause problems and possible failure for small business, and they should work with entrepreneurs to collect taxes rather than force them to liquidate for payment. The Small Business Administration should continue to provide support to entrepreneurs to help them**

**avoid failure. In many cases it is more cost effective to help the small business than it is to go through the courts to liquidate them for tax payments.**

**There is a system relationship between the most frequently stated reasons for failure. If the entrepreneur starts the business undercapitalized with high fixed costs, and economic activity slows down, it becomes increasingly difficult to meet high fixed costs. When going to the bank or other source for credit, and being turned down, many firms are forced out of business by creditors either voluntarily or nonvoluntarily. Couple this with slow accounts receivable due to the economy, tax problems, and the loss of a major customer make the odds of survival low.**

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# FRANCHISES: SO WHAT'S NOT TO LIKE?

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**ABSTRACT**

***Franchise problems can be divided into two categories: inducement problems and relationship problems. The inducement problem concerns misrepresentations which occur in the marketing of the franchise opportunity to the potential investor. Relationship problems occur after the franchise has been sold to the franchisee and relate to performance failure by the franchisor. This paper will discuss inducement problems and pitfalls.***

## INTRODUCTION

**Franchise ownership is a popular and prevalent form of conducting business in the United States. Franchise systems first appeared in the 1860s. Product franchising was the first form to develop in response to an expanding national market for complex and expensive manufactured goods. The concept expanded in the 1920s to include business-format franchising, by which the franchise itself was marketed as a distinct product (Dickie, 1992). Today, franchises can take the form of distributorship, chain-style business operations, or processing-plant arrangements (Clarkson, 1995).**

**Over one-third of all retail sales consummated in the United States are transacted through franchised outlets, representing $758 billion in revenue (Hearing 103-9, 1993). Projections expect that this figure will jump to one-half by the year 2000 (Cutler, 1991). Franchised operations allow the franchisee access to many of the efficiencies of big business, while permitting the owner a substantial degree of independence as well (Dicke, 1992).**

**In 1992, the International Franchise Association (IFC) commissioned the Gallup Organization to prepare a national franchise owner study. The results indicated that most franchisees considered their franchise to be successful, and suggested that the franchisees had no regrets concerning their investment (Hearing 103-9, 1993). While commonly cited statistics estimate a ninety-five percent success rate for franchises, that statistic is controversial. Arguably the statistic does not accurately define failures to include enough terminating events, such as *discontinuance* (Hearings 102-82, 1992). Further, while it is generally accepted that franchises fail at a lower rate than non-franchised businesses, the risk of franchise failure in some industries is higher than for non-franchised establishments (Walker & Cross, 1988).**

## CASE STUDY: A PUBLICATION FRANCHISE

**Diane and Allen had lived in the Houston area for over twenty years. Allen was a professor of history at a university in Houston, while Diane was a civil engineer at a private consulting firm for most of those years. In 1989, she decided to take advantage of her spousal**

**tuition waiver at Allen's institution, resigned her position at the firm, and enrolled in the university's MBA program. The combination of a business and technical degree was quite popular in the 1980s, and Diane thought the business background might help her to secure a management position in another consulting firm. She was tired of the technical drudgery of her previous job and wanted to try something different; more people-oriented.**

**When Diane completed her studies, however, there were no positions available. The economy had taken a downturn which immediately affected construction starts, and commensurately, the field of civil engineering. Shortly after Diane graduated in 1991, a friend was brutally murdered in her place of business in the middle of the afternoon. This event brought home to Diane and Allen the increase in crime and violence in their community. Since Diane had not located work after graduation, and the prospects looked bleak, Allen agreed to test the market for a teaching job at another university. It was time to get out of Dodge.**

**When Allen was extended an offer from a small, regional school in the Southeast, Diane had to access her options. Since Diane had wanted to move into management in a more people-oriented position, she decided to explore franchise opportunities which would allow her to run her own business. The couple attended a franchise expo at the convention center in Houston. One in particular caught Diane's eye. It was a publication franchise: Television News & Schedule (TNS). The basic concept involved sales. The weekly television schedule was printed and delivered to business establishments around town free of charge for customers. Revenue was generated for the franchisee based on the sale of advertisements to area merchants. The sales representative for TNS, Rhonda, made it sound so easy! So fun! So profitable!**

**The cost of the franchise, unlike some, was not astronomical: only $24,500! And, the franchisor was willing to finance $7,500 of that amount at really reasonable terms. The only other fee would be royalties based upon sales after the franchise was up and running. Moreover, the entire operation seemed legitimate. The franchisor had been in business since 1971. While the extent of the exclusive territory granted in many franchises can be a real concern, TNS was willing to grant Diane and Allen a seven county area in their new location for immediate operation and future expansion.**

**Although Rhonda admitted that she was not supposed to give projected earnings, she *ran the numbers* for Diane and Allen, giving them lucrative projected earnings through 28 weeks, after a six to eight week start-up period. She further projected earnings after the first year to be $1200 net profit weekly, $1450 net weekly after the first quarter of the second year, $1700 net weekly after the first half of the second year, etc., based on the addition of ads.**

**As negotiations moved to conclusion, Rhonda provided Diane and Allen with a document containing *Information for Prospective Franchisees* as required by the Federal Trade Commission. The document listed a schedule of production costs, the names of persons affiliated with the franchisor, the obligations of the franchisor and franchisee respectively, causes for termination of the franchisee's rights under the agreement, and any pending litigation or bankruptcy proceeding involving the franchisor (there was none). The document also contained an audited financial statement for the franchisor. Finally, the document**

**contained a disclaimer with respect to any actual, average, projected or forecasted sales, profits or earnings that may or may not have been furnished by the franchisor's salespersons.**

**Diane and Allen decided to purchase the franchise. After moving to their new home, they attended a training program in Massachusetts to learn the business. That session was to be followed by on-site visits by the franchisor's sales representatives. Upon returning from Massachusetts, Diane set to work calling on merchants in her assigned territory. His schedule permitting, Allen helped, since he had attended the training program offered by INS for *associate publishers*. That the results of their efforts were disappointing is an understatement. The three visits by the sales representatives were no more fruitful in obtaining advertisers than their own efforts had been at that point. In reality, the task they faced defied reason. Here Diane was, in a new city, knowing no one, trying to sell advertising in a publication which didn’t exist. Right, and how about a plot of fertile land in the Mojave, while I'm here!**

**Assuming that the whole operation might flow a little smoother if there was a book in existence, Diane decided to go to press with the few brave advertisers who had purchased space at a drastically reduced price. Diane was talented as far as the design of the advertisements and layout of the book was concerned. She pulled together an attractive publication. However, publishing brought with it a new set of problems.**

**Once an associate went to press, the process had to be continued on a weekly basis. The TNS recommended printer was located in another state. That required correspondence by overnight courier, and hectic deadlines. All that to do, in addition to trying to sell additional advertisers, secure distribution locations, and distribute the books.**

**Being in print did not ease the burden of securing advertisers. In fact, publishing heralded still another problem: payment. While seeing the book around town made a few more advertisers eager to contract for space, they were certainly less eager to pay. Unlike some businesses which are faced with nonpayment from customers, Diane did not have the option of slapping a lien against the property of delinquent purchasers. Once the ad appeared, they had received the benefit of their bargain, a benefit which could not be retracted. Further, in a recessionary economy, suppliers of tangible goods receive preferred payment; suppliers of commercial advertisements are expendable.**

**In short, long hours and hard work were to be expected...but so was payment...and at the end of the first year, so was that $1200 a week net profit. It wasn't in sight. The total stress of the enterprise began to affect Diane's health. TNS corporate was unresponsive to her post-publication problems. They didn't seem concerned that she was financially unable to pay her royalties, either. Finally, when she was asked by a merchant, "What ever happened to that other 'gal' who used to publish that 'freebie' about four years ago," she decided to cut bait.**

**After 14 months of operation, Diane ceased publishing, to the dismay of many loyal advertisers who had profited from her efforts. She subsequently secured employment on an engineering project. When that was over, she started an independent consulting firm. Never, but never, had she enjoyed engineering, nor appreciated her talent in that field, so much!**

## SOME PRACTICAL OBSERVATIONS

**Many white collar workers like Diane sought to take advantage of franchising opportunities in the wake of economic downturns (Burke, 1991). Whatever the motivation, all potential franchisors must be financially prepared, committed to good management, committed to working long and hard, committed to salesmanship, and committed to thoroughly investigating the opportunity in which they are interested (Sturgis, 1993). Even so, such preparedness and commitment may not translate into success. In retrospect, Diane and Allen highlight some additional pitfalls as well.**

***A Franchisee Should Be Familiar With The Business*. It would be valuable for a potential purchaser of a fast food franchise to be familiar with restaurant management. However, at a minimum, the franchisee should be familiar with the nature of the business. In Diane's case, the business was, simply put, sales. She had no prior experience in any type of sales. While she rose to the occasion better than many could, she found that she hated sales. While learning that lesson is invaluable, it is a lesson best learned with someone else's money.**

***A Franchisee Should Be Familiar With The Area*. In starting any business, it is advisable to first be a member of the community. Knowing people in the community is an asset in conducting business. If Diane had started her franchise in her north Houston neighborhood, or even in her childhood hometown, her efforts might have been more greatly rewarded, and at a faster pace. Even with substantial backing by a franchisor, which Diane did not enjoy, it is challenging to move to a community and begin successful operations, particularly if that community is small, with its own entrenched network of relationships.**

***A Franchisee Must Be Cautious And Skeptical*. Trust is for friends, not franchisors. Franchisors pursue a profit motive. While TNS provided the disclosure required by law and was hardly a fly-by-night operation, several items of interest to franchisees were not mentioned. Although the financial statement disclosed income generated, it did not break that income down into royalties paid, income from the printer on books printed, or the sale of franchises. Most likely, the bulk of TNS's income came from the latter two sources, while the former source of income, most likely was represented in the *accounts receivable* entry, or possibly, the *uncollectible* category, a testimony to the lack of success of the franchisees. Diane certainly could never afford to pay the royalties she owed.**

## THE LEGAL ENVIRONMENT OF FRANCHISING

**Do not be mistaken, if potential franchisees do not look after themselves, the law will not either. Unfortunately, many franchisees have an unrealistic expectation that the law will protect them from franchisors who are less than candid, and that justice eventually prevails (Cutler, 1991; Hammond, 1979). That is simply not the case.**

**There are three federal laws which do grant rights to franchisees, but these statutes are not sufficient to address all potential abuses which can occur in the franchise industry. The Automobile Dealer's Franchise Act of 1956 protects car dealerships from a bad faith termination of the franchise. The Petroleum Marketing Practices Act protects retailers of**

**petroleum products from bad faith termination, or failure to renew (Clarkson, 1995). On a broader scale, The Federal Trade Commission's Franchise Rule requires disclosure of certain information which is material to making an informed decision concerning the purchase of a franchise prior to the signing of the franchise agreement (Foster, 1988; Foster, 1989). The veracity of the statements contained in the *offering circular*, or *disclosure document*, however, are not verified by the FTC (Smith & West, 1986). Although the required disclosure does eliminate some of the evils which occurred prior to its adoption, the FTC Franchise Rule is not sufficiently comprehensive (Hunt & Nevin, 1976).**

**Further, the Rule, unfortunately, is purely regulatory in nature; it does not grant a private cause of action for aggrieved franchisees. The remedies provided by the rule allow the FTC to investigate, issue cease and desist orders, freeze assets of franchisors who fail to comply, issue redress judgments, and ultimately seek criminal sanctions for violations of its orders. Since the rule took affect in 1979, the Commission has brought 34 cases involving over 30,00 injured investors and has obtained judgments of four million dollars in civil penalties (Cutler, 1991). However, limited resources dictate that only the most egregious offenders will merit the attention of the FTC. Many inducement and relationship problems continue unaddressed. In fact, most abuses occur in the smaller franchise operations which sell at less than $100,000 (Dizak, 1993).**

**On the state level, fifteen legislatures have passed laws which regulate franchise offerings, require disclosure and registration with the state by the franchisor, and often grant to franchisees a private cause of action for losses occasioned by the franchisor's failure to comply (Burke, 1991; Hammond, 1979). Some of these statutes provide greater protection for the franchisee than what is provided under federal law. For example, under New York's Franchise Sales Act, a franchisor must submit a prospectus to the Attorney General's office for review before it can be used in the public offer and sale of the franchise (McInerey, 1991). Moreover, Iowa recently passed a comprehensive law primarily aimed at relationship problems. The Iowa Franchise Investment Act grants franchisees legal remedies with respect to unfair practices concerning the franchise's transfer, termination, and nonrenewal, and also protects franchisees from potential encroachment by the franchisor's subsequent sales (Oleck, 1992). Nevertheless, the overwhelming majority of states have not passed legislation to complement and augment the Rule of the Federal Trade Commission.**

**On the other hand, all states have passed Deceptive Trade Practices Acts. These acts, sometimes referred to as *little FTC Acts* prohibit deceptive acts or practices in the conduct of trade or commerce (Leaffer & Lipson, 1980; Lovett, 1971). They primarily exist to protect consumers from unfair trade practices; as such, they may or may not be applicable to franchisees. That issue will depend on the definition of *consumer* as provided by the statute or as interpreted by the court. Massachusetts is the only state which specifically provides business plaintiffs with a cause of action under its statute (Pirozzolo, 1977). Bringing suit under these acts is attractive to litigants because most not only allow treble damages, but attorneys' fees as well (Wax, 1985). If applicable, this legislation should embrace inducement problems which encompass deceptive, though possibly not fraudulent, practices in procuring the franchise contract.**

Without statutory grounds for relief, a franchisee is left only with common law grounds for recovery. Common law fraud is a potential remedy for inducement problems. However, fraud is difficult to establish because it requires some degree of scienter or proof of an intent to defraud (Garner, 1993). For relationship problems, breach of contract is a possible avenue of redress; however, often the contract is so one-sided, the franchisee can suffer losses without the franchisor breaching the actual terms of the agreement. Unless the agreement rises to the level of being unconscionable, there is no grounds for relief. Further, with respect to bogus potential earning claims, even if there is no disclaimer in the circular provided by the franchisor, as there was in Diane's case, common law contract law will not allow that evidence to be admitted except in limited circumstances. The Parole Evidence Rule prohibits the introduction into evidence of the parties' prior negotiations, agreements, or contemporaneous oral statements that contradicts or varies the terms of the agreement (Clarkson, 1995). Although fraudulent misrepresentations introduced to establish a defense to the contract represent an exception, again, the franchisee must be able to make that presumptive showing.

Even if a franchisee could establish a statutory or common law cause of action, most of the time that course of conduct is not worth its burden. If an unsuccessful franchisee owes the franchisor uncollected royalties or a part of the initial franchise fee, a counterclaim can be expected. Further, most lawyers are reluctant to take such cases on a contingency fee basis because of the uncertainty of recovery and the up-front costs of discovery. Alternatively, if a statute provides for the recovery of attorneys' fees, the attorney, of course, must win the case in order to recover. Thus, only an obviously meritorious case would be considered. If enough similarly situated franchisees are affected, class action suits in which the rewards for counsel increase exponentially, represent an additional opportunity for recovery. Indeed, there has recently been an increase in such suits against franchisors (Hearings 102-82, 1992). Finally the last option available to aggrieved franchisees under the law is the least attractive: write it off. Tax laws allow lost investments to offset income for tax purposes. But that is the rub...there has to be income to offset. In Diane's case, her subsequent income along with that of Allen could be used. Unfortunately, for franchisees who have sunk their savings into their business and who have nothing substantial to fall back on, this option is unavailable.

## SUGGESTIONS FOR REFORM

There are several legislative initiatives which should be considered by congress and state legislatures which would at least address some of the inducement problems associated with the sale of a franchise. Many of these suggested measures have been explored in part in hearings which have been held before the House Committee on Small Business.

*Require Historical Data To Be Included In The Disclosure Statement.* Franchisees should be provided with information concerning the earnings of past franchise owners over the previous five year period. Currently only fifteen percent of the members of the IFA make such information available (Hearings 102-82, 1992). The substantiated operating history of all units is essential information for an informed purchase decision and should be required by law (Kezios, 1991). The accurate failure rate of franchises should be duly noted as well. While

**current disclosure requires the financial health of the franchisor to be revealed, that condition may not be probative for speculating on the health of the franchisees.**

***Prohibit The Use Of Profit Projections By Franchisor.*** **This practice is prevalent in the franchise industry and manifestly abusive (Dizak, 1993). The law should either prohibit the practice, or alternatively, require the information to be included in the disclosure statement so that gross overstatements can be verified and admitted into evidentiary proceedings for administrative or private legal action.**

***Require The Release Of The Names And Addresses Of All Past And Current Franchise Owners.*** **Presently it is a common practice for franchisors to *churn* their markets: that is, to sell failed franchise territories over and over again (Hearings 102-82, 1992; Cutler, 1991). Requiring historical operating data should reveal this practice; however, for simplicity, the information should be mandated as a separate requirement as well. Such information would at least give prospective franchisees a staring point for a legitimate investigation of the reasons, presumed or real, for the success or failure of other franchisees.**

***Simplify The Language of Disclosure Statements And Require A More Detailed Financial Statement.*** **Surveys indicate that most potential franchisees cannot comprehend even the minimal disclosure statement currently required by law (Dizak, 1993). The form should be simplified, while at the same time the financials should be simplified and clarified by providing more detail. While a few accountants and lawyers do purchase franchises, the disclosure document, nonetheless, should be written for the average lay person, and not require that the purchaser be able to read between the lines and interpolate the information.**

## CONCLUSION

**Until such reforms are implemented, skepticism, caution, and vigilance are a franchisee's best weapons against inducement problems. Just because a franchise is listed in a guide to franchising opportunities does not mean that the operation is somehow endorsed. TNS was listed in such a publication (Bond & Bond, 1994). Nevertheless, several key facts were either misrepresented or concealed from Diane and Allen: 1) the failure rate, 2) the profit projections, 3) the existence of a previous associate publisher in the area they purchased, 4) the kickback the franchisor received from the printer, and 5) the lack of continuing support from the franchisor.**

**Even if reforms are passed it is unlikely that government resources will be sufficient to police all abuses in the industry (Cutler, 1991). Therefore, a potential purchaser should thoroughly investigate the franchisor, and locating as many past and current owners is an excellent place to start. Unless an investor can look at herself in the mirror and say, "It's only money", and MEAN it, it is not safe to rely on the law to make amends.**

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# BANKING SERVICES FOR SMALL BUSINESSES: A STUDY OF ENTREPRENEURS' NEEDS AND EXPECTATIONS

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## ABSTRACT

***This article reports the results of a study aimed at identifying the types of financial and banking products/services that small businesses need and value the most. The study also examines aspects of quality and manners of service delivery that small business establishments consider as important and expect to be provided by their banks. Finally, it compares small business owners'/managers' views regarding overall quality of services of community/local banks vis-a-vis that of their non-local counterparts.***

## INTRODUCTION

**The relationship between banks and small businesses has always been one of mutual dependence. Small businesses are a very important customer group for banks. Small business borrowers, according to one estimate, account for one quarter of total bank credit provided to non-financial businesses and represent 80-90% of the business customers serviced by account managers (Hatch and Wynant, 1991). Most commercial banks consider any business with sales of up to $10 million as small (Nixon, 1994). Using this definition, some 20 million small businesses are served by 14,000 banks in the United States (Nixon, 1994; Posner, 1992).**

**While large corporations have access to a variety of capitalization alternatives, bank loans are often the small business owner's only option. Some estimates suggest that commercial banks provide about one-third of the total capital for small businesses (Gillette, 1982). Furthermore, while large companies have experts and departments providing input to their financial decisions, small business owners often have no one to turn to for advice but the bank. They need considerable guidance and hand holding. As such, the typical small business banking relationship involves more than just the exchange of money for a note. Banks usually provide small businesses with an array of services including advice about capital needs and uses, and information regarding industry performance and outlook.**

**Given the interdependence between banks and small businesses, and the importance that small businesses have to both local and national economies in terms of job creation and economic development stimulation, it is imperative for banks to better understand the nature**

**of financial and banking needs and priorities of this segment of their market. It is in pursuit of this objective that the present study was designed.**

**Specifically, the purpose of this paper is to report the results of a study designed: (a) to assess and identify the types of financial and banking products/services (e.g., depository services, merchant accounts, loan products, etc.) that small businesses need and value the most, and (b) to identify the aspects of quality and manner of service delivery (e.g., personal attention, knowledge of business, timely response, etc.) that small businesses consider as important and expect to be afforded by their banks. The study also will compare small business owners'/managers' perceptions regarding the overall quality of bank services relative to locally owned and managed banks versus non-local financial institutions.**

## METHODOLOGY

**Data for this study were obtained from small businesses located in a Midwestern community of approximately 100,000 residents. Dun and Bradstreet's directory of local businesses, indicating the name, address, and size of each business, was used as the sampling frame. Data were collected through a questionnaire survey addressed to the owner and/or president of each of nearly 500 small business establishments. Approximately 85 completed and useable questionnaires were returned. Of these, approximately 85% had 50 or fewer employees, and 80% had $5 million or less in annual sales revenues. Also, of the participating small firms, 49% work only with one financial institution, 27% with two, and the remainder with three or more. Finally, nearly 56% of these business establishments characterized their banks as locally owned and operated.**

**The survey instrument, among other things, asked respondents to, first, rate on six point scales the importance (1 = not at all important, 6 = extremely important) that they attached to each of 35 business-related banking services and products usually offered by financial institutions. Next, they were asked to rate, on similar scales, how much importance they would attach to each of 32 factors/characteristics in selecting the bank that would meet their business needs. These factors represented different aspects of quality and manner of service delivery by banks and financial institutions. Finally, they were asked to rate on a seven point scale (1 = Excellent, 7 = Very Poor) the overall quality of services they have been receiving from their primary financial institution, and whether or not that institution was locally owned and managed.**

**For each of the two categories of items, mean item ratings were calculated and rank ordered to determine the most/least important business-related products/services as well as the most/least important aspects of service delivery and service quality. In addition, using analysis of variance, the overall service quality of local financial institutions were compared to those of their non-local counterparts.**

## RESULTS AND CONCLUSIONS

**Table 1 presents the mean performance ratings of various banking products/services as judged by the participating small business owners/managers. According to the table, depository services, drive through banking, commercial loans, line of credit, lending services, and tax deposit accounts top the list of banking and financial product/service needs of the small business community as a whole. Further, closely behind and of relatively secondary importance to small firms are such banking products as working capital loans, overdraft protection services, equipment loans, cash and coin services, merchant accounts (credit card services), mortgage loans and other loan products, phone banking services, and letters of credit. It is intriguing that SBA loans were not viewed to be nearly as important as other services and products mentioned earlier. Finally, services related to international banking, discount brokering, payroll processing, business counseling, as well as energy loans and courier services appear at the bottom of the list of small firms' banking priorities and do not seem to command much importance to the typical small business establishment.**

**TABLE 1**
**RELATIVE IMPORTANCE OF VARIOUS BANKING PRODUCTS/SERVICES TO SMALL BUSINESSES**

| Banking Products/Services | | Mean Importance Ratings* |
|---|---|---|
| 1. | Depository Services | 4.78 |
| 2. | Drive Through Banking Services | 4.51 |
| 3. | Commercial Loans | 4.43 |
| 4. | Line of Credit | 4.40 |
| 5. | Lending Services | 4.38 |
| 6. | Tax Deposit Account Services | 4.08 |
| 7. | Working Capital Loans | 3.86 |
| 8. | Overdraft Protection Services | 3.78 |
| 9. | Equipment Loans | 3.74 |
| 10. | Cash and Coin Services | 3.69 |
| 11. | Merchant Accounts (e.g., Visa, MasterCard) | 3.62 |
| 12. | Mortgage Loans | 3.62 |
| 13. | Loan Products | 3.58 |
| 14. | Phone Banking (Access to Account Info. via Telephone) | 3.53 |
| 15. | Letters of Credit | 3.38 |
| 16. | Cashier Checks | 2.83 |
| 17. | Wire Transfer Services | 2.72 |
| 18. | Safety Deposit Boxes | 2.68 |
| 19. | SBA (Small Business Administration) Loans | 2.66 |
| 20. | Travelers' Checks | 2.62 |
| 21. | Investment Services (e.g., Money Market Accounts) | 2.45 |
| 22. | Trust Services | 2.43 |
| 23. | Automatic Clearing House (Automatic Billing Services) | 2.26 |
| 24. | Payroll Services | 2.23 |
| 25. | Electronic Banking Services (e.g., ATM Machines) | 2.20 |
| 26. | Collection Services | 2.13 |
| 27. | Leasing Services (e.g., Auto Leasing) | 2.09 |
| 28. | Individual Retirement Accounts (IRAs) | 2.07 |
| 29. | Pension and Retirement Planning Services | 2.02 |
| 30. | Counseling Services | 1.99 |
| 31. | Energy Loans | 1.84 |
| 32. | Payroll Processing Services | 1.82 |
| 33. | Discount Brokerage Services | 1.72 |
| 34. | Courier Services | 1.65 |
| 35. | International Banking Services | 1.62 |

*** 1 = Not At All Important, 6 = Extremely Important**

**It is reasonable to expect that not all types of small businesses would have the same banking and financial needs. As such, the data was broken down based on business type to add more insight into the study's findings. As a result of that analysis, some interesting similarities and differences among businesses in different industries emerged. For example, cash and coin services, depository services, and commercial loans topped the list of retailers' banking needs, while drive through, depository, and phone banking services made up the list for construction companies and medical/dental offices. Manufacturing businesses and wholesale/distribution operations both identified line of credit, lending services, and depository services as their top priority items among available banking services.**

**The importance of various service attributes that constitute *quality* relative to banking services is presented in Table 2. First, except for bank size and assistance with financial projections, all other salient banking service attributes listed in the survey were judged by the small businesses participating in this research to be of fairly high importance. Second, of the 32 items listed on the survey, 10 items generated mean importance ratings of higher than 5 (on 6-point scales). Also, the study participants placed the greatest premium on the assurance of confidentiality of their business and financial information. Along with confidentiality, the bank's ability/willingness to resolve errors and problems quickly and accurately, to show trust and confidence in both the business and the business person, and to have competitive service charges make up the top five factors reflecting quality attributes of greatest value to banks' small business clients. Other factors of relatively high significance to this segment of the banking market include the format and clarity of bank statements, showing genuine interest in the customer and making a conscious effort to keep his/her business, interacting with the customer at a personal level and treating them with courtesy, being a reliable source of credit, and having competitive loan rates and terms.**

**It is reasonable to expect that the differences in quality of service requirements among various types of businesses would be minimal and not nearly as pronounced as was the case regarding product/service needs. When the data was stratified based on industry type, the results did in fact support this expectation. Small businesses operating in different industries, with few exceptions identified virtually the same banking service attributes as the ones they would consider most important to them when selecting a bank to do business with. Specifically, confidentiality of client information topped the list for all businesses with the exception of manufacturing firms. The latter group rated "being a reliable source of credit" as the most important factor to them; confidentiality did not appear even in their top-five list. Also, having competitive service charges was included in the top-five list of all firms with the exception of construction companies. Further, while medical/dental offices were the only businesses that identified "consistency in credit decisions" as one of the five most important service attributes to them, "competitive loan rates and terms" was the item that was included only in the top-five list for wholesale/distribution companies.**

**Finally, a comparison of the overall quality of service between community banks and non-community banks, as perceived by their respective small business clients, showed a statistically significant difference ($F = 3.15$, $p \leq 0.10$). That is, compared to the small business**

clients of the non-community banks, small business which banked with local institutions rated the overall quality of their banking services significantly more favorably.

**TABLE 2**
**RELATIVE IMPORTANCE OF QUALITY DIMENSIONS OF BANKING SERVICES TO SMALL BUSINESSES**

| | Banking Products/Services | Mean Importance Ratings* |
|---|---|---|
| 1. | Keeping Client Information Confidential | 5.64 |
| 2. | Resolving Errors and Problems Quickly and Accurately | 5.52 |
| 3. | Showing Confidence in the Client's Business | 5.41 |
| 4. | Having Competitive Services Charges | 5.33 |
| 5. | Showing Trust in the Client | 5.29 |
| 6. | Bank Statements Being Clear and Understandable | 5.27 |
| 7. | Trying Hard to Keep the Client's Business | 5.24 |
| 8. | Having Personable and Courteous Employees | 5.22 |
| 9. | Being a Reliable Source of Credit | 5.14 |
| 10. | Having Competitive Loan Rates and Terms | 5.05 |
| 11. | Give Client Opportunity to Work with Same Bank Official | 4.96 |
| 12. | Having Convenient Operating Hours | 4.95 |
| 13. | Having a Strong Banking Reputation | 4.89 |
| 14. | Taking Time to Understand Clients' Financial Needs | 4.88 |
| 15. | Being a Competitive Business Lender | 4.82 |
| 16. | Proximity and Convenience of Bank Location | 4.81 |
| 17. | Showing Interest in the Client's Success | 4.81 |
| 18. | Showing Consistency in Credit Decisions | 4.73 |
| 19. | Making Efforts to Improve Banking Services | 4.71 |
| 20. | Quick Response Time on Loan Applications | 4.65 |
| 21. | Ease of Access to Loan Officers | 4.65 |
| 22. | Present Innovative Solutions to One's Financial Needs | 4.65 |
| 23. | Bank's Understanding of the Local Alternatives | 4.53 |
| 24. | Knowing and Explaining Loan Alternatives | 4.49 |
| 25. | Offering a Wide Variety of Financial Services | 4.36 |
| 26. | Help with Paperwork, Explain What is Needed and Why | 4.31 |
| 27. | Providing Sound Business Advice | 4.30 |
| 28. | Showing Flexibility in Collateral Requirements | 4.29 |
| 29. | Bank's Interest and Presence in the Community | 4.26 |
| 30. | The Bank Being Locally Owned and Managed | 4.02 |
| 31. | Providing Assistance with Financial Projections | 3.76 |
| 32. | Bank Size | 3.25 |

* 1 = Not At All Important, 6 = Extremely Important

The results of this study will help banks better understand the true banking and financial needs of entrepreneurs and small firms. This should assist them to more effectively serve and meet the needs and concerns of this important segment of their banking market. Further, the study results provide financial institutions with the ammunition they need to better assess their own strategic strengths and weaknesses, identify positioning gaps in their commercial markets, and seek and secure a stronger competitive position vis-a-vis their rivals in those markets. Finally, the results indicate that while small firms define quality of banking services in more or less similar terms, their product/service needs are divergent and tend to be

**a function of the structural and idiosyncratic differences in their industries/operations. The related information provided in this study could go a long way in helping banks and financial institutions to not only do a more effective job of segmenting their small business market, but also more effectively differentiate and promote their products/services to their small business clients.**

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# ENTREPRENEURIAL TAX OPPORTUNITIES THROUGH HISTORIC PRESERVATION

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**ABSTRACT**

***What do you do with an 1893 warehouse that is dysfunctional in 1993? The railroad no longer runs by it and the warehouse has stood in disrepair for decades. Because tax laws allow certain advantages for historic properties restored and converted for commercial use, entrepreneurs seeking tax credit and distinctive office space can take advantage of the provisions of the tax laws. This article presents the details of how a Midland Railroad warehouse was converted to office condominiums, one of which was purchased by a partner in the development for his upscale advertising agency. The conversion yielded tax advantages and has also positively affected the image of the agency. The article should be useful to other entrepreneurs who wish to claim similar advantages through restored historic properties.***

## BASSET&BECKER ADVERTISING

**Jack Basset began his own advertising agency in 1975, and his business grew steadily during the following years. A decade later, Jack formed a partnership with Bill Becker. Their agency's goal was to be the premier advertising agency in Columbus, Georgia. Their billings now exceed $2 million annually. Clients include the Columbus Regional Healthcare System, the Columbus area McDonald's restaurants, the banking firms, CB&T and Synovus; the growing information systems company, Total Systems Services (TSYS); and the agency's first client, Columbus Country's Barbecue.**

**The agency has seven associates. The two partners handle most of the account contacts and planning in addition to graphics work, writing, and communications work. They supervise the subcontract work such as video production and contract talent. The Art Director focuses on graphic design, printing, and negotiating subcontract work. She also supervises two other art associates. The *traffic* person manages media placement, 80% of which is computerized. Finally, the agency employs a bookkeeper.**

**Basset&Becker subscribe to a monthly software service so that they can buy media time better than any competitor. According to Jack Basset, they had to buy this plan to keep the Columbus McDonald's business. McDonald's reduced the number of its advertising agencies from 240 to 27 nationwide. Basset&Becker was retained. While Basset believes their use of information technology to be average on the national advertising scene, it is above average for the region. *"We are doing the same things with computers that medium size agencies billing $30 to 50 million annually are doing."***

**Basset&Becker had handled the account for a major historic restoration project in Columbus: 1 Arsenal Place. This building had been restored and space was leased. Basset&Becker promoted this development, *"back then we couldn't afford something like that. We had to grow some more."* When the agency became a partnership and continued to grow, it began to look for distinctive yet affordable space. Rozier Dedwyider, then with Uptown Columbus, helped them look for deals. According to Mr. Basset, *"Rozier is responsible for more buildings being saved than anyone else in Columbus."* First they looked at houses in the historic district then an old bakery building and a fire station which still had its old terra cotta roof. They looked at the old Midland Railroad warehouse in 1991.**

## PROPERTY PRIOR TO RESTORATION

**The Midland Railroad warehouse was on the demolition list prior to restoration. It had been condemned because storm damage had caused the structural integrity of the building to be questioned. The Bradley Company, which had been instrumental in restoring many historic properties in Columbus, had lost interest in the building when the downtown office market softened. The old warehouse had 16,000 square feet of space, with no interior walls. Old brick walls and heart-of-pine trusses supported the structure. Warehouse doors which slid back and forth on rollers to open and close warehouse bays remained in place. The dirt floor had been covered with cement. There was no plumbing and no electricity.**

**Standing in the middle of a train yard, the building is exposed to strong light and heat from both the east and west. It is located in downtown Columbus adjacent to a well-preserved older textiles plant and a beautifully restored train depot, used by Total Systems Services, Inc., for executive offices. The old warehouse is within minutes of the historic district and Chattahoochee River front, where other industrial properties had already been restored for commercial use. Extensive river front development is planned. Basset&Becker thought it was perfect.**

## TAX LAW REVIEW

**As an incentive for modernizing and rehabilitation of existing buildings, Congress enacted the Revenue Act of 1978, which was modified by The Revenue Act of 1986 (Arnold, 1987). The major benefit of this act is to provide a tax credit of 10% of rehabilitation costs for buildings put into service before 1936, and a 20% tax credit for buildings that are certified historic structures regardless of age.**

**Substantial rehabilitation of the building is required in order to qualify for tax credit. Eligible buildings include factories, warehouses, both wholesale and retail stores, office buildings, and similar type buildings. The use after rehabilitation, not the prior use, determines eligibility. Rehabilitation expenditures that qualify are interior or exterior restoration or renovations that materially extend the useful life or significantly upgrade its usefulness. The expenditures must be capitalized rather than expensed. Expansion or enlargement of the building is not a qualifying expense.**

**There are certain requirements regarding demolition and destruction of exterior and interior walls. These requirements are designed to maintain structural integrity of buildings on the Certified Historic Structures (CHS). The certification procedures for CHS designation satisfy the same requirements. Depreciation of the rehabilitation costs may be combined with the depreciation of the rehabilitated structure, providing the taxpayer elects to use straight-line depreciation for both. Straight-line is the only alternative now, but property put into service prior to 1986 could use accelerated depreciation.**

**Passive income and loss questions are addressed by the act. The investor may take the tax credit equivalent of a $25,000 deduction even if he does not actively participate in the management of the project. The availability of the tax credit begins phase out at an Adjusted Gross Income (AGI) of $200,000 and is terminated at an AGI of $250,000.**

## IMPLEMENTATION

**Basset&Becker Advertising was growing and needed to move to larger and more impressive office space. They looked at houses in the historic district and many older buildings in town before becoming interested in the old railroad warehouse. Working with Rozier Dedwyider from Uptown Columbus, the partners in Basset&Becker formed a limited partnership with the Bradley Company's Real Estate Development division. The partners acted as a general partner and the Bradley Company as a limited partner in 6th Avenue Freight Office Partners. 6th Avenue formed to develop office condominiums from the old Midland Railroad warehouse. At present, there are two condominium occupants: the advertising agency with 3,610 square feet and Total Systems Services' Human Resources function, which signed a three year lease for approximately 13,000 square feet.**

**The old concrete floor was torn out. Electricity and plumbing were installed as is done for a typical slab construction. Interior walls extending 8 feet were added, leaving the heart-of-pine ceiling trusses exposed. Electricity and plumbing were run in pipes placed inside these interior walls. The partners had to continue to demonstrate that they were following the guidelines for rehabilitating historic buildings (Murtaghm, 1988). They had originally planned to install windows in every warehouse bay, but the Department of Natural Resources (DNR) believed that these windows would violate the historic integrity of the old railroad warehouse, a structure listed on the National Register of Historic Places. They compromised with windows installed on every other bay. The original warehouse doors for these bays were removed, restored, and rehung.**

**Because of the lack of surrounding trees in the old rail yard, the partners had wanted to use tinted glass to reduce heat and glare, but the DNR contact also believed that tinted glass would violate historical integrity. Bronze aluminum around windows and doors had to be painted dark green. From the standpoint of the exterior as a containing envelope for the building, the restored building looks as it did in 1893 with the exception of the roof, which is only partially visible from a nearby viaduct.**

**The roof was a tar and gravel roof. It was replaced with slab foam insulation on top the wood roofing and then another built up roof added. They considered using seamed metal**

**roofing, but since the angle of the roof is fairly flat and the roof is not visible, they used less expensive roofing shingles.**

**Throughout the planning and implementation process Rozier Dedwyider of Uptown Columbus stayed in contact with the DNR to be sure that they would be able to qualify for the tax credit, that no construction violated the extensive guidelines for rehabilitating historic properties. Mr. Dedwilder was experienced in dealing with the DNR. Many details had to be handled before construction, but once construction began, the agency occupied the restored space within two months. Some work still remained to be done, but the work space was functional.**

**Beaded board siding, chair rail, old-style molding around doorways, stained glass, and antique furnishings all work to create a nice, clean, *airy* interior while emphasizing the distinctive character of the property. The interior warehouse structure remains fully visible with the 8 foot interior walls. Heating and air ducts, painted a charcoal color, are visible but unobtrusive. Old brick and heart-of-pine trusses and wood ceiling dominate. The effect is that of a stage set. Old brick is visible on all sides of the work space interior. Against that old brick, a sky-blue patterned wall paper is used with white chair rail and molding. The beaded board siding is painted pale grey. Bays which were converted to windows have a coordinating wall paper. Wooden blinds are used with the windows. The conference room, featuring an old oak table and an enlarged photograph of the warehouse in horse and buggy days, is a comfortable and welcoming meeting room. The agency was unable to find an old photograph of the warehouse, so their graphic artists merged an old photograph of warehouse traffic in the 1890s with a photograph of the restored building, reproduced it in brown tints, and had it enlarged to portrait size. The finished portrait bears all the marks of historic authenticity. The portrait, hung in the meeting room, adds interest and emphasizes the building's long history as well as new use.**

**In the center of the office condominium, which features seven different work areas, is a kitchen complete with bar stools. Most of the agency's associates eat lunch together there daily. *"It's a good time to catch up with each other,"* says partner Jack Basset. The agency has an informal work atmosphere. *"We play as much as we work here,"* Mr. Basset said jokingly. *"We may get anxious but we never get up tight."* In keeping with this informality, only two workspaces have doors and these doors are to provide semiprivacy for client conferences and sound proofing for the recording studio. Nevertheless, the *old house* aura provided by the siding, wallpaper, molding, and partitions provide a sense of privacy and security. The workspace is a marriage of the formal and informal, the traditional and the unconventional, of history and the latest in high tech graphics tools. The workspace is interesting and inviting.**

## COST BENEFIT ANALYSIS

**Because the partners were very careful to follow historic rehabilitation guidelines for certified historical properties, they gained a federal income tax credit for 20% of their net improvement. They were also able to obtain a facade loan, a 10 year loan that is forgiven at the rate of 10% each year, providing that the historical integrity of the building continues to**

**be maintained. The agency partners, as owners of the condominium, can get passive income from the rent of the building to the agency.**

**Before moving, they were paying $2,200 in rent. Now, they are buying their space and paying $1,600 a month. They must also pay taxes, insurance, and other additional costs. Because they are owners of a condominium, they are also liable for association dues and assessments. Right now, however, a billboard located on the property is rented for $5,000 a year, so this rent is used for maintenance and improvement reserves. No association dues are currently being charged. Utilities average about $400 per month for their 3,610 square feet, with the summer months being the ones of most intensive use. Two heating and air units were installed, one for the east side of the building and one for the west side because of the warehouse's exposure.**

**The condominium will probably be more marketable, should the partners decide to sell, when the remainder of the building's condominiums are sold to different companies instead of being leased. In the foreseeable future, however, the agency has no plans to sell or move.**

**Mr. Basset says that profits have grown since the purchase of the office condominium, but that it is hard to isolate the move as the main reason. The agency is using more computers and doing more of their own work in house. It is possible that the comfortable work environment has helped to lower the anxiety level associated with new and increasing computer usage. They have seen a tremendous change in the tools of the advertising trade since 1992 when they first occupied this restored space.** ***"We have stacks of CDs instead of stacks of books."*** **Some researchers (Naisbitt, 1982; Senn, 1995) believe that the principle of** ***high tech, high touch*** **is an essential component for effective computer usage in an organization:** ***"The more you rely on advanced technology, like information technology, the more important it is to consider the 'high touch' aspects."*** **(Senn, 1995, 21). Other researchers find that the architecture associated with older buildings tends to alleviate rather than produce stress (Hale, 1994). According to Mr. Basset, while they are not using the leading edge tools of a New York city ad agency, they are using the latest information technology tools for an ad agency in their region and for their size.**

**A surprising benefit of the restored property is how much time is saved because** ***"99% of our meetings take place here. I rarely leave the office. Being able to stay in one place helps me to get more done."*** **Clients like to meet at the restored railroad warehouse. Lunch in also saves time and facilitates idea exchange. The restored warehouse is a good work environment and** ***"people just like to be here. Many of our clients involved in civic activities ask to use the meeting room for their civic organizations' meetings after work. Most clients now prefer to come to Sixth Avenue for meetings with the agency . . . In the advertising business, perception is reality,"*** **and, continues Mr. Basset,** ***"the restoration gives clients the perception that we're something special, we're competent, we're creative."***

**Mr. Basset says that without the tax credit and facade loan the cost picture would be quite different, enough different that the project would be difficult to justify from a purely economic point of view. With the tax credit and facade loan, Basset&Becker improved and expanded while lowering their monthly costs.**

## CONCLUSIONS AND IMPLICATIONS

Throughout small to medium size towns in the Southern U.S. are historic downtown buildings which have been abandoned (Ziegler and Kidney, 1980). At the same time, small entrepreneurial ventures are growing and looking for quality work space. Office condominiums for small businesses offer many advantages, particularly if they involve preservation of historic properties (The National Trust for Historic Preservation, 1976). The tax advantages for restoring historic properties for commercial use can make the cost per square foot more attractive than that of new construction or than that of existing rental office space. Although the DNR guidelines must be followed carefully if the tax credit is to be claimed, the restored property may also have many intangible benefits. The association of the business with the restored historic structure may have a positive affect on clients' or customers' perception of the business.

An important implication of Becker&Basset's experience is the perception of the business that using a restored historic property provides. Companies such as advertising agencies and information systems firms are *mind trusts* and perceived to be unstable over long periods of time. Their association with a historic property may allay fears of volatility among their clients. The creative use of a property lends credence to the business' creativity and competence. Finally, when frequent association with clients is important, as it is with both the advertising agency and information systems firm, then having clients feel comfortable in the business' environment, to even prefer that environment to their own, is an important intangible benefit. Historic properties restored for use as office condominiums offer important tangible and intangible benefits. Furthermore, as the trend toward telecommuting accelerates, shared office condominiums in outlying areas may offer an attractive alternative or supplement to the home office.

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# ARE HUMAN RESOURCE MANAGEMENT PRACTICES IMPORTANT IN SMALL FIRMS?

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## ABSTRACT

*It has been said that sound human resource management (HRM) programs and practices contribute to business success. A survey of small business owner perceptions of the value of their HRM practices found rating differences of those practices to vary from 98 percent important to only 45 percent important. The perceptions of the owners were compared to managers of similar-sized subsidiaries and were found to be lower than the general managers in all cases.*

## INTRODUCTION

Small business start-ups and growth have been credited with almost half of all jobs created in the United States during the 1980s. Small businesses therefore played a major role in prolonging the economic growth that occurred during that period and demonstrated their importance to the future. Although small firms have been growing in size and number, they also have been failing. The failure rate has been said to exceed fifty percent during the first five years (Gaedeke and Tootelian, 1985; Hofer and Sandberg, 1987). Research has uncovered many factors contributing to the failure of small firms, but a lack of management skills appears to be at the top of the list (Peterson, Kozmetsky and Ridgway, 1983). One necessary skill may be that of finding and keeping good employees. According to Hay and Ross (1989), the owners that get help from many sources also tend to achieve the most success.

Because they create jobs, small firm owners must be able to recruit, select and retain new employees. They must have sufficient staffing skills to attract and retain the kind of employees who can make a positive contribution to the success of the firm. Therefore, owners must have human resource management (HRM) skills, and must make use of the human resource management practices that will staff the enterprise with productive employees. The HRM practices employed by the owners would thus contribute to the firm through the behavior and the performance of the employees.

Since small firms employ fewer people, each employee is a significant part of the firm. Each employee could interact with customers and other employees, and could be called upon to make decisions having long-term effects on the firm. This makes subordinate employees important to the positive outcomes desired by the owner. It also makes HRM skills and practices important to the owner and to the success of the firm.

Are small firm owners people-oriented and employee-oriented? Do they have HRM skills and the knowledge to put HRM practices into effect in their growing firms? These

**actions on the part of the owner would be important because of the part the employees could play in the overall success or failure of the small firm. Many writers have emphasized the importance and impact HRM practices have on the performance of small businesses (Aziz and Anderson, 1986; Hambrick and Crozier, 1985; Schuler, 1990). Can we assume that owners do appreciate and make use of HRM practices? How do small business owners compare to managers of similar-sized subsidiaries of larger firms?**

## METHODOLOGY OF THE STUDY

**To find answers to these questions, small business owners were surveyed and asked to respond to questions about the value of their HRM practices. General managers of similar-sized subsidiary firms were surveyed and the two groups were compared.**

**A homogeneous, single-state database (*Alabama Directory of Mining and Manufacturing*) was used to obtain a sample of firms for the survey. Research has shown that firms within a single state all face similar laws, taxes, and proximity to markets (Cochran, 1981; Gomez-Mejia, 1987). Using small businesses from a single state would therefore help eliminate many extraneous variables. Manufacturing firms were chosen because it was assumed that small manufacturers would be somewhat labor intensive and would have HRM programs and practices in use.**

**The sample was chosen systematically (every fifth firm in the database), and one thousand firms were then mailed a two-page questionnaire. The owners of the small firms and the general managers of the subsidiaries were asked both demographic questions and questions about their perception of the value of their HRM practices to their particular firm. The HRM questions were derived from basic HRM practices found in current textbooks (see for example, Schuler, 1990). Although there are numerous HRM practices, the list of practices was reduced to thirteen to shorten the questionnaire and to encourage responses. The resultant thirteen practices provided a wide variety of separate and distinct HRM practices covering a broad spectrum of HRM. This ranged from employee search to hiring to discipline and the contribution of all thirteen HRM practices (see for example, Aziz and Anderson, 1986; McEvoy, 1984; Schuler, 1990).**

**The questionnaire was field tested by a group of SHRM members to insure that the questions were relevant, understandable, and broadly based. The owners and general managers were asked to rate (on a scale of 1 to 7), their perception of the contribution made by each of the thirteen HRM practices to the success of their particular firm. Other research has shown that this type of subjective perceptual response can be a substitute for quantitative data (Dess and Robinson, 1985; Smith et al, 1989). This type of rating scale thus can be used to make statistical comparisons (Kerlinger, 1973).**

## RESULTS OF THE STUDY

**The independent small firms returned 152 questionnaires and the general managers of subsidiaries returned 53. A comparison of the results is shown in Tables 1 and 2.**

**Table 1**
**A Comparison of the Perceptions of HRM Practices Between Owners and General Managers**

| | Percent Rating Important | | Percent Rating Unimportant | |
|---|---|---|---|---|
| **HRM Practice** | **Owner** | **Manager** | **Owner** | **Manager** |
| Promotion from within | 98 | 100 | 0 | 0 |
| Realistic job preview | 89 | 100 | 5 | 0 |
| Safety program | 88 | 92 | 5 | 8 |
| Discipline program | 86 | 94 | 5 | 0 |
| Grievance program | 85 | 90 | 5 | 4 |
| Paying market salaries | 77 | 92 | 14 | 2 |
| Communication program | 72 | 85 | 14 | 2 |
| Performance evaluations | 70 | 91 | 16 | 0 |
| Search methods | 60 | 65 | 20 | 9 |
| Job descriptions | 58 | 79 | 27 | 9 |
| Orientation program | 51 | 77 | 33 | 15 |
| Training program | 46 | 77 | 29 | 6 |
| Separate HR manager | 45 | 68 | 40 | 19 |

Rating scale: 5-7 Important; 4 Neutral (not shown above); 1-3 Unimportant

The HRM practices have been listed in a descending order of importance as rated by the small business owners. Ratings of 5-7 for a particular practice show that practice as being of some importance, with ratings of 1-3 being unimportant to the firm. A rating of four was neutral, and was not included in the computations for Table 1. While both groups agreed on the relative importance of some HRM practices, others received widely differing ratings.

Promoting from within, realistic job previews, safety, discipline, and grievance programs all received similar high ratings. All of these HRM practices were rated as important or very important to both subsidiary managers and small firm owners. Managerial disagreement was found with paying market salaries to employees, communicating to employees about the firm, performance evaluations, using job descriptions, socializing and training new employees, and having a separate HR manager. Table 2 shows the mean ratings for each HRM practice.

The practices rated important were promotion from within, using job previews, safety programs, and grievance programs. Rated somewhat important were communication programs, paying market salaries, performance evaluations, and search methods. Neutral ratings were given to job descriptions, orientation programs, training programs, and using a separate HR manager. On the other hand, all of the practices were rated as important or somewhat important by the subsidiary managers. Significant differences between the two groups were found for seven of the thirteen practices. Researchers have found that small firms may be different in many respects from larger firms (see for example, O'Neill and Duker, 1986).

**Table 2**
**Comparison of Ratings of HRM Practices**

| HRM Practice | Rating values: Owner | Rating values: Subsidiary | p value |
|---|---|---|---|
| Promotion from within | 6.5 | 6.6 | .538 |
| Realistic job preview | 6.1 | 6.4 | .135 |
| Safety program | 5.8 | 6.4 | .050 |
| Discipline program | 5.9 | 6.3 | .108 |
| Grievance program | 5.8 | 6.1 | .348 |
| Paying market salaries | 5.1 | 5.6 | .104 |
| Communication program | 5.2 | 6.1 | .003 |
| Performance evaluations | 5.0 | 6.1 | .001 |
| Search methods | 4.7 | 5.0 | .355 |
| Job descriptions | 4.4 | 5.5 | .006 |
| Orientation program | 3.9 | 5.2 | .002 |
| Training program | 3.8 | 5.2 | <.001 |
| Separate HR manager | 3.6 | 5.2 | <.001 |

Rating scale: 7 Very Important; 6 Important; 5 Somewhat Important; 4 Neutral; 3 Somewhat Unimportant; 2 Unimportant; 1 Very Unimportant

**Table 3**
**Correlations of Ratings With Sales per Employee**

| HRM Practice | Correlation Coefficient | p value |
|---|---|---|
| Promotion from within | .083 | .155 |
| Realistic job preview | -.060 | .230 |
| Safety program | -.016 | .425 |
| Discipline program | -.202 | .006 |
| Grievance program | .026 | .375 |
| Paying market salaries | -.121 | .068 |
| Communication program | -.016 | .422 |
| Performance evaluations | -.023 | .391 |
| Search methods | -.151 | .032 |
| Job descriptions | -.091 | .134 |
| Orientation program | .032 | .346 |
| Training program | -.015 | .428 |
| Separate HR manager | .076 | .177 |

To further investigate the value of HRM practices, the ratings by the small business owners were correlated with the sales per employee figures reported for each firm. Sales per employee is a measure of organizational performance that shows the utilization of the human resource, and can be used to compare small firms (see for example, Kirchhoff and Kirchhoff,

**1987). Most of the correlations between the HRM practices and firm performance were negative, and only three had a P value of less than .1 (see Table 3). The HRM practice with the strongest correlation was discipline (P value = .006).**

## DISCUSSION

**The rating differences between the two groups, as found in Tables 1 and 2, could have occurred for a variety of reasons. The differences may be explained as a difference between managers and small business owners in their perceptions of the value of people, in perceptions of the value of HRM practices, or in their knowledge of human resource management itself.**

**Perhaps small firm owners are focused on being creative, on finding financial resources, or on interacting with customers, since they have no parent company providing support. The idea, the fledgling firm, and making the most of a *window of opportunity,* may preoccupy the owners' thoughts, plans, and activities. The extra assistance subordinate employees could offer may not be available in independent firms because that climate of encouragement is missing.**

**These results may indicate that managers have a better understanding of the part HRM plays in good management practices and in the management of their businesses than owners, or it may be that HRM support received from the parent firm may have made a positive impact on the managers. If an HRM system were established in a subsidiary, the manager may have had an opportunity to evaluate HRM contributions made to the firm.**

**The negative correlations between firm performance and HRM ratings may indicate that, as small firms improve, the need for using HRM practices declines. Other research has reported that HRM in small firms was of low priority and had a short-run emphasis (i.e., Amba-Rao & Pendse, 1985; McEvoy, 1984).**

**If starting or growing small firms is important to our economy, then the owners of these firms also are important. Given that importance, the difference between the ratings indicates that small firm owners may need help in the management and staffing of their firms. In order to help them succeed, assistance in techniques, methods, and ways to implement good HRM practices may have to be provided. Understanding basic HRM practices is a learned behavior that should not occur through trial and error. It cannot be assumed that small firm owners are experts at starting or managing a small business. This research indicates that small firm owners may need help in the staffing process, and in dealing with people within the firm.**

**When compared to general managers of small subsidiaries, the small firm owners in this study rated every HRM practice lower than did the general managers. Several practices were rated much lower. If this is indicative of small business owners in general, they are missing an opportunity. To enlist the help and involvement of their employees, they will have to improve their recognition of the value of practices that could have a positive influence on employee performance. That would especially include HRM practices, since these practices have been shown to have an impact upon employee performance.**

**For the owner and the small firm to succeed, help and information are needed from many areas. According to research, the firms that can best obtain that help also tend to achieve the most success (Hay and Ross, 1989). In that study, none of the failed firms had**

**made an effort to obtain help. Although assistance may be obtained from several sources, the employees may be one source that has been overlooked by the small firm owner. If allowed and if encouraged, the contribution and commitment of employees may make that incremental difference for the small firm that leads to success instead of failure.**

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# THE ECONOMIC IMPACT OF THE CONTRACT WITH AMERICA ON SMALL BUSINESS

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**ABSTRACT**

***Since Republicans gained control of the House of Representatives in the last election, much has been written about the party's political objectives outlined in the Contract With America. The first one hundred days of the new Congress were filled with bills which made major changes in many areas of federal programs and discussions of numerous additional potential adjustments to government as we know it. The legislation before Congress could have a major impact on small business and the economic environment for entrepreneurial undertakings. There has been much discussion of long-term plans to completely restructure the income tax laws. In the near future, many adjustments to the current tax code and government structure have also been proposed. On the negative side, some politicians are calling for the elimination of the Small Business Administration and the federal economic support of technology research. However, on a positive note, proposed legislation would greatly increase the amount of assets which small firms could immediately expense for tax purposes, make it easier for small business owners to pass the company on to their heirs, lower the tax rates for capital gains, "simplify" the tax laws, and reduce the amount of government regulation and red tape applicable to small companies.***

***Will small business ultimately gain or lose economically under the Contract? The overall impact of these changes on small firms will become clearer over the next few months as legislation is finalized. This paper will examine the potential economic ramifications for small business.***

## INTRODUCTION

**The Republicans are now several months along in their efforts to pass legislation which reflects the ideologies of the Contract With America. Fortunately, many of the issues identified by the White House Conference on Small Business as being of paramount importance to its constituent group are under consideration (Selz & Mehta, 1995). However, the movement that originally started out as a steamroller has recently been bogged down in disagreements between the House and Senate and squabbling within the Republican ranks. As a result, the current business environment is clouded with uncertainty, much of it traceable to the political battles in Washington over which programs to fund and which regulatory changes to make. The situation is definitely in flux, with many major issues still being hotly debated. Discussions center mainly on income tax reforms and reducing the economic burden of federal regulation.**

## PROPOSED INCOME TAX CHANGES

**Proposed changes to the tax laws are numerous and varied. The most sweeping proposals are to do away with the income tax as we know it and replace it with a simplified, more equitable tax system. Several variations of a flat tax have been suggested along with a possible value-added levy. These plans would shift more of the tax burden from individuals to businesses (Gleckman, 1995). All of these proposals also constitute a form of consumption tax rather than income tax. Disenchantment with the Internal Revenue Service and the complexity of the current tax rules has resulted in widespread popular support for changes in the tax structure. That complexity is one reason businesses currently spend over fifty billion dollars to compute, file, and plan their income tax liabilities (Flat shares, 1995). All of the new plans attempt to minimize the costs of compliance through tax simplification.**

**The proposal thought most likely to be adopted in the future is the flat tax proposed by Congressman Armey (Richman, 1995). Companies would still compute their taxable income as revenues less expenses, but what qualifies as a tax deduction would change dramatically. Businesses could still deduct costs of goods sold expense, wages, salaries, and amounts paid for services. However, no deductions would be allowed for interest or for employee fringe benefits other than pensions. One plus would be that capital investments could be written off at the time of purchase rather than being expensed over the useful life of the asset. All firms would be subject to the same tax rate, regardless of size. Individual investors would not be taxed on interest, dividends, or capital gains form their investments because the companies would already have paid tax on those monies (Gleckman, 1995).**

**Should smaller firms support a flat tax proposal? The answer to that question may hinge on the type of industry and financing involved and also whether it is an established or a start-up company. Those businesses in construction or other industries tied to interest rates may suffer a major decline if the interest deduction is removed for individuals and companies. The elimination of the tax deduction for interest expense could also generate long-term benefits for firms that finance their operations mainly through equity. By removing tax considerations from financing decisions, stocks and bonds would be treated equally. This would not be advantageous for those firms which have accumulated substantial debt. These businesses have long had their borrowing subsidized while firms financing mainly through equity have enjoyed fewer tax breaks. Under the proposed changed, companies which are highly leveraged would lose one of their largest tax deductions and their continued existence could be threatened. Presumably, any changes could be phased in to alleviate the potential adverse impact of these provisions. Labor intensive industries could also be hurt financially under the flat tax because they would no longer be able to deduct the costs of employee health insurance or any other fringe benefit besides pensions. However, firms could mitigate the impact of this change by shifting compensation into increased salaries and pensions and having employees pay for the health benefits themselves.**

**Proponents of the flat tax argue that the main beneficiaries under the proposal may be those firms which are just getting started. Such businesses normally have a minimum of debt. Banks don't like to make risky loans to new firms with unproven products. Therefore, start-up**

**firms will not suffer as much from the loss of the interest deduction as more established firms. Since new businesses frequently are forced to utilize equity financing, it could be advantageous to have stocks and debt placed on an equal tax footing. Removing income taxes from the financing decision and eliminating taxes on capital gains and investment income should increase the attractiveness of stocks. This may result in increased availability of capital for some small businesses and may lower the cost of capital (Richman, 1995).**

**Other aspects of a flat tax may also be beneficial to smaller companies. New companies normally engage in intensive capital investment during the start-up phase and could benefit from the immediate expensing of such expenditures. Although the positive effect of this provision might be minimal during the first year or two when many new firms are not profitable, it could greatly reduce the new company's taxes in the early years when profit is finally achieved. Since all businesses are to be taxed the same way, the legal form of the business organization would be immaterial for tax purposes. This would allow smaller firms to enjoy the limited liability advantages of the corporate form without the previous tax disadvantages. These changes, combined with the elimination of taxes on individual investment income may result in the entrepreneur getting to keep more of the profits of the business. This could encourage more individuals and capital into innovative new businesses. Since small businesses are a major source of new jobs in the economy, it would appear to be advantageous to encourage their proliferation. This is especially true at a time when the number of small companies is declining due to the increased competitiveness of restructured large firms (The puzzling infirmity, 1995).**

**The second major long-term income tax proposal is very similar to the flat tax but does not allow businesses a deduction for wages paid to their employees. This is a national sales tax also referred to as a value-added tax (VAT). VATs are utilized in most European countries. The value-added is the value that a producer adds to raw materials or purchases (other than labor) before selling the new or improved product or service. This tax is assessed on each stage of the production process. The VAT is extremely attractive to politicians because it is an indirect tax on consumers. The levy is collected from companies which then pass the increased costs along to individuals in the form of price increases. As in the flat tax, depreciation is replaced by the immediate expensing of capital expenditures. No taxes would be paid on savings or investing, only on purchases or consumption. The concept of a national sales tax on consumption is vehemently opposed by the retail industry, which fears legislation calculated to encourage consumers to curb spending could reduce sales (Gray,1995).**

**Should small business support a movement towards a VAT? Most European countries allow exempt very small firms from complying with the VAT due to the record keeping burden imposed on firms by the national sales tax. However, some proponents of the VAT argue that such exemptions would not be necessary in the United States because little firms already have to keep extensive records for state income taxes anyway. If no special considerations are made for small companies, then there are several negative impacts VAT could have on little firms. A VAT would not appear to be an attractive alternative for any small company in a service industry. Since no deduction is allowed for employee wages, such firms would loose one of their largest tax deductions and could expect their taxable income to rise dramatically. Several**

**additional issues were raised by an earlier House of Representatives Committee on Small Business. First, companies would have to keep extensive records of all purchases, whether the items were subject to a VAT or exempt, and the sales price of the finished product with which those items were associated. While much of this information would be available through the regular accounting system, things can get much more complex if multiple VAT tax rates are applied to different products. In those instances, the costs to small business of maintaining the records can greatly exceed the amount of taxes collected from those firms. Secondly, if the VAT is due at the time of purchase, then the tax may be payable on the buildup of inventories which have not yet generated any revenues. This could result in cash flow problems for some companies. Third, the VAT assumes that the firms which pay the tax pass that amount on to the customer in the form of higher prices. A small firm in an industry with several larger competitors may have little or no ability to pass along such costs if the other companies do not (United States, 1988). For these reasons, a VAT does not appear to be as advantageous as a flat tax from the perspective of small firms.**

**From the discussions above, it is obvious that the multitude of problems in firms from the current tax system to a totally different structure, as well as strong lobbying from groups which would be adversely affected by the proposed new tax systems makes radical change unlikely in the short run (Kimery, 1995). Less ambitious recommendations are to continue tinkering with the current tax rules to achieve greater simplification and equity in the tax laws. These suggestions call for reduced tax rates on capital gains, increased depreciation deductions, greater immediate expensing of capital expenditures, and increased estate tax exemptions. Capital gains have been an area of contention for years. One reason for popular opposition to reductions in taxes on investment gains is that such laws are viewed as favoring the wealthy. The new capital gains proposal seeks to avoid that criticism by allowing all taxpayers to benefit. This is accomplished by taxing only half of long term capital gains and indexing those gains to adjust for inflation. This would allow taxpayers to avoid paying any income taxes on a portion of their capital gains. Reducing taxes on capital gains could make equity investments more attractive and allow small businesses to obtain capital more easily. Unfortunately, the new provision is not limited only to those capital gains from investments in certain small companies. As such, it may be less advantageous for new start-up firms than the current law which only grants preferential treatment to capital gains from investments in qualifying small companies. This may be offset in part by the suggestion to index capital gains for inflation. Unfortunately, a long list of assets would be denied coverage under this provision, indexing for businesses may be removed for budget reasons, and the computation would be very complex (Willens & Phillips, 1995).**

**Indexing is also being proposed for depreciation computations. These measures would allow companies to compute depreciation expense based on a rough computation of the current value of the assets. Firms would be allowed to deduct depreciation expenses that exceeded the historical cost of the item being expensed. The only negative is that the computations are once again expected to be very nasty. The proposal also reduces the depreciation in the first few years in exchange for greater deductions later (Cromwell & Weiss, 1995). While capital intensive small companies could benefit in the long run from increased writeoffs, the two big**

**questions would be the cost of computing the deduction and whether or not anyone trusts Congress to leave the law intact long enough for the long run benefits to be realized.**

**Perhaps more advantageous from the viewpoint of small business are two other proposals being discussed. The first of these would increase the amount of capital expenditures which could be expensed immediately to $25,000. This could be of benefit to most small firms and involves no new computations. For larger firms, the tax savings of this proposal may not approach those of the indexed depreciation discussed above, but this suggestion is likely to have the support of labor intensive small firms as well as capital intensive companies. The second proposal of great interest is to increase the estate tax credit so that estates under $750,000 will not be subject to any wealth transfer taxes (Willens & Phillips, 1995). For entrepreneurs whose family businesses comprise the bulk of their estate, this would be a welcome change. Although this is not a great increase over the current level of exemption, it is at least a movement in the more favorable direction. This would reduce the possibility that the business would have to be sold to pay transfer taxes.**

## REDUCING THE BURDEN OF GOVERNMENT REGULATIONS

**Current tax proposals are not the only items being considered by Congress which could have a major impact on the financial burden placed upon small business by the federal government. Other areas of legislation which could also have a major effect on small companies are movements to reduce the burden of government regulations and to limit product liability. The National Federation of Independent Business estimates small businesses spend more than $100 billion a year to comply with federal regulations (Small business gets some, 1995). Congress is currently working on a bill which requires the federal government to reduce the paperwork required of businesses and there have been discussions about requiring a cost/benefit analysis for all proposed regulations. The House recently passed a bill to reduce the cost of environmental regulation for business by barring the Environmental Protection Agency from enforcing many of the federal laws under its jurisdiction (House would strip EPA, 1995). Although reconsideration of the pollution regulations was one of the items cited by the White House Conference on Small Business, it is uncertain whether the bill approved by the House will become law and whether or not a repeal of federal regulations will reduce businesses' environmental liabilities in court cases. Congressional attempts to limit product liability are in a similar state of uncertainty.**

## LIMITING PRODUCT LIABILITY

**The number of product liability cases has increased 500 percent over the last twenty years. The average amount assessed against companies has doubled and insurance rates have soared (Gross, 1995). Many companies reject potential products or markets because of possible legal liability exposure. Congress is considering banning product liability suits where the product involved is over fifteen years old or where the injured party's judgment was impaired by illegal substances or drinking. Some safe haven rules are also being proposed for**

**pharmaceutical producers and other manufacturers whose products have passed federal safety and regulatory requirements. If such provisions can survive adverse lobbying efforts from the trial lawyers, some small businesses could see a reduction in their product liability insurance. The magnitude of the decrease in insurance expenses would depend on the type of business involved and the inclinations of the insurers to pass along any cost savings. The total impact of any bill in the area will be difficult to assess for several years because lawsuits which have already been filed could easily take that long to resolve. Perhaps the greatest short-term benefit to small companies is that a uniform federal law would replace the varied state statutes that currently govern product liability (Gross, 1995).**

## CONCLUSION

**It is apparent that actions currently being considered by Congress under the Republican Contract With America could have far-reaching consequences for small businesses. Should entrepreneurs support or oppose the proposed changes? For many of the income tax bills, the answer to that question could vary depending on the specific facts of that company's situation. In the case of the possible regulatory changes, most small businesses could benefit from the proposed changes if Congress and the President can ever reach agreement on a bill. Overall, the Contract With America, with the exception of the possible imposition of a VAT, appears to be favorable for small business.**

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# CONTRACTUAL CONCERNS FOR THE 'GLOBAL' ENTREPRENEUR

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**ABSTRACT**

***This paper discusses some of the legal issues entrepreneurs should consider when negotiating a contract for the international sale of goods. It focuses on the legal principles relating to the formation and performance of the agreement, method of payment, and dispute resolution. How should contract terms be adapted for international trade? Should the provisions of the Uniform Commercial Code (UCC) be used as the legal basis for the contract involving a sale of goods or should the Convention on the International Sale of Goods (CISG) apply? What method of payment should be used for an international sale? And, in case of a dispute, should it be resolved through litigation or arbitration?***

## INTRODUCTION

No longer is an entrepreneur limited to the domestic market. The world has become a global market place with unlimited opportunities presenting themselves to all those who wish to pursue them. However, once an opportunity has been recognized, how can it be realized in this complex global environment? Can only large corporations take advantage of this vast international marketplace, or can the entrepreneur also learn to successfully maneuver in this global environment?

Anyone venturing into the global commercial arena must become aware of some of the legal rules which govern that game. Parties to an international contract not only have to be familiar with their own domestic law, but also other domestic laws and international conventions which affect the transaction. Therefore, a basic understanding of key domestic laws and international rules which directly relate to the formation and performance of international contracts is critical to the entrepreneur who wishes to sell his/her goods abroad.

## UCC VS. CISG

In the United States, parties take it for granted that a contract for the sale of goods is governed by the Uniform Commercial Code (UCC), regardless of where the seller and buyer are located. All states have adopted Article 2 of the UCC, which deals with contracts covering the sale of goods. Therefore, the resulting uniformity in this area of law has greatly simplified business transactions across state lines. The legal rules governing the formation and execution of this type of contract are predictable, thus facilitating commercial transactions within the boundaries of the United States.

**Unfortunately, such uniformity of commercial law does not exist across national boundaries. Every country has its own domestic law which governs business transactions, and these legal rules can vary greatly. However, various attempts have been made to create more uniform international commercial laws, with the broadest success having been accomplished by the United Nation's Convention on Contracts for the International Sale of Goods (CISG, 1980). This Convention reflects the interests of both developed and less developed nations and bridges the differences between the common and civil law systems. The CISG was adopted in 1980, ratified by the United States in 1986, and entered into force on January 1, 1988. So far, at least 42 countries have ratified this Convention.**

**The CISG, unlike the UCC, deals only with international sales contracts, not domestic contracts, and it establishes the rights and obligations of the parties to such agreements. Some of the provisions of the CISG are the same or similar to the provisions of Article 2 of the UCC, but others are quite different. Therefore, it is important that the parties not only know when the CISG applies, but how its provisions will affect the agreement of the parties.**

**Article 1(1) of the Convention provides that contracts between parties whose places of business are located in different States are governed by the terms of the CISG, as long as each State has ratified or acceded to the Convention, or as long as "the rules of private international law [i.e., choice-of-law rules] lead to the application of the law of a Contracting State." However, Article 6 of the Convention permits the parties to exclude the application of all or some of the Convention's terms. Therefore, the provisions of the CISG will automatically govern international contracts of member States, unless the parties specifically exclude all or part of the CISG terms, and in its place, substitute the domestic law of one of the member States. However, if only one of the contracting parties is subject to the CISG, then there is no automatic application of CISG terms and the parties are free to choose the governing law for their agreement.**

**The CISG does not apply to all types of commercial transactions. It specifically excludes from coverage consumer sales and sales involving instruments, ships, aircraft, and electricity. It also excludes contracts for the sale of goods where the predominant portion of the agreement relates to the provision of services. In those instances, the parties again are free to choose the law which will govern these transactions.**

**The CISG also does not address all subjects normally covered by the UCC. It does not provide rules for determining the validity of contracts (mistake, fraud, duress, and illegality), the capacity of parties, the seller's liability for defective goods, and third party claims. Again, these issues will have to be resolved through domestic law.**

**However, once the parties have chosen to be governed by the terms of the CISG, it is important to note the differences between the CISG and similar UCC provisions. The following exhibit contrasts the treatment of five areas involved in contract formation under the UCC and under the CISG. As the exhibit demonstrates, there are substantial and important differences between the UCC and the CISG provisions affecting the formation of a contract for the international sale of goods. It is vital that an entrepreneur be familiar with these differences when choosing the law which governs the sale.**

*Statute of Frauds* - the UCC requires that all contracts for a sale of goods involving a price of $500 or more must be in writing. Some exceptions are allowed (i.e. an oral contract for specially manufactured goods is still enforceable). The CISG, on the other hand, does not require contracts to be in writing, therefore all oral agreements, regardless of the contract price, are generally enforceable. Thus, to avoid entering into unintended commitments, the entrepreneur should communicate, in writing, that no negotiations or agreements are binding without a written contract.

*The offer* - the UCC will enforce offers, even though the terms of the offer, such as price, quality, date of performance, and time of performance are unspecified. The quantity term is the only term required under the UCC, and even there the UCC permits exceptions. Output and requirement contracts are enforceable, even though no specific quantity is specified in these agreements. The CISG, on the other hand, is much less flexible. The offer must be definite, especially as to quantity and price. But, the word "definite" is not defined in the CISG, and therefore, subject to court interpretation. To avoid problems in enforceability of offers, simply be specific as to the terms of the offer, especially those involving quantity and price.

*Revocation of the offer* - the UCC permits the offeror to revoke the offer at any time prior to acceptance by the offeree, unless a 'firm offer' was made. A 'firm offer' is defined in the UCC as an offer made in writing. Then, if the conditions are met, the offer becomes irrevocable for the specified time. The CISG also generally permits offers to be revocable, but there are two significant exceptions. If an offer must be accepted within a stated period of time, it is treated as irrevocable until such time has elapsed. Unlike the "firm offer" of the UCC, this offer does not have to be in writing or be made by a merchant to become irrevocable. Secondly, if it is reasonable for an offeree to assume that the offer was irrevocable and steps were taken in reliance, then it is treated as irrevocable. Therefore, offers are more likely to be irrevocable under the CISG than the UCC, and specific language as to the revocability of offers should be used to avoid misunderstandings.

*Acceptance* - the UCC provides that an acceptance is effective the moment it is made by the offeree, resulting in an agreement between the parties. Should the acceptance get lost in transit, the agreement still stands. Under the CISG just the opposite result would occur. An agreement is not made until the acceptance is received by the offeror, therefore, if the acceptance gets lost in the mail, there is no agreement between the parties. However, both the UCC and CISG provide that an offer can be accepted by performance of the required act, even though such performance has not yet been communicated to the offeror. The UCC, however, requires that notice of performance be given within a reasonable time to the offeror, where the CISG has no such notice requirement. Since acceptance is effective at different points in time under the UCC and CISG, it is critical to be aware of this difference when choosing the law which governs this agreement.

*Acceptance with additional terms* - the UCC does not invalidate an acceptance which contains changed or additional terms. Instead, it permits these different terms to become part of the agreement unless these terms "materially" change the meaning of the contract, with the word "material" left undefined and subject to court interpretation. The CISG also permits additional terms, but its definition of "material" in essence eliminates additional terms from becoming part of the agreement. "Material" is defined as anything which would "alter the terms of the offer", and most additional terms would reach that result. Therefore, an acceptance under the CISG and the UCC would not necessarily achieve the same result.

## LETTER OF CREDIT

The payment for goods in an international sale is often more complicated because the parties are not familiar with each other's laws and financial status. Therefore, the entrepreneur must select a method of payment which will minimize the risk inherent in a global transaction. Payment by an irrevocable and confirmed letter of credit specified in the

**international sales agreement accomplishes that goal. A letter of credit constitutes a bank's guarantee for payment of the goods. It involves three separate agreements:**

1. **the initial sales contract between the seller and buyer where the buyer requests payment by letter of credit;**
2. **a second contract between the buyer and his bank outlining the conditions under which the bank will issue a letter of credit, and;**
3. **the actual letter of credit issued to the seller specifying the documents to be received in exchange for payment made to the seller.**

**When payment is made by letter of credit, the seller will be paid for the goods as soon as the requested documents are presented to the bank issuing the letter. The seller does not have to wait for payment until the buyer receives the goods. However, a simple letter of credit still leaves the seller at risk. The buyer's bank has the right to revoke its letter of credit at any time prior to payment, and even if the bank honors the letter, it may be unable to pay for lack of funds. To eliminate this risk, an irrevocable and confirmed letter of credit must be issued.**

**When the buyer's bank issues an irrevocable letter of credit, it now guarantees payment for the goods upon proper presentation of documents. When the letter of credit is also confirmed, not only the buyer's bank, but a second bank (the confirming bank) also guarantees payment for the goods. This second bank is chosen by the seller and generally located near the seller's business. As soon as the goods are shipped, the seller can deliver the required documents to the confirming bank to receive full payment for the goods. The confirming bank will forward these documents to the buyer's bank in exchange for payment and the buyer's bank, in turn, will forward them to the buyer in exchange for his payment.**

**In summary, payment by letter of credit greatly reduces the risk in an international transaction. The buyer, by requesting shipping documents, has assurance that the goods have been shipped, and the seller can ship those goods, knowing that payment is guaranteed.**

## COMMERCIAL TERMS

**Shipment of goods involve commercial terms which define buyer and seller obligations and the risk of loss. The UCC has incorporated shipping terms which clarify these issues, but the CISG has not. Therefore, the parties to an international sales agreement must specifically include commercial terms to define rights and obligations of the parties and allocate risk.**

**The International Chamber of Commerce has published International Commercial Terms (INCOTERMS, 1981) which provide commercial terms for the shipment of goods and the allocation of risk of loss for sales transactions worldwide. Such terms as FOB (Free on Board), FCA (Free Carrier), CIF (Cost, Insurance, Freight) and others define the parties' rights and obligations while the goods are in transit. These terms have a close correlation to UCC terms, but one cannot assume that their meanings are identical. Therefore, it is**

**imperative that both the seller and the buyer have a complete understanding of all commercial terms before they are incorporated into their agreement.**

## DISPUTE RESOLUTION

**Arbitration is by far the most commonly used method for resolving disputes resulting from international commercial transactions. The United Nations Convention on Arbitration (New York Convention, 1958) made such worldwide use possible. Every signatory State agreed to enforce in its domestic courts not only the contractual agreements to arbitrate, but also the final arbitration awards. Therefore, drafting an appropriate arbitration clause is the key to successful dispute resolution. An arbitration clause should specify the place for conducting the proceeding and the substantive and procedural rules for resolving the dispute. To be enforceable, it must be in writing and must meet criteria set out in the Convention.**

**There are a number of international institutions available as arbitrators for disputes. The International Chamber of Commerce (ICC) is probably the best known with headquarters in Paris and regional offices throughout the world. The American Arbitration Association (AAA), the London Court of International Arbitration (LCIA), and the Arbitration Institution of the Stockholm Chamber of Commerce (SCC) are also popular choices. Each arbitral institution has developed its own procedural rules used to govern hearings.**

**The United Nations Commission on International Trade Law has also developed a set of arbitration rules (UNCITRAL Arbitration Rules) which have received widespread support. The various arbitral institutions have agreed to abide by the UN arbitration rules when the parties so designate in an agreement. Therefore, the parties should familiarize themselves with the various arbitration rules before they make a decision on arbitration procedural rules.**

**Once an award has been obtained, the parties should also be familiar with provisions of the New York Convention governing the enforcement of arbitral awards. The Convention mandates that an award must be confirmed upon request, unless it meets one of the grounds listed in the Convention for non-recognition or enforcement. However, the courts favor enforcement, and the party challenging such an award must prove that an exceptions applies.**

## ADDITIONAL CONTRACT PROVISIONS

**Issues of currency and language must be addressed in international agreements, and issues relating to impossibility of performance are more critical. Therefore, the entrepreneur should include contract clauses relating to these issues to reduce potential conflict.**

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# ARE FASB ACCOUNTING PROPOSALS FOR STOCK BASED COMPENSATION A THREAT TO ENTREPRENEURSHIP?

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## ABSTRACT

***The FASB proposals for accounting for stock based compensation are illustrated to show how they might affect a small start up company. The allegations that this accounting is a threat to entrepreneurship is discussed and it is argued that these allegations are illogical. Accounting standards should be debated on their representational faithfulness, not whether they hurt or help a certain type of company.***

## INTRODUCTION

**In December 1994, the Financial Accounting Standard Board withdrew the exposure draft of a proposed statement, *Accounting for Stock Based Compensation*, which had been issued in June 1993. The exposure draft proposed a substantial revision in the way companies account for stock options used to compensate executives, requiring recognition of compensation. The old accounting rules were established by APB Opinion 25, *Accounting for Stock Issued to Employees*. The FASB's exposure draft met a flurry of opposition from businesses, politicians, and from CPAs in both public practice and in commerce and industry. FASB chairman Dennis R. Beresford stated, "no matter how hard we tried to convince people of the correctness of our stand, there simply was not enough support..." (Beresford, 1995, 18). The FASB concluded their efforts in the stock compensation area by issuing Statement of Financial Accounting Standards Number 123, adopted January 1996. This statement abandons the accounting methodology proposed in the exposure draft, requiring instead only certain footnote disclosures of what income would have been if compensation were to be recognized.**

**A major concern of those opposed to the new accounting methods put forth in the 1993 exposure draft was that they would have a disastrous effect on American Business. More specifically, the charge was made that the new accounting standards would be a threat to entrepreneurship. In mid-1993 Congresswoman Anna Eshoo (California) submitted a congressional resolution calling for the FASB not to change its current accounting rules because the new accounting "poses a threat to economic recovery and entrepreneurship in the United States...and stunts the growth of new-growth sectors, such as high technology, which**

**relies heavily on entrepreneurship" (Kieso & Weygandt, 1995, 823). Indeed, the FASB received more letters on this proposal than any other matter in its history. Senators Gramm (Texas) and Lieberman (Connecticut) "made it clear that if the FASB didn't drop its proposal, they'd kill it in congress" (Colvin, 1995, 16).**

**Do the allegations that the FASB's accounting proposals threaten entrepreneurship have any basis in fact? We examine this issue and try to provide an answer to the question.**

## BACKGROUND

**In 1984, the FASB started a major project to determine if compensation expense should be reported for stock options granted to executives. From the beginning, the business community opposed the project, feeling the accounting rules under APB Opinion 25 were appropriate. The FASB eventually put the project on hold while it completed a study on more fundamental questions related to debt and equity.**

**Meanwhile large stock option grants continued to be given to executives. In most cases the company did not report compensation expense. The SEC received criticism from legislators and the press about the lack of reporting on these options and pressured the FASB to do something. In January 1992, Senator Carl Levin (Michigan) introduced a bill in Congress that would require publicly traded companies to recognize an expense based on the fair value of options granted to employees. He delayed action on the bill, provided the FASB issue new accounting rules. In June 1993, the exposure draft was issued. The opposition was intense. The FASB looked for political support but found little. The SEC commissioners all expressed reservations about the proposed ruling. In mid-1994 the FASB agreed to delay, by one year, certain requirements in the exposure draft. Finally, on December 9, 1994, the FASB met and decided against mandating that companies report the value of employee stock options as an expense. They made such accounting optional. If a company chooses not to record these awards as an expense, however, it would have to disclose in a footnote to the financial statements what the effect on net income would have been had the company recognized the expense based on FASB specified guidelines.**

## THE DIFFERENCE BETWEEN OPINION 25 AND THE EXPOSURE DRAFT

**To distinguish the difference in accounting under Opinion 25 and the FASB exposure draft, we will use a simple illustration. Small Company has 1,000,000 shares of common stock outstanding. Annual revenues are $10,000,000 and expenses are $7,000,000 yielding a pre-tax income of $3,000,000. The company is small and growing and decides to save cash by compensating the senior managers by offering stock options as a substantial portion of top executive compensation. Twenty percent of current outstanding shares are granted as stock options at the beginning of year one. The Small Company options expire in five years and have a $30 exercise price. The executives must stay with Small Company three years for the options to vest. The market value of the stock on the date of the grant is $25.**

The accounting under Opinion 25 (Figure 1) recognizes compensation expense on the measurement date based on the excess of the market price over the option price at that date. The measurement date is the date at which both the number of shares which can be purchased and the purchase price are known. Opinion 25 does not recognize compensation expense in our illustration because the option is "out of the money" on the measurement date, which means the exercise price is above market. This is normally the case with stock options granted executives because the IRS Code requires that the exercise price be at or above the market price for an option plan to be considered an incentive stock option (a qualified plan). Companies almost always elect a qualified plan because of the tax advantages it provides to the executives. In such a plan, the executive pays no tax at the date the options are received. Tax is also deferred on the date of exercise, although the executive has a gain on the difference between the option price (in this case $30) and the market price which is higher than $30 (or the purchase would not occur). Tax is only paid on the date of the sale of the shares, usually at capital gain rates, depending on the holding period.

Figure 1
APB Opinion 21 Accounting
Small Company
Income Statement
Year 1

| | |
|---|---|
| Sales | $10,000,000.00 |
| Expenses | 7,000,000 |
| Pretax income | 3,000,000 |
| Taxes | 1,200,000 |
| Net income | $1,800,000 |
| Earnings per share | $1.80 |

Small Company has given its executives the right to purchase 200,000 shares of its stock at $30 per share after year 3 and before the expiration of year 5. This grant is obviously giving the executives something of substantial value, but Opinion 25 recognizes no compensation. The assumption that something of value is being transferred to the executive is supported by consistent evidence that financial markets place value on such options, even though they are below the strike price at the time. The value of such options in the market lies in the potential future value based on the possibility that the market value of the stock will go above the option price before the expiration period passes.

The accounting proposed under the exposure draft (Figure 2) would recognize compensation expense, and allocate it over the three year vesting period of the options, under the assumption that the options do indeed have a value which is subject to measurement even though the option price is above the market price at the date of the grant. The period of the compensation is assumed to be equal to the vesting period of the options, the period over which the Company benefits because the executives must stay with the company in order to exercise the options.

The obvious problem is how to assign a value to the options. The exposure draft requires the use of an option pricing model such as Black-Scholes. Under the exposure draft requirements we use the Black-Scholes model, assuming a risk free interest rate of 7% and an annual standard deviation of the stock price of 40% and calculate a $10.03 value for each option. If only 182,535 of these options vest due to an anticipated 3% employee turnover, the total compensation cost of this grant is $1,830,822 or $610,274 per year. Clearly, in our example, the effect on the Income Statement is substantial, exceeding 20% of pre-tax income. The accounting for these options under the FASB proposal and under APB 21 is illustrated in Figures 1 and 2.

Figure 2
FASB Proposed Accounting
Small Company
Income Statement
Year 1

| | |
|---|---|
| Sales | $10,000,000.00 |
| Expenses | 7,610,274 |
| Pretax income | 2,389,726 |
| Taxes | 955,890 |
| Net income | $1,433,836 |
| Earnings per share | $1.43 |

The material impact on earnings illustrated in Figures 1 and 2 are typical for a small start-up company. Ciccotello and Grant (1995: p. 74-75) argue that the FASB proposed accounting will affect small companies much more than large companies for two reasons: (1) the number of shares under option for large companies, although large in gross terms, is small in relation to the number of shares outstanding; and (2) the stock price volatility of a large more established company generally is lower than that of a small company. The higher stock price volatility causes the options of the smaller company to be valued higher, while the higher proportion of options to shares outstanding for the small company dramatically increases the materiality of their effect on the income statement.

## THREAT TO ENTREPRENEURSHIP?

The exposure draft is controversial for many reasons. Applying the FASB's own standards as established in their conceptual framework, recognition of an item in the financial statements requires that the item must meet the definition of an element in the financial statements and be reliable, relevant, and measurable. (*FASB*, 1984: par. 63) After exhaustive consideration of these issues, the FASB concluded that the stock option transactions met all the criteria for expense recognition. These conclusions can be questioned from a number of theoretical perspectives, the most crucial being the reliability of using an option pricing model to measure the value of the options. These concerns are valid, although estimates are used in numerous other areas of accounting. The purpose of this paper, however is not to argue these issues but to focus on the validity of the entrepreneurial threat argument.

This argument seems to rest on the assumption that the accounting rules in the exposure draft will result in recognition of additional expenses for American Businesses, particularly new start-up companies in the high-tech areas which traditionally rely on stock options to attract management and engineering talent. It presumably is assumed that these additional expenses will make it more difficult for these companies to succeed by making it

**more difficult to attract capital and reduce the value of their equity securities in the market place. Such thinking, if taken at face value, is almost certainly illogical. The FASB addresses this issue:**

> ***Some opponents of recognizing compensation cost for stock options are concerned about the adverse effect they contend it will have on the income statements of American Businesses. The Board believes that the effect of recognizing compensation cost for employee stock options is neither more or less adverse than the effect of recognizing depreciation (or any other) cost. Recognition of depreciation always reduces a company's profit or increases its loss. American businesses would look more profitable on paper if they discontinued that practice. However, no one recommends not recognizing depreciation to eliminate its adverse effect on the income statement. The Board believes that the rationale that a potentially adverse effect on income statements argues against recognition is no more compelling for compensation than any other cost. (FASB, 1993: par. 70)***

**The contention that the accounting proposed in the exposure draft is a threat to entrepreneurship is, in our judgement, misguided. The implicit benefit of issuing an accounting standard is the increased credibility and representational faithfulness of financial reporting as a result of the revised accounting. The issue is whether the recognition of compensation cost for stock-based compensation paid to employees will improve the representational faithfulness and credibility of financial statements. All parties involved will make better decisions with information which better represents actual results.**

**Those opposed to the new standard would better base their opposition on attacking the representational faithfulness of the new standard, rather than suggesting that entrepreneurship is better off with misleading or inaccurate information. Steven Wallman, a commissioner of the SEC has this to say about the stock compensation matter:**

> ***There can be no ignoring ... the political and lobbying campaign that was waged with respect to this issue. Regardless of your view as to whether [the] FASB reached the preferred result, no one can believe that the best mechanism for establishing accounting standards is to politicize them... (Wallman, 1995: p. 83)***

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# NEW VENTURE ASSESSMENT TECHNIQUES: TOOLS FOR IMPROVING SUCCESS

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**ABSTRACT**

***The following is a description of several new venture assessment techniques which, when applied well, can improve the success of a venture. These analytical tools available to the entrepreneur to access the viability of a new venture are neither complex nor are they expensive to construct. The application of these tools in the assessment process will serve to provide needed information on the new ventures probability of success, as well as build a framework for the development of detailed marketing strategies.***

## ENVIRONMENTAL SCANNING AND NEW VENTURE ANALYSIS

**Successful entrepreneurs have an uncanny ability to separate market opportunities from the chaotic sea of ideas. Real opportunities exist when the new venture is based on a product or service which creates value for an identifiable market segment. The entrepreneur needs to structure the venture in such a way as to maximize the creation of customer value.**

**The means by which an entrepreneur adds value is through innovation in the marketplace. The successful entrepreneur uses product, process or service innovation as the tool to exploit change. Innovation is the instrument which empowers resources to new ends, thus creating value. The enduring strength of an entrepreneurial-driven economy is the continuous creation of value. Thus, in evaluating an idea, the individual must determine if the idea will represent a significant innovation in the marketplace, or is it simply a different way of doing the same thing.**

**Implicit in these discussions is the assumption that the new venture has a well-focused target market segment. Analyses of the opportunity thus become dependent upon the specific behaviors of a well-defined market segment. The viability of the new opportunity will involve an in-depth analysis of the demographics of the marketplace, the nature and behavior of the competition, the envisioned competitive advantage of the proposed venture, and the identification of the competitive vacuum which will create the opportunity.**

**In evaluating an idea for its potential value as a business opportunity, it is important to identify all the relevant risks and to evaluate these risks in terms of: (1) the possibility that some risks may be eliminated through proactive strategies, (2) spreading the risk where possible, and (3) managing risks that are considered worth incurring. Risks include market or competitive risks, financial risks, and technical risks. Risk analysis is conducted to answer the overriding question: Can the entrepreneur and the entrepreneurial team *make it happen*?**

**The uncertainties and turbulence of the marketplace represent the major sources of risks for a new venture. Market turbulence and uncertainties are created as a result of a combination of many factors. The general condition of the economy, the political/social environment, the legal environment, the technological environment of a given field, the capital markets; all of these factors contribute uncertainty to the ability of a given idea to result in a real opportunity. The effective entrepreneur must develop the means to deal with these sources of potential chaos. An analysis of the potential uncertainties associated with each opportunity must also be performed in a diligent fashion. While this analysis will not eliminate the risks, it will remove some of the uncertainty, and allow one to make sure that the risks that are taken are reasonable.**

**At the macro-level, the new venture must be acutely aware of the impacts of societal changes on the market for the new product or service. The process used has been termed environmental scanning. Environmental scanning is the process by which the various critical environmental sectors that influence the future viability of the venture are scanned, evaluated, and an assessment is developed to assist the entrepreneur in determining the impact of change of the potential venture. For the entrepreneur the purpose of the environmental scanning process is to identify what new opportunities will be created through the shifting of major environmental forces. The questions to be answered deal with the appropriate market fit between the new venture and the market for the product or service.**

**Environmental scanning produces a better understanding of the critical forces that alter the long-term conditions under which business must operate. Further, the forces can be monitored, and the effect of changes forecasted. What remains essential to effectiveness is an understanding of the fundamental relationships between the predicted changes and the market potential for the product or services. Environmental scanning has relevance when it allows the entrepreneur to more effectively focus her strategic marketing plan to take full advantage of the most attractive market opportunities while correspondingly reducing the risk associated with environmental changes that will have a negative impact on the new venture.**

**The analysis of the future competitive environment is made more complex through the realization that the occurrence of one event influences the occurrence of other events. The term cross-impact is used to describe these cause and effect relationships. Cross-impact relationships exist both within the same broad sectors of the macro-environment, as well as between sectors. The occurrence of any event is like a stone dropped into a pond. The ripple effect caused by the actual introduction of the stone into the pond serves to change the dynamics of the entire pond. A breakthrough in technology may not only alter other technologies but may also serve to influence economic, social, political, and even lifestyle forces in our environment. Without considering the cross impacts of change, forecasting future events can become overly linear. Cross-impact analysis adds a richness and depth to our thinking about the future as well as an increase in the accuracy of the forecast. The future, and its opportunities, is the result of an interaction or collision of forces, trends, and events beyond the entrepreneur's control.**

**Market-driven businesses are operated by entrepreneurs who remain focused on customers, competitors, capabilities, costs and cross functions.**

| | | |
|---|---|---|
| 1. | *Customers.* | **Successful companies know specifically who their customers are and understand *how* and *why* those customers buy their goods and services.** |
| 2. | *Competitors.* | **Entrepreneurs study their competitors to determine their relative strengths and weaknesses in serving the targeted customers. They constantly ask, "How can we beat our competitors?" and "What can we learn from them?"** |
| 3. | *Capabilities.* | **Market-driven companies compare their current strengths with the ever-changing demands of their customers and make adjustments when necessary. They are not afraid to enter new markets or to abandon old ones.** |
| 4. | *Costs.* | **Successful companies constantly strive to lower cost and/or to improve product or service performance in order to give their customers greater value.** |
| 5. | *Cross functions.* | **Market-driven businesses encourage teamwork across every area of the business in order to coordinate activities and decisions that will better serve their customers.** |

**Successful new ventures require access to the right data; it is the foundation on which an individualized marketing campaign is built. Business owners must collect three types of information:**

| | | |
|---|---|---|
| 1. | *Geographic.* | **Where are my customers located? Do they tend to be concentrated in one geographic region?** |
| 2. | *Demographic.* | **What are the characteristics of my customers (age, educational levels, income, sex, marital status, and many other features)?** |
| 3. | *Psychographic.* | **What drives my customers' buying behavior? Are they receptive to new products, or are they among the last to accept them? What values are most important to them?** |

**The most recent development in market research, psychographic profiles, has become a valuable tool to many entrepreneurs.**

## THE NEW VENTURE EVALUATION PROCESS

**In order to determine if the new venture has the potential to become a viable business opportunity, an entrepreneur should be willing to undertake a vigorous opportunity evaluation process. The screening involves answering a series of questions that shed light on the potential for the idea to actually become a product or service upon which a business can be created. Entrepreneurs who fail to evaluate their venture often discover, after they have invested a great deal of time and money, the answers to the questions that the opportunity evaluation process would have revealed. When the idea becomes reality in the form of a product or service, how will this new product or service differ from what the market already has? Second, how will the product create value for the buyer or end user? What, exactly, do we know about the buying behaviors of the marketplace?**

**The evaluation of an opportunity always begins with the basic questions whose answers help the entrepreneur determine the magnitude of the opportunity. The search hopefully**

**reveals that the product or service is dramatically superior to existing offerings in the market in ways that create value for the buyer and do not require a significant alternation of use patterns by the consumer. If the new product or service achieves these outcomes, the entrepreneur has a product or service with exceptional promise. This part of the analysis involves asking a series of questions about the idea. First, how is it different from the existing products or services presently being offered in the market. If the answer is at either extreme, either very different of no differences, a potential problem could exist. If there is little new about the product or service, it will be difficult to convince existing buyers to switch from what they are presently purchasing. If the product or service is dramatically different from what the market is presently using, there may initially be strong resistance to change from what is known, to a product that is so different from what is now in use. The analysis needs to uncover the sources of resistance to change and attempt to quantify the degree of difficulty anticipated in overcoming the resistance among early adopters.**

**The more that can be learned about the psychology of the market and the behavior of buyers, the more effective will be this segment of the analysis. At least two elements of the market for the product or service need to be estimated; first, the likely demand for the product and, second, the timing of that demand. The entrepreneur begins by attempting to determine the exact nature of the superiority of the product or service, specifically focusing on how the new product or service creates value for the user beyond what they presently have. Does this new product increase the user's efficiency? If so, by how much? Can this improvement in efficiency be easily demonstrated to the potential buyer? The nature of the relationship between the product or service and the value created for the buyer needs is generally the first step in an analysis of this potential opportunity.**

**Timing in the market is almost always critical to success. What percentage of the market segment for which this product is targeted are likely to be early adopters? Does this number of buyers represent adequate revenues to make the venture financially viable? Timing becomes critical to success of a new venture when it is anticipated that it will take a long period of time before the market accepts the new product or service in sufficient numbers to provide an adequate revenue stream. Consider what takes place when the market is slow to adopt the new product or service; the cost of operating the new venture continues providing painful cash flow problems, and second, competitors have ample time to incorporate the best features of your product or service. Timing must be determined to measure the additional risk associated with slow market acceptance.**

**Figure 1 provides a simple overview of the first step in the process. At the conclusion of this first step, the entrepreneur will have a good estimate of the potential for success of the new product or service, as well as a recognition of the barriers what must be overcome to ensure successful introduction of the product or service. If the opportunity looks viable after this step in the evaluation process; it would be necessary to proceed to the next step.**

**Assuming an adequate demand for the product or service exists, the next step involves another set of questions whose answers will provide a greater depth of understanding regarding the new venture creation. Figure 2 outlines the questions that next need to be**

**addressed. This part of the evaluation process attempts to quantify technical, competitive and financial risk.**

**Figure 1: New Venture Evaluation Process (Part I)**

**Figure 2: New Venture Evaluation Process (Part II)**

Experienced entrepreneurs know that no new venture exists without risk. Some risk can be reduced through aggressive proactive strategies, while others must be "factored into" the risk/reward equation. One thing is certain, an identified risk can possibly be reduced or avoided but an unidentified risk will surely become a threat to the viability of the new venture.

In order to evaluate the nature of the risk the entrepreneur must attempt to discover what new product development activities potential competitors have undertaken, their historic rate of success in new product development and marketing, their depth of financial support for these activities, and the existing advantages the competitors have in the marketplace. The capabilities of competitors and their willingness to defend their market position against the intrusion of a new competitor can be evaluated to determine the competitive risk of the venture.

There are also technical risks and financial risks. Technical risk involves an objective determination of whether the idea can actually be converted into a "market-ready" product with the capabilities and characteristics envisioned. Many great ideas on paper fail to materialize as products. Financial risk is what entrepreneurs often worry about most. Will be venture have adequate capital to support the efforts between start-up and the point where revenues are sufficient for a viable long-term business?

The exact nature of the *window of opportunity* is outlined in Figure 3. Applying the answers to the questions posed above, the entrepreneur must evaluate the lead time the new product might have in the marketplace, the capability and resources the new venture must

**have to successfully enter the market and become a viable competitor, and, whether the new venture has the capability to defend itself against attacks of existing competitors in the market.**

**Figure 3: The Window of Opportunity: Does the New Venture Have One?**

**Positive circumstances would include some of the following set of conditions:**

1. **The new product can be brought to market in a very short time.**
2. **The technical risk is low due to earlier work on the proof of concept or the existence of a previously tested prototype.**
3. **Competitors do not traditionally pursue an aggressive product development strategy.**
4. **Competitors are not technically sophisticated.**
5. **Competitors have not previously displayed aggressive strategies in defense of their market position.**
6. **The new venture has the capabilities and the resources to successfully implement a new product entry strategy.**

**The new venture will have certain strengths and weaknesses that determine the capabilities of the organization. Competitive strategy involves maximizing those capabilities in a fashion that differentiates the organization from competitors. It is important, then, for the new venture to assess competition to develop a profile of major competitors. The objective of competitive analysis is to project the likely array of responses that competitors will make given various scenarios of changing market conditions. Some of those conditions reflect competitive action while others reflect other environmental changes.**

**Drawing upon the work of Michael Porter, Figure 4 shows a framework for analyzing competitors. The left side indicates some factors that drive what competitors do while the right side shows what they currently do or are capable of doing. Some basic questions are posed under each major area of analysis.**

## MARKET SEGMENT ANALYSIS

**Market segmentation is essentially an identification process designed to identify subgroupings within a given product-market such that each subgroup responds differently to particular market offerings. Through segmentation, entrepreneur marketer hopes to most effectively match the market offering to the wants and needs of the market, thus improving consumer satisfaction. Customer preferences are better satisfied when offerings are more tailored to their specific requirements than when offerings are broader in scope trying to appeal to a total market. Market segment analysis is at the heart of micromarketing.**

**Market targeting is the process of analyzing segments so that one or more may be chosen for servicing. Two basic steps are involved: identifying segments and evaluating them. There is a broad range of variables used to identify market segments. In practice, often several variables are used together. Figure 5 suggests basic types of segmentation variables often used.**

**The goal of segmentation is to identify meaningful groups whose members are similar to one another in market responses but different from members of other groups: not identifying them for the sake of grouping. Segments must be identifiable: descriptive differences must exist that separate groups from one another. Groups must be accessible so that market offerings can be delivered to a particular group with minimal "waste" coverage of other segments. Finally, segments must be profitable.**

**Figure 4: Competitor Analysis ***

* **Adapted from M.E. Porter (1980).** ***Competitive Strategy: Techniques for Analyzing Industries and Competitors.*** **New York: The Free Press.**

**Figure 5: Segmentation Variables ***

***  Adapted from D.W. Cravens (1994). *Strategic Marketing*, fourth edition. Burr Ridge: Irwin.**

**There are two basic approaches to forming segments: (1) grouping customers together using one or more descriptive characteristics and then exploring response differences among groups or (2) grouping based on response differences and then working backwards to determine if descriptive characteristics exist which differentiate groups. The first approach may be done using various techniques ranging from managerial experience coupled with existing information to simple cross-tabulations to database use to AID analysis. The second approach generally relies on more sophisticated statistical tools such as cluster analysis, discriminant analysis, and multidimensional scaling.**

**Once identified, segments must then be evaluated to determine their attractiveness as a market target. As Figure 6 shows, evaluation includes customer analysis, competitor analysis, positioning analysis, and financial/market analysis. Customer analysis involves building a comprehensive profile of segment members so that the marketer can understand member behavior and how it may be influenced. Included would be an analysis of customer satisfaction. Satisfaction results from a comparison of customer expectations (or prior experience) of a market offering from the perceived performance of those marketing offerings. Based on the analysis of existing market segment satisfaction with existing marketing offerings, can the entrepreneur identify specific unmet or undermet needs? In Figure 7, the entrepreneur can evaluate the attractiveness of the new marketing offering with the unmet or undermet needs of each defined market segment.**

**Figure 6: Analyzing Market Segments ***

*  D.W. Cravens (1994). *Strategic Marketing,* fourth edition. Burr Ridge: Irwin.

**Figure 7: Matching Unmet or Undermet Needs of the Market Segment with Specific Superior Attributes of the New Product or Service**

| Description of Unmet or Undermet Needs | Value Creating Features of the Product/Service |
|---|---|
| 1. | |
| 2. | |
| 3. | |
| ... | |
| N. | |

**Competitive analysis involves revisiting the analysis done earlier to determine which competitors play a key role in the segment(s) being evaluated. Positioning entails portraying the market offering in a manner that differentiates it from competitors and is desirable in the buyer's mind. Finally, market and financial attractiveness must be analyzed to determine if pursuing the segment is worthwhile in terms of the projected revenue, costs, and profit.**

## MARKETING STRATEGY

Once entrepreneurs have effectively analyzed their macroenvironments, market opportunities, and market segments, they are then in a position to outline a marketing strategy. As Figure 8 shows, a marketing strategy consists of two essential decisions: identifying a target market(s) and developing a marketing mix. The strategy should be based on six criteria: consumer satisfaction, devotion to quality, attention to convenience, concentration on innovation, emphasis on speed, and dedication to service and customer satisfaction.

Figure 9 shows basic steps involved in marketing research. The steps outlines all involve decisions that need to be made prior to actually conducting the research. Some information ("secondary data") already exists that may prove valuable, but often new information ("primary data") will need to be generated through surveys, observation, or even experiments. The major sources of secondary data are the various government agencies, periodicals, trade associations, and public reports produced by a host of private organizations. There are two basic rules in searching for appropriate secondary data -- start with general information and proceed to more specific data, and use available expertise to locate data.

The analytical tools available to the entrepreneur to access the viability of a new venture are neither complex nor are they expensive to construct. The application of these tools in the assessment process will serve to provide needed information on the new ventures probability of success, as well as build a framework for the development of detailed marketing strategies.

**Figure 8: Foundations of Marketing Strategy**

| Figure 9: Steps in the Marketing Research Design Process | |
|---|---|
| **Step** | **Description** |
| **Define the Problem** | **Determine the decision(s) facing management and the information relevant to those decisions** |
| **Specify approximate value of information** | **Determine the maximum that can be spent on the project using budget rules or expected value approach** |
| **Select data collection method(s)** | **Determine whether secondary data, survey or observation, or experimentation will produce the required data and choose the method to use** |
| **Select measure instrument** | **Determine whether and how to use questionnaires, attitude scales, observation, and/or projective techniques** |
| **Select the sample** | **Determine who and how many respondents or objects to measure** |
| **Select the analytical approach** | **Determine the appropriate means of analyzing the data to provide the required information** |
| **Interpretation** | **Look ahead and ask yourself "so what?" Will that information help solve my problem?** |