

PERSONAL FINANCE

A Guide to Money and Business

EDITOR

Stephanie Schwartz Driver

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Alphabetical Table of Contents

<i>Contributors</i>	4	Finance, Personal	90
<i>Introduction</i>	5	Franchise	94
		Inflation	96
Accounting and Bookkeeping	6	Innovation	100
Bankruptcy	10	Interest	102
Better Business Bureau	14	Inventory	105
Brand Names	16	Job Search	108
Budget	19	Market Research	112
Bundling	23	Minimum Wage	117
Business Plan	26	Money	123
Cash Flow	29	Mortgage	126
Chambers of Commerce	31	Mutual Funds	129
Commodities	34	Outsourcing	132
Compound Interest	36	Patent	135
Consumer Protection	38	Pricing	142
Contracts and Contract Law	42	Product Development	147
Copyright	46	Recession	152
Cost of Living	51	Savings and Investment Options	155
Credit	54	Small Business	159
Credit Cards and Debit Cards	59	Stocks and Bonds	163
Credit History	64	Taxation	168
Debt	69	Trademark	170
Demographics	73	Unemployment	172
Distribution Channels	76	Venture Capital	176
Economies of Scale	80		
Entrepreneurship	83	<i>Glossary</i>	182
Exchange Rates	88	<i>Index</i>	185

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Introduction

The need for financial, economic, business, and entrepreneurial literacy is relevant not only on the personal level. It is also one of the keys to the financial strength of nations. As Alice M. Rivlin, former vice chair of the Federal Reserve board, said, “A free market economy works well only when the participants—producers, consumers, savers, investors—have the information they need to make intelligent decisions.” In order for any country’s economy to thrive, people need to understand the constituents of their economy. Informed consumers will hold their financial institutions to high standards, helping to ensure the soundness of the financial system and the growth of the economy.

The goal of *Personal Finance: A Guide to Money and Business* is to lead students toward a fuller understanding of those aspects of business and finance they will commonly encounter in their lives. This A-to-Z guide will provide guidance for students learning to manage personal financial affairs, from setting budgets and managing spending and borrowing to understanding their financial rights and responsibilities. It will also help them to put their personal

economic lives in a national context, understanding the ways that broader economic trends, such as inflation or economic recession, affect their own options. In doing so it will give them the economic background they need to understand current events of national and global significance.

Personal Finance: A Guide to Money and Business recognizes that today’s students are the foundation of tomorrow’s national economic success. In response, it aims to give future entrepreneurs a grounding in the basics of running a successful enterprise, from crafting a business plan to understanding some of the nuances of contracts and intellectual property law.

Each article in this collection contains references for further research on the Internet so that students can independently take their reading to the next level. These online resources are from reputable institutions and will remain up-to-date in the context of a rapidly changing economic landscape.

—Stephanie Schwartz Driver

Accounting and Bookkeeping

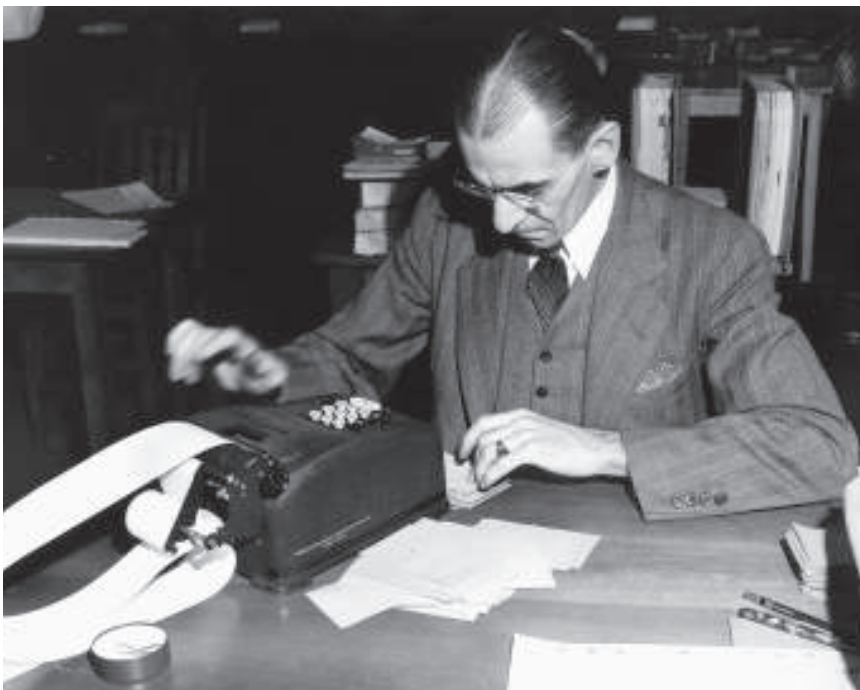
Businesses use accounting and bookkeeping to identify, measure, record, and communicate information about their financial activities. Information provided through accounting and bookkeeping helps people—those working within a firm and those with whom the firm does business—make informed decisions about business operations and strategy.

Accounting as it is practiced today can be described as a cycle including the following steps:

1. Collect data.
2. Analyze data.
3. Enter data into journals.
4. Post to ledger accounts.
5. Prepare a trial balance.
6. Calculate adjustments and record adjusting entries.
7. Prepare adjusted trial balance.
8. Compile financial statements.
9. Close appropriate accounts and prepare post-closing trial balance.

In this cycle, the first five steps fall into the realm of bookkeeping; the final four steps, into accounting.

In 1943, an accountant totals the returns at the seed dealers, W. Atlee Burpee Company in Philadelphia.



Bookkeeping Functions

For as long as people have been engaged in commerce or trade, they have needed to do some form of bookkeeping. Before computers, records of business transactions were kept in journals or books (hence the term bookkeeping). Although the term has evolved to reflect technological advances (such data recording is now often referred to as record keeping or data processing), its purpose has remained the same: to document and preserve information about financial activity, thus providing information to be used in financial decision making.

Bookkeeping begins with a collection of data. Many events affect a business every day; however, only those activities that affect it financially qualify as sources of data for bookkeeping. Such activities are called transactions. Examples of transactions include purchases or sale of inventory or equipment, loans taken out or paid, and payment of employees' salaries. Documentation is gathered representing these transactions in the form of receipts, bank statements, invoices, and so on. Activities that cannot be documented in dollar amounts, such as the hiring and training of new employees or a competitor lowering its prices, do not qualify as transactions, even though they do affect the business.

After data are collected, they must be analyzed. The analysis involves business accounts in five main categories: assets, liabilities, owner's equity, revenue, and expenses. Revenue and expenses are considered part of owner's equity. The amount of money in each category, or the balance of each account, is recorded on an ongoing basis, and an analysis is done to determine the effect of each transaction on the accounts. For example, if a business uses \$500 cash to purchase goods to sell, the analysis would show that, as the bill was paid in cash, the amount of cash (an asset) held by the business has decreased by \$500. At the same time, the business gained goods to sell, increasing the amount of inventory (also an asset) by \$500.

Once data are collected and analyzed, they must be recorded, or entered, in a journal. This is the third step of the

accounting cycle. This third step reflects the basic accounting equation:

$$\text{Assets} = \text{Liabilities} + \text{Owner's Equity}$$

Every transaction is entered chronologically into a journal using the double-entry accounting system. This system reflects the fact that every transaction affects two accounts, which keeps the accounting equation balanced. For example, one entry can increase assets and another entry can decrease assets by the same amount; or assets can be increased and liabilities can be increased by the same amount. Both examples preserve the accounting equation.

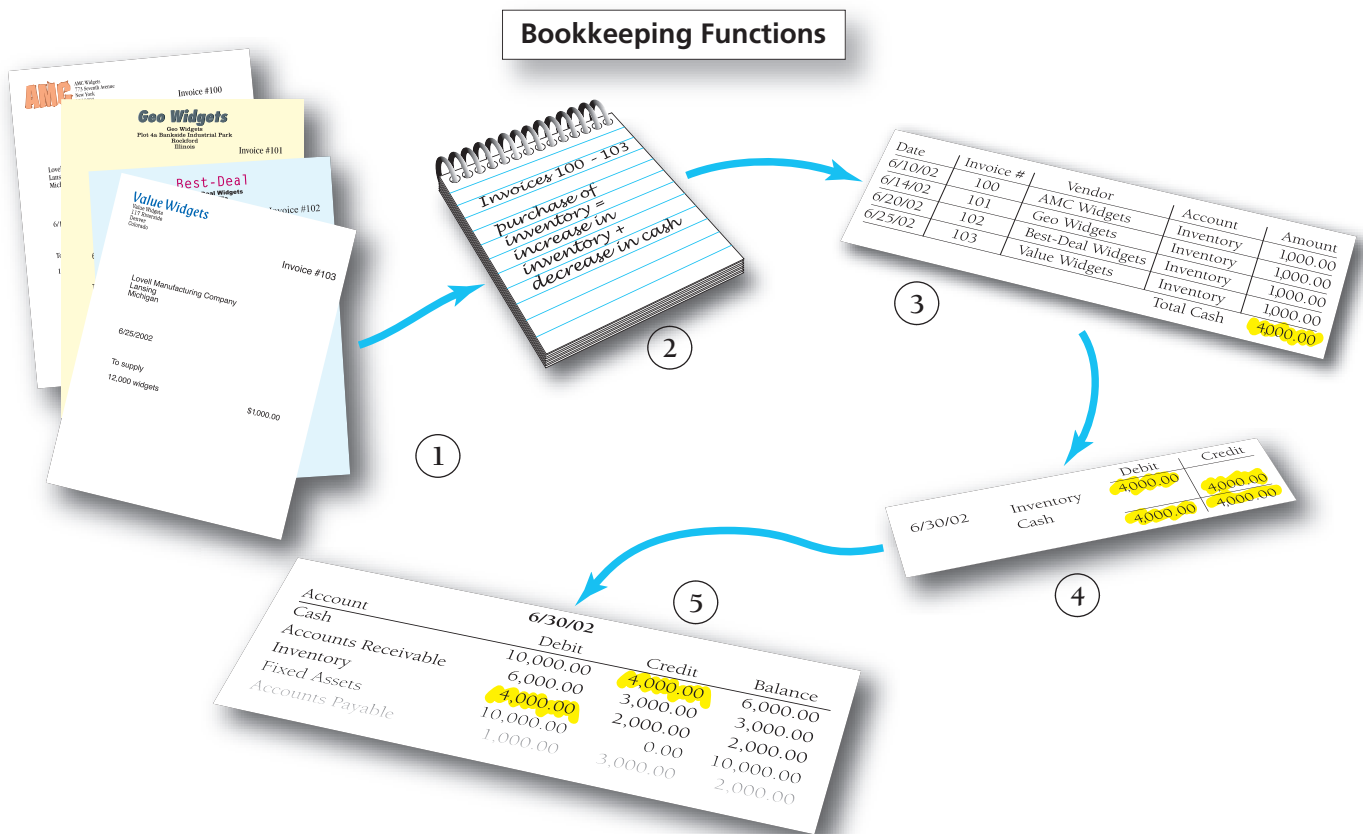
Activity in each of the three types of account of the basic accounting equation is divided into debits and credits, representing increases and decreases. A debit is an increase in an asset account or a decrease in a liability or equity account. A credit is the opposite—a decrease in an asset account or an increase in a liability or equity account. Each transaction, following the double-entry accounting system, is entered twice: in one account as a debit, and in another as a credit.

Because the basic accounting equation must balance, the debit and credit for each transaction must be equal. If a business purchases supplies for \$500 cash, a journal entry is made as a debit on the inventory account and a credit on the cash account, both in the amount of \$500.

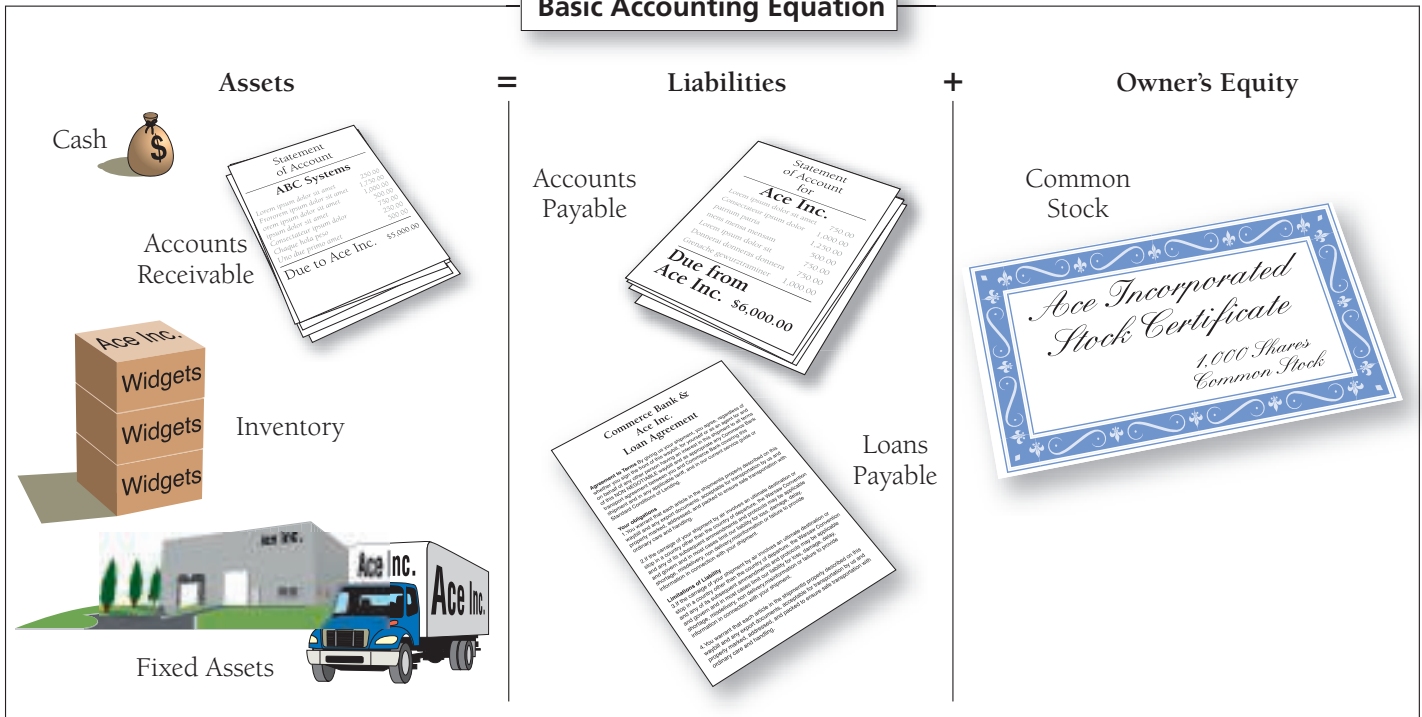
Once a transaction is recorded in the journal, it is transferred into the company's ledgers. This process, called posting, is the fourth step in the accounting cycle. A company typically uses a general ledger and a subledger. The general ledger shows each debit and credit from the journal—listed for each account on a single page of a book, with debits appearing on the left and credits on the right. The general ledger is usually maintained by computer; a subledger is maintained if more detail is required for a specific account than the general ledger provides.

The final bookkeeping responsibility, preparing a trial balance, is typically done every month. The trial balance is a report summarizing the general ledger; it lists all accounts in the general ledger with their corresponding

Steps in bookkeeping:
 (1) collecting data; (2) analyzing data; (3) entering data into journals; (4) posting to ledger accounts; and (5) preparing a trial balance.



Basic Accounting Equation



The basic accounting equation.

debit or credit balances, as well as the total amount of debits and credits. The trial balance is critical because it ensures that journal entries have been posted correctly. The total dollar debit amount must equal the total dollar credit amount; if it does not, the bookkeeper must go back through the previous four steps in the accounting cycle to find where the error was made. Once the trial balance is correct, the bookkeeper's work is done.

Accounting Functions

The general purpose of accounting is to use the bookkeeper's data to create reports that can be used internally (management reporting) and externally (financial reporting). Management reporting provides members of the company's management with information to help them understand the company's performance and to make decisions for improving it. Financial reporting enables people outside the company to understand how well or poorly the company is operating. To successfully create these reports, the accountant must complete the final four steps of the accounting cycle.

The accounting functions begin with the completed trial balance. Although the

trial balance summarizes the important financial transactions that have taken place, it does not include other information such as interest earned but not yet received or prepaid expenses not yet recorded by bookkeepers that may have a significant economic impact on the company. Economic events like these must be calculated and adjusted in the sixth step of the accounting cycle.

After all adjusting entries are made, the accountant must prepare the adjusted trial balance. The adjusted trial balance is the same as the trial balance produced in the bookkeeping process, but it includes all of the accountant's adjusting entries. Again, the total dollar amounts of the debits and credits must be equal; if they are not, the accountant must review the adjusting entries for errors and correct them.

Once the adjusted trial balance is established, it can be used in the creation of financial statements, which is the eighth step of the accounting cycle. Four primary financial statements are used to convey account information: the income statement, statement of changes in retained earnings, balance sheet, and cash flow statement.

Income Statement. The income statement reports the profitability of the company for a specific period. It uses all of the revenue and expense accounts from the trial balance and summarizes them. For example, the company may have many expense accounts, but on the income statement they are reported on one line called “Other Expenses.” The result is a net income figure (revenues minus expenses).

Statement of Changes in Retained Earnings. This report shows all transactions that affect retained earnings during the period. The report is created using the previous period’s retained earnings, the net income from the income statement, and anything that decreases the retained earnings. The result is the current period’s retained earnings.

Balance Sheet. The balance sheet shows the company’s financial position at a single point in time. It uses all asset and liability accounts from the trial balance and summarizes them. For example, a company may have one account for office supplies, another account for cleaning products, and so on. These accounts may be reported in one line item called “Other Assets.” The goal is to summarize the company’s financial position clearly so people inside and outside the company can make informed decisions.

Cash Flow Statement. The cash flow statement summarizes the inflows and outflows of cash during a given period. The report is typically broken out into cash flows from operating activities, investing activities, and financing activities. The cash balance at the beginning of the period plus or minus the cash flows from these three activities equals the current cash balance in the trial balance and on the balance sheet.

When the financial statements are completed, the accountant must close the appropriate accounts and prepare the post-closing trial balance. This is the final step in the accounting cycle. Revenue and expense accounts are not cumulated over time. In each accounting period, revenues and expenses must start at zero to correctly generate the income statement for the next period. Therefore, the accountant must enter reversing entries to transfer revenue and expense



account balances into owner’s equity. For example, if interest expense had a debit balance of \$500, an entry to credit interest expense and debit owner’s equity must be made. Once all closing balances are made, a post-closing trial balance is generated to ensure that the debits still equal the credits.

In the same way that individuals need money to survive, so does every business organization. From local schools and hospitals to the largest, richest corporations, all institutions base their daily decisions on their financial status. Can they afford to buy the new equipment they need? Will a decline in revenue force them to lay off employees? The decisions institutions make determine their success, and accounting and bookkeeping inform those decisions.

Computers play a key role in accounting.

Further Research

Association of Chartered Accountants in the United States.

www.acaus.org

Home page of the Association of Chartered

Accountants; site also features an international history of accounting practices.

Bean Counter

www.dwmbeancounter.com

This site offers educational resources on bookkeeping and accounting.

Chartered Accountants of Canada

www.cica.org

Home page of the Canadian association

— *Andréa Korb and David Korb*

Bankruptcy

When individuals and businesses get into financial difficulty, they sometimes file for bankruptcy. In the United States, bankruptcy proceedings are governed primarily by federal law and, to a lesser extent, by state law. The law allows debtors—both individuals and businesses—to seek relief from existing debts; the purpose of relief, when it is granted, is to enable debtors to get a fresh start. The law also provides for the quick, equitable distribution of debtors' assets among creditors when claims against debtors are sustained.

One of America's founding fathers, Benjamin Franklin, once remarked that creditors observe "set days and times" and expect to be paid at agreed-upon times. Traditionally, debtors were subjected to punishment, including debtors' prison and involuntary servitude, for not paying debts. Today's legal system does not follow a punitive philosophy in its approach to bankruptcy.

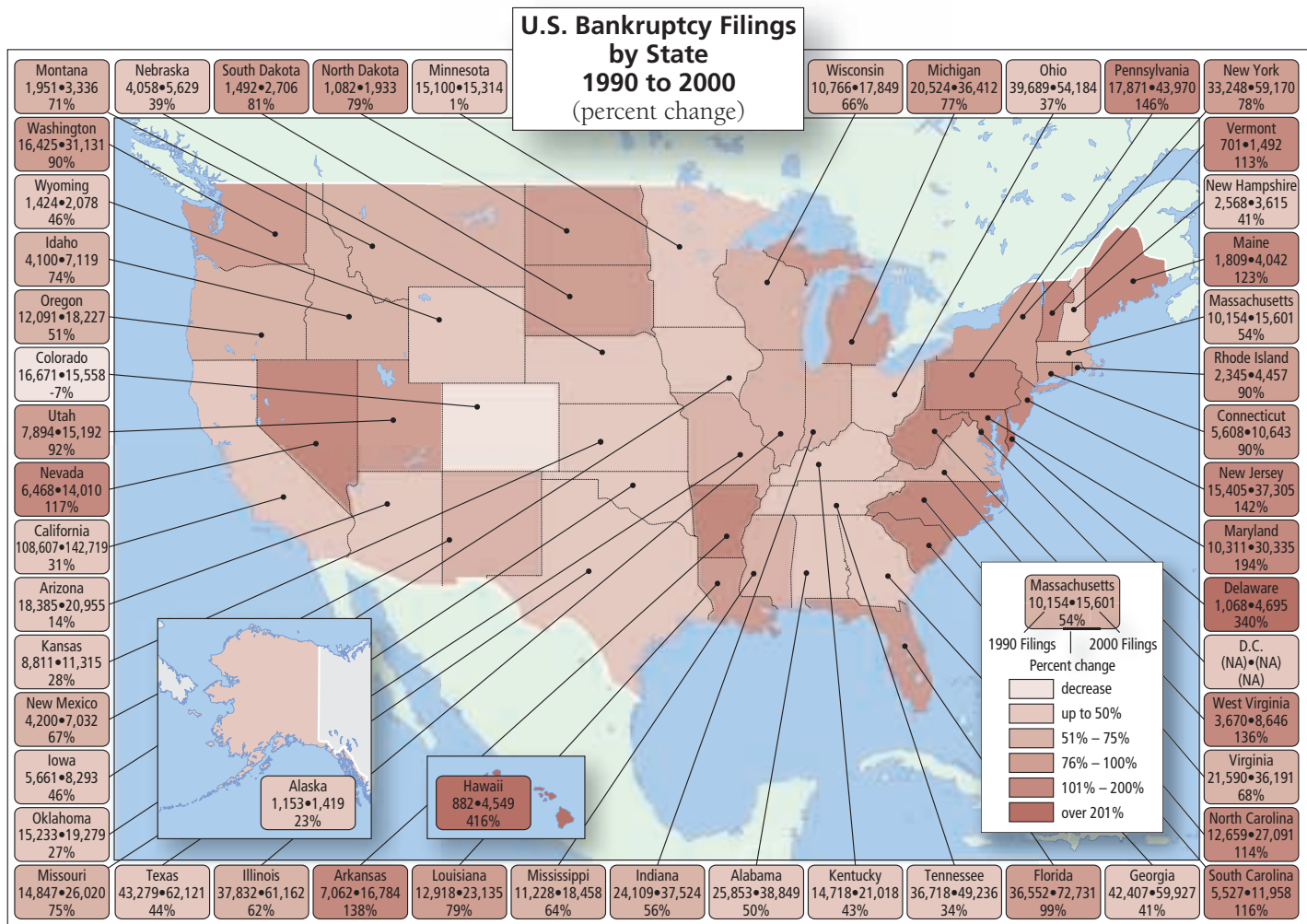
Bankruptcy Law in the United States

Federal bankruptcy law is contained in Title 11 of the U.S. Code. Chapter 7 provides for liquidation proceedings (the selling of various assets and the distribution of proceeds to creditors). Chapter 11 governs reorganizations. In reorganization cases, creditors usually look to the debtor's future earnings as a source for repayment, whereas in liquidation cases creditors look to the debtor's property. Chapter 12 (applying to family farms) and Chapter 13 (applying to individuals) provide for the adjustment of debts of parties with income; that is, these chapters provide for repayment plans.

Chapter 7 governs what is called straight (or ordinary) bankruptcy. In straight bankruptcy proceedings, debts are liquidated; the debtor's assets are sold and proceeds are distributed to creditors. The debtor may be an individual, a partnership, or a corporation. (Railroads, insurance firms, banks, savings and loans, and credit unions cannot be debtors under Chapter 7.)



An illustration of a debtors' prison in England; the origins of U.S. bankruptcy law were partly inspired by the harsh treatment of debtors in Europe.



Source: American Bankruptcy Institute.

Certain debts, however, are not dischargeable under Chapter 7; the debtor cannot be released from them even if he or she has filed for bankruptcy. These include debts arising from customs duties and taxes, alimony, maintenance, or child support awards, fraud, embezzlement, larceny, or violation of a fiduciary duty (for example, the duty a lawyer owes to a client). Certain consumer debts and cash advances are also nondischargeable.

An ordinary bankruptcy proceeding is initiated by the filing of a voluntary or an involuntary petition. More than 99 percent of all bankruptcy petitions are filed voluntarily. Any person who is a debtor may file a voluntary petition and need not be insolvent to do so. (Insolvency is a financial condition in which an individual is unable to pay his or her debts as they come due or a condition in which liabilities exceed assets.)

A voluntary petition results in an automatic stay (a court order that suspends creditors' claims until the issues have been resolved). The petition must include a list of all creditors, a list of all property owned by the debtor, a list of property claimed by the debtor to be exempt, and a statement of those assets considered necessary for a fresh start. Precisely what is exempt from claims of creditors depends on state law. To be official, a bankruptcy petition must be given under oath and signed by the debtor. Concealing assets or knowingly supplying false information in a bankruptcy petition is a crime.

An involuntary petition under Chapter 7 occurs when creditors force a person (or a business) into bankruptcy. An involuntary petition cannot be filed against a farmer, bank, insurance company, nonprofit corporation, railroad, or a person who owes less than \$10,775. If a debtor opposes an involuntary

petition, the court must hold a hearing. If the court finds that legal grounds for involuntary bankruptcy exist, the court will order relief on behalf of creditors.

Chapter 13 of the bankruptcy law provides for adjustment of debts (repayment plans) of an individual with regular income, under specified conditions. After a debtor completes all or nearly all payments under a Chapter 13 plan, the court will grant a discharge of all debts (except alimony and child support, student loans, criminal restitution and fines, and debts requiring payment over a period longer than that of the plan). Even if the debtor does not complete the plan, a hardship discharge may be granted under certain conditions—for example, if failure to complete the plan was caused by circumstances beyond the debtor's control.

Chapter 11 Bankruptcy

When corporations fall into deep debt, they often use a Chapter 11 reorganization pro-

ceeding. In 2001, America's second-largest corporation, Enron, filed for Chapter 11 reorganization. This ranked as the largest U.S. bankruptcy until September 2008, when Lehman Brothers Holdings, an investment bank, and Washington Mutual, a commercial and retail bank, both filed for bankruptcy; General Motors, with assets of \$91 billion, filed in 2009, the largest U.S. bankruptcy for an industrial company.

Chapter 11 reorganization allows debtors to restructure finances, the business to continue, and creditors to be paid. A bankruptcy case under Chapter 11 is started by the filing of a petition requesting an order for relief. Petitions may be voluntary or involuntary. A petition will result in a stay or suspension of creditors' actions against the debtor.

An individual or company filing for bankruptcy under Chapter 11 is usually allowed to operate as a debtor-in-possession (the debtor may continue to operate the business) unless a creditor or a party-in-interest (another party with a claim against the debtor) requests appointment of a trustee. A debtor-in-possession has 120 days after the order for relief to file a plan and 180 days to obtain acceptance before others can file a plan. After creditors have approved the plan, the court holds a hearing to confirm the approval, and the debts not provided for in the plan are discharged.

For many years, creditors have complained to Congress that current bankruptcy law permits debtors to avoid their debts too easily. Some of the more common objections are that debtors' homes receive too much protection, that businesses can stay too long in Chapter 11 reorganization, and that credit card debts are too easily discharged. By summer 2001, such complaints had generated strong support in Congress, and bills had been drafted to tighten bankruptcy procedures under Chapters 7 and 13. According to some proposed reforms, consumers also would have found discharging credit card debt more difficult. By the fall of 2001, however, leg-

**Largest U.S. Bankruptcies
1980 to 2008**

	Company	Bankruptcy Date	Total Assets Pre-Bankruptcy
1.	Lehman Brothers Holdings Inc.	09/15/08	\$691,063,000,000
2.	Washington Mutual, Inc.	09/26/08	\$327,913,000,000
3.	WorldCom, Inc.	07/21/02	\$103,914,000,000
4.	Enron Corp.	12/02/01	\$65,503,000,000
5.	Conseco, Inc.	12/17/02	\$61,392,000,000
6.	Pacific Gas and Electric Co.	04/06/01	\$36,152,000,000
7.	Texaco, Inc.	04/12/87	\$34,940,000,000
8.	Financial Corp. of America	09/09/88	\$33,864,000,000
9.	Refco Inc.	10/17/05	\$33,333,000,000
10.	IndyMac Bancorp, Inc.	07/31/08	\$32,734,000,000
11.	Global Crossing, Ltd.	01/28/02	\$30,185,000,000
12.	Bank of New England Corp.	01/07/91	\$29,773,000,000
13.	Lyondell Chemical Company	01/06/09	\$27,392,000,000
14.	Calpine Corporation	12/20/05	\$27,216,000,000
15.	New Century Financial Corp.	04/02/07	\$26,147,000,000
16.	UAL Corporation	12/09/02	\$25,197,000,000
17.	Delta Air Lines, Inc.	09/14/05	\$21,801,000,000
18.	Adelphia Communications Corp.	06/25/02	\$21,499,000,000

Source: BankruptcyData.com, New Generation Research, Inc., Boston, <http://www.BankruptcyData.com>



islaters were confronted with a steep downturn in the U.S. economy. As unemployment rates rose and business failures increased early in 2002, the movement for bankruptcy reform was eclipsed by congressional attention to issues of national security and proposals for stimulating economic recovery. However, in 2005, Congress passed the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005, a major reform of the bankruptcy system as it pertains to individuals. Among its measures, the new law required mandatory credit counseling and education and tightened eligibility for Chapter 7 filings.

Bankruptcy reform issues again surfaced after 2008 as both corporations and individuals were affected by the economic recession and bankruptcy rates rose. Legislators continue to examine how best

to reconcile the legitimate interests of creditors with the public's interest in fostering resilience on the part of debtors.

—Carl Pacini

An employee of the bankrupt Pan Am Airlines passes baggage loaders and machines headed for the auction block in 1992.

Web Resources on Bankruptcy

www.BankruptcyData.com is the premier business bankruptcy resource Web site. It provides access to updated information on business bankruptcy filings.

www.abiworld.org, the Web site of the American Bankruptcy Institute, is a great resource for information on bankruptcy.

www.swiggartagin.com/lawfind provides information on all legal aspects of bankruptcy; it is maintained by the Boston law firm Swiggart and Agin, LLC.

www.nacba.com is the home page of the National Association of Consumer Bankruptcy Attorneys, serving the needs of consumer bankruptcy attorneys and consumer debtors in bankruptcy.

www.bankruptcy-expert.com, a service of the Moran Law Group in California, provides information on personal and business bankruptcies.

www.hg.org/bankrpt.html is a useful research guide to every aspect of bankruptcy law.

Better Business Bureau

The Better Business Bureau (BBB) was created by businesspeople to police business practices. Its 125 local offices in the United States and Canada, usually incorporated as independent nonprofit businesses, gather information on local businesses, handle millions of consumer complaints and inquiries each year, and monitor local advertising. These efforts provide consumers with information; indirectly, BBBs regulate advertising and sales practices—a feat all the more impressive because the BBB operates as a voluntary association with little means to punish those who violate its guidelines.

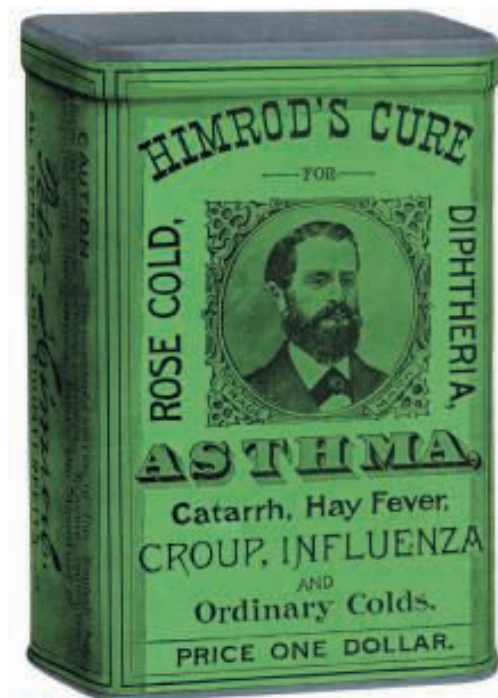
Local BBB offices in the United States are affiliated with the National Council of Better Business Bureaus. The council's National Advertising Division (NAD) monitors the accuracy of national advertisements. The council is a supporting member of the independent National Advertising Review Board (NARB), which examines advertiser appeals of NAD rulings.

Both locally and nationally, the BBB is supported by membership fees. Member

businesses agree to follow BBB guidelines. Such participation is strictly voluntary; attempts to force businesses to follow BBB guidelines have been struck down in U.S. courts as violations of antitrust law.

The BBB arose from the “truth in advertising” movement of the early twentieth century in the United States. At the turn of the nineteenth century, advertising claims made for some products were so outrageous that several magazines refused to carry any medical advertising. Advertising professionals, fearing that the entire industry's reputation would be sullied beyond repair, began to push for reform. In 1912, a New York City association of advertising professionals formed a vigilance committee. The 33-member committee began investigating complaints about misleading advertising, turning fraudulent ads over to law enforcement officials. Although the committee was established only to investigate advertising, the members quickly found themselves handling complaints by consumers about the sales practices of retailers. This experience prompted the Associated Advertising Clubs of America to establish a National Vigilance Committee later that year. In 1921 the National Better Business Bureau of the Associated Advertising Clubs of the World was incorporated, becoming an independent entity in 1926. In that year, the BBB had 45 local offices; by 1962 the number had increased to 122.

Although the BBB provides consumer information, it differs from consumer organizations in important ways. It focuses narrowly on good business practices rather than consumer protection (although the two goals sometimes overlap). Thus, the NAD and NARB focus on the accuracy of claims made in national advertising, but whether an advertisement aimed at adults is in good taste is outside the purview of either organization. In addition, while the BBB sometimes makes recommendations regarding consumer-protection legislation, it is not a lobbying organization and generally avoids drafting laws and trying to influence policy.



The BBB was created to protect consumers from fraudulent advertising like this nineteenth-century ad for Himrod's Cure, which promises to cure everything from hay fever to diphtheria.



James Bast, former president of the BBB, introduced the BBBOnline service, which helps customers evaluate businesses that advertise on the Internet.

The BBB also has no legal authority to regulate companies. It establishes guidelines for business practices but, unlike government agencies that issue regulations, has no way to enforce its guidelines. Occasionally a local BBB office will sue a business in court, but the main weapon in the BBB's arsenal is publicity. For example, if an advertisement is found by the NAD to be deceptive, the punishment imposed on the advertiser is simply that the division publishes a report of its findings. A local BBB office can also suspend the membership of a business that does not follow its guidelines; in such a case the office will usually issue a press release explaining its action to the local media, which tend to cover BBB suspensions and admonitions closely. These tactics often prove to be effective. Indeed, consumer organizations that strongly criticized the creation of the NAD and NARB in the early 1970s as simply a ploy by the advertising industry to avoid government regulation have largely dropped their opposition and now work with BBB organizations.

To preserve its influence, the BBB cultivates a reputation as an honest broker between businesses and consumers. Local offices have full-time staff and seek a wide range of business support to prevent them

from becoming beholden to a single company. Businesses and business associations sometimes charge the BBB with going overboard in its efforts to be impartial. The BBB has maintained its support within business circles, however, because it is seen as protective of legitimate businesses and as a workable alternative to government regulation.

Further Research

Better Business Bureau

www.bbb.org

This site features product and policy news as well as consumer and business guidance.

Better Business Bureau in Canada

www.cbccc.ca

The Canadian Council is the coordinating and licensing body for Canada.

—Mary Sisson

Basic Principles of Truth in Advertising

1. The primary responsibility for truthful and non-deceptive advertising rests with the advertiser. Advertisers should be prepared to substantiate any claims or offers made before publication or broadcast and, upon request, present such substantiation promptly to the advertising medium or the Better Business Bureau.
2. Advertisements which are untrue, misleading, deceptive, fraudulent, falsely disparaging of competitors, or insincere offers to sell, shall not be used.
3. An advertisement as a whole may be misleading although every sentence separately considered is literally true. Misrepresentation may result not only from direct statements but by omitting or obscuring a material fact.

—Better Business Bureau Code of Advertising