

JUST SAY “CHARGE IT”: THE USE OF CREDIT CARDS IN ENTREPRENEURIAL STARTUPS

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Abstract

This paper reviews the use of credit cards in small business startups and for everyday use by entrepreneurs. Credit cards, especially those classified as personal accounts, have become a surrogate for traditional sources of capital by bootstrappers. Indeed, the use of credit cards is among several methods entrepreneurs have adopted to launch businesses. The use of credit cards can be hazardous. On the other hand, some entrepreneurs have leveraged credit cards to create multimillion dollar businesses. Entrepreneurship educators and scholarly researchers should therefore acknowledge both bootstrapping and credit cards as the means by which most businesses are actually started and grown. Students must be trained to critically and creatively analyze every possible method by which they can possibly start, finance and operate a business.

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Introduction

Contemporary entrepreneurship courses, relying on popular textbooks, tend to emphasize (or at least include) writing a business plan. Indeed, Katz, Harshman and Dean (2000) observed that writing a business plan is “the sine qua non of modern entrepreneurship education” (p. 235). So far, so good—this paper raises no argument about the value of business planning, or with writing. The use of spell-check, correct grammar, and coherent thinking is also encouraged. However, the plot thickens. This paper does suggest that neither courses, nor authors who are involved in the development and writing of business plans should proceed under an assumption that “bankers, investors, and lawyers” (p. 235) are necessarily the target audience of that writing. A reality check would strongly suggest that most business startups rely on sources of startup capital besides that which arises from the coffers of bankers, investors, and lawyers.

Business plans have an internal function, and an external function (Hormozi, Sutton, McMinn and Lucio, 2002). According to guidelines from the U.S. Small Business Administration, SBA, in its publication (1993), *How to Write a Business Plan*, and despite any emphasis that courses may inculcate in the minds of students about traditional sources of capital through bankers and investors

There are two main purposes for writing a business plan. The first, and most important, is to serve as a guide during the life of your business. It is the blueprint of your business and will serve to keep you on the right track. To be of value, your plan must be kept current. If you spend the time to plan ahead, many pitfalls will be avoided and needless frustrations will be eliminated. Second, the business plan is a requirement if you are planning to seek loan funds. It will provide potential lenders with detailed information on all aspects of the company’s past and current operations and provide future projections. (pp. 2-3).

A textbook emphasis on- and business plans written for an audience of bankers and investors may be popular and appropriate for students at affluent institutions (Maddy, M. 2000). Venture

capitalists and angels do exist (Wirtz, 2001; Fried and Hisrich, 1995; Freear, Sohl and Wetzel, 1994), they just don't make themselves visible to the average undergraduate student by regularly frequenting classes at the average institution. In reality, even experienced business professionals, much less recently minted undergraduate students would probably better served by focusing their personal and business development efforts on learning more about bootstrapping (Van Auken, 2005; Van Auken, 2004; Roberts, 2003; Arora, 2002; Worrell, 2002; Winborg and Landstrom, 2001; McCune, 1999; Hyatt and Mamis, 1997; Van Auken and Neely, 1996; Mamis, 1995; Bhide, 1992; Mamis, 1992).

Overwhelmingly, startup entrepreneurs who do succeed in launching businesses do so by using other non-traditional methods for creating and launching businesses. Startups typically report a lack of access to venture capital and bank financing (Cole, Lahm, Little, and Seipel 2005; Van Auken and Neely, 2000). In keeping with this line of reasoning, this paper also argues in favor of increasing classroom emphasis on bootstrapping, and providing students with the skills to make progress with their ideas and create unique advantages (Brush, et al, 2001), despite a lack of traditional capital. Ingredients include picking the right type of business (one that is susceptible to low start-up costs), and understanding off-the-beaten track strategies such as, how to negotiate six months' free rent; how to enlist suppliers and customers as "champions" of the business; how others "do it," and the like.

The Widespread Use of Bootstrapping

Entrepreneurs typically rely on a variety of non-traditional methods to raise capital, or to otherwise mitigate some of their startup capital needs. In other words, the vast majority of all businesses are founded by individuals who employ bootstrapping as a means to launch their respective enterprises. Bootstrappers typically utilize methods such as bartering, sharing, negotiating, drop shipping, locating in low-cost facilities such as a home-based business (Pliagas, 2000), guerilla marketing (Levinson, 2005), and do-it-yourself (DIY). Relative to cash resources, business founders have leveraged credit cards (Detamore-Rodman, 2003; Anonymous, 2002; Deceglie, 1998), mortgaged homes, dipped into retirement funds, and used just about any other way to get their hands on operating funds including severance packages, negotiated supplier repayment terms, internally generated cash flow, and money from friends, relatives, or personal savings (Pliagas, 2005; Williams, 2005; Roberts, 2003; Mamis, 1992).

Bootstrapping is essentially a creative process (Mieszkowski, 2003; Arora, 2002; Freear, Sohl and Wetzel, 1995; Bhide, 1992). While it has been characterized as a creative financing method, which is true, that description doesn't necessarily convey the richness of the term. At an observable level, bootstrappers are saving money and building business revenues, sometimes starting from scratch or very modest beginnings (Fenn, 1999).

However, there is also a mindset (Lahm, 2005) on the part of these entrepreneurs who use "ingenuity and a lot of gumption" (Fenn, 1999, p. 43) to start their businesses. These individuals are sometimes characterized as driven (Longenecker, Moore and Petty, 2002), passionately committed zealots who take on their startup challenges as a personal quest. As a consequence, the businesses they create often exhibit remnants of earlier days (reflected in their organizational cultures), as illustrated by the following passage, which describes the beginnings and meteoric---internally financed---growth of The Pampered Chef:

Today “The Kitchen Store That Comes to Your Door” occupies a modern 220,000-square-foot brick warehouse and office in an industrial park outside Chicago, employs more than 400 full-time workers, and fills orders for a sales force of 20,000 part-timers. Behind an everyday desk in an unassuming second-floor office--cost-constraint remnants from her bootstrapping years--chief executive Christopher remains TPC’s master chef. And, never having financed growth beyond the company’s \$3,000 beginnings, she (together with her husband) owns every spoonful of the still-rising soufflé. (Mamis, 1995, p. 40).

The number of businesses that are founded through the use of bootstrapping is difficult to determine definitively. This is because small businesses may use both traditional sources of capital (particularly bank financing) in a mix, along with non-traditional sources (Shermach, 2004; Parchois, 2000). Further, some traditionally capitalized businesses no doubt have owners who may practice an observed behavior such as credit card use on behalf of his or her business, but that could be a matter of shopping convenience (Swain-King, 2004) as compared to the opposite end of the spectrum, wherein the credit card usage may represent a significant source of financing to the business. In addition, as mentioned above, besides tapping sources of capital, bootstrappers also employ specific methods. One thing is obvious, bootstrapping is the method most entrepreneurs to start the vast majority of businesses (Worrell, 2002). One estimate suggested that approximately 75 to 85 percent of startup businesses use some form of bootstrapping (McCune, 1999, p. 1).

Small Business Financing Patterns

Overview

Except as cited otherwise, data and statements in the following section are taken directly, or developed from the SBA (Office of Advocacy) report, *Financing Patterns of Small Firms: Findings from the 1998 Survey of Small Business Finance*; Office of Advocacy Web site FAQ’s (updated June, 2004); the Board of Governors of the Federal Reserve System (*Report to the Congress*, 2002); the National Federation of Independent Business (NFIB) *National Business Poll: Business Structure* (Dennis, 2004); and the U.S. Census Bureau (2002).

- Over 80 percent of the small businesses surveyed used some kind of credit and had outstanding debt on their books at the end of 1998.
- Fifty-five percent of small firms had some kind of traditional loan, while 71 percent obtained credit from non-traditional sources, mainly owners’ loans and credit cards.
- The most frequently used kinds of credit were personal and business credit cards, lines of credit, and vehicle loans.
- Forty-six percent of small firms used personal credit cards, 34 percent used business credit cards, and 28 percent used lines of credit.

- A large percent of the smallest firms were forced to use personal credit cards because of limited availability of loans and of business credit cards.
- Very small firms tend to use alternative sources because other sources of financing, which are usually cheaper, may be unavailable; these firms also appear to rely heavily on costly personal credit cards and owners' loans.
- The use of home equity lines for business purposes is an important source (although not be quantified by the SBA study).
- The use of owners' loans and personal credit cards leveled off or diminished as firm size increased.
- Owner loans are a very convenient source of financing and may be preferred for their simplicity.

Small Women-Owned Firms

Credit cards were the most often used kind of credit, with 48 percent and 29 percent of firms using personal and business credit cards, respectively.

1.3 million women-owned small businesses had \$110.3 billion in debt comprised of:

\$99.6 billion from the six traditional types of credit.

\$9.5 billion from owners.

\$1.2 billion in credit card debt.

The most important form of borrowing was mortgage loans, which accounted for 43 percent, and credit lines, which accounted for 22 percent.

As compared to men, many women entrepreneurs avoid the sale of equity in their businesses and "are more likely to rely on credit cards and personal loans" (Thomas, 2001, p. B.2). "Women are not only more likely to start their businesses on a shoestring but also more likely to operate on a shoestring" (Brush, et al, 2004, p. 59).

Small Minority-Owned and Hispanic-Origin Firms

Personal credit cards, business credit cards, and lines of credit were the most frequently used types of credit, with 46 percent, 29 percent, and 20 percent respectively.

773,000 minority-owned small businesses had \$59 billion in debt comprised of:

\$51.5 billion in the six traditional loan categories.

\$6.6 billion in loans from owners of partnerships and corporations.

\$990 million in credit card debt.

Minority- and Hispanic-owned firms' reliance on high-cost personal credit cards and owners' loans was heavier than that of all firms. This was especially the case for very small minority

firms. This seems to confirm the anecdotal complaints expressed by very small firms regarding the shortage of credit and the inefficient operation of the credit markets for these firms. Overall, the means to acquire capital through traditionally accepted sources is more limited for minority and women entrepreneurs (Brush, et al, 2004).

Very Small Firms

In its *National Business Poll: Business Structure*, the National Federation of Independent Business (NFIB) reported that approximately one-third of small businesses “employing nine or fewer people are located in the home” (Dennis, 2004, p. 5). The same report indicated that “59 percent of small (employing) businesses are owned by one individual (including his/her spouse if applicable)” and “twenty-seven (27) percent or over one in four have two owners” (p. 4). Hence, the NFIB’s data shows that 86 percent of small (employing) businesses have only one or two owners.

While the NFIB’s data set and that of the SBA are not formally related, it is important to note that most businesses are very small enterprises. The SBA’s data set distinguished very small businesses with no employees, and its report emphasized that these businesses are an important source of new business startups. According to the U.S. Census Bureau (Economic Census, 2002) most nonemployers “are self-employed individuals operating very small unincorporated businesses, which may or may not be the owner’s principal source of income.”

The Census Bureau uses Internal Revenue Service (IRS) data obtained from the annual business tax forms that are filed to identify nonemployer businesses. The Bureau’s 2002 nonemployer data (latest available) indicated that there are a total of 17,646,062 million nonemployers across all industry sectors, with \$770,032,328,000 in receipts. To place the number of nonemployer firms in perspective, 2001 Census data showed 5.7 million firms with employees and 17 million without employees (for a total of 23.7 million businesses). With or without employees, small businesses with less than 500 employees account for 99.7 percent of all businesses.

In Table 1, the SBA’s data shows that among all very small firms, which it also defined as those with zero employees (as did the Census Bureau), the number one type of credit used was personal credit cards (48.2 percent). If we multiply the two figures (number of nonemploying businesses times the percentage that use credit cards) together, we can estimate that approximately 8,505,402 million businesses, with zero employees across all industry sectors are using personal credit cards as a source of business capital.

TABLE 1
Very Small Firms with Zero Employees and Their Credit Sources

Credit Type or Supplier	All Small Firms	Minority-Owned Firms	Women-Owned Firms
Any Depository Institution	32.8	16.8	15.1
Commercial Bank	17.3	8.9	12.4
Finance Company	11.5	11.2	5.4
Leasing Company	2.5	1.7	1.9
Family and Friends	3.6	6.9	4.2
Owner Loans	0.2	1.1	0.5

Personal Credit Card	48.2	43.3	47.7
Business Credit Card	17.4	18.8	14.1
Line Credit	12.8	5.5	8.0
Mortgage	6.5	9.7	7.2
Vehicle	12.3	13.9	11.0
Very small firms, defined as those with zero employees. Data Source: SBA, <i>Financing Patterns of Small Firms: Findings from the 1998 Survey of Small Business Finance</i> , p. 19.			

It is well known among disgruntled business founders that banks can be difficult to deal with (if not impossible) when it comes to any discussions about startup capital for a new business (Van Auken and Neely, 1999; Van Auken and Carter, 1989). Most banks require an already established positive cash flow, three or more years in business, and good business as well as personal credit (Parchois, 2000). Thus, it is interesting to note that despite a reputation for being uncooperative with startups, the underlying source of capital that is being used by many businesses is still banks, except that they are lending, via plastic (Nixon, 1997).

Just Say “Charge It”

Credit Card Usage is Becoming More Popular

While 1998 SBA data above is already provocative, de Paula (2003), writing in *U.S. Banker*, cited more recent industry sponsored research. According to that later research, credit cards are becoming increasingly popular:

Of the 64 percent of small business owners who use plastic for business expenses, 57 percent use personal cards, with 33 percent using those personal cards exclusively and 24 percent using them in addition to small-business cards, according to research recently commissioned by MasterCard. The research also indicates that of those who use credit cards for business expenses, 42 percent use only small-business cards. Credit cards of all kinds are quickly gaining in popularity as a method of financing for small business owners, says Charles Ou, senior economist in the Small Business Administration’s Office of Advocacy. The SBA estimates increased credit card use may account for nearly all of the growth in its smallest loan category--micro-business loans--which are those under \$100,000. While other forms of micro-business loans haven’t risen much, micro-business lending through credit cards is up by 34.5 percent from \$7.9 billion in 2000 to \$10.7 billion in 2001. This far outpaces overall growth in micro-business loans, up only 4.4 percent from 2000 to 2001, for a total of \$126.8 billion. (p. 54).

According to Rosenfeld (1999), commercial loans enjoy a “hallowed reputation for respectability” (p. 1), however, “more and more small business owners are turning to credit cards for funding...because they are easy to come by and the credit limits are high” (Scully, 2002, p.1). De Paula further observed that banking industry executives see the market for small business credit cards “as a growth area, mainly because the personal credit card market is saturated and because business owners tend to spend more per month and carry higher annual balances than

the average consumer, promising higher fees and interest revenue” (p. 54). Another reason that banks have become more aggressive is that “statistical models prompted a major leap forward. They demonstrated a strong correlation between company principals’ repayment of personal debt, and the likelihood that a small business loan would be repaid, and made it easier to handle the risk.” (Kitchenman, 1999, p.37).

Upon opening the floodgates to market expansion, some banks found similarities between small business credit card users and regular consumers, as compared to large corporations (Cocheo, 1997). However, they also found that they were sometimes competing with themselves (i.e., internally) due to competing offers that are presented to the same consumer, for business and personal credit cards. Cocheo (1997) quoted Cynthia Gadberry, director of marketing, BancBoston, Small-Business Banking, who (in recognizing the problem for banks) asked, “Why would anyone pay a higher rate for a commercial product?” (p. 7). (As a sidebar, but one that is related, bootstrappers have long recognized that in many instances the same product or service, once it is identified as a commercial product as compared to a personal product, comes with a significantly higher price tag; accordingly, they use the “personal” version of whatever that product or service may be.)

Some evidence suggests that certain potential applicants for traditional business credit do not even bother to apply (Buttner and Rosen, 1992). Kon and Storey (2003) identified a subject group that they called discouraged borrowers, described as “good borrowers who do not apply for a bank loan because they feel they will be rejected” (p. 37). Other research pertaining to discriminatory lending practices has similarly identified individuals who did not apply, “because they believed their applications would have been turned down” (Cavalluzzo, K.S, Cavalluzzo, L.S. and Wolken, 2002, 641). Hence, it is obvious by now, disenfranchised applicants for traditional business credit may adopt the view that they should, “Just Say “Charge It.”

Multiple Credit Cards

Business founders have used multiple cards for startup funding. However, Selz (1994) reported that entrepreneurs were using credit cards both for startup capital, and to finance operating expenses. *Entrepreneur, Inc., The Wall Street Journal*, and others in the business press regularly feature stories about card-carrying, bootstrapping entrepreneurs. Often, the imagery surrounding the individuals who are highlighted portrays a heroic (if not swashbuckling) persona. An article featured in *Inc.* magazine concluded that despite the horror stories that result from the use of credit cards to finance new businesses, personal credit cards remain a fast, cheap, and easy way to obtain much needed start-up capital (Hise, 1998).

The *Wall Street Journal* reported that it was not unusual for individuals who were starting businesses to amass “myriad of credit cards for this purpose—possibly 14 or 15!” (McCue, 1999, p. 6). Increasingly, credit cards are becoming a financing tool of choice (Loftus, 2004). As Prince (2003), writing for *Entrepreneur* magazine, observed: “Good, old-fashioned plastic” is a source of capital that remains “plentiful even in tough times” (p. 1). The result has been twofold: some fallout in the banking industry, but also numerous success stories.

“Many people use multiple credit cards to finance fledgling or marginal business ventures, which can result in hefty card balances. Personal bankruptcies are soaring to record levels right now”

(Streeter, 1996, 15). Relative to success stories, they are both abundant and compelling. An entrepreneur may leverage multiple cards for a while, and then grow a multimillion dollar business (Scully, 2001). *Entrepreneur* magazine's November 2004 cover story article titled, *Young millionaires*, profiled one business founder who initially amassed \$50,000 in credit card debt; his company now has 55 stores with "sales topping \$30 million" (Kooser, Pennington, Riggs, Torres and Wilson, pg. 82).

Plastic: The Entrepreneur's New "Venture Capital Card"

In many ways, the banking industry has painted itself into a proverbial corner. On the one hand, it would like to service good-paying small business customers, and it sees the potential in those customers as they represent a new marketing opportunity (Vincent, 2000). Credit cards, after all, are in a sense a commodity. It was not all that long ago that the banking industry knew virtually nothing about marketing or customer service. Consultants could teach basic skills such as, greet the customer as he or she enters the lobby, and their advice was considered cutting-edge. On the other hand, bankers, as debt based and not equity-based lenders thrive on security, literally. As a consequence of these conditions, some entrepreneurs have created a de facto "venture capital card" (Nixon, B.(1997, p. 33):

Another option for entrepreneurs seeking financing for a start-up venture is credit cards. Although difficult to measure, bankers concede that it is happening....Many entrepreneurs perceive that the process of obtaining a commercial loan from a bank is too difficult, or that it would ultimately be a vain effort. In some respects, this perception is not far off the mark. "In a typical small business banking environment, you start to measure capacity to repay and other factors relating to the five C's of credit....A credit card, or multiple credit cards, can be obtained over the telephone or through the mail, although the interest rate likely is higher. The bottom line for the entrepreneur is that this source of credit is easier to tap. "Some [credit card issuers] just give you the mirror test"...."They hold a mirror up to your face and if you're breathing, you get a card." In such instances, credit cards are serving as a substitute for venture capital. The possible problem for the banking industry, and credit card issuers in particular, is that when a consumer credit card becomes a business credit card, or when a home equity loan is used to establish a business venture, the risk profile of the credit product changes. Another issue: Credit card issuers and home equity lenders typically don't ask what the proceeds of these loan products will be used for and how they will be repaid. (p. 33).

In the final analysis, it is standard practice for thousands of entrepreneurs to use their personal credit cards to provide initial capitalization (Hise, 1998). They serve as a possible, if not highly likely substitute for traditional capital.

Conclusion

This paper has reviewed the use of credit cards in small business startups and for everyday use by entrepreneurs. Credit cards, especially those classified as personal accounts, have become a surrogate for traditional sources of capital by bootstrappers. Indeed, the use of credit cards is

among several methods entrepreneurs have adopted to launch businesses. While the banking industry and the federal government (Board of Governors of the Federal Reserve, Report to the Congress, 2002) have both expressed concern, banking industry executives recognize, and are actively pursuing credit card marketing efforts to small businesses. The process for acquiring traditional capital does perform a screening function by identifying business startups that do not have sufficient assets to guarantee debt repayment. However, many startups, having no tangible assets to report, cannot meet this test; all they have is the strength of an idea and whatever other skills, knowledge, and abilities they may bring to the table. As observed by Nixon (1997), even Bill Gates would have been told “sorry” (p. 31).

The use of credit cards can be hazardous, and bankruptcies have been on the rise in recent years. On the other hand, some entrepreneurs, having been thwarted in their efforts to obtain traditional capital, have leveraged credit cards to create multimillion dollar businesses. Entrepreneurship educators and scholarly researchers should therefore acknowledge both bootstrapping and credit cards as the means by which most businesses are actually started and grown. To insist that students write business plans under the assumption that investors, bankers, and angels will necessarily comprise the audience for their writing (and converge to offer salvation) suggests a teaching strategy that is totally out of step with the realities of launching a business that the vast majority of students will ultimately face. Students must be trained to critically and creatively analyze every possible method by which they can possibly start, finance and operate a business.

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