CHAPTER 21

The Sole Proprietorship and the Partnership

Key Terms

entrepreneur	proprietor	partnership
business plan	limited life	contract
marketing	limited funds	computer peripherals
profits	capital	SWOT analysis
expenses	unlimited liability	
sole proprietorship		

For a number of years, George Lee had been thinking about owning his own business. When he was in high school, George opened a savings account at a local bank. He was preparing for the day when he would open his own company and be his own boss.

After graduation, George got a job with a company that operated a chain of retail stores that sold computers and computer supplies. Over the next four years, he learned the retail computer business from the inside. Although he had started as a stockroom clerk, he soon advanced to sales. After two years with the firm, he became an assistant manager of one store. All the while, he continued to set money aside in anticipation of the day when he would open his own business.

George was not alone in wanting to own a business of his own. There are now well over 20 million small businesses in the United States. And that number keeps growing. Government statistics tell us, for example, that every week some 3,000 new businesses are begun. Not all of them succeed, though. Indeed, every year the number of failing businesses reaches into the tens of thousands.

In this chapter, you will study businesses and their role in the U.S. economy. When you have finished reading the chapter, you should be able to answer the following questions:

- Why do people go into business for themselves?
- Why are most businesses sole proprietorships?
- Why do some businesses organize as partnerships?

WHY DO PEOPLE GO INTO BUSINESS FOR THEMSELVES?

Although George Lee liked his job as assistant manager of a computer store, he still looked forward to the day when he could start a business of his own. It thrilled him to think of being his own boss, of trying out new ideas, and, if things worked out well, of earning great profits.

The day finally came when George felt that he had saved enough money to go ahead with his plans. He found an empty store for rent in a nearby shopping center. He then went to his local bank to see if he could borrow the additional funds he would need to start operations. He discussed his plans with Ms. Hamilton, the bank's loan officer. She thought that George's idea sounded very promising. She asked him to write a *business plan* that she could present to the bank's loan committee. Before lending money to a business of any size, banks and other investors usually ask for a formal business plan. Business plans describe the following:

- Nature of the business and the business's goals.
- *Marketing* plans, including the location and type of market the company expects to reach, the potential demand for its product or service, and how the company plans to advertise and price its product or service.
- What is the competition and what advantages the new company may have over the competition.
- Planned ways of operating the business.
- Planned key personnel, including who will run the business and what are their skills, training, and experience.
- Types of business insurance that will be purchased.
- Projected financial data, including the amount of money needed to start the business, a monthly budget for the first year of operation, a cash flow statement, an income statement, and a balance sheet.

A few days later, Ms. Hamilton called George to tell him that the bank would lend him several thousand dollars. Based on Ms. Hamilton's recommendation and his business plan, the bank felt confident that George's store would be a success and that he would be able to repay the loan out of his earnings.

Using the bank loan and the money he had saved, George was able to furnish his store and buy the computer equipment and supplies that he planned to sell. In the language of economics, George was an entrepreneur. George Lee called his store Byteland. It was an instant success. Everyone liked the rock-bottom prices and excellent service that George provided. But he had to work very hard. He opened the store at 9 A.M. every morning and remained there until closing at 6 P.M. every night. He was salesperson, bookkeeper, stock clerk, and janitor. Because there was no one to relieve him, he even had to eat his lunch in the store.

In time, the store's success enabled George to hire an assistant to help him with sales. But it was still his business. For that reason, George felt that he had to keep a close eye on things. After all, if the customers stopped coming in, George would no longer be able to pay the rent or keep up with bank payments.

As sales increased, George looked for ways to expand his operations. One idea that he had was to sell his merchandise also by mail order. By advertising his computers and supplies in certain national magazines, George reasoned, he could greatly increase his sales. More sales would lead to more profits.

Profits are what remain out of income after a business has paid all its costs of doing business. These costs are its *expenses*. When George worked for the computer store, the company paid him a wage. As you have learned, wages are the hourly rewards paid to workers for their labor. After George started his own business, he began to look to profits as the main reward for his efforts.

A mail-order business requires national advertising and catalogs. But George could not pay for them without another loan. Unfortunately, the bankers insisted that they could not lend him any more money until he paid off his first loan. Besides, George was not sure that he could handle more work even if he got the loan. He decided to forget about mail order for the time being.

WHY ARE MOST BUSINESSES SOLE PROPRIETORSHIPS?

Byteland was a *sole proprietorship*—a business owned and run by one individual. (The owner is called the *proprietor*.) The proprietorship is the most common form of business in the United States.

Advantages of the Sole Proprietorship

Those who choose to organize their businesses as sole proprietorships do so for several reasons:

1. Ease of Operation. George chose to form his company as a sole proprietorship because it is the easiest and least expensive kind of business organization to create. Although requirements vary from one state to another, in most instances entrepreneurs can obtain the licenses or permits required to operate a business without outside help.

Other kinds of businesses frequently require the services of a lawyer, an accountant, or both before they can be set up or closed down.

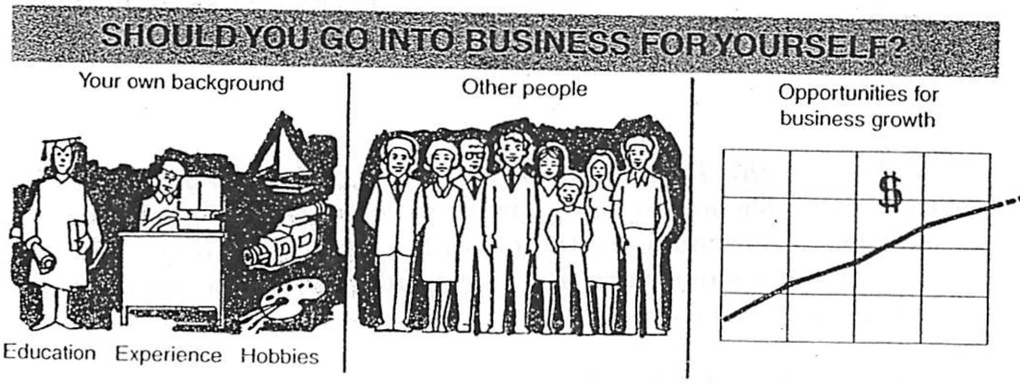
2. Potential Profits. The owner of a sole proprietorship can do whatever he or she wishes with the profits. Let us suppose that George Lee sold \$150,000 worth of merchandise last year. This amount was his income from doing business. Suppose, too, that it cost George \$25,000 to rent and operate his store and pay taxes, \$15,000 to pay the bank loan, \$7,000 for his assistant, and \$60,000 to buy the merchandise that he sold. How much profit would he have made? \$43,000. Why? Because income (of \$150,000), minus expenses (of \$107,000) equals profits (\$43,000).

Sole Proprietorship: What advantages may the owner expect from running a store by herself? What problems may she face?

Personal Economics

SHOULD YOU GO INTO BUSINESS FOR YOURSELF?

Figure 21.1 Factors Affecting Your Decision About Starting a Business



A. The illustration above appeared in a U.S. government publication. Its purpose was to help people who were thinking of starting their own business. Study the illustration. Explain the meaning of each of the three parts of the illustration by answering these questions:

1. What does your background have to do with your selection of a business to start?
2. Why are the following factors included under a person's background: (a) education (b) experience (c) hobbies?
3. Why should other people affect a person's choice of business?
4. What is meant by "opportunities for business growth"? How should this factor influence a person's choice of business?

B. If you have ever thought that you might like to own a business, you should look at the following checklist. You should be able to answer these seven questions in detail before you actually take the plunge. As you read them, ask yourself these questions: (a) What is the meaning of each of these items? (b) Why was each item included? How is it important?

Checklist

1. What business should you choose? In what business have you had previous experience? Do you have special technical skills, such as those needed by a pharmacist, a plumber, an electrician, or an air conditioning service person?
2. What are your chances for success? What are conditions like in the line of business you are thinking of entering?
3. How much capital will you need to operate the business? (*Capital* in this case refers to money.)

4. Where can you get the money?
Will your own savings be adequate, or will you have to borrow?
5. Where should you locate?
Should you open your business near your source of materials, near your source of labor, or near your customers?
6. What records should you be prepared to keep?
Are you going to keep the records yourself? Hire a bookkeeper? Have an outsider come in periodically?
7. Will you keep up to date?
How do you plan to keep up with changes in your trade?

3. "You're the Boss." For many people, the most attractive feature of the sole proprietorship is the opportunity it offers for independence. Proprietors are their own bosses. They can set their own hours and assume risks that they would not be able to take if they worked for someone else.

Disadvantages of the Sole Proprietorship

The sole proprietorship carries with it a number of disadvantages, however. Foremost of these are limited life, limited funds, limited abilities, and unlimited liability.

1. Limited Life. A proprietorship can last only as long as the person who owns it. George Lee's business would come to an end on the day he died. While his heirs might be able to continue the business, doing so could involve a legally complicated procedure. For that reason, proprietorships are said to have *limited life.*

2. Limited Funds. We have seen that George Lee wanted to expand into the mail-order computer business. But he was unable to do so. He did not have the necessary funds, and the bank was unwilling to lend him more money. One of the reasons for the bank's reluctance to lend George more money has to do with the limited life of the sole proprietorship. If George were to die, who would pay his debts? This, then, is another shortcoming of the proprietorship. Funds are limited to the amount that proprietors themselves are able to raise.

3. Limited Abilities. There are just so many skills and talents that one person can possess. No one, including a sole proprietor, is an expert at everything. But the sole proprietor is just that: the only owner of a business. All too frequently a business suffers as the proprietor tries to solve problems about which she or he knows little or nothing.

4. Unlimited Liability. A proprietorship has *unlimited liability*. Its owner can be held personally *liable* (legally responsible) for all the debts of the business. If Byteland fails, George Lee's home and all his savings and investments could be seized to pay what he owes to his creditors.

Limited life, limited funds, limited abilities, and unlimited liability explain why many people hesitate to go into business for themselves. But there are other forms of business organization that overcome some or all of these handicaps. These are the partnership and the corporation.

To illustrate, let us return to our story of George Lee and his company, Byteland.

One day, George met Dolores Ramon, a former high school classmate. Dolores said that she had spent the years since graduation working in the electronic toy department of a mail-order house. She was now thinking about investing her savings in a business.

This information gave George an idea. "Why not team up?" he asked Dolores. After all, Byteland was doing quite well and would do even better if it could move into mail order. With her *capital* (money) and experience, the business would have just what it needed to expand. Moreover, the two could share the responsibility for running the business. This would take a lot of the load off George. The suggestion sounded great to Dolores. She went on to describe some of the ideas she had about mail order and how they could be used to expand sales.

WHY DO SOME BUSINESSES ORGANIZE AS PARTNERSHIPS?

George was glad that he had thought of asking Dolores to go into business with him in Byteland. They formed a *partnership*—a business owned by two or more persons. As a first step in forming a partnership, the two had a lawyer prepare a *contract* (legal agreement) for them. Under its terms, Dolores Ramon agreed to invest $40,000 in the business. In exchange, she was to be made an equal partner. This meant that both she and George would split their profits (or losses) on a 50–50 basis. The new firm would also be known as Byteland.

George and Dolores rented warehouse space and published a catalog. Because they had more money to spend on merchandise than George alone had had, the partners were able to buy in larger quantities and at lower prices. Lower wholesale prices enabled them to lower their own prices and to raise sales. They also hired a part-time clerk to work during peak hours in the store and a full-time worker to assist in the warehouse. Dolores spent most of her time looking

Understanding Economics

SUCCESSFUL ENTREPRENEURS

More and more Americans find the idea of owning a business of their own to be an attractive one. But with only a third of all newly opened businesses lasting more than five years, one has to ask these questions before going into business for oneself, "Why do I want to do this?" and "What does it take to succeed?"

As for the reasons for risking time and financial loss by opening a business, most people will mention things like:

"There is real satisfaction in being your own boss and watching something that you created, prosper, and grow."

"There is a certain amount of power, influence, and respect from others that goes with owning your own business."

What does it take to succeed in business? While opinions differ, most authorities agree that to be a success requires the right combination of:

- training and experience
- careful planning
- adequate financing

It is beyond the scope of this book to discuss in detail how each of the above ingredients contributes to business success. What follows, however, are brief biographies of three successful entrepreneurs. Each of them started with an idea, some would say a "dream," that ultimately became a reality. As you read the biographies, think about how these entrepreneurs became successful.

Muriel Siebert

Her father's illness compelled Muriel Siebert to abandon college and the accounting career for which she had been preparing. In 1954, with only $500, she drove from Cleveland, Ohio, in quest of a job in New York City. Although jobs then were scarce, her persistence paid off: she was hired by a brokerage firm as a trainee.

Siebert's accounting skills and her ability to analyze financial statements attracted new clients. As her reputation grew, she moved to other firms. Each new job increased her responsibilities and salary.

She learned to deal with the problem of being a woman in a predominantly man's world. "I changed jobs three times because they were paying a man more than

I was making for the same job." Once, she had to walk up the stairs to attend a board meeting because the club at which the meeting was being held would not take women in their elevator.

By 1967, Siebert thought it time to launch her own brokerage firm. But before she could trade stocks and bonds, she needed to have a seat on the New York Stock Exchange. No woman had ever owned her own brokerage firm or held a seat on this exchange. No woman, that is, until 1967, when the forces resisting her finally agreed to sell her a seat. Muriel Siebert & Co., the first brokerage firm owned by a woman, was open for business. By 2001, her firm earned $32 million in revenues.

Robert L. Johnson

Robert L. Johnson was born in Hickory, Mississippi, in 1946, the ninth of ten children. His family soon moved to Illinois. Robert Johnson graduated from the University of Illinois and moved on to earn a Master's degree from Princeton University. After Princeton, Johnson landed a job as a lobbyist for the National Cable Television Association (NCTA).

Johnson had long felt that television could be used to promote black-owned businesses and media. He would do this by producing television programs especially targeted to African-American viewers. Convinced that his idea had merit, Johnson turned to the problem of finding the money necessary to turn the dream into reality. As a first step, he applied for and received a bank loan of $15,000. Then through a combination of effort, timing, and luck, Johnson was able to enlist the support of NCTA and other leading firms in the cable television industry to provide the necessary satellite space and additional financing.

Johnson named the new venture Black Entertainment Television (BET). At 11 P.M. on January 11, 1980, BET officially aired its first program. It became the largest black-owned broadcasting company on cable TV. Ten years later, BET was reaching 25 million homes. In 2000, Johnson sold BET to Viacom for nearly $3 billion, making him the nation's first African-American billionaire. Johnson agreed to remain with the company as its Chairman.

James Chu

James Chu was born and raised in Taiwan, where he later entered the business world by selling Chinese-English dictionaries and English instruction tapes. In 1986, he accepted an offer to run U.S. operations for a Taiwanese computer keyboard manufacturer. Although that job

did not work out, Chu was able to use the contacts he had made to start his own company in the United States, in 1987. It specialized in selling *computer peripherals* (equipment that can be connected to a computer).

As his organization grew, Chu saw a need for high-performance, competitively priced color monitors. In 1990, he gave his company a new name, ViewSonic, and launched a colorful advertising campaign featuring three Australian finches as the logo for his new monitors. Apparently the finches were a big hit, for ViewSonic soon became the world's fastest-growing brand of monitors.

Chu's achievements earned him many honors including the Ernst & Young "Entrepreneur Of The Year," in 1994, and *TransPacific Magazine's* "Top Under 40 Asian American Entrepreneur," in 1996. At the time, one magazine writer said that ". . . Chu may be the most successful immigrant in American history." His success has continued. In 2001, for example, with Chu serving as ViewSonic's President and CEO, the company received the top award in display technology.

after the mail-order end of the business. George concentrated on the retail store. They met several times a week to "discuss problems."

Advantages of the Partnership

George and Dolores's experiences tell us something about the advantages of the partnership form of business. We can summarize the advantages as more money for the business and the knowledge and experience of two people instead of one.

1. More Money (Capital) Available. Because there is more than one owner in a partnership, there is more than one source of money. In the case of Byteland, Dolores Ramon brought an additional $40,000 into the business. Also, banks are more willing to lend money to partnerships than to proprietorships. This fact is true because the loan is guaranteed not only by one person, but by each and every partner.

2. "Two Heads Are Better Than One." When she came into the business, Dolores Ramon brought special skills and experience with her. She made it easier for Byteland to enter the mail-order business. Moreover, Dolores and George were able to "put their heads together" to discuss and solve their business problems. (This situation is what people mean when they say that "two heads are better than one." When George had operated the business as a sole proprietorship, he had to solve all problems by himself.)

Disadvantages of the Partnership

There are a number of disadvantages to a partnership. The most important of these are its unlimited liability, limited life and resources, and the problems that arise when partners disagree.

1. Unlimited Liability. Each and every partner in a business may be held liable for its debts. No matter how many partners a business has, any one of them can be responsible for paying off what it owes. For this reason, there is no limit to the amount of money that a partner may lose. Why? Because there is no limit to

Partnership: Sharing business responsibilities lightens the job of these partners. What problems may they face?

Personal Economics

WHAT'S WHAT? TRY SWOT

Every now and then, entrepreneurs need to step back and examine their business to see how things are going. In doing so, they will be looking for answers to questions like: "Where are we now?"; "Where do we want to be in the near and distant future?"; and "How do we get there from here?" While there are any number of ways to assess a business, one method that has become popular in recent years is known as *SWOT analysis.*

SWOT provides entrepreneurs with a framework to organize and develop business strategies. The elements of SWOT are:

Strengths
Weaknesses
Opportunities
Threats

Typically, an entrepreneur or a management team will investigate each element of the business using the SWOT formula of strengths, weaknesses, opportunities, and threats. Upon completion of the study, steps may be taken to use the firm's strengths and opportunities while reducing its weaknesses and threats.

SWOT in Action

Leslie Prentiss and Dana Bird, owners of Happy Trails Bike Company, have decided to use a SWOT analysis study of their business operations. After consulting with customers, suppliers, and employees, Prentiss discovered the following:

1. Everyone agreed that Happy Trails's location—across the street from a major park with miles of bike paths—was ideal for bicycle rentals.
2. The company had to defend itself from lawsuits by rental customers who had injured themselves in falls.
3. While Happy Trails's bikes are in good condition, most lack gears, even though the bike paths are hilly in places.
4. A number of customers left after being told that the business had no "bicycles built for two" available for rent. They were, however, available for sale on a "special order" basis.
5. Many customers have said that they enjoyed cycling so much that they would like to buy a bike of their own. Others were heard to say that they would especially like to buy from Happy Trails because the staff ". . . seemed to know a lot about bikes."
6. Shoppers entering the store to look at bicycles and equipment often leave without having spoken to any employee.
7. A number of prospective rental and new-bike customers wanted to take their young children with them on the bike trail. But since Happy Trails did not have the necessary equipment (e.g., trail-a-bikes, and jogging strollers), they took their business elsewhere.
8. A number of customers said that they liked the friendly service they had received.
9. Bicycles in need of repair were quickly restored to service. As a result, the business never lost a rental because of unavailable bikes.

Prentiss and Bird entered their findings in a table similar to the following one.

Positive	Negative
Strengths	Weaknesses
Opportunities	Threats

1. On a separate sheet of paper, prepare a chart like the one shown. Then enter the information obtained in Prentiss's study.
2. Using the information contained in the SWOT analysis, identify and explain two things that Happy Trails might do to expand its business and increase profits.

the amount that the firm may lose. Thus we see that in a partnership, as in a sole proprietorship, there is unlimited liability.

2. ***Limited Life.*** A partnership is legally ended when one of the partners dies. While it is possible to continue the business by forming a new partnership, to do so can present legal problems.

3. ***Limited Funds.*** As in the case with the sole proprietorship, the amount of money the partnership can raise is limited. This limit depends upon the personal resources of the partners, plus whatever money they can borrow.

4. ***Partners May Disagree.*** It has been said that a partnership is often a "very unsteady ship to sail." Sometimes, partners will have such serious disagreements that they can no longer function as a team. When this happens, it can easily bring the business to an end.

Byteland Grows Larger

Business at Dolores and George's Byteland grew quickly. The partners soon began to talk about opening several additional stores.

"Before you open any more stores, you ought to think about incorporating," Jed Frank, their lawyer, recommended.

"Jed, do you think Byteland is big enough for us to form a corporation?" asked Dolores.

"Yes, Dolores," Jed replied. "As a matter of fact, your business does not have to be very large in order to incorporate. And it would make a lot of sense for you to form a corporation."

"Well, then," George Lee chimed in, "why don't the three of us meet tomorrow morning so that you can tell us about these advantages?"

SUMMARY

In this chapter, we learned that people go into business for themselves in the hopes of directing their own financial destinies and earning profits. We also learned that the sole proprietorship is the most common form of business organization. Proprietorships are popular because they are easy and inexpensive to form. But sole proprietorships can raise only limited amounts of money. And the total burden of responsibility of running the business is on the owner.

As compared to a sole proprietorship, a partnership provides the advantages of additional capital and the sharing of the responsibilities of ownership. But both the proprietorship and the partnership have limited life, limited capital, and unlimited liability. It is because of these disadvantages that many business firms are organized as corporations.

LOOKING AHEAD

George, Dolores, and Jed agreed to meet the next day to discuss the possibility of converting Byteland into a corporation. We will read about the results of that meeting in the following chapter. As we do, we will also learn about the advantages and disadvantages of incorporating and the reasons why all large businesses are corporations.

EXERCISES

✔**Matching** Match each term in Column A with its definition in Column B.

Column A	Column B
1. sole proprietorship	*a.* personal responsibility for all the debts of a company
2. partnership	*b.* another word for "money"
3. unlimited liability	*c.* the money earned by an individual or a firm
4. capital	*d.* a business owned by one person
5. contract	*e.* a business owned by two or more persons
6. income	*f.* the risk that a business will close upon the death of an owner
7. expenses	*g.* what is left out of income after expenses are paid
8. profits	*h.* the costs of doing business
9. limited life	*i.* a legally binding agreement

Multiple Choice Choose the letter of the item that best completes the statement or answers the question.

1. Which one of the following is *not* an advantage of a sole proprietorship? (a) The proprietor may keep all the profits. (b) The proprietor can lose only a limited amount of money. (c) The proprietor is his or her own boss. (d) There is no limit to the amount of money one may make.
2. A sole proprietorship has limited capital. This means that (a) only a limited number of machines and factories are available for proprietorships (b) the amount of money that a proprietorship can raise is limited (c) there is no limit to the amount of money one can lose in a proprietorship (d) two heads are better than one.
3. A sole proprietorship is a business organization that (a) has only one owner (b) has only two or three owners (c) is very small (d) does not have to pay taxes.
4. The term "profits" refers to (a) the total income received by a business (b) all the expenses of running a business (c) the total of all the income and expenses (d) anything left out of income after expenses have been deducted.
5. Both the sole proprietorship and the partnership have unlimited liability. (a) This is an advantage of both forms of business organization. (b) This means that there is no limit to the amount of money a proprietor or partner may lose. (c) This means that there is no limit to the amount of money a proprietor or partner may make. (d) This means that there is no limit to the things a proprietor or partner may be expected to do in running a business.

Imagine Applying for a Loan

Imagine that you are planning to open a small store where you intend to sell candy, magazines, newspapers, toys, and stationery. You have several thousand dollars saved up. You plan to add to your savings by getting a loan from your local bank. When you go for your loan, the banker gives you a form to complete. It asks some detailed questions about your business plans. Some of these questions are listed below. How would you answer them if you really were in this situation? Why do you suppose a bank might ask questions like these?

1. What kind of business do you plan to operate?
2. Why do you want to open this business?

3. What three problems do you expect to be most troublesome? Explain briefly.
4. What made you select the location for your business?

✔ *Imagine Setting Up a Partnership*

Peter Brimar and Paul Hanno have been friends since high school. Now that they have completed their training at a local trade school, they have decided to go into the food-catering business together as partners. Peter has $20,000 in savings that he will be able to put into the business. Paul has $10,000. The partners agree that they will both draw weekly salaries of $500 from the business. In addition, they agree that, if there are any profits remaining at the end of the year, Peter will get two-thirds, while Paul will get one-third.

In order to avoid any misunderstanding, they put this agreement in writing and both partners signed it.

1. Why do you suppose partners usually put their agreements in writing?
2. Why did the partners agree that Peter Brimar would get two-thirds of the profits, while Paul Hanno only one-third?
3. Suppose that Brimar and Hanno have asked you to draw up the partnership agreement for them. On a separate sheet of paper, write out an agreement that both partners can sign. All the details described above should be included.
4. At the end of the first year, the partners had $48,000 in profits to share. (This was in addition to the salaries they had already drawn.) How much did each partner receive?
5. At the end of the second year, the partnership came to an end. The partners had $10,000 in debts. Peter Brimar had no more money in the bank, but Paul Hanno had saved up $15,000 during that time. How was the $10,000 paid off?

✔ *Using the Internet*

For practical advice on how to start your own business, visit the Website of the U.S. government's Small Business Administration, at <<http://www.sba.gov/starting/>>. If you want to prepare your own business plan, go to <<http://biztech.nfte.com/>>.

CHAPTER 22
The Corporation

Key Terms

corporation
charter
stock certificate
share of stock
stockholder
limited liability
unlimited life
double taxation
S corporation
corporate income tax
not-for-profit corporation
government-owned corporation
cooperative
closed corporation
open corporation
board of directors
proxy
officers
franchise
franchisor
franchisee

The partnership of Ramon and Lee was doing very well. It was doing so well, indeed, that the partners, Dolores Ramon and George Lee, decided to open several more Byteland stores. It was then that their attorney, Jed Frank, suggested that they form a corporation.

"But I thought that all corporations were multimillion-dollar businesses," said George.

"It's true, of course, that all large business firms are corporations," Mr. Frank replied. "But, as a matter of fact, most corporations are small businesses just like yours."

As you read this chapter, you will learn what Mr. Frank meant by his last statement. You will also learn the answers to the following questions:

- What is a corporation?
- What are some of the advantages and disadvantages of corporations?
- Who owns, controls, and manages large corporations?

WHAT IS A CORPORATION?

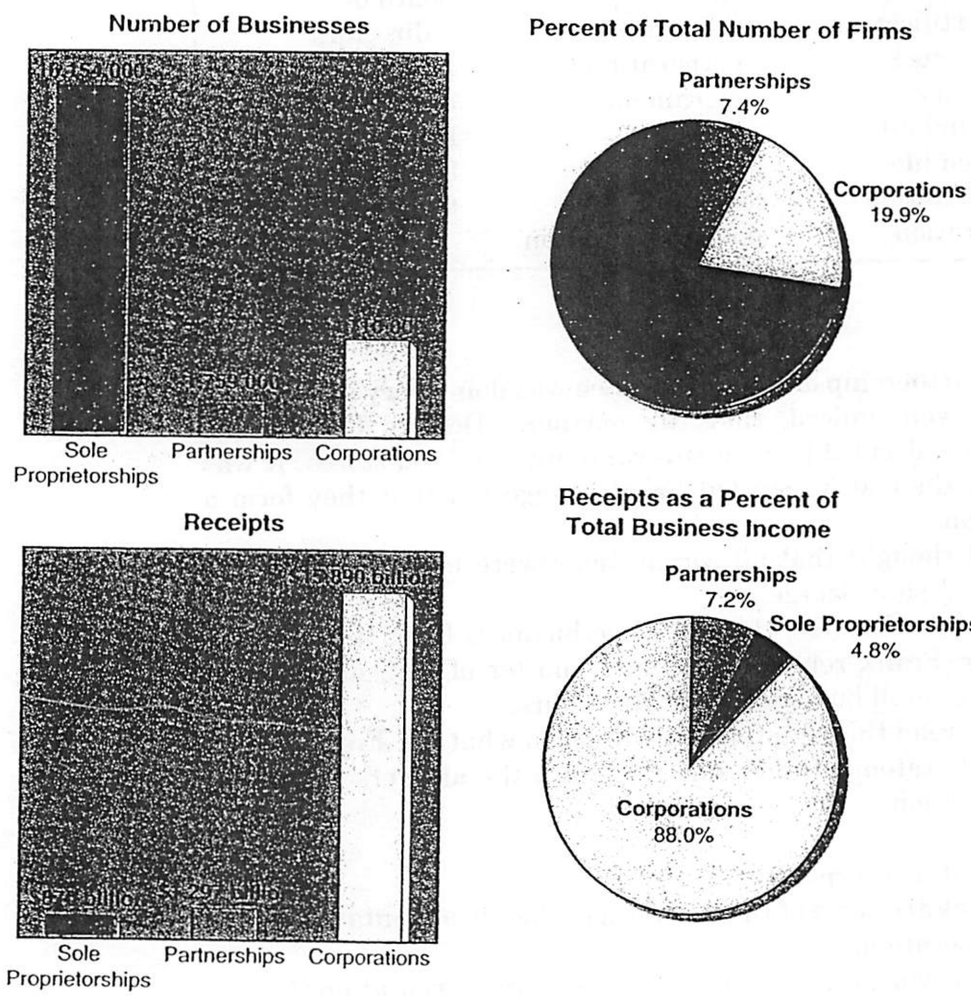
Dolores Ramon, George Lee, and Jed Frank sat around a table in Byteland's office. They met to discuss the possibility of transforming Byteland from a partnership to a corporation.

Mr. Frank continued the meeting by saying, "I think you will find these illustrations to be of interest." The illustrations he showed them looked like the ones in Figure 22.1.

"When you look at the pie chart 'Percent of Total Number of Firms,'" Mr. Frank asked, "what strikes you?"

"I see that about 73 percent of all business organizations are sole proprietorships," said George.

Figure 22.1 Proprietorships, Partnerships, and Corporations: Number and Receipts



"That's right," Dolores chimed in, "but look at the 'Receipts' pie chart. It shows that corporations account for 88 percent of all business receipts."

"I bet I know what that tells us," George said. "Jed, are all of the biggest businesses in the country corporations?"

"That's correct," their lawyer said. "And here's another fact about corporations: About 85 percent of all corporations are *small* businesses. Let me tell you why."

"Great," said Dolores. "Why don't you begin by telling us what a corporation is?"

"I'd be glad to," Mr. Frank replied. "A *corporation* is a business that is licensed by a state or the federal government as a legal individual. The license is called a *charter*. Ownership of the corporation is represented by *stock certificates*, or, as they are more commonly called, *shares of stock*. The people who own these shares of stock are known as *stockholders*."

So, for example, if Byteland were to incorporate with 1,000 shares of stock, both Ramon and Lee (each of whom owns half of the business) would receive 500 shares each. If, at a later date, Ramon or Lee sold 100 shares to someone else, that person would own a 10 percent interest in the business (because 100 shares is 10 percent of 1,000 shares).

WHAT ARE SOME OF THE ADVANTAGES AND DISADVANTAGES OF CORPORATIONS?

Advantages of Corporations

Corporations have advantages over the sole proprietorship and the partnership forms of business that we discussed in Chapter 21. The three most important advantages are limited liability, unlimited life, and easy transfer of ownership.

1. Limited Liability. There is no limit to the amount of money you might lose as a proprietor or partner. Were the business to shut down, partnership law allows any one of the partners to be held responsible for all the company's debts.

But such is not the case with a corporation. It has *limited liability*. This is because a corporation, in the eyes of the law, "has a life of its own." This phrase means that, if the corporation owes money to someone, only the business is responsible for the debt, not the people who own it. For example:

Lance Lotte invested $5,000 in a partnership. A year later, the partnership in which Lance had invested went out of business. The money that Lance had invested in the partnership was all he had in the world. All, that is, except for a savings account amounting to $15,000 that he was planning to use to help send his daughter, Lana, to college.

At the time that it folded, the firm was in debt for a total of $15,000. Naturally, those to whom the business owed the $15,000 wanted to be repaid. But none of the partners had any money. None, that is, except Lance. Since the business was a partnership, the law allowed the creditors to regain their $15,000 from him. Lana had to make other plans for her future.

But suppose, instead, that the business in which Lance Lotte invested was a corporation. In that case, no individual could be held responsible for the $15,000 debt. The most that Lance could have lost would have been his original $5,000 investment. Lana could have gone to college.

2. Unlimited Life. The life of a sole proprietorship and a partnership is limited. The law requires that these businesses be brought to an end upon the death or retirement of any of their owners. When this happens, a sole proprietorship and partnership, if they are to continue, must go through a complicated legal process in which new owners are substituted for the old ones. A corporation does not have this problem. It has *unlimited life.* When stockholders die, their shares simply become part of their estates and are passed along to their heirs. For that reason, corporations can (in theory at least) live forever.

3. Easy Transfer of Ownership. Selling a sole proprietorship or partnership can be a very complicated and expensive process. The sale requires the services of lawyers and accountants. But shares of stock in a corporation can be sold merely by signing them over to a new owner.

Disadvantages of Corporations

Not all businesses are corporations. Indeed, as you saw earlier, the most popular form of business organization is the sole proprietorship. Corporations have the disadvantages of being costly and complicated to set up, and their owners are subject to double taxation.

1. Costly and Complicated to Set Up. The reason why there are so many more sole proprietorships than corporations is that proprietorships are easier and less costly to set up. In order to organize as a corporation, a firm must first get permission from the state or federal government. This is a complicated and costly procedure that usually requires the assistance of a lawyer.

Understanding Economics

OTHER FORMS OF BUSINESS OWNERSHIP

Most businesses can be classified as sole proprietorships, partnerships, or corporations. There are, however, special types of corporations and other business organizations that operate in special situations. You may be familiar with some of them. They include government-owned corporations, S-corporations, not-for-profit corporations, and cooperatives.

1. Government-Owned Corporations. Corporations owned by federal, state, or local governments fall into this category. *Government-owned corporations* are usually created to provide a product or service that the private sector is unwilling or unable to offer. The United States Postal Service, National Aeronautics and Space Administration (NASA), Federal Deposit Insurance Corporation (FDIC), and any number of metropolitan public transit authorities are examples of government-owned corporations.

2. S-Corporations. Think of the "S" in *S-corporations* as standing for "small" because S-corporations were especially designed to benefit smaller businesses. S-corporations enable firms that qualify as "small" to enjoy the advantages of corporate ownership while avoiding many of the disadvantages. Like regular corporations, S-corporations have the advantage of limited liability. But unlike regular corporations, they do not have to pay corporate income taxes. Thus, they avoid the disadvantage of double taxation, which is associated with regular corporations.

3. Not-for-Profit Corporations. *Not-for-profit* (also called nonprofit) *corporations* are organized to provide an educational, religious, or other nonbusiness service rather than to earn a profit. Not-for-profit corporations do not sell stock. Most importantly, because they earn no profits, not-for-profit corporations pay no income taxes.

4. Cooperatives. A *cooperative* is a business owned by members using its services. People benefit from membership in cooperatives because the organization can perform more effectively than individuals acting alone.

Do you know someone who lives in a co-op (another word for cooperative)? If you do, they can tell you that the multiple dwelling in which they live is owned by the families who live there. But cooperative housing is but one type of cooperative.

Consumer cooperatives are retail businesses owned by its members. Members share in its profits and/or purchase goods or services at lower cost.

Producer cooperatives manufacture or grow the products they sell on behalf of their members. Producer co-ops are most often found in agriculture. Ocean Spray Cranberries, Inc., which controls over 70 percent of the cranberry market, is a 900-member producer cooperative.

2. Double Taxation. In the eyes of the law, the corporation is a person. Just as people pay income taxes, so do coporations. In fact, they are taxed twice.

The profits of most corporations are subject to *corporate income taxes*. These taxes are levied by the government. (They are not levied on partnerships or proprietorships.) After the corporate tax is paid, part or all of what remains out of a corporation's profits may be paid out to the stockholders. These profits, or *dividends*, as they are called, are then subject to personal income taxes. Thus, the stockholders are said to be subject to "double taxation," first, when the corporation's profits are taxed, and second, when the stockholders' dividends are taxed at income tax time.

After Jed Frank had finished telling Dolores and George the advantages and disadvantages of corporations, Dolores exclaimed.

"You've convinced me. Let's incorporate."

"Absolutely," George agreed. "How soon can we get going on forming a corporation?" Acting on Ramon and Lee's instructions, Jed Frank applied for and received permission in the form of a charter that transformed Byteland from a partnership to a corporation. From now on, the company would be known as Byteland, Inc.

WHO OWNS, CONTROLS, AND MANAGES LARGE CORPORATIONS?

Byteland, Inc., is a small, *closed corporation*. This type of corporation is one whose stock is not for sale to the general public. Indeed, in Byteland's case, all its stock is owned by just two people: Dolores and George.

But some businesses are *open corporations*. Anyone can purchase the stock of these corporations. As you can see in the table on page 339, the number of stockholders in some of the nation's largest open corporations reaches into the hundreds of thousands. And, in one instance, it reaches over 3 million.

But how can 3.5 million owners of stock manage a business? Where does the money come from to operate such a large enterprise? The pages that follow will answer these questions.

Board of Directors

Stockholders in large corporations elect representatives to oversee business operations and look after their interests. These representatives are known as *directors*. Together, they make up the corporation's *board of directors*.

Electing the directors of a corporation is different from political elections. Americans select their government representatives on the basis of "one person, one vote." That phrase means that one citizen's vote is as important as another's. But this is not the case in

Shareholders in Widely Held U.S. Corporations

Corporation	Number of Shareholders
AT&T	3,500,000
Verizon	1,029,000
Walt Disney	842,000
Exxon Mobil	721,000
IBM	646,000
General Electric	557,000
Coca-Cola	395,000
Procter & Gamble	278,000
Walmart	257,000
Merck	231,000

an election for a corporation's board of directors. In corporate elections, stockholders have one vote for every share of stock they own. Let us suppose, for example, that the J Corporation consists of 175 shares of stock. Jack owns 50 shares of stock in the corporation, Jill owns 25 shares, and Jean owns 100 shares. In an election for the chairperson of the board of directors of the corporation, Jack and Jill vote for Jill. Jean votes for herself. Who won the election?

If you said "Jean," you would be absolutely right. Her ballot counted for 100 votes, while the shares of stock of Jack and Jill add up to only 75 votes.

Since most stockholders have other responsibilities, and since corporate meetings may be held hundreds or even thousands of miles from their homes, few stockholders attend annual meetings of their corporations. Instead, stockholders in giant corporations give their voting rights to others. They do this by signing a form known as a *proxy*. In most instances, the holders of proxies can vote as if the stock were their own. For that reason, the boards of directors of large corporations generally ask their stockholders to give them their proxies whenever they announce a stockholders' meeting.

Officers

Directors are not usually involved in the day-to-day operations of their corporations. These are the concerns of the firms' *officers*: the president, secretary, treasurer, and vice presidents. (See Figure 22.2 on page 340.) Boards of directors, however, will be involved with questions directly affecting the stockholders, such as:

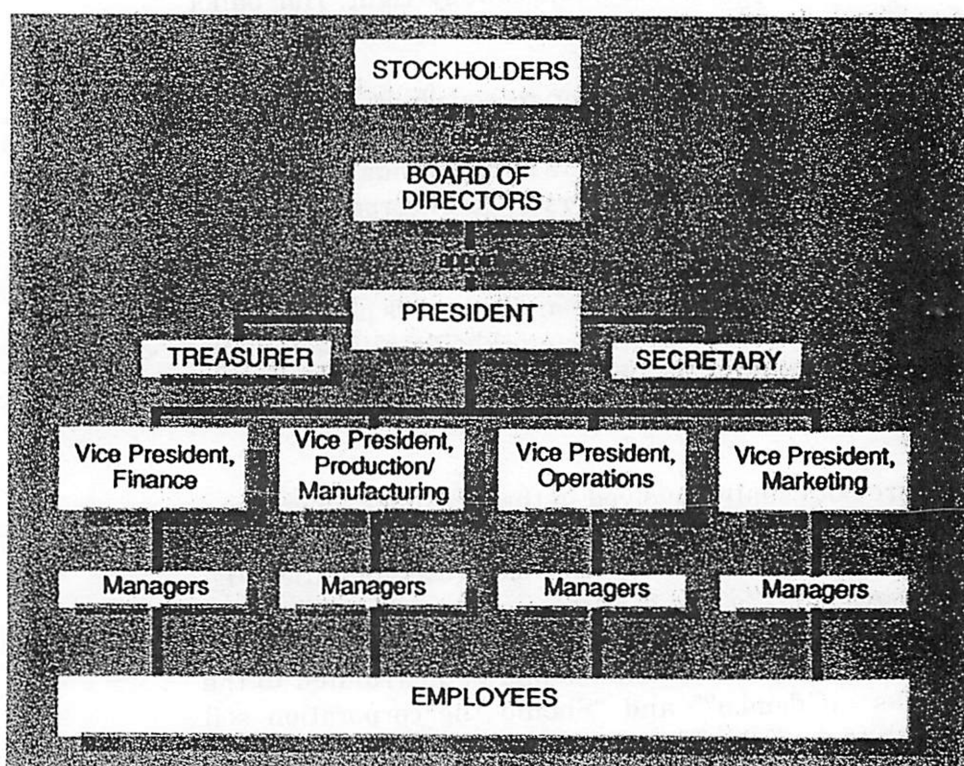
"How much of this year's profits should be distributed to the stockholders (as dividends)?" and "Should the corporation sell more of its stock to the public?"

Technically speaking, those who own a corporation are its stockholders. But as we have seen, those who control a corporation are the members of its board of directors. As a practical matter, therefore, in giant corporations ownership and control are quite separate.

Of course, the directors are responsible to the stockholders who elected them to office. But stockholders rarely take an active interest in those who represent them. Most will either ignore the annual meeting or give their proxies to the existing board. For that reason, most boards continue to serve for long periods of time. Occasionally, however, the news media report on the struggle for control of a particular corporation. This often leads to proxy fights in which competing groups ask stockholders to give them the right to cast their ballots.

Some people feel that it is a terrible thing that most stockholders in large corporations have lost control of their business to the small group of "insiders" sitting on their boards. Apparently, most stockholders feel otherwise. They would argue that only specially trained persons of considerable talent have the ability to run today's giant corporations. The stockholders' principal interest seems to be in sharing in the profits and growth of the companies rather than in controlling business operations.

Figure 22.2 Organization Chart of a Typical Manufacturing Corporation



Understanding Economics

THE FRANCHISE ALTERNATIVE

"I'm tired of working for other people, I'd love to own a business of my own—be my own boss, keep all the profits, and build up something for the future."

"Have you thought about buying a franchise?"

"No, tell me about it."

Franchises are individually owned businesses that are licensed to operate as if they were part of a larger chain of outlets or stores. Those who sell franchises are known as *franchisors*. Those who buy and operate franchises are the *franchisees*.

Advantages of Franchises

Those who buy franchises do so because it enables them to operate a business of their own with: (1) limited capital, (2) a recognized name and advertising, (3) a tested way of doing business, and (4) less risk.

1. Start a Business With Limited Capital. One of the most difficult problems facing small businesses is lack of money. It takes money to start an operation, and it takes money to keep it going. Eventually, entrepreneurs expect that income generated by the business will be enough to cover expenses and generate a profit. But until that time comes, a business must rely on its own sources of funds.

Franchisors have a good idea of how much money is needed to start and operate one of their businesses. They also have the resources necessary to secure loans and other financing for qualified franchisees.

2. Name Recognition and Advertising. Franchises often have nationally recognized names like McDonalds, Meineke, and Avis. While an independent fast-food stand cannot afford national advertising, Wendy's and Burger King can. This advertising pretty well guarantees that even newly opened franchises will have customers waiting.

3. A Proven Way of Doing Business. Those who buy franchises know that the business has worked many times before. When problems arise, the franchisees can look to the franchisor for help in solving them.

4. Less Risk. According to the U.S. Department of Commerce, better than 90 percent of all franchises make it through their fifth year. This is much higher than the national average for other types of businesses.

Disadvantages of Franchises

Franchises are not without their disadvantages. Most notable of these are the following:

1. Restrictions on Freedom of Ownership. Unlike privately owned businesses in which the entrepreneur is his/her "own boss," franchisors have a great deal of control how the business will operate. They can, for example, prescribe how employees should dress, set the hours of operation, decorate the facility according to their standards, and require that franchisees purchase equipment and supplies from them.

2. High Costs. Costs of operating a franchise may be higher than a privately owned business. One reason for this is that the cost of equipment and supplies furnished by franchisors is often more costly than similar items purchased elsewhere. In addition, franchisees are usually required to pay an annual fee to the franchisor for the privilege of owning the franchise.

3. Success Often Depends on the Reputation of Others. Mistakes, or improper business practices by one franchisee can reflect badly on all the others.

4. Competition From Franchisor. Even success can cause problems. In some instances, franchisees have been so successful that the franchisor opened its own outlet in the same neighborhood.

Franchise Start-Up Costs

Franchise	Nature of Business	Minimum Start-Up Investment
Radio Shack	Retail electronics stores	$ 50,000
Dunkin' Donuts	Food/quick-service bakery products/donuts	$200,000
Meineke	Discount muffler and brake repair services	$ 50,000
Sir Speedy	Printing, copying, digital networking	$125,000
Blockbuster	Retail video rental and sales	$200,000

SUMMARY

A corporation is a business organization recognized by government as a legal individual and owned by its stockholders. As compared to the sole proprietorship and partnership forms, the corporation offers the following advantages: limited liability, unlimited life, and ease of transfer to a new owner. The greatest disadvantages of the corporation are that it is costly to organize and it may be subject to double taxation.

Stockholders in large corporations elect boards of directors to represent them in controlling the corporation. Stockholders have one vote for every share of stock they own.

Responsibility for the day-to-day operation of large corporations is in the hands of the officers and their staffs. In this way, ownership is separated from management in large corporations.

LOOKING AHEAD

How do corporations raise money? How do individuals buy shares of stock? The answers to these questions are contained in the following chapter. As you read, you will also be introduced to the world of high finance. You will learn about the role of the stock market and about the speculators and investors who trade there.

EXERCISES

Matching Match each term in Column A with its definition in Column B.

Column A	Column B
1. corporation	*a.* a document that authorizes another to vote one's stock
2. stockholder	*b.* the people who control corporations
3. charter	*c.* a business licensed by a government as an individual and owned by its stockholders
4. S corporation	*d.* a form of corporation for a small business
5. proxy	*e.* an individually owned business licensed to operate as if it were part of a chain
6. board of directors	*f.* a problem faced by corporations
7. limited liability	*g.* an owner of a corporation
8. double taxation	*h.* the principal advantage of the corporation
9. franchise	*i.* a state-issued license to incorporate
10. cooperative	*j.* business owned by its members

Multiple Choice Choose the letter of the item that best completes the statement or answers the question.

1. A corporation is (a) the same thing as a very large partnership (b) always owned by two people (c) always larger than a sole proprietorship or a partnership (d) licensed by a state or federal government and owned by those holding shares of its stock.
2. A corporation has limited liability. This means that there is (a) no limit to the amount of money the corporation may lose (b) no limit to the amount of money an individual stockholder may lose (c) a limit to the amount of money the corporation may lose (d) a limit to the amount of money an individual stockholder may lose.
3. One advantage of the corporation over other forms of business organization is that ownership is easily transferred. The reason is that (a) there are more corporations than any other kind of business (b) ownership is transferred through the sale of stock (c) all one needs to do to sell one's stock is to turn the matter over to one's

attorney (d) most people know someone who would be willing to buy shares in a corporation.

4. Compared to sole proprietorships and partnerships, corporations are (a) more likely to be controlled by their owners (b) subject to fewer taxes (c) usually smaller (d) more expensive to form.

5. The major responsibility of the board of directors in a large corporation is to (a) take care of the day-to-day problems of running the business (b) look after the well-being of the employees (c) look after the interests of the stockholders (d) direct the purchase of supplies and equipment.

6. A small corporation is totally owned by five stockholders: Smith, Diaz, Chin, Blue, and Fink. Smith owns 100 shares of stock; Diaz owns 200; Chin owns 600; Blue owns 150; and Fink owns 100. Both Chin and Blue want to run the business. In the election for chairman of the board of directors, Chin voted for himself; everyone else (including Blue) voted for Blue. Who won? (a) Chin (b) Blue (c) Fink (d) It was a tie.

7. The ownership and the control of a large corporation may be separate. This means that (a) all the stockholders live a long distance from the company's offices (b) persons who own stock in the corporation are not permitted by law to run it (c) persons who serve as officers are not permitted to receive dividends (d) only a small percentage of the stockholders may be elected to the board of directors.

✔**Understanding Charts and Graphs** Study Figure 22.1 on page 334 and then answer the questions below.

1. How many sole proprietorships, partnerships, and corporations are there in the United States?

2. What percentage of the total are sole proprietorships? partnerships? corporations?

3. What are the total receipts of all U.S. corporations?

4. Of that total, what percentage was made up of sole proprietorships? of partnerships?

5. Why do you suppose that there are more sole proprietorships in the United States than any other kind of business organization?

CHAPTER 23
Buying and Selling Stocks and Bonds

Key Terms

securities	stockbroker	speculator
common stock	stock exchange	bull
capital gain	Securities and Exchange Commission	bear
preferred stock		mutual fund
corporate bond		investor
investment bank		

"And now, turning to Wall Street, traders were bullish as stocks moved sharply higher in a day of quiet trading. . . ."

"The bears were out in force today as stock averages turned downward. Bond prices rose. . . ."

Every day millions of Americans pick up their newspapers, turn on their television sets, or check the Internet in order to keep up with their investments in stocks and bonds. Perhaps you have read or seen some of these reports and have wanted to learn more about the subject. In this chapter, we will be taking a look at how stocks and bonds are sold. We will learn why corporations sell stocks and bonds, how they reach the general public, and the reasons why people buy them.

When you have finished reading the chapter, you will be able to answer the following questions:

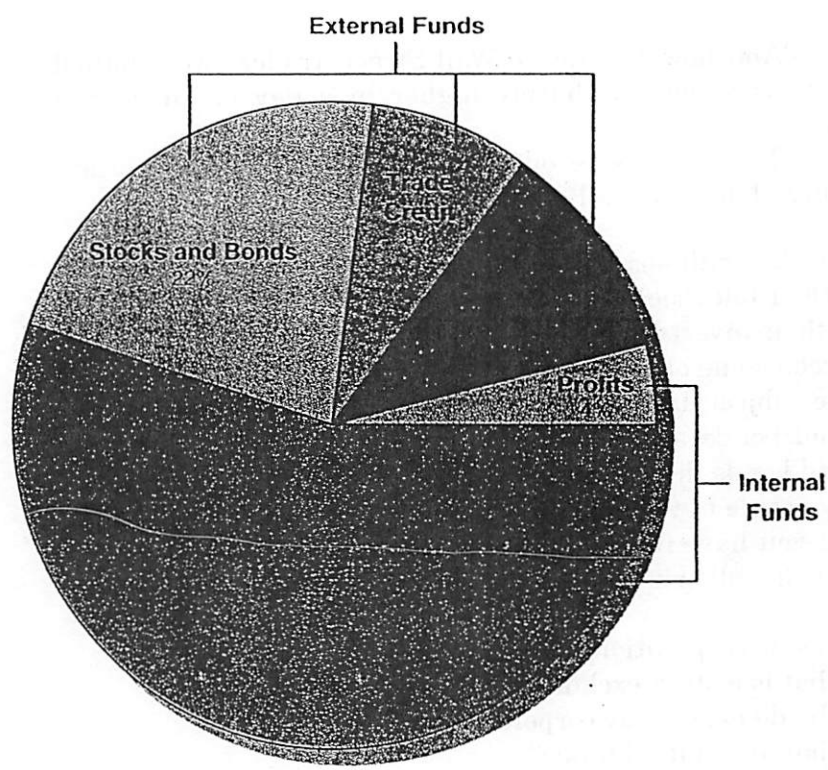
- How do corporations obtain funds?
- What is a stock exchange?
- Why do people buy corporate stocks?
- What are mutual funds?
- How is the public protected in the sale of securities?

HOW DO CORPORATIONS OBTAIN FUNDS?

Your garden may be the most beautiful in the neighborhood. But unless your garden receives its regular supply of water, sunlight, and fertilizer, it will wither and die. A business, like a garden, needs nourishment in order to thrive and grow. It needs *capital*, or money. Money is needed to pay for the day-to-day expenses of running a company. Money is also needed to buy replacements for worn-out machinery, tools, and other equipment. A growing business will also have to have money to pay for new factories, machinery, and offices.

You learned in the previous chapters of this unit that sole proprietorships and partnerships depend upon the money that their owners bring to their businesses. Proprietors and partners may also borrow money from outside sources such as banks to help finance their operations. Banks lend money to businesses in exchange for interest payments (as discussed in Chapter 5). These loans are usually made for short periods of time—a year or less.

Figure 23.1 Sources of Corporate Funds



Corporations, like sole proprietorships and partnerships, obtain the money they need for growth from both internal sources and external ones. (See Figure 23.1.) *Internal funds* are those earned by the corporation in the course of business. These funds are mostly used to pay the corporation's expenses.

One of a corporation's most important items of expense is *depreciation*. This expense is the money that a corporation sets aside to replace its old or out-of-date equipment.

Whatever sums remain after business expenses are paid represent profits, as you have learned. A corporation does not have to distribute all of its profits to its shareholders. Profits that are not paid out are an important source of business funds.

External funds are those that come from individuals and institutions outside the corporation. Bank loans and mortgages are external funds. So, too, are *trade credit* (delays in payment that firms grant to business customers) and corporate securities such as stocks and bonds.

Sale of Corporate Securities

One factor that sets the corporation apart from the sole proprietorship and the partnership is the legal right of a corporation to sell its *securities*. This term is another name for its stocks and bonds. Stocks represent ownership in corporations. Bonds represent loans to corporations.

1. Stocks. Most corporate securities are held as *common stock*. Owners of common stock are entitled to vote in the selection of the corporation's board of directors and to receive a percentage of the profits, if any, of the corporation. The money paid to stockholders from a corporation's profits is called a *dividend*.

Corporations often issue *preferred stock* in addition to common stock. Holders of a company's preferred stock are entitled to a fixed dividend whenever the corporation's board of directors decides to pay it. Holders of common stock do not receive dividends until the holders of preferred stock have been paid. If a corporation is dissolved and all its assets are sold for cash, the creditors will be paid first. The holders of preferred stock and the holders of common stock, in that order, will receive their share of whatever is left. Usually, the holders of preferred stock do not vote to elect the company's board of directors.

Although the sale of stock accounts for only 5–10 percent of *new* corporate financing, it is the method that attracts the most attention from the public. One reason, of course, is that so many

Common Stock of the Ford Motor Company: Corporate stocks are sold by brokers who are members of stock exchanges.

people own stocks. In a recent year, for example, some 20 percent of U.S. families had investments in corporate stocks. And millions more had invested indirectly when they purchased life insurance policies and shares of mutual funds, or had money in pension funds. The people who manage these businesses invest the public's money in corporate stocks. All told, some 49 percent of U.S. families have directly or indirectly invested in securities. Some, having purchased individual shares in their name, own the stock *directly*. Others are said to own shares *indirectly*. They did this by investing in mutual funds and/or retirement accounts that invested some or all of their funds in stocks.

*2. **Bonds.*** When the public buys *corporate bonds*, it is lending money to the corporations that issue them. These bonds represent a debt. They also are promises from the corporation to pay a fixed rate of interest for a certain number of years. For example, a 20-year, $5,000 bond may pay an 8 percent rate of interest. The bondholder receives $400 interest each year. When the bond "matures" in 20 years, the bondholder is entitled to $5,000, or the *face value* of the bond. Corporations are legally obligated to pay interest on bonds. Failure to do so can put them out of business by forcing them into bankruptcy.

WHAT IS A STOCK EXCHANGE?

Corporations that want to raise money by selling shares of stock usually do so by going to a special kind of institution known as an *investment bank*. Investment banks are businesses that help corporations sell their stocks to the public. These banks buy entire issues of stocks from corporations. The banks hope to earn profits by selling these corporate stocks to the public, often through stockbrokers.

At this point, the corporation has raised money through the sale of its securities. The public holds shares of stock in the corporation. From this time forward, income from the sale of stock will go to the individuals who own the stock, *not the corporation*.

Let us consider the case of the Miracle Flashlight Company. Good-quality products and its slogan, "If it works, it's a Miracle," have made the Miracle brand a success. Malcolm Blue, president of the company, and chairperson of the board of directors, has concluded that the firm needs to raise $100 million. This money will be used to build a new plant, purchase modern machinery, and hire more workers.

After meeting with a group of investment bankers, Mr. Blue decided that Miracle could raise the $100 million through the sale of stock. The board has approved Blue's plan. Miracle would sell 4 million shares of stock at $25 a share to the investment banks.

New York Stock Exchange: On the trading floor of the exchange, brokers buy and sell stocks for their customers. Individuals, corporations, public institutions, and private groups may own shares of the same company.

Bond Traders: The bonds issued by corporations, states and localities, and utilities are sold by investment-bond specialists.

That would give Miracle its \$100 million (4 million × \$25 = \$100 million). For their part, the investment banks planned to resell the stock to the public for slightly more than \$25 a share, thereby making a profit on each of the 4 million shares.

Once it has received its money from the investment banks, Miracle Flashlight is no longer involved in the purchase or sale of its stock. From that time on, those who own the stock and wish to sell it and those who wish to buy it will have to deal with *stockbrokers*. These people work for brokerage firms (such as Merrill Lynch and Shearson Lehman Hutton) that buy and sell shares of stock for their customers on stock exchanges.

Finding a buyer for shares of stock could be a problem were it not for the nation's *stock exchanges*. Stock exchanges are marketplaces in which the stocks of certain corporations can be bought and sold. Buyers and sellers of stocks and bonds send their orders to the "floor" of these exchanges, where the transactions take place. The largest of these floor-based exchanges are the *New York Stock Exchange* (*NYSE*) and the *American Stock Exchange* (*AMEX*), both located in New York City. Several smaller stock exchanges are located in other cities around the nation, including Philadelphia, Chicago, and Los Angeles. Stock exchanges are also located in major cities abroad—for example, London, Paris, and Tokyo.

Stocks not listed on any exchanges are traded in the over-the-counter-market (OTC). Unlike the NYSE, where securities are traded on the floor of the exchange, OTC stocks are traded over a vast telecommunications network. The network, known as the *National Association of Securities Dealers Automatic Quotations*, or *NASDAQ*, is composed of thousands of brokerage firms. While most of the 5,000 or more companies traded on the NASDAQ are small firms, it also trades the securities of some of America's best-known technology firms such as Microsoft, Intel, and Apple.

The exchanges provide a place where stockbrokers can get together to trade on behalf of their customers. The prices at which trades take place are the results of auctions. Buyers announce the price they are willing to pay, sellers state the price they are willing to take for their stocks. When the two agree on a price, a transaction is made. Stock prices are directly affected by the laws of supply and demand (discussed in Chapter 4). If the demand for a particular stock were to increase, the price of the stock would rise. But if the supply of the stock were to increase, the price would be likely to fall.

With millions of people buying shares of stock every year, we might next ask the question, "Why do people buy corporate stocks?"

WHY DO PEOPLE BUY CORPORATE STOCKS?

People who buy stocks do so for a variety of reasons. The major reasons are: for yearly income; for investment, and for speculation.

Yearly Income (Dividends)

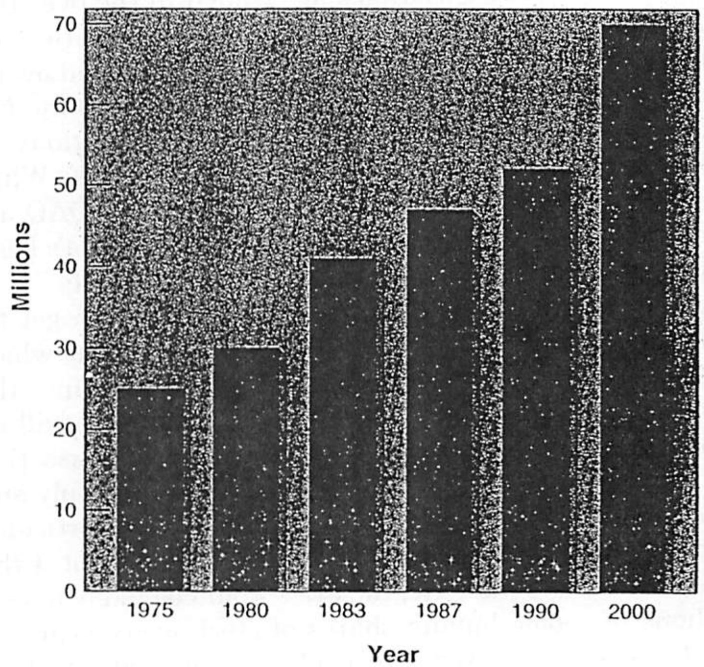
Many people who buy stocks do so primarily to receive income, or dividends. *Dividends* are the portion of a corporation's profits that are distributed to its stockholders. If a company paid its stockholders $1 per share in dividends, a person who owned 100 shares of stock received $100 in dividends during the year.

The size of a company's dividends depends primarily on its success in earning profits. For this reason, people who buy stocks know that there is no guarantee that they will receive the same dividend, or any at all, from one year to the next.

Investment

The value of a share of stock often changes from one day to the next. When shares of stock increase in value, there is said to be "growth in the value of its capital." There are many reasons why a company and its stock will become more valuable. Perhaps its

Figure 23.2 Number of Corporate Stockholders Since 1975



profits have been increasing. Or it may have developed a new manufacturing process, and the prospects for future earnings look particularly good. In fact, anything that makes the company seem more attractive will cause the price of its stock to rise. Owners of the stock will then be able to sell their shares at a profit. This profit is called a *capital gain.*

People who buy stocks in the hope that their value will increase over the long term can be either investors or speculators. The term *investors* describes people who buy securities with the intention of holding them for the long term. They do this as a way of: (1) earning dividend or interest income, or (2) profiting from the possible rise in value of the securities over the long term.

Speculation

The term *speculators* refers to those who hope to profit by correctly predicting short-term fluctuations in the value of stocks and bonds. We have seen that the price of a stock may rise or fall from day to day. (It may also stay the same.) If people *knew* which way the price of a stock was going to go before it happened, they could easily profit from the knowledge. While no one can predict future

Figure 23.3 Newspaper Stock Exchange Listing (Disney Corporation highlighted)

52 Week				Yld	PE	Sales				
High	Low	Stock	Div	%	Ratio	100s	High	Low	Last	Chg
18.78	11.88	Dial	.16	1.0	dd	5228	16.55	16.15	16.27	−0.26
45.65	22.83	DiaOffs	.50	1.9	36	7692	26.70	26.01	26.03	−0.76
43.55	25.75	Diebold	.64	1.6	33	3201	39.95	39.20	39.47	−0.36
22.50	12.06	Dillards	.16	1.0	dd	5408	16.05	15.56	15.86	−0.24
21.79	14.81	[illegible]	1.88	10.1		208	18.74	17.70	18.59	+0.59
11.61	4.81	Dimon	.36	5.0	10	400	7.25	7.15	7.24	−0.01
34.80	**15.50**	**Disney**	**.21**	**1.0**	**dd**	**68522**	**21.50**	**0.01**	**20.50**	**−0.98**
17.63	10.10	Dist&Srv	.25e	2.1		1366	12.05	11.88	11.92	−0.28
26.00	10.04	DrReddy n	.10p			994	19.98	19.71	19.80	−0.03
27.65	14.60	Dole	.40	1.5	cc	938	26.37	25.80	25.83	−0.43
24.05	10.50	DollarG	.13	0.9	27	37736	15.23	14.10	14.75	+0.72
25.78	8.40	DollarTh			11	621	15.69	15.30	15.30	−0.15
25.40	24.56	DmCNG pf	1.95	7.7		959	25.40	25.18	25.35	[illegible]
69.99	55.13	DomRes	2.58	4.3	18	11475	60.53	59.51	59.63	+0.13
66.56	55.50	DmRes04	4.75	8.0		1205	60.14	58.75	59.50	+0.40
25.05	15.70	DmRsBW	3.21e	16.1	[illegible]	72	20.00	19.88	19.91	+0.06
10.74	6.80	Domtar g	.14			120	9.69	9.46	9.46	−0.13
40.35	24.45	Donaldson	.30	0.9	20	2034	34.35	33.60	33.70	−0.20
31.90	24.30	[illegible]	.96	3.7	27	2540	30.75	29.80	29.93	−0.58
16.20	12.55	Donnelly	.40	3.1	14	92	12.90	12.75	12.85	−0.05
8.00	1.06	[illegible]			dd	204	2.35	2.25	2.27	−0.07
43.55	26.40	Dover	.50	1.5	7	5460	35.42	34.05	34.05	−1.45
17.00	10.38	DoverD	.18	1.4	16	208	13.55	13.30	13.30	−0.15
39.67	25.06	DowChm	1.34f	5.5	dd	237138	26.15	23.66	24.55	−1.90

Reading from left to right, the listing presents the following information: 52-week high and low prices ($34.80 and $15.50). Company name. Dividend: Dollar amount of the company's per-share earnings paid to shareholders ($.21). Yield: Per-share dividend divided by per-share stock price, expressed as a percentage (1.0). Price-earnings ratio: Compares the stock's current market price to the company's earnings per share of stock (dd means that there was a loss, so the percentage could not be calculated). Sales volume: Number of shares bought and sold on the previous day, in hundreds (6,852,200 shares). Prices paid for the stock during the previous day: highest, lowest, and closing ($21.50, $0.01, $20.50). Net change: Difference between the past two days' closing prices ($.98).

events with absolute certainty, speculators feel they can make some pretty good guesses. When they are correct in their predictions, speculators profit. When they are wrong, they lose money.

Every business day, millions upon millions of shares of stock are bought and sold at the nation's stock exchanges. When a sale takes place, the price and number of shares traded are instantly recorded and reported in brokerage houses and on wire services around the world. Stock prices and transactions are published daily in major newspapers around the world and are available almost instantly on many Internet sites.

Speculators hope to profit by correctly predicting whether a stock will rise or fall in value. Those who predict a rise in the price of a stock are known as *bulls*. To be "bullish" on something is to be optimistic about its future. Speculators who expect the price of a stock to fall are called *bears*. To be "bearish," therefore, is to be pessimistic about the future.

Understanding Economics
SPECULATORS AND THE STOCK MARKET

Marjorie Morris, Clarence Berens, Harry Wong, and Sylvia Finn do not know one another, but they have a number of things in common. Each thought that they could profit by buying the stock of companies in the electronics industry, and selling them after they had gone up in value. Each made their buy on March 24, 2000, and held on to their stock for about a year.

DATE: March 24, 2000

Buyer	Stock	Number of Shares Purchased	Price Per Share	Total Cost
Morris	Microsoft	70	$111.69	$7,818.30
Berens	Cisco Systems	100	79.38	7,938.00
Finn	Intel	100	69.53	6,953.00
Wong	Yahoo	40	194.00	7,760.00

On March 29, 2001, each of the speculators sold their shares at a substantial loss. Here is how it happened.

Starting in January of 1997, stocks issued by electronics and Internet-related companies (popularly described as the "dot-coms") began a run-up in prices that looked to many speculators like it would never end. Despite warnings that stock prices never increase forever, people like Morris, Berens, Wong, and Finn kept buying those securities, and prices continued their advance. "Look at those stocks climb," they said. "We will make a fortune!"

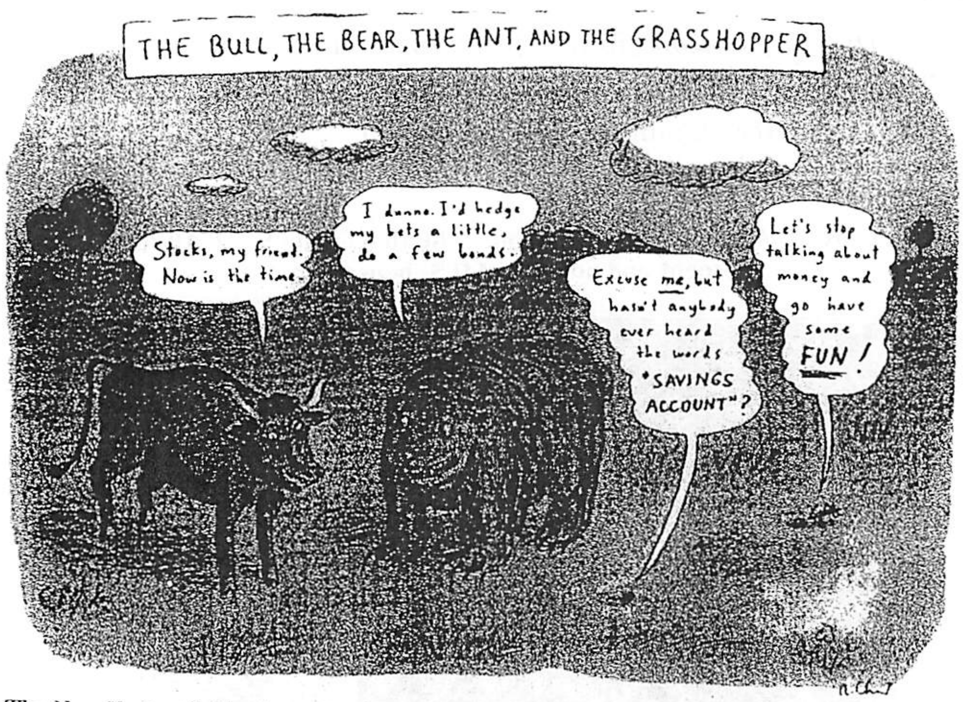
Alas, there was no fortune to be made because early on in 2001 the long predicted collapse of the electronics and dot-com stocks began. In the course of that decline, the four speculators saw their potential profits disappear. Meanwhile, the collapse of electronics stocks came as a terrible blow to investors across the United States and overseas. As the value of their investments fell, panicky stockholders ordered their brokers to sell. Our four speculators did the same. On March 29, 2001, Morris, Berens, Wong, and Finn sold the stocks they had purchased only a year earlier. The results of their sales are summarized in the table below:

DATE: March 29, 2001

Buyer	Stock	Number of Shares Sold	Price Per Share	Total Received
Morris	Microsoft	70	$55.38	$3,876.60
Berens	Cisco Systems	100	15.25	1,525.00
Finn	Intel	100	28.56	2,856.00
Wong	Yahoo	40	15.00	600.00

In less than one month's time, Morris had lost $3,941.70; Berens, $6,413; Finn, $4,097; and Wong, a whopping $7,160! Millions of other investors also lost money in the stock market that month.

The reasons why the electronics industry stocks collapsed when they did may never be known. Whatever the reasons, the events stand as a stark reminder for those who thought it possible for stock prices to rise indefinitely. The fact is that the only thing certain about stock prices is that they will *fluctuate*. Sometimes they will rise, and sometimes they will fall. For that reason, investors and speculators alike need to be prepared for the unexpected, which may occur at any time.



© The New Yorker Collection 1997 Roz Chast from cartoonbank.com.
Optimistic bulls expect stock prices to rise, while pessimistic bears expect them to fall.

WHAT ARE MUTUAL FUNDS?

Although the advice given above about investing is good, few people have the knowledge, time, or money to follow the advice. But there is a method for people of average means to invest in stocks and bonds while limiting their risks. For millions of investors, the method is to invest in *mutual funds*.

A mutual fund is a company that invests on behalf of its shareholders. People purchase shares of the mutual fund, and the company pools the money of all these people. The company invests the pooled money in a variety of securities, including stocks, corporate bonds, and government bonds. Income earned by a fund is distributed to the shareholders in accordance with the number of shares they own.

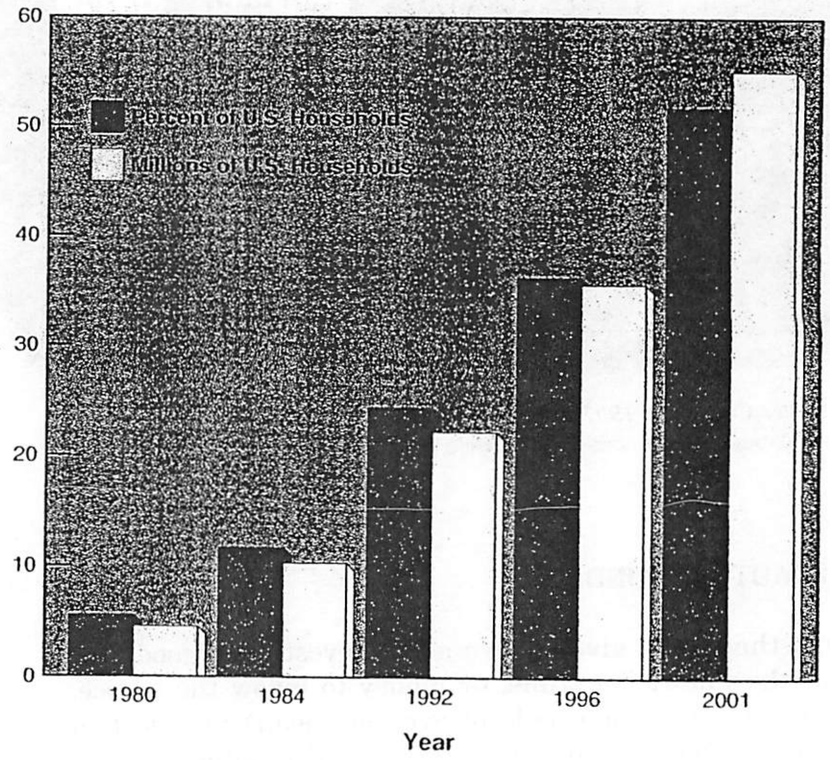
Advantages of Mutual Funds

1. Professional Management. The employees of a mutual fund are trained to study financial information, economic trends, and political developments. Few investors have the time or expertise to do this.

2. Diversification. To reduce the risks of ownership, mutual funds invest in a wide variety of stocks and bonds.

3. Liquidity. A mutual fund investment can be turned into cash quickly and easily.

Figure 23.4 Household Ownership of Mutual Funds Since 1980 (percent and number of U.S. households)



Personal Economics

SOME ADVICE TO WOULD-BE INVESTORS

Are you thinking about investing in corporate stocks or bonds? Then consider the following advice:

1. Investigate before you invest. Know something about the business in which you plan to invest: its finances, history, and future outlook. Get the advice of an expert.

2. Do not "put all your eggs in one basket." You can reduce your risks by *diversifying* (investing your money in a number of companies rather than in just one or two). You can further diversify by putting your money in different kinds of stocks or in both stocks and bonds.

3. Keep checking your investments. Nothing is forever! Even the best of corporations will at times perform poorly. Keep an eye on your investments, and switch to new ones when necessary.

Disadvantages of Mutual Funds

Mutual funds are not free from risk, however. If stocks in general are doing poorly, so too will most mutual funds. Generally, funds that invest in government securities carry less risk than ones that invest in corporate stocks. In addition, many different companies sell mutual funds. Some of these companies are better managed than others. So, even when investing in mutual funds, investigate before you invest.

HOW IS THE PUBLIC PROTECTED IN THE SALE OF SECURITIES?

The federal government has taken steps to protect those who invest in corporate stocks and bonds. In the 1930s, it established the *Securities and Exchange Commission* (*SEC*) to regulate the sale of securities. The SEC also tries to make it easier for the public to get the information that it needs to make intelligent decisions about investments. The SEC does *not*, however, offer advice on the worth of any particular stock or bond. The decision to buy or sell is left to each individual investor.

In 1970, Congress took another step to protect investors by creating the *Securities Investor Protection Corporation* (*SIPC*). Like the Federal Deposit Insurance Corporation (FDIC), which insures bank accounts, the SIPC insures the cash and securities in customer accounts in the event that a brokerage firm were to fail.

State governments also regulate securities, specifically those that are not subject to federal regulation.

Each of the major exchanges also acts as a self-regulator. An exchange establishes rules for trading and will penalize or expel a member who fails to follow its rules. An exchange does not guarantee the safety of any investment traded. Nor does it take responsibility for the advice given to an investor by any of its members.

What does this mean for you, your family, and your friends? It means that if you are thinking of buying securities or mutual funds, you would be wise to be careful. Remember, you can easily lose part, or all, of your investment.

SUMMARY

Corporations pay for their operations from their earnings or from money raised from outside sources. Outside sources include loans and the sale of stocks and bonds. Lenders are paid interest for the use of their money. Stockholders receive a share of the company's profits in the form of dividends. Stock exchanges make it possible for millions of shares of stocks and bonds to change hands daily.

People invest in corporate stocks to receive dividends, to acquire capital gains, and to speculate.

Mutual fund companies pool large sums of money that they invest on behalf of their customers. In this way, the mutual funds offer the advantages of professional management and diversification to investors of modest means.

The federal Securities and Exchange Commission regulates the purchase and sale of stocks and bonds. The primary function of the SEC is to see to it that the public is given accurate and honest information about the corporations whose securities are offered for sale. Another federal agency, the Securities Investor Protection Corporation, protects the investing public by insuring the contents of their brokerage accounts.

LOOKING AHEAD

The following chapter looks at one of the major reasons for the size and wealth of the U.S. economy: mass production. This term refers to the ability of businesses to manufacture large quantities of goods at low cost and to sell them at a profit.

EXERCISES

Matching Match each term in Column A with its definition in Column B.

Column A	Column B
1. investment bank	*a.* the agency that regulates the sale of stocks and bonds
2. stock	*b.* any investment based on one's hope to profit from its short-term rise or fall in value
3. stock exchange	*c.* a business that sells new issues of stocks and bonds to brokers
4. bond	*d.* one who buys and sells stocks for investors
5. capital gain	*e.* a place where publicly traded securities are bought and sold
6. dividend	*f.* one who expects the price of stock to rise
7. speculation	*g.* an increase in the value of a share of stock
8. bull	*h.* one who expects the price of stock to fall
9. bear	*i.* a pool of funds invested in a variety of stocks
10. mutual fund	*j.* a share of ownership in a corporation
11. stockbroker	*k.* a debt of the company that issues it
12. Securities and Exchange Commission	*l.* a payment by a company to its stockholders

Multiple Choice Choose the letter of the item that best completes the statement or answers the question.

1. Recently, XYZ Corporation, one of the nation's largest corporations, sold several million shares of its stock to the public. How was the stock sold? (a) by mail-order catalog (b) by one or more investment banks (c) over the counter at the corporation's many stores and offices (d) all of the above.

2. A year after all its stock was sold, investors are still busily buying and selling shares of XYZ stock. Who receives the money from these sales? (a) the individual owners of XYZ who choose to sell their stock (b) the XYZ Corporation (c) the managers of the XYZ Corporation (d) the stock exchange that handles the sales.

3. Alvin Atwell is buying shares of stock in a retailing corporation because he is convinced that the price of its stock is going to rise very soon. Alvin is a (a) "bear" (b) pessimist (c) careful investor (d) "bull."

4. Millicent Marcus owns 100 shares of the Blue Sea Fishing Company of Portland, Maine. At the end of the year, Blue Sea declares a $1.50 dividend. How will this declaration affect Millicent? (a) Each share of stock will increase in value by $1.50. (b) She will receive a check for $150. (c) She will receive a check for $1.50. (d) It will have no effect at all on Millicent because she lives in Oregon.

5. The Securities and Exchange Commission (a) regulates the amount of money and credit in circulation (b) supervises the coining of money (c) regulates the sale of stocks and bonds (d) guarantees home mortgages.

6. Stock dividends (a) must be paid to stockholders every year (b) are paid to those who lend the corporation money (c) represent shares of profits and are paid to stockholders (d) are not taxable.

7. Which of the following is true of corporate bonds? (a) They represent a debt of the corporation. (b) They pay bondholders a fixed rate of interest. (c) They promise to repay bondholders a specified amount after a fixed period of time. (d) All of the above.

✔**Developing Skills in Economics** Study the graphs on pages 352 and 357 and then answer the questions below.

1. How many people owned shares of corporate stock in 1975? in 1987? in 2000?

2. What has been the trend in corporate stock ownership over the period shown? (*Trend* refers to the general course or direction in which something is moving.)

3. What reasons can you suggest for this trend in corporate stock ownership?

4. How many households owned shares in mutual funds in 1980? in 1992? in 2001?

5. What was the trend in mutual fund share ownership in the period shown?

6. What reasons can you suggest for the trend in mutual fund ownership?

✔***Using the Internet***

The following Websites will provide further information about investing:

1. *The Stock Market Game* at <<http://www.smgww.org>>. Sponsored by the securities industry, *The Stock Market Game* enables participants to discover the risks and rewards involved in decision-making, the sources and uses of capital, and other related economic concepts.

2. *You & The Investment World*—published by the New York Stock Exchange, the pamphlet introduces readers to the marketing of stocks and bonds, and the principals of trading in securities. *You & The Investment World* is available at <<http://www.nyse.com/about/about.html>>.