

# Business Ethics and Starting a Small Business

## INTRODUCTION

This lesson deals with two distinct topics—business ethics and what it takes to start a small business. Ethical and social responsibility should characterize any kind of business enterprise, from a globe-spanning multinational company to a local, single-owner small business. Information about getting started in a small business will give you an up-close look at two things: First, you'll get some idea of the problems a budding entrepreneur faces. Second, you'll get some insight into whether you have the interests and abilities you'll need to start your own business.

## ASSIGNMENT 4: DEMONSTRATING ETHICAL BEHAVIOR AND SOCIAL RESPONSIBILITY

**Read this assignment. Then read pages 108–135 in your textbook.**

The root of the word “ethics” is *ethos*. As derived from the original Greek, *ethos* means “a way of life.” Ethics, then, can be thought of as “how to properly follow the ethos of one’s society.” This idea suggests that standards of ethical behavior are purely a social or cultural product, but what’s ethical in one society may not be ethical in another society.

To some extent, that’s true. In ancient Egypt, as among Hawaiian nobility in times long past, brother-sister marriage wasn’t only acceptable but required to maintain the blood purity of a noble lineage. (Cleopatra was the child of a brother-sister marriage.) In traditional Hindu society, a wife was expected to throw herself onto her deceased husband’s funeral pyre.



## Ethics in Business

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On closer inspection, we find that beyond peculiar differences in customs from society to society, there's a set of universal ethical standards. Across the globe and across the centuries, philosophers and religious teachers have maintained that respect for human life, integrity, self-control, honesty, courage, and self-sacrifice are right. Lying, cheating, stealing, cowardice, and cruelty are wrong. Virtually all of the major religions teach some version of the Golden Rule: "Treat others the way you want to be treated."

One other thing you'll want to think about in this section is the difference between *ethical* and *legal*. Laws are often created to protect the interests of powerful people or organizations. Slavery was legal to protect the "property rights" of slaveowners, who depended on slaves for cheap labor. Civil disobedience may be illegal—even if it's an effort to address obvious social injustice. In the world of business, malicious office gossip may be legal, but that won't make it ethical.

## Personal Ethics

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There are five ethical perspectives that one can use as a moral platform for behaving ethically from situation to situation. These include the *utilitarian approach*, the *rights approach*, the *fairness or justice approach*, the *common good approach*, and the *virtue approach*. Refer to Figure 4.1 on page 114 in your textbook for a detailed description of each.

Eight principles for making ethical decisions were developed by the Markkula Center for Applied Ethics at Santa Clara University. They include the following:

1. Concern for the well-being of others
2. Concern for the autonomy of others
3. Trustworthiness and honesty
4. Willing compliance with the law, save when civil disobedience is deemed the more ethical choice
5. Basic justice and fairness
6. Refusing to take unfair advantage

7. Benevolence (following the Golden Rule)
8. Doing no harm to others or to our natural environment

Your textbook offers you a five-step process for dealing with an ethical dilemma:

1. *Recognize an ethical issue when it arises.* (Beyond the letter of the law, what's the spirit of the law? Whom will a conflict impact?)
2. *Gather the facts.* (Look at all sides of an issue.)
3. *Evaluate alternative actions,* using one or more of the five ethical perspectives.
4. *Act on your decision,* perhaps with advice from friends or mentors.
5. *Reflect on your decision.* (Apply hindsight to consider what may have been done differently.)

## Corporate Ethics

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Under modern law in developed countries, and certainly in the United States, corporations are peculiar critters. Individual investors are liable for losses only to the extent of their investment. Corporations are legal fictions, yet they're afforded the rights of individuals—freedom of speech, for example, as well as the right to due process under law. A corporation has a life of its own beyond that of the mere mortals who come and go under the corporate charter.

Helping others is the heart and the head of both individual ethical behavior and organizational behavior. And yet, if you've been following the news for the past decade or more, you'll realize that starkly unethical and socially irresponsible behavior is found all over the map. In recent years, the anti-social behavior of large corporations has gotten most of the attention. The collapse of corporate giants like Enron and World.Com stands out because they aroused the ire and outrage of stakeholders who were harmed, as well as the federal government.

Yet, well before the Enron debacle, corporate organizations had been struggling with ethical and social responsibility issues. In fact, nearly 90% of larger companies—those with 500 or more employees—have drafted codes of ethics. There are two main kinds of corporate ethics codes:

1. *Compliance-based ethics codes* are focused on preventing unlawful behavior by way of increased control over personnel and punishing wrongdoers. In effect, the focus is on avoiding punishment that might be meted out by regulatory agencies or customer or supplier blowback.
2. *Integrity-based ethics codes* focus on clearly defining the company's code and creating a corporate culture or work environment that encourages ethical behavior. The idea that employees are responsible for the organization's activities is emphasized, and it's understood that leaders should lead by example.

Pages 116–117 in your textbook offer a five-step process that can improve the business ethics picture in America.

## **Sarbanes-Oxley**

In response to the rash of corporate corruption scandals on the late 1990s and beyond, the *Sarbanes-Oxley Act*, also known as the *Corporate and Criminal Fraud Accountability Act*, passed the U.S. Congress in 2002 with an overwhelming majority. The bill has a lot of stipulations, which include the following:

- Corporate whistleblowers are afforded greater (but not exhaustive) protection from retaliation.
- New penalties are established to make boards of directors, managers, and accounting firms liable for inaccurate or fraudulent financial reporting.
- A new public agency was formed to oversee, audit, and regulate accounting firms.

Does Sarbanes-Oxley deliver as hoped for? Not entirely. One-size-fits-all legislation often tends to create awkward inconsistencies. For one thing, the time and costs of compliance with the act are a burden on businesses large and small.

For another thing, the act applies only to firms whose shares are publicly traded (on the securities exchanges). It doesn't affect privately held firms, like Ford Motor Company.

## Corporate Social Responsibility Defined

Three determinants of corporate social responsibility are recognized.

1. *Corporate philanthropy* is the extent of a company's expenditures on programs or projects aimed at the public good. Beyond substantial charitable donations, nonprofit organizations are often founded by for-profit companies. McDonald's Ronald McDonald Houses for critically ill children are an example.
2. *Corporate responsibility* covers a broad spectrum of social concerns. Minimizing pollution, efficient energy use, the hiring of minority workers, the production of safe products, and maintenance of safe working conditions are examples.
3. *Corporate policy* is the position a firm takes on political and social issues. Beyond your text's discussion, you should note that most people entering business careers express their preference for allying themselves with socially responsible companies.

## Responsibility to Stakeholders

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### Customers

Success in business requires pleasing customers. And one big brass key to that end is honesty. Honesty builds trust. And consumer trust is inherently valuable. Indeed, accountants' term for consumer trust is *goodwill*. Goodwill is reckoned as an asset that can be directly valued as 6% or more of a firm's net worth. However, as you'll see in your text, maintaining up-front, transparent business conduct that builds trust isn't always easy.

Part of establishing consumer trust is evidence of being a good citizen. And, all things being equal, a company that's perceived as socially conscious is likely to be viewed favorably by customers or potential customers—not to mention new MBA graduates.

## **Investors**

What constitutes a company's responsibilities to investors? Page 123 in your textbook offers several ideas in response to that question.

## **Employees**

Labor is a vital factor of production. Ethically, therefore, workers and employees should be equitably and justly rewarded for their role in producing goods or providing services.

In this light, several business responsibilities are recognized:

- Businesses must create jobs to grow.
- Employees who demonstrate reliable levels of productivity, talent, and skill should be able to expect upward mobility within the company and hopes for a better future.
- Adequate pensions should reward an employee's long-term loyalty and commitment to a company.
- Wages and salaries should, overall, sustain an adequate standard of living consistent with a reasonably satisfactory quality of life.

## **Society and the Environment**

As your textbook notes, more than a third of Americans make their living by working for nonprofit organizations, which, in turn, are supported by for-profit enterprises. This fact shows us that many businesses strive to be good citizens. Meanwhile, most of us understand that environmental quality is a public good. Companies that find ways to offer goods and services

that are “environmentally friendly” can serve the public good. And it’s a good idea to remember that the public includes company employees and their families.

## Measuring Social Responsibility

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This section looks at five perspectives on measuring corporate social responsibility.

1. *Social audits* may be requested by a company, but they’re usually carried out by companies that provide this sort of service. A company’s audit score will increase on evidence of socially responsible practices, like good hiring practices, donations to charities, and environmental enhancement programs. It will decrease on evidence of layoffs, inadequate pollution measures, or unfair discrimination against minorities. Finding valid ways to make any of these measurements can be difficult.
2. *Socially conscious investors* may insist that a company extend its socially responsible practices to its suppliers. If suppliers happen to be in countries with weak or lax worker standards, that can be an uphill battle.
3. *Environmentalists*, especially as represented by environmental organizations like Greenpeace or the National Wildlife Association, can pressure companies to meet environmental standards by publicly advertising their real or alleged lapses.
4. *Union officials* can act as labor-practices watchdogs and publicize company instances of violations of labor law or accepted labor practices.
5. *Customers* can vote with their feet and their pocketbooks by taking their business elsewhere.

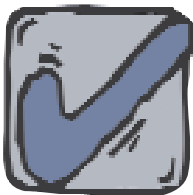
Ultimately, it isn’t enough for companies to follow ethical and socially responsible practices. They must also convince the public that they’re doing so. So-called “public service” commercials from big companies—often involving costs amounting to millions of dollars—are clear and present evidence of that assertion.

## Ethics and Social Responsibility Globally

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This final section offers a brief and interesting discussion of ethical challenges facing businesspeople coping with trade and labor practices in foreign lands. Notice the literally global problems presented by government and corporate scandals in many nations. Pay attention to efforts underway to create some kind of global ethic under organizations like the Organization for Economic Cooperation and Development.

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### Self-Check 4

1. For most of us, the main sources of ethical principles and ideals are \_\_\_\_\_ and culture.
2. CEO Walters has to decide whether to introduce a new product into the toy market. He ultimately makes his choice based on doing the greatest good for the greatest number of people both inside and outside the company. Walters is using the \_\_\_\_\_ approach to ethics.
3. A systematic evaluation of how well a company is implementing socially responsible programs is called a \_\_\_\_\_ audit.
4. If only because it enables responsible employee conduct, an \_\_\_\_\_-based ethics code is usually preferable to a \_\_\_\_\_-based ethics code.
5. Environmentalists, customers, and socially conscious investors all serve as \_\_\_\_\_ groups regarding the extent of a business organization's level of social responsibility.
6. Hiring minority workers, producing safe products, and using energy wisely are all aspects of corporate \_\_\_\_\_.
7. People inside a company who report illegal or unethical company behavior are called \_\_\_\_\_.
8. Corporate philanthropy, corporate responsibility, and corporate \_\_\_\_\_ are all factors in determining a company's level of social responsibility.

**Check your answers with those on page 140.**

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# ASSIGNMENT 5: ENTREPRENEURSHIP AND STARTING A SMALL BUSINESS

**Read this assignment. Then read pages 136–173 in your textbook.**

Read about how Chuck Loomis started his business in the opening pages of the chapter. That can inspire you to think about how a few small businesses grew into very large businesses. You'll learn—if you hadn't already—that businesses invented by entrepreneurs have led to industries of all kinds, which, in turn, have created jobs for millions.

## What Does It Take to Be an Entrepreneur?

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Entrepreneurs with all kinds of dreams for the next great idea—or a new wrinkle on an old idea—tend to have common characteristics. Pages 138–143 in your textbook discuss these characteristics.

## Types of Business Ownership

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*Sole proprietorships* offer the heady atmosphere of independence. It's great to be one's own boss. It's nice to be the sole beneficiary of your business's profits. On the other hand, you can expect to work long, long hours. Also, your net profits will be taxed as personal income, and you're subject to *unlimited liability*. If things go sour, you might lose your home, your car, and your sense of humor.

*Partnerships* are legal forms of business that bind two or more people to a set of common business objectives. Partnerships come in several flavors:

- In a *general partnership*, all the owners share the income and financial obligations of the business, and each partner is subject to unlimited liability.

- A *limited partnership* binds one or more general partners with one or more limited partners. A *general partner* is an owner (partner) with unlimited liability for the negative outcomes of a company's operations. The limited partners are owners (investors), but they're liable only for business outcomes to the extent of their investment.
- A newer form of partnership, the *master limited partnership (MLP)*, is actually formed pretty much like a corporation. However, to avoid the handicap of unlimited liability, many states now allow a legal form called a *limited liability partnership (LLP)*. In an LLP agreement, each partner's liability is confined to its acts or failures to act (omissions). That is, each partner is culpable and liable for the results of its particular actions.

*Corporations* are legal entities that stand apart from the individuals involved in financing or managing an enterprise. There are three basic kinds of corporations:

The individual states provide varying standards for chartering a *conventional (C) corporation*. C-type corporate charters grant investor-owners limited liability. They also specify the provisions for corporate governance, such as corporate policies and the appointment of a board of directors. The shares of a traditional corporation may be held privately, or they may be made available to the public. In the latter instance, the *initial public offering (IPO)* will involve registering and listing the company with a stock exchange, such as the NYSE. Overall, the great advantage of traditional corporations is that they can sell stock to raise serious amounts of capital.

*S-corporations* are created by the government. They're taxed in the same way as sole proprietorships or partnerships. Qualifying restrictions for S-corporations require the following:

- There shall be no more than 100 shareholders.
- Shareholders must be individuals or estates that are both citizens of and residents of the United States.
- The corporation may offer only once class of stock.
- No more than 25% of revenues may result from passive sources, such as rents or interest.

*Limited liability corporations (LLCs)* are similar to S-type corporations, except that they aren't encumbered by S-type restrictions. LLC charters provide managerial flexibility and choice as to the manner of taxation. They don't have to hold annual meetings; managers can change direction as they see fit. However, LLCs can't sell stock to raise capital. Thus, their revenues (as returns on assets and business operations) are usually contingent on access to lender credit.

## Franchises and Cooperatives

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### Franchises

You've already looked at franchises in the context of global trade. Here, the focus is on domestic enterprises. A *franchise* is purchased from a parent organization, such as McDonalds, Holiday Inn, or Jiffy Lube. However, the franchisee is responsible for setting up franchise ownership in accordance with the laws and ordinances of their locality.

Chain stores, like Wal-Mart or Target, are owned by those companies. They're known as *company stores*. A chain store isn't a franchise operation. A major advantage of purchasing a franchise is access to marketing, management assistance, and employee training. Also, as a franchise owner, one has the advantages of running a sole proprietorship. And, in general, because they have so much backup assistance, the failure rate for franchise operations tends to be quite low.

The biggest disadvantage of franchising, aside from having to share profits with the franchisor, is the high startup cost. A few years ago, the startup cost for a McDonald's franchise was \$100,000. The front end for a Holiday Inn franchise can top \$5 million.

### Buying an Existing Business

Just as there are real-estate brokers, there are brokers who handle the sale of businesses. Assuming a business that interests you goes on the market, buying an already existing business has advantages:

- There's already a customer base.
- The business will have a track record of such things as profit and loss statements, seasonal business fluctuations, taxes, utilities costs, and so on.
- Physical assets, such as the building, office equipment, desks, furnishings, and so on, will already be there, depending on the type of business.
- The previous owner may agree to stay on for a while to help you get your feet on the ground.

The main disadvantage in buying a business is capital. (Inadequate capital is a major factor in business success or failure.) Unless you have a large amount of money, the added expense of loan payments could drag down your bottom line for quite some time.

## Cooperatives

In a nutshell, a *cooperative* is an arrangement that permits people to pool their resources for different purposes. Independent grocers can join a wholesaling cooperative to put them on a level playing field with large grocery chains. Not-for-profit hospitals can form a cooperative to get a better deal on pharmaceuticals or other kinds of medical supplies.

## Corporate Expansion

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### Mergers

*Acquisition* occurs when one company buys out another company. A *merger* occurs when two companies join to form one company. A *vertical merger* occurs when two or more companies engaged in different operations within an industry merge into a single corporate entity. Imagine a petroleum production company, a refinery operation, and a chain of retail gasoline outlets all under one corporate roof. That would be the outcome of a vertical merger, also referred to as *vertical integration within an industry*.

A *horizontal merger* is the joining of two companies in the same industry to expand their market through shared expertise and the production of complementary goods and services. The merger of two wireless companies is an example.

A *conglomerate merger* joins firms in completely different industries. This sort of merger is generally aimed at diversifying investments and broadening sources of revenue. General Electric's purchase of NBC is an example. Indeed, many large companies, like GE, have controlling interests in goods and services ranging from investment services and communications media to military hardware and consumer goods manufacturing.

There are instances when a party attempts to buy out or gain control of another company through a *hostile takeover*. In general, this means getting hold of more than 50% of the target company's common stock. These efforts may be quite nefarious. For example, in behind-the-scenes maneuvers, the bidding party may lure major stockholders to relinquish their holdings at prices above current market value. They're made an offer "they can't refuse." Meanwhile, people holding significant but lesser numbers of shares are also approached with similar deals. Once the "pirate" has acquired his 50+% goal, he or she can, in effect, override the board of directors and take control of the company.

## Types of Buyouts

A *leveraged buyout (LBO)* amounts to one or more parties bidding to take control of a business through borrowing sufficient funds—often against the collateral value of the company to be acquired. In effect, the stock holdings of managers, employees, and investors are purchased at an attractive price.

An LBO may also take the form of a *management buyout*. In effect, groups of employees or lower-level managers may join together to purchase a company. A management buyout may not have to be leveraged by way of loans—if the buyers have enough cash available. However, in most cases, the needed cash can't be raised, and an LBO is necessary to offering an acceptable bid.

## Getting Started in Your Own Business

The challenges of this section should get your undivided attention. They're designed to help you think about how to set up your own business. That process includes five dimensions: (1) planning the business, (2) financing the business, (3) knowing your customers (marketing), (4) managing employees, and (5) keeping records (accounting). Read pages 160–168 in your textbook for an in-depth discussion of each.

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### Self-Check 5

1. When managers, employees, or a group of investors attempt a \_\_\_\_\_ buyout, they'll borrow money to fund the buyout of a company.
2. As opposed to a general partnership, a form of business organization that includes both limited and general partners is referred to as a \_\_\_\_\_ partnership.
3. Janine is about to open a hair salon. She knows she must set up a system for keeping business records, but since she knows a lot more about botany than financial recordkeeping, she'll be wise to hire the services of a professional who can set up the \_\_\_\_\_ system.
4. In a \_\_\_\_\_ merger, two firms within the same industry join together, allowing them to diversify or expand their product lines.
5. Perry and Jake are trying to start a local office-supply business. They get lucky when Jake meets with Tom Landry, a wealthy local car dealer who decides to invest in the venture. Mr. Landry would be called a/an \_\_\_\_\_ investor.
6. While the advantages of acquiring a \_\_\_\_\_ include being able to offer an established product while receiving training and assistance, the biggest disadvantage is the high startup cost.
7. Because entrepreneurs must take risks—even though they may be carefully calculated risks—a successful entrepreneur must be tolerant of \_\_\_\_\_.
8. In business, a group of people who have unsatisfied needs or wants and are able to spend money to satisfy those needs or wants is called a \_\_\_\_\_.

**Check your answers with those on page 140.**

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