How to Organize and Run a Small Business

How to Organize and Run a Small Business

Course Description

This course is a primer for aspiring small business owners and entrepreneurs. The course explores step-by-step procedures necessary to set up and manage a small business. Topics include the development of a business plan, market entry strategies, organization and management, financing, internet marketing, software, and critical factors for small business owners and entrepreneurs.

Field of Study	Business Management and Organization
Level of Knowledge	Basic
Prerequisite	Basic Math
Advanced Preparation	None

Table of Contents

Section 1: Getting Started 1

Learning Objectives: 1

Introduction 1

Types of Businesses 3

Other Information Sources 9

Buying an Existing Business 10

Determining How Much to Pay for the Business 12

Get Started 14

Business Location 15

Developing a Business Plan 18

Components of the Business Plan 21

Section 2: Debt and Equity Financing 25

Learning Objectives: 25

Financing Options and Strategies for Small Businesses 25

Debt Financing 28

Equity Financing 33

Leasing Instead of Purchasing 35

Section 3: Managing Financial Assets 36

Learning Objectives: 36

Working Capital 36

Cash Management 37

Inventory Management and Control 39

Credit and Collection Policy 41

Section 4: Legal Considerations 45

Learning Objectives: 45

Deciding upon a Legal Structure for the Business 45

Legal Contracts 49

Business Licenses 50

Obtaining a Patent, Trademark, or Copyright 50

Protecting Against Criminal Acts 52

Section 5: Accounting, Cost, and Financial Analysis 55

Learning Objectives: 55

Internal Controls 55

Accounting Records 57

Financial Statements 59

Financial Statement Analysis 61

Budgeting 64

Costs of a Business 66

Cost Analysis 70

Are You Breaking Even? 71

Choosing the Fiscal Year 74

Section 6: Taxes 75

Learning Objectives: 75

Individual and Partnership Income Taxes 75

Corporate Taxes 76

Subchapter S Corporation and Limited Liability Corporation 78

Payroll Recordkeeping and Taxes 79

Sales Tax and Other Small-Business Taxes 80

Section 7: Marketing 82

Learning Objectives: 82

Marketing Research and Planning 82

Product Introduction 84

Advertising, Internet Marketing, Networking and Social Media Marketing 85

Sales Force 88

Pricing 90

Packaging 92

Trade Shows 93

Section 8: Operations 94

Learning Objectives: 94

Managing the Business 94

Insurance 96

Important Records 100

Computerizing the Small Business 101

Section 9: Managing Human Resources 104

Learning Objectives: 104

The Recruitment Process 104

Management of Employees 106

Contracting Out Services 107

Glossary 108

Index 116

Section 1:

Getting Started

Learning Objectives:

After studying this section, you will be able to:

- Recognize the advantages and requirements of different business organizations.
- Identify factors to consider when buying an existing business.
- Recognize methods for determining how much to pay for a business.
- Identify important factors for selecting a new business location.
- Recognize the key sections of a business plan and how it can be used.

Introduction

An entrepreneur is one who generally owns, manages, organizes, and assumes the risk of a business. The entrepreneur starts a business because he or she believes they have a product or service that customers want or need.

The Small Business Administration (SBA) Office of Advocacy defines a small business as one that is independently owned, is locally operated, is not dominant in its field of operation, and has fewer than 500 employees.

There are just over 30 million small businesses in the U.S., and more than 99 percent of American businesses are considered small. Small businesses employ approximately 49% of the employees in the U.S. Of course, many of today's giant companies began as small businesses.

Before starting a new business, ask some tough questions, including: Who are the competitors, and can I outperform them? What are the downside risks? What is the trend in the industry? How does the economy look? Can I raise the necessary funds? Why is my product or service better than the competition's? Do I really know how to run a successful business?

At the very beginning, get competent professional advice from an attorney and an accountant. You want them to advise you on what to do and what not to do. An attorney will know how to form the business legally and how to protect you from possible lawsuits. An accountant is generally needed to set up the books and handle recordkeeping and tax matters. Once the books are set up, you will be able to assess your financial position and take corrective steps as needed to “stay on course”.

Depending on whose statistics you follow, between 50 and 90 percent of new businesses fail within the first couple of years. Why? There are a number of different possibilities, including lack of adequate capital, failure to keep track of the money, deficient recordkeeping, poor internal control, inadequate understanding of the competition, mismanagement of business affairs, poor organization, and lack of knowledge of the features and prices of the products and/or services offered.

To properly manage money, you must know where the cash inflow is coming from and how dependable it is as well as the amount and timing of cash outflows. Is revenue stable? What are the sources of capital? How difficult will it be to raise additional funds? You have to know in advance, what the expenses will be, when these expenses must be paid, and whether the expenses are reasonable. You must also know the amounts of debt that need to be repaid and when the payments are due. You must make allowance for unexpected contingencies, or you may find yourself short of cash. You must constantly do your homework when it comes to finances!

Remember the four principles of running a small business, often called the Four Ps:

- Be **passionate** about what you do.
- Realize that **people**—both employees and customers—are the backbone of your business.
- Make each customer interaction **personal**.
- Serve a great **product** or perform an outstanding service.

How important are small businesses to the U.S. economy?

The SBA Office of Advocacy defines a small business as one with less than 500 employees.

Small firms:

- Represent 99.7 percent of all employer firms.
- Employ almost half of all private-sector employees.
- Pay more than 40 percent of total U.S. private payroll.
- Have generated 60 to 80 percent of net new jobs annually over the last decade.
- Create more than 50 percent of nonfarm private gross domestic product (GDP).
- Supplied more than 23 percent of the total value of federal prime contracts in FY 2019.
- Produce 13 to 14 times more patents per employee than large patenting firms. These patents are twice as likely as large firm patents to be among the one percent most cited.
- Are employers of 37 percent of high tech workers (such as scientists, engineers, and computer workers).
- Are 52 percent home-based and 2 percent franchises.
- Made up 98 percent of all identified exporters and produced over 33 percent of the known export value.

Sources: U.S. Bureau of the Census; Advocacy-funded research by Joel Popkin and Company (Research Summary #211); Federal Procurement Data System; Advocacy-funded research by CHI Research, Inc. (Research Summary

#225); Bureau of Labor Statistics, Current Population Survey; U.S. Department of Commerce, International Trade Administration.

How many new jobs do small firms create?

From 2000 to 2018 small businesses accounted for 64.9% of net new jobs. (Source: SBA Office of Advocacy/Business Employment Dynamics, Bureau of Labor Statistics.)

Types of Businesses

Franchises

A franchise is a license to sell a product or service within a certain territory. Many types of franchise businesses exist, including restaurants, travel agencies, and recreation services; examples include Dunkin' Donuts, McDonalds, and Baskin-Robbins. Franchises are advertised extensively on the internet through sites such as www.franchiseforsale.com and www.franchiseopportunities.com and there are ads for franchises in daily new sources such as The New York Times and The Wall Street Journal. Overall, nearly 3% of all firms are franchises.

With a franchise, an owner can run a small business but have the advantages of a big business by leveraging the franchisor's reputable name, product, or service. The probability of success with a franchise is higher than if you start from scratch.

Before entering into a franchise agreement, inquire about the franchisor at the Better Business Bureau, local bank, and Chamber of Commerce. Also, consider how many competing franchises already exist.

The initial franchise fee, covering training, marketing assistance, product research, and recordkeeping, may be as low as $5,000 and as high as several million dollars, depending on the reputation of the franchisor. You will also generally receive a support system and discount prices on supplies. Further, royalty payments based on sales levels are typically due to the franchisor and there may also be fees for advertising and promotion. The total costs can be significant, resulting in lower profit margins compared to those of independently-owned businesses.

In deciding upon a particular type of franchise, select an industry that you are comfortable with. Are you professionally and personally right for that type of franchise? You should consider product life cycle, growth rate, product demand, and demographics. Select a mature or growing industry, not a declining one.

Contact the franchisor you are interested in directly or use a franchise broker. You may contact the International Franchising Association (www.franchise.org), who puts together deals and offers advice for more information. A good source listing the names, addresses, and all needed information about franchisors is www.sba.gov/sba-franchise-directory.

Before entering into a contract, obtain preliminary information from the franchisor. The Federal Trade Commission Franchise Rule requires all franchisors to furnish you with the names and addresses of a minimum of ten franchisees closest in proximity to you. Contact franchisees to obtain their opinions of the franchisor and other information regarding the franchise's operations. Further, under the Federal Trade Commission (FTC) rules, the franchisor or franchise broker must provide a prospective franchisee with a disclosure statement that addresses 23 specific items, including particulars about the franchisor, at least 14 days prior to:

- Franchisee making any payment to franchisor in connection with the proposed sale of the franchise or
- Franchisee executing the contract

The FTC law also requires the following:

- The franchisor must give the prospective franchisee an earnings claim document if the franchisor makes any statements as to the return a buyer may expect. This earnings claim document must be updated every 90 days for actual income statistics. The franchisor has civil liability for any misstatements.
- The franchisor must give the franchisee a copy of the agreement at least five days before the contract is to be executed.

The disclosure document should contain the following information:

- Name and address of franchisor.
- Criminal and civil actions against the franchisor.
- Background of chief executives.
- Franchisor's financial statements for the prior three years.
- Previous statistics of franchises, including the number of operations, number terminated by either party, and renewals refused.
- Payment terms, including initial and other fees.
- Description of product line and market.
- Life of franchise.
- Termination and cancellation clauses.
- Restrictions placed on franchisee, including territorial restrictions, equipment to be used and products to be sold.
- Duties of franchisee.
- Nature and cost of training.
- Financing arrangements including interest rate and collateral.

The ownership agreement with the franchise varies; the franchisee may or may not own the property. The percentage of sales the franchisee must remit to the franchisor may also vary.

Consult with your attorney and accountant in appraising all aspects of the franchise arrangement.

Service Business

A service business's major source of revenue is the fees it charges for services rendered to consumers; typically service businesses include specialized repair and maintenance services, home and health services, beauty parlors, dry cleaning establishments, leisure facilities, accounting and tax services, and financial advice firms (e.g., brokerages). The success of the business depends on the owner's and employees' skills. Service businesses typically do not have significant investments in fixed assets.

Once you have assessed your skills, chosen the service(s) to offer, registered your business, and ensured you are in compliance with all the federal and local regulations affecting the business including minimum wage, fair employment, safety and hazard, pension rights regulations, you ready to accept customers. Prior to your official opening date, consider listing your business in the local online search directories and be sure to create a website and social media posts that introduce your service and offer an incentive to motivate customers to contract for your services. Examples of incentives are free initial office consultations or a free oil changes.

In a service business, personal recommendations are the best source of customers so make sure you do quality work at reasonable prices, offering guarantees when appropriate, so your customers will be satisfied and recommend your services to others. Always be honest and open with your customers and avoid using high-pressure tactics.

Retail Stores

A small retail store cannot compete with chain retailers in terms of variety, price, and cost control. The small retailer should concentrate on offering unique goods, an attractive shopping environment, and personal service. You can specialize, giving your business a niche in the market; customers going to small retail stores may be looking for merchandise or services not usually found in a chain store. Cater to customer tastes and have convenient hours; express appreciation to your customers for their business. Any customer complaints should be handled immediately and appropriate credit given. Good payment terms should be given to good customers. Be candid with customers by recommending a lower-priced item, for example, that will do the job at least as well as a higher-priced item, instilling loyalty and increasing the likelihood of repeat customers and referrals. Perhaps you can offer a longer warranty period than competitors and repair services for a greater range of problems.

The sales staff should be sincere, well informed, and properly dressed. The customer should always be given the benefit of the doubt.

The store parking lot should be easy to enter and leave, especially when competitive stores exist nearby (e.g., three gas stations in close proximity). Customers do not like to wait in cars.

If there is competition in the immediate vicinity, you should offer better selections, carry higher-priced or lower-priced product lines depending on the situation, provide higher quality goods and services, and have more attractive displays.

Stock brand name and private brand merchandise. Brand name items typically generate a higher profit margin.

Signs and show windows should give some clue as to the prices and types of merchandise or services available. Window displays should be attractive and informative.

Staple items should be put in the rear of the store and impulse items should be placed in the front of the store. Customers will be attracted to the impulse items on their way to buy the staples.

Try to balance the size of the departments in the store. Space in one department should not be disproportionately larger than others unless that department is expected to generate significant sales volume, requiring more goods to be available on the sales floor, or the size of the product requires more space. Locate departments selling bulky items with low sales volume in the rear of the store and departments with high margin items in the front of the store.

Send reminders to customers for their next scheduled appointment for services such as car maintenance and carpet cleaning.

There are tricks of the trade for certain types of retail stores. For example, in a clothing store, fitting rooms should be private, well lit, and mirrored. In a restaurant, patrons want cleanliness and privacy.

Wholesalers

A wholesaler acts as an intermediary between manufacturers and retailers. The majority of wholesale firms purchase materials in large quantities, warehouse them, break them down into small shipments, and distribute them. Wholesalers must respond quickly and accurately to retail orders to keep loyalty.

A wholesaler should know what to stock, where to cut costs, how to price merchandise, how to advertise and market, what product lines and fads are developing, what geographic territory to serve, how to use credit wisely, what records to keep, and how to identify and monitor excessive inventory and potential shortages of goods. A wholesaler can provide valuable information to retailers on running their businesses in areas such as pricing, selling, kind and quantity of inventory to maintain, selecting equipment, financing, and deciding upon a suitable location. An aggressive wholesaler may provide financial assistance by giving the retailer initial stock on extended credit terms.

Inventory management is crucial. High turnover is important in controlling the obsolescence of goods and storage costs; slow-moving items have to be identified and handled.

Inventory control may be maintained by (1) observation, (2) periodic stock count, and (3) perpetual recordkeeping. Ideally, the inventory control system measures the actual amount of stock on hand of each item, its value, amount sold, and amount purchased. Since the observation method relies on judgment and memory, it is not a good method to use. The stock count method is a periodic count providing an indicator of the rate of movement and the quantity on hand. It provides a record of experience with the item; however, it is susceptible to possible error. A perpetual inventory record is a daily record of inventory balances, including purchases, receipts, sales, and returns. Physical inventory is compared to book inventory, and any discrepancies are noted. Good inventory control will help to minimize thefts and significantly reduce the amount of slow-moving or obsolete merchandise.

Profit and loss should be determined by customer, commodity, brand, department, and territory. Larger order sizes generally reduce credit, delivery, and selling costs.

A successful wholesaler provides unique, superior, and profitable items. The wholesaler must sell goods to retailers at reasonable prices so the retailers can resell them at competitive prices. The wholesaler may take back goods the retailer cannot sell.

A good layout is needed in the warehouse to be cost-effective. Receiving, stocking, order picking, order assembly, and shipping functions should be organized. In stocking, it should be easy to perform storage, replenishment, locating, and retrieving.

You must know your costs by item and monitor them on a regular basis. What are the industry norms for the costs? Are your costs high, low, or average? Why? Is there anything you can do to lower your costs?

It is important to have sound territorial management. If you have too many locations, your costs may be excessive in relation to the volume of orders you obtain. If you do not have enough locations, you may lose sales you could have had and/or incur higher delivery costs. Profitability should be determined by territory, considering selling and delivery costs. Before entering a new territory, evaluate the degree of competition and determine your ability to effectively compete.

An effective cost control system is needed which can help minimize transportation costs. Perhaps you can share distribution centers with another wholesaler. It may be cheaper to contract delivery outside than to buy and use your own trucks. For instance, UPS will offer warehousing and delivery logistics.

A wholesaler should try to keep a retailer from bankruptcy due to financial problems by extending the repayment period or easing credit terms, if feasible.

Computers software will help order processing, recordkeeping, and inventory maintenance in order to speed up the flow at low cost with minimal errors.

Mail-Order and Online Businesses

Many consumers buy from catalogs and online to save time and money. Printed or online catalogs allow consumers to buy many products in a leisurely atmosphere. To identify items available from suppliers that you may wish to include in your business catalog, refer to online domestic directories like ThomasNet (www.thomasnet.com), MFG (www.mfg.com), or Kompass (www.kompass.com). Online overseas directories include Alibaba (www.alibaba.com), AliExpress (www.aliexpress.com), and IndiaMart (www.indiamart.com). The Association of National Advertisers, (www.ana.net), has information on direct sales via mail-order or online.

You have to decide whether the type of products you wish to sell are suitable for mail-order and online sales. If the products spoil easily, mail order or online may not be suitable. What is the survivability in physical terms? The products must be sold in sufficient quantity to justify the costs of selling them; advertising, both in print and online, can be very costly.

The mail-order/online business can deal only with a manufacturer who will deliver the merchandise on time. Purchases should be made directly from the manufacturer to avoid the middleman's profit; product selection must be made carefully to meet demand and ensure quality and ample supply. The product line must be flexible to meet competitive pressures.

Is the market a general population or a segment thereof? Is the market national, regional, or local? Try to get the manufacturer to give you exclusive territorial rights.

You will generally achieve greater sales if you offer merchandise on installment terms or provide a discount to customers who make immediate payment in full.

Give customers the option of faster delivery at an extra charge. In any event, try to send out the merchandise quickly. If there is a delay, notify your customer, monitor the order closely, and consider providing the customer the option of canceling the order. According to FTC rules, a customer may cancel any order not received through the mail within 30 days of the order. If you do not fill the order, customers may complain to the FTC or to the state's attorney general, prompting an investigation.

Damaged goods should be replaced immediately. If a dispute arises, generally assume the customer is right; give an immediate refund if the customer requests it unless it is clear that the customer was responsible for the damage.

It is against FTC rules to make misleading "free" offers, to substitute one product for another without permission, to fail to give refunds, and to use questionable collection practices. You should make sure your advertisements clearly describe what the products are in order to minimize returns. Returns may cause bad will, along with extra handling and postage charges.

In direct mail and online, you create advertisements for consumers who are likely to order the product. Your mailing and email lists may include those customers who have bought from you before. Sometimes, mailing lists are purchased; or you may obtain a listing of mailing list houses from the SBA or other organizations so you can select which ones to use. You may rent a mailing list through a broker; however, an additional charge typically applies each time you use it. Sometimes, competitors may exchange lists. However, keep in mind, the quality of a mailing list or an email list will vary significantly. Many purchased lists will include old, out-of-date information. The highest quality lists are those you develop yourself from loyal customers or potential customers who agreed to join your list.

If you send out direct mail as an advertisement, which is still very common, the mail-order package should typically include a sales letter, circular, order form, and business reply envelope. An 800-telephone number should be included along with the web address and an online ordering option.

Ads may be placed in standard media like newspapers and magazines that your target audience is likely to read, or on the internet and targeted through keyword search or in display ads. Try to convince buyers that your product is better in price, quality, or status than the competition. For effective ads, the more interesting the ad, the greater the likelihood of making a sale; both print and web advertising is about capturing attention and providing information. Your ad could have a full description of the merchandise, or it may just be a teaser ad to convince folks to visit your website.

CAUTION: You are legally liable for any false or misleading information about the merchandise. If you employ an advertising agency, make sure it is not also retained by your major competitors.

Check for possible problems with your product with the FTC, Food and Drug Administration, Better Business Bureau, or postal authorities. Consult an attorney about possible product liability problems and take out proper insurance.

Tips for trimming shipping and mailing costs are available on the USPS site -- Pricing Resources for Businesses (https://www.usps.com/business/prices.htm). You may also want to check if you will save time and money by using a private mailing service, such as United Parcel Service.

The internet brings your business into your customer's home or office and can directly interface with your point of sale (POS) system which helps maintain your system totals and receive orders in real-time. Increasing your presence on the internet is a key to success in today's competitive environment. There is no better way to expand your presence and your bottom line than by adding online capabilities to your retail business or connecting with customers through internet marketing.

Other Information Sources

Owning and running a business is a continuous learning process. Research your idea and do as much as you can yourself, but don't hesitate to seek help from people who can tell you what you need to know.

Service Corps of Retired Executives (SCORE), a nationwide volunteer organization of retired business executives and professionals, is a good place to start. Information and assistance are also available from trade associations, Chambers of Commerce, community colleges, universities, and Small Business Development Centers.

Make it your business to know what business information is available, where to get it, and, most importantly, how to use it. Sources of information include:

U.S. Small Business Administration (SBA):

- SBA District Offices
- Small Business Development Centers (SBDCs)
- Service Corps of Retired Executives (SCORE)
- Small Business Institutes (SBIs)

Consult the websites provided by your local SBA office or call the Small Business Answer Desk at 1-800-368-5855, for information on any of the above resources.

You may request a free copy of the SBA's Directory of Business Development Publications from your local SBA office or the Answer Desk. SBA has a library of over 100 business publications that sell for a nominal fee.

The federal government's Web portal – www.usa.gov/business?source=busa – makes it easier for businesses to find information about taxes, immigration laws, workplace safety, environmental requirements, and other regulations. The information can help small business owners avoid costly mistakes and improve compliance with regulations.

Also check out:

- State Economic Development Agencies

- Chambers of Commerce
- Local Colleges
- Libraries
- Manufacturers and suppliers of small business technologies and products

Buying an Existing Business

In deciding if it pays to purchase an already established business, there are many things to consider. One of the first things you should do is visit the business and observe such aspects as location, appearance, and clientele. You should also request background information about the business, including a list of customers and financial statements. Why is the owner really selling? Are there any issues? If so, what are they? The reason given for selling the business may not be the actual reason, so you will have to be a detective. Is revenue down? If so, why? Is there increased competition? If so, what are the details? Have there been product liability issues, lawsuits, previous bankruptcies or other legal problems? Are there cash flow issues including the owner failing to make timely payments?

Do your homework by researching the company on the internet, reviewing the company's websites, and speaking with others including businesspeople in the area, customers, current and former employees, and trade association staff. Ask for bank references and contact the Better Business Bureau for previous complaints. Also, obtain a report on the company from Dun and Bradstreet. Additionally, you should consider performing internet searches regarding the company and reviewing any of the business's websites. The last thing you need is a lemon.

You will want to learn about, and analyze, the following before making your decision:

1. *Sales and Net Income.* Project future revenue and earnings. Prior and current years' figures may serve as a benchmark. Ask for copies of the financial statements and tax returns. Compute relevant ratios, such as the profit margin (net income/sales). Make sure to retain a certified public accountant (CPA) to review and audit the records for correctness. For example, are expense/sales ratios in line with expectations? If the potential seller refuses to provide important records, a red light should go on in your mind.

   Note: The further into the future you project financial figures, the less reliable they are because of economic uncertainties. Typically, do not forecast more than five years ahead.

   What can you do to improve the financial condition of the business? Besides retaining a CPA, seek the professional advice of an attorney, an insurance agent, and a banker.

2. *Accounts Receivable.* Age the accounts receivable to assess possible uncollectibility. Is the customer base concentrated or diversified? Is the credit policy too liberal or stringent? Which customers are likely to stay with you if you buy the business?

3. *Inventory.* Observe the inventory, and have it appraised. What is its condition and salability? Can you get the going rate for the merchandise?

4. *Goodwill.* Does the business have a good name? Will the seller's leaving have an adverse effect and if so, to what degree?

5. *Proprietary Items.* Are proprietary items (e.g., patents) worth anything? If so, can you keep them?

6. *Building, Equipment, and Furniture.* What is the condition and age of the capital assets? What are they worth? What would the cost be to replace old assets? Do you have to modify the equipment to make it suitable for your own use?

7. *Liabilities.* Are there any liabilities, such as unpaid bills, pending litigation, or back taxes that have been incurred that you will be responsible? If so, how much are they? Seek the advice of a CPA and an attorney. Your purchase contract should stipulate that any claims against the business before you took ownership are the responsibility of the seller.

8. *Budget.* Prepare a budget of future sales, expenses, and profits.

9. *Cost Control.* Are current costs "fat"? Can you cut costs to reduce areas of inefficiency?

10. *Contracts.* Are there favorable contracts (e.g., low rental leases, low-interest-rate mortgages) that may be transferred to you? When do the contracts end? What are the renewal terms?

11. *Suppliers.* Are suppliers reliable, or is a change needed?

12. *Quality control.* Can you improve the quality of the product?

13. *Product and/or Service Market.* Is the market for the product and/or service expanding, stable, or declining?

14. *Legal Requirements.* Will you, as the new owner be required to obtain certain permits and licenses? Is so, what kind? An attorney should be consulted.

15. *Customer Lists.* If it is a mail order or online business, will you own the customer mailing list after you buy the business?

16. *Major Personnel.* Will key personnel remain after you buy the business?

17. *Production Efficiencies.* Can you correct current production inefficiencies and reduce manufacturing costs, perhaps by buying up-to-date equipment?

18. *Franchises.* Will you have the exclusive franchise in the area, and what are the contractual terms?

19. *Unique Situations.* Perhaps the prospective seller has done well because of unique reasons (e.g., race, religion). If you do not have this same background, you may run into problems.

20. *Seller Cooperation.* Will the seller provide consultation for a reasonable period of time when you take over? Will the seller introduce you to the major customers and suppliers? Have the seller sign a non-compete agreement so customers may not move to him or her for a period of time after the sale.

Determining How Much to Pay for the Business

Basically, a business is worth what someone is willing to pay. In determining the value of a business prior to purchase, consider the type of business and its major activities, industry conditions, competition, marketing requirements, management possibilities, risk factors, earning potential, and financial health.

The most common valuation approaches are based on earnings or assets. Under the earnings approach, adjusted average net income may be capitalized at an appropriate multiple; with the assets approach, hard assets (such as inventory and equipment) are valued at fair (i.e., appraised) market value. The sales price of comparable businesses in the industry may also provide useful norms. The idea is to establish the target company's value based on actual sales of other companies that are indicative of the target company's current value.

Still another way to arrive at a business's value is "opportunity value." Many businesses could make a lot more if they were running perfectly. If a potential buyer believes there is an opportunity to increase earnings by improving management, then they might pay a higher price than they would have based on a strict earnings or assets valuation calculation.

Following is additional detail for some of the most common valuation approaches/methods:

Valuation Based on Earnings. Net income should be multiplied by a profit multiplier that is typical for the industry to approximate the company's value. The multiplier should generally be higher for a low-risk business and lower for a high-risk one. For example, the multiplier for a high-risk business may be 1 while that for a low-risk business may be 3. A five-year average adjusted historical earnings figure, calculated using the five most recent periods, is typically representative of the company's earning power. The computation follows:

Average Adjusted Earnings (5 years) x Multiplier (based on industry norm) = Valuation

Weighted-average adjusted historical earnings, in which more weight is given to the most recent years, are more representative than a simple average. This makes sense because current earnings reflect current prices and recent business activity. In the case of a five-year weighted average, the current year is assigned a weight of 5 while the initial year is assigned a weight of 1. The multiplier is then applied to the weighted-average five-year adjusted historical earnings to derive a valuation. An example follows:

Year	Net Income	x	Weight	=	Total
20X6	$130,000	x	5		$650,000
20X5	120,000	x	4		480,000
20X4	100,000	x	3		300,000

20X3	80,000	x	2	160,000
20X2	90,000	x	1	90,000
				$1,680,000

Weighted-Average 5-year earnings: $1,680,000/15 = $112,000

Weighted-average 5-year earnings x Multiple = Capitalization-of-Earnings Valuation

$112,000 x 3* = $336,000

*Multiple of 3 used for this example. Multiples may be based on factors such as earnings stability, risk, anticipated growth, or liquidity.

Present Value of Future Cash Flows. A company may be valued at the present value of future cash earnings and the present value of the expected selling price. The growth rate in cash earnings may be based on prior growth, future expectation, and the inflation rate. The discount rate may be based on the market interest rate of a low-risk asset investment. Cash earnings are important because they represent profits that can be used for investment or other purposes. Use a calculator, Excel, or refer to a present value table in an accounting or financial text.

Valuation Based on Book Value (Net Worth). The business may be valued at the book value of the net assets at the most current balance sheet date.

Fair Market Value of Net Assets. The fair market value of the net tangible assets of the company may be based on independent appraisals. An addition may be made for goodwill. A business broker, who handles the purchase and sale of businesses, may be hired to appraise the tangible property. Usually, the fair market value of the assets exceeds their book value.

Gross Sales (Revenue) Multiplier. A business value may be computed by multiplying sales by a sales revenue multiplier typical in the industry. The industry norm gross revenue multiplier is based on the average ratio of market price to sales. For example, if revenue is $5 million and the multiplier is .1, the valuation is $5,000,000 x .1 = $500,000. If reported earnings are suspect, this method may be advisable. Note: There is typically a big discrepancy between the seller's asking price and the buyer's offer. For example, you own a janitorial service with gross annual sales of $200,000. The owner's asking price is 50 percent of gross sales ($100,000), and the buyer pays 60 percent of the asking price ($60,000) or 30 percent of gross sales.

Market Comparison; Values of Similar Businesses. The market price of comparable companies in the industry should be obtained. What did similar businesses sell for recently? What would be the price for this particular business? Although an identical match is not possible, reasonable comparability between companies should exist (e.g., size, product, structure, and diversity). Industry sources include Dun and Bradstreet.

Integration of Methods. The valuation of a company may be estimated based on a weighted-average value of several methods. The most weight should typically be placed on the earnings methods and the least on the assets approaches. For example, assume that the fair market value of the net assets method provides a value of $3 million, and the earnings method gives a value of $2.4 million. If the earnings method is assigned a weight of 2 and the fair market value of net assets method is assigned a weight of 1, the business valuation is:

Method	Amount x	Weight	Total
Fair Market Value of Net Assets	$3,000,000 x	1 =	$3,000,000
Capitalization-of- Excess Earnings	$2,400,000 x	2 =	$4,800,000
		3	$7,800,000
			÷ 3
Valuation			$2,600,000

Get Started

The right mindset is just the beginning. Running a business also takes a sharp business sense. Knowing how to take advantage of market conditions and developing strategies to get through the tough times will help turn your great idea into a successful business.

One of the first things you'll need to do is develop a business plan. It will be the road map you'll use to establish and guide your business. Start by defining your idea in business terms. This is not a time to focus only on the positive. You need to take a hard, critical look at your plan and all its components.

Ask every question you can think of and ensure each one is answered so that you can make well-informed decisions and address the relevant factors in your business plan.

- *What type of business do you want to own*? Will it be retail, service, or manufacturing?
- *Who's the competition*? Is the community large enough to support another similar business? Head to the local chamber of commerce for details.
- *Where will you locate your business*? Is there a similar business nearby? Get information on the community's plans for business growth, such as shopping malls and business park expansions.
- *Will you be able to find enough qualified people to employ*?
- *Will you buy, lease, or build space for your business*? Buying space is costly. For that reason, it's usually wise to rent at first in case your plans don't work out.
- *How will you identify customers for your product or service*? Look at population figures--current and projected.
- *How will you sell to potential customers or clients*?

Find out not only if your prospective customers really are viable, but also where your product or service fits in the marketplace. Talk to your intended suppliers and, if possible, your intended customers. Also do some research at the library, on the internet, and through trade associations. Contact the SBA. Your goal here is to get as much information in measurable form as you can. These facts and figures can--and should--be used to make solid projections for your business.

Be prepared to revise your business plan (see the "Developing a Business Plan" section) if the information you gather doesn't add up to a strong possibility of success. Or make discreet inquiries about the availability of an existing business. This is no time to go it alone. Find and consult qualified professionals--real estate agents, lawyers, accountants, public relations experts, and consultants--to help you make the best decisions. Ask other local business owners for referrals or check the internet or Yellow Pages. Even if your dream business is small and you have a great deal of experience in that particular line of work, don't expect to know all there is about running a business. Good advice may be the difference between success and failure.

Business Location

The best location varies with the type of business. It is usually best for a retail store to be near other retail stores, preferably in a shopping area. For example, a supermarket generates a lot of traffic; proximity to one may increase your traffic flow. A mail-order business should be near a post office, or an established UPS or FedEx route. A distributor should be as close as possible to customers, provided rent is low. The choice of location for a manufacturer depends on the product line and marketing factors.

Generally, a retail business should be near its potential customers. Population data may be obtained from a town office or the SBA. Determine the buying patterns of the population: Are they consistent with your proposed product or service? Is the customer profile consistent with your product (e.g., age, occupation, and sex)? An economically healthy community is usually best.

Clothing stores and jewelry stores are usually more successful in main or outlying central shopping areas. Grocery stores, drugstores, gasoline stations, and bakeries do well on major thoroughfares and on neighborhood streets outside of the main shopping districts.

The store should be visible if you rely on impulse buying. A corner location at a busy intersection is preferred because of constant pedestrian flow. If people need cars to reach your store, you will need access to ample parking.

Service companies not heavily relying on impulse buying (e.g., beauty parlors and travel agencies) need less visibility but more attractive décor and internal comfort. The exterior and interior design of the space should reflect the personality of the business.

In looking at a location in a shopping center or mall, determine what competing stores exist and who the other tenants are. Also, look at traffic patterns. What stores are about to open? Will your business do well in lively surroundings in an active mall (e.g., record shop, bookstore, and ice cream parlor)?

If your business is more vulnerable to pilferage, remember that this activity is more likely to happen in a shopping mall. Stores such as a conservative, high-priced men’s store may not do as well in a mall.

Be cautious in signing a lease in a shopping mall that has not yet opened. If the contractor cannot sign enough tenants, he or she may go out of business. Make sure your agreement spells out your exact location and its specifications. Try to get a “no-compete” clause prohibiting the opening of a store that would be in direct competition with yours (e.g., only one pet store). Determine what other types of businesses will be opening and how will they could affect your business.

The location of your business should preferably be in a low-crime area.

A wholesale business should be located to minimize transportation costs. The warehouse should be centrally located to reduce delivery costs to regular customers. There should be easy access to major highways for quick travel.

In deciding on a location for a small plant, you should seek a place near your market, customers, suppliers, raw material sources, and skilled labor. An industrial park may be suitable. Other considerations include whether the neighborhood population would be receptive to your business and the availability of tax incentives from the local government.

The benefit of a pure online business is that the location can be virtually anywhere. Depending on the nature of the business and whether you sell physical items, you may find the only requirement is proximity to shipping companies. Warehouse costs can be minimized by locating your business in a low-cost city or state. Or, you may be able to start the business out of your home.

Home Offices

Many start-ups are formed in the home, and there are numerous stories of how major companies started in a spare garage, such as HP and Google.

The share of businesses that are home-based has remained relatively constant over the past decade, at about 50% of all firms. More specifically, 60.1% of all firms without paid employees are home-based, as are 23.3% of small employer firms and 0.3% of large employer firms. The industries in which businesses are most likely to be home-based are information (70.0%), construction (68.2%), and professional, scientific, and technical services (65.3%).

There are a number of advantages to starting your business at home. Here are a few:

- Low-cost start-up costs: Depending on your business, you might be able to start it part-time while still working elsewhere. This helps maintain your income while establishing your new business.
- No commute. Not having a long commute to and from a separate office can save a great deal of time and money. Less time is wasted in traffic and on gas.
- Greater flexibility. Working from home allows you to work during your most productive times. Some people find early morning their most productive times. For others, it may be night. And, you'll be able to wear what you want, assuming no customers will be coming to your home.
- Fewer distractions. You can control distractions easily by creating a quiet zone. You reduce distractions that come from coworkers, employees, and other office noise.
- Less stress. Work from your home can be more peaceful. It's your environment, set up the way you want. You can take breaks as needed and avoid unpleasant and time-wasting meetings.
- Save money. By working at home, you save money by avoiding the long commute, and you can also deduct a portion of your home office expenses on your taxes.

The disadvantages of working from home include:

- Not all types of businesses are possible from home. If you need lots of storage space for equipment or inventory, or if you need space to actually make things, the home may not be ideal. Also, some neighborhoods may have zoning or other restrictions related to conducting some kinds of businesses.
- Self-discipline: A great deal of self-discipline and motivation is required when you are in your home environment. Some people need other folks around to stay motivated.
- Loneliness. It can be pleasant to have access to coworkers and colleagues. Working alone can be isolating.
- Finding the right balance. When the distinction between work and home is gone, it can be hard to stop working. Some people working from home feel like they put in more hours, not less, because the computer, phone, etc. are only a few feet away.
- Space requirements. Creating a home office or workspace can require a dedicated space in your house.
- Professional office. If you need to spend time with clients and maintain a professional appearance, the home is not always the best place to meet. Some small business owners solve this by meeting at the client's location or a coffee house.
- Teamwork. Some businesses require collaboration and teamwork to be successful. Although telecommunications can help here, there is no substitute for face-to-face interaction.

Requirements to Claim a Home Office Deduction

Generally, deductions for a home office are based on the percentage of your home devoted to business use. So, if you use a whole room or part of a room for conducting your business, you need to figure out the percentage of your home devoted to your business activities.

There are two basic requirements for your home to qualify for a deduction:

- Regular and exclusive use.
- Principal place of your business.

Regular and Exclusive Use.

You must regularly use part of your home exclusively for conducting business. For example, if you use an extra room exclusively to run your business, you can take a home office deduction for that room. There are exceptions to the exclusive use test for areas in the home used regularly as a daycare facility or for storage of business inventory or product samples.

Principal Place of Your Business.

You must show that you use your home as your principal place of business. If you conduct business at a location outside of your home, but also use your home substantially and regularly to conduct business, you may qualify for a home office deduction.

For example, if you have in-person meetings with patients, clients, or customers in your home in the normal course of your business, even though you also carry on business at another location, you can deduct your expenses for the part of your home used exclusively and regularly for business.

You can deduct expenses for a separate free-standing structure, such as a studio, garage, or barn, if you use it exclusively and regularly for your business. The structure does not have to be your principal place of business or the only place where you meet patients, clients, or customers.

Generally, deductions for a home office are based on the percentage of your home devoted to business use. So, if you use a whole room or part of a room for conducting your business, you need to figure out the percentage of your home devoted to your business activities before you can calculate the deduction.

Developing a Business Plan

Before you get started you have to ask yourself some very basic questions, such as ‘what is your business model’ —in other words, ‘how you are going to make money’. Business success often seems a matter of luck, or even magical, to many inexperienced business owners. They don't realize that there is usually a critical difference between those businesses that succeed and those that fail. Often that make-or-break difference is a business plan. Without a plan, a business can easily flounder and fall victim to poor business decisions resulting from a lack of planning.

A business plan is a must when you start a business. The business plan is a road map to guide you through the precarious first few years. It serves as a written guide for your future operations and covers your short-and long-term goals, details about your business, your management strategy, your method of operation, and timetables. Of course, the goals must be realistic.

A well-prepared business plan serves at least three critical functions:

1. Getting the business started off right. A business plan serves as the foundation for any new business. It helps a business get off to the right start and stay on track. Putting together a business plan forces you to think strategically about your business.

It allows you to plan your business on paper before you've committed your time and money to it. Having to consider each of the practical matters that goes into starting and operating the business may reveal crucial details that you might not have considered. Unless you know how each part of the business is going to function before you begin operations, you're taking a chance that some unforeseen detail could sabotage your entire effort. Besides being useful for anticipating and avoiding problems, a business plan is useful for uncovering opportunities.

2. A blueprint for success. A business plan is as essential to building a business as a blueprint is for building a house. In fact, a business plan is a blueprint for your business' operations and growth. It details your business objectives and how you intend to accomplish them. Setting down in writing what you are going to achieve shows you clearly where you need to focus your time, energy, and capital. Once your business is in operation, you can gauge your success by comparing your actual results to your plans and adjust the plan as needed to address any issues or changes in the business environment.

3. Raising Money. A business plan is essential for raising money. One of the most common reasons for business failure is under-capitalization. Businesses need financing to take them from the initial business idea to success in the marketplace. Often the amount needed is beyond the resources of the business owner. Without a business plan, it is virtually impossible to raise capital for the business from outside sources. Lenders and investors are more interested in the management team than in the product or marketing opportunities. They'll want to know if you have the knowledge and ability to make the plan work, and what makes you and your business unique -- what you have that no one else does.

How to Write Your Business Plan

A business plan should be written specifically to the audience for whom it is intended. When a business is in the formative stages, the business plan should be written to aid you in making sound decisions for getting the business up and running. This kind of plan is designed to help you put the business together piece by piece.

Once the business is operating, the business plan should be written to convey your vision to employees and others who are helping you achieve your dream. It should provide a step-by-step guide for what is going to be done and who will do it.

Any time a plan is needed to raise capital, it should be written with the lender or investor in mind. It needs to convey your enthusiasm and optimism about the anticipated success of your business without making unwarranted claims. It also has to explain how and when the lenders or investors will be paid off.

Writing a business plan may seem like a lot of work, which may explain why so few businesspeople actually develop one - and why so few new businesses succeed.

You have to develop a course of action. For example, you should decide what marketing strategy (methods for selling your product or service) to use for your business.

In the business plan, prepare to answer the following questions: When will the company show a profit, who will work, and how many hours will be required? You should schedule the purchase of certain equipment and supplies. If you are starting a business that has seasonal peaks and valleys, be sure to allow for the busy and slow months. How and when do you see the company growing? What must you do to achieve growth?

Business Plans Can Be a Loan Proposal

Business plans give lenders the information they need to decide whether to lend money to a new business or to an existing business for expansion. Most business plans are ineffective because they do not include everything lenders require or because they are not specific enough.

How can you present your case in a manner that will convince the loan officer and overcome any business prejudices? This can be done through a loan proposal. A loan proposal is an up-to-date business plan that shows how the bank's loan will improve your company's worth.

Normally, the loan proposal begins with an overview of your company's history, the amount of money you need, the proposed use and allocation of the loan proceeds, and the collateral you have available to secure the loan.

The loan proposal should include:

- A cover letter stating the amount requested for your proposed term and a brief summary of your business and its financial goals.
- A market analysis explaining how your concept fits in with current business trends and why it will succeed in the marketplace.
- A description of how the business will be run. Include resumes of key personnel.
- A financial plan including current and projected figures. Loan officers are particularly interested in liquidity and profitability.

Components of the Business Plan

Each business plan is unique because each business is unique. As such there cannot be a standard format of the plan. Nevertheless, presented below is a brief overview of its contents. Once a complete business plan is generated, it can be tailored for different audiences. For instance, a shorter, overview plan can be used to solicit initial interest. A plan focusing on detailed financials can be used for potential investors or bankers.

Cover Page

Here you provide the name of your company, its address and phone number, and the founder's chief executive's name. If the plan is going to be distributed to several bankers or investors, make sure you number each plan prominently on the cover page and include a statement to the effect that the document contains proprietary material and should not be photocopied. These steps enable you to keep track of who has your plans and hopefully deter recipients from copying or circulating the plan.

Table of Contents

This should include a logical listing of all the business plan's sections together with page numbers.

Executive Summary

This is the single most important section of the business plan because most readers – especially lenders and investors – turn to it first and decide, based on the three or four minutes they spend skimming it, whether to take the rest of the plan seriously. The executive summary should capture the readers' attention, enticing them to read more and convey the flavor of the rest of the plan. When readers finish the executive summary, they should have a good sense of what you are trying to do in your business. They should be enthused enough to read on and learn more about your company.

The Company

The section after the executive summary is where you articulate the company's underlying philosophy and how you intend to succeed. You do that by covering two basic subjects: your company's strategy and its management team.

Strategy

This is really a fancy term for your company's overall approach to producing and selling its products and/or services. You should have certain underlying principles and approaches to doing business that enable you to build on your strengths and distinguish your company from the competition.

Management Team

With matters of strategy dealt with, you can move on to the management team. For a new business especially, potential stakeholders will search in your business plan for clues as to whether the people in your company are up to the task. Consider including highlights of the team's expertise, track records of success, and an organizational chart if available. Lenders and potential investors will want to know that there is a reliable team capable of achieving success. Investors and lenders feel most comfortable with a team managing a company rather than a single individual.

The Market

Who are your customers? Describing the market involves identifying your customer prospects and determining how best to reach them. It should be noted, however, that marketing is not the same thing as selling or promoting; they are separate tasks. Selling and promoting are the implementation of your marketing plan.

The Product/Service

Here is where you do what most entrepreneurs like to do best; describe the features of their product or service including why it is better than competitor's products or it will benefit customers. Indeed, many entrepreneurs become so enamored with their product or service that they make light of market issues. They figure their product or service is so wonderful, how could people not want to buy it?

Sales and promotion

You need to determine how you will reach your customers and sell to them. Do you have an in-house sales force, or will you use manufacturer's representatives, direct mail, or contracted telemarketers to sell your product/service? Do you expect to advertise, or will you rely on public relations?

Manufacturing (if appropriate)

This section should discuss your supply sources, equipment, capacity, and quality control. If you are subcontracting certain components or processes, the subcontractors' capacities should be discussed. Can the subcontractors deliver on time?

The Finances

Your business plan needs to provide as clear and precise a picture as possible of your company's financial condition. You provide that picture primarily through a presentation of three types of financial statements: cash flow, income statement, and balance sheet. Your business plan should discuss the most important revelations and issues raised by the financial statements, such as when your business will reach break-even, when it is expected to become profitable, and what the most significant expenses are. This section should also say something about the company's financial requirements over the coming five years. If you are using the business plan to seek a loan or investment, you should state how much you need and the form in which you prefer it (loan, combination debt and equity, etc.)

Supporting Documents

You must provide all necessary supporting documents, including personal resumes of owners; personal financial requirements and statements; budgets; letters of reference; copies of leases, contracts, or legal documents; anything else of relevance.

Finishing Up

Double-check Business Plans for Accuracy and Consistency

Once you have written your business plan, have an accountant or financial analyst verify the accuracy of your figures and financial analyses. Ask him or her to make sure that the totals are correct and consistent throughout the plan. For example, the marketing costs specified in the marketing plan section should agree with the projections for marketing listed in the financial plan; the machinery called for in the manufacturing plan should be listed in the financial plan. If the numbers do not add up, your business plan is likely to be turned down. Careless errors imply that the owner will be careless in other aspects of the business.

By preparing a business plan before you meet with a banker or venture capitalist, you increase your chances of success. To further increase your chances, take a CPA with you. Bankers will want to speak with you to ensure that you are both passionate and realistic about the new venture; however, they don't expect you to have the financial or accounting background necessary to answer all their questions in these areas.

Points to Note

The business plan is your business in a nutshell. Some vital points to bear in mind are as follows:

- View the business plan as your company’s representative.
- Consider customizing your business plan for different audiences.
- Be realistic and acknowledge weaknesses.
- Keep rewriting to keep the plan current; use a professional writer if possible.

10 Steps to Start Your Business

From: www.sba.gov

1. Conduct market research: Market research will tell you if there's an opportunity to turn your idea into a successful business. It's a way to gather information about potential customers and businesses already operating in your area. Use that information to find a competitive advantage for your business.
2. Write your business plan: Your business plan is the foundation of your business. It's a roadmap for how to structure, run, and grow your new business. You'll use it to convince people that working with you — or investing in your company — is a smart choice.
3. Fund your business: Your business plan will help you figure out how much money you'll need to start your business. If you don't have that amount on hand, you'll need to either raise or borrow the capital. Fortunately, there are more ways than ever to find the capital you need.
4. Pick your business location: Your business location is one of the most important decisions you'll make. Whether you're setting up a brick-and-mortar business or launching an online store, the choices you make could affect your taxes, legal requirements, and revenue.
5. Choose a business structure: The legal structure you choose for your business will impact your business registration requirements, how much you pay in taxes, and your personal liability.
6. Choose your business name: It's not easy to pick the perfect name. You'll want one that reflects your brand and captures your spirit. You'll also want to make sure your business name isn't already being used by someone else.
7. Register your business: Once you've picked the perfect business name, it's time to make it legal and protect your brand. If you're doing business under a name different than your own, you'll need to register with the federal government, and maybe your state government, too.
8. Get federal and state tax IDs: You'll use your employer identification number (EIN) for important steps to start and grow your business, like opening a bank account and paying taxes. It's like a social security number for your business. Some — but not all — states require you to get a tax ID as well.
9. Apply for licenses and permits: Keep your business running smoothly by staying legally compliant. The licenses and permits you need for your business will vary by industry, state, location, and other factors.
10. Open a business bank account: A small business checking account can help you handle legal, tax, and day-to-day issues. The good news is it's easy to set one up if you have the right registrations and paperwork ready.

Section 2:

Debt and Equity Financing

Learning Objectives:

After studying this section, you will be able to:

- Identify options and strategies available for small business financing.
- Identify the advantages of leasing vs. purchasing assets.

Financing Options and Strategies for Small Businesses

Probably the largest obstacle facing entrepreneurs is the need for startup financing to open for business. Depending on the type of business, an entrepreneur may need initial monies for licenses and fees, remodeling, furniture and equipment, professional fees (e.g., attorney fees), inventory, supplies, rent, wages, advertising, or other costs associated with opening the doors. In addition to start-up expenses, after you have opened for business, you will incur day-to-day operating expenses, which may be a financial hardship until you begin generating positive cash flow and start to become profitable. In financing the business, remember that most businesses lose money in the first and second years of operation. Later, you may need growth financing to expand your business and maximize the earnings potential.

Before seeking financing, do your homework. How much money do you need and why? Itemize all your expected costs. What will you be doing with the money? Be prepared to give realistic financial projections. The actual funds you have to invest from all sources must be sufficient to cover these costs in order to succeed with your venture.

If you display confidence in the business, you will transmit your feeling to potential creditors and investors. Ask for a bit more money than you think you will need since there will undoubtedly be some unforeseen expenses to be covered.

In deciding upon a source of financing, consider the following:

- *Availability*. What sources may you realistically tap?
- *Cost*. What is the cost (e.g., interest rate) associated with the financing source? Will you be able to meet such costs when due or will they generate cash shortages?
- *Flexibility*. Are there any lender restrictions that may inhibit your freedom of action or ability to obtain further financing? Are there any limitations on how you can use the funds?
- *Control*. Will you be giving up any control in the company in obtaining the financing?
- *Risk*. What is the risk associated with the particular funding source? Will you have to make early, significant loan payments?

The ability to finance a business depends on its reputation and prospects, the amount of money needed to start and operate the business, and the owner's personal resources. If you are well known in your field, you may be able to finance with a substantial amount of outside capital. But if you are starting without these advantages, you may have to depend more on your personal resources. Some people have started businesses successfully using their personal savings or borrowing against their houses or other assets. The advantage of using your own funds as much as possible is that you do not have to go through the time-consuming process and hassle of obtaining outside funding. Also, you do not have to worry about repaying the loan or giving up an equity ownership interest. However, few businesses can operate for a long period of time with only personal financing. Further, it is probably not advisable to place all of your personal resources into a business because of the risk of losing your investment.

Following are some sources of financing:

One source of funds may be relatives and friends. This is an attractive source because it is generally quick, less costly, and easy. There are fewer written reports and statements to prepare as well as less legal work and fewer disputes between the parties. It is best to treat this money as a loan, supported by a formal loan agreement that bears an appropriate interest rate, rather than an equity interest; in this way, you can keep total control and achieve the maximum reward for your services. Also, if you give an equity interest, others may interfere in the smooth running and decision-making processes of the business.

You can borrow against the cash surrender value of your life insurance policy. For example, you may decide to borrow up to 80 percent of the amount accumulated in the policy. You then will pay interest on the loan in addition to the premium.

An often-overlooked source of money is your suppliers. Trade creditors and equipment manufacturers are indirectly involved in the operation of the business and have an interest in seeing it succeed. They understand your business, are connected with it, and therefore may prove to be viable lenders.

Equity and debt financing are discussed later. To obtain such financing, you will have to prepare a proposal and business plan which should highlight the nature and objectives of the business, financial health, the owner's background, references, product line and/or services, markets to be served, customer base, competition, suppliers, manufacturing costs, cost structure, proposed financing terms, dollar amount of financing required, proposed use of the money, and description of personnel. The proposal should include how much you need, the preferred terms, and repayment preferences. Projected and actual financial statements, including a balance sheet, income statement, and statement of cash flows, will also be needed. Cash flow projections for the next year are crucial.

By projecting what you think you are going to sell and spend during the upcoming months, you can identify potential financial difficulties on the horizon.

Here are some of financing options, strategies, and actions to consider.

- *Research the capital markets*. Current capital markets offer a variety of lending alternatives. In addition, today's capital deals often combine several types of lending tools and techniques. Investing some time upfront to learn about the types of financing available and how to use them properly will enable you to get the best deal and avoid getting taken to the cleaners by sophisticated lenders.
- *Match your financing needs with the correct lender and financing product*. After determining the framework of your financing needs, identify the type of lender that fits your industry, your type of company, and your specific financing needs. For example, don't approach a bank or commercial lender if you need mezzanine financing, because you won't have the collateral to support the loan. Similarly, borrowing from a venture capitalist when you could have used mezzanine financing may cause you to give away more equity than necessary. If you're uncertain about which type of lender to use, hire a professional who knows the markets and can help you find the right type of financing for your borrowing needs.
- *Write a world-class business plan*. In order to get the most money at the best terms, create a business plan that lenders can't resist. Make it clear and compelling so lenders can understand it and believe you can get where you want to go. A well-documented business plan contains both narrative descriptions and hard numbers. The key is making sure that one supports the other. For example, every line item in the plan should have some narrative that describes the assumptions behind the numbers. However, the narrative must be credible or the lender won't buy your plan. Above all, don't think that a two-page summary will capture the attention of lenders. It takes more than a few pages to provide the raw data to support your projections and conclusions.
- *Minimize risk*. Entrepreneurs often think they have to bet the farm in order to obtain financing. However, sound financing should involve less risk, not more. To minimize your exposure, look for lenders willing to structure flexible deals. Avoid agreements filled with restrictive covenants and warrants. Generally, don't take out a second lien on your house or give any kind of personal guarantees. Build a cushion into the deal in case things go wrong. Before signing any financing agreement, always ask yourself, "Am I taking more risk to finance this growth than I had before I decided to grow the company?" If the answer is yes, don't sign.
- *Adjust your lending agreement for actual performance*. When lending institutions create loan packages, they typically discount your performance projections and increase their compensation through additional fees or equity. In most cases, you can't avoid this discounting because lenders need some way to protect themselves. However, you can negotiate a performance clause that adjusts the terms should you achieve your objectives as outlined in the agreement. If your lender refuses to consider this option, shop around for a different lender.
- *Conduct a broad search of lending institutions*. When looking for growth capital, start with about 100 lenders and work your way down to a final "short list." In particular, look for lenders who specialize in your industry and companies that are similar in size and type to your company. If you're looking to grow a chain of auto repair shops, for example, don't approach a venture capitalist who specializes in lending

to biotech companies. Once you have a small group of finalists, present your business plan to all of them at the same time. By creating competition among several lenders, you increase your chances of getting the best deal.

- *Think big*. Plan your borrowing based on your company's potential, not on your current capital position. Project how much you would need to grow the company to its full potential and strive to get the best financing with the least risk, the least dilution, and fairest transaction terms.
- *Never give up control*. You may have to relinquish some equity in order to obtain capital, but if you have to give up control to grow your company, don't do the deal. The best way to avoid giving up control is to create competition for your transaction.

Debt Financing

Debt financing may be a simple way to raise money. Basically, it describes any kind of loan. However, lenders can be brutally negative about the prospect of survival of a new business. Small businesses often pay three to five points more in interest rates, are required to put up greater collateral, and need to show a ratio of assets to debt of no less than three to one to obtain financing.

There are many sources of debt financing, including commercial banks, savings and loan associations, credit unions, commercial credit, and sales finance companies. Most lenders will require some form of collateral to guarantee their loans. Such collateral may include real estate, stocks, bonds, cars, cash value of life insurance policies, inventory, and equipment.

Trade creditors are a good source of financing because funding (i.e. buying materials, merchandise, or equipment on credit) is readily available. In effect, it is a cost-free source of financing. Trade credit is a spontaneous source of financing because it arises automatically as part of a purchase transaction. Because of its ease in use, trade credit is the largest source of short-term financing for many firms both large and small. Suppliers are often sympathetic because you are a source of business. If you are short of funds, you may want to delay payments to suppliers. However, be careful not to stretch them too far because that may damage your credit rating. When discounts are offered, such as 2/10, net/30, take them if possible because of the high opportunity cost associated with forgoing the discount.

You may also use your personal and business credit cards to buy items or services for your business. However, two drawbacks are that the interest rate on credit cards is very high and you must make minimum monthly payments. Home equity loans are a cost-effective alternative to other types of loans because they offer some of the best interest rates available. But you may not want to risk your family home to launch your business venture. Before going this route, you should carefully consider the risks involved.

Short-term bank loans tend to be granted without too much concern for collateral since these loans are usually paid off from sales made in the ordinary course of business. Medium-term loans, running for one to five years, are more likely to require collateral. These loans are often made to finance machinery and equipment, furniture and fixtures, and store alterations. A medium-term loan, in contrast to a short-term loan, may impose operating restrictions (e.g., working capital level, further debt financing). Long-term loans run for more than five years. These loans are the least often sought and probably the hardest to get. They are usually linked to specific business purposes, the most common of which include purchases of real property and major expansions. They are generally backed by specific assets of the business. Obtaining a long-term loan involves a fair amount of time and paperwork.

Banks are conservative about lending to new businesses. They want a borrower with a reputation and a business that has profit potential. Generally, a bank will not lend money to a new business for the purpose of paying off its debts to other creditors. The bank wants the funds to be used constructively. The bank generally wants the owner to put up a sizable amount of his or her own money to show the owner is confident and is willing to take risks. A good working relationship with bank loan officers may facilitate subsequent financing.

There are various types of bank loans, including:

- *Borrowing against a savings account*. This involves a lower cost, and your deposit still earns interest.
- *Unsecured loan*. To obtain an unsecured loan, you need an excellent credit rating. However, the interest rate may be higher, since there is no collateral.
- *Secured loan*. The loan is backed up by collateral.
- *Term loan*. This is a loan that involves repayment in periodic installments that include principal and interest. A high credit rating and collateral are typically required.
- *Straight loan*. This is a short-term loan payable in a single payment.
- *Line of credit*. The bank agrees to make money available if you need it up to a specified predetermined maximum. It is good for a seasonal business.
- *Cosigner loan*. If your credit rating is a problem, you will need someone of good financial standing to cosign the loan.
- *Real estate loan*. You can take out a mortgage against the value of real estate, including a home equity loan. Typically, you can receive financing for up to 80 percent of the value of the property. A mortgage is a long-term financing source that runs for about 15 to 25 years. Thus, you can delay full payment until far off into the future, minimizing near-term cash squeezes.
- *Equipment loan*. You can get a loan against the value of the equipment, typically up to 80 percent of its value. The loan is usually tied to the life of the equipment.
- *Accounts receivable financing*. The bank will advance you money against accounts receivable balances, which serve as security for the loan. Typically, the advance is up to 80 percent of the value of the receivables. When customers remit payments to you, you in turn send the payments to the bank to reduce the loan balance.
- *Inventory financing*. Inventory may be used as collateral for a loan. Typically, the bank will lend you up to 50 percent of the value of the inventory.
- *Warehouse loan*. This is a loan based on warehouse receipts delivered directly by the lender. The lender has legal possession of the goods while the loan is in effect.

You can sell your accounts receivable to a *factor* to obtain funds. Typically, the factor will advance up to 80 percent of the value of the accounts receivable. Factoring may be without recourse, meaning that if the customer does not pay the factor, you are not responsible. Thus, the factor is taking the risk of noncollection. The factor charges a fee on the accounts receivable financed (e.g., 2 percent) and interest on the advanced funds. A factoring arrangement is more costly than other private loans from banks and finance companies.

One attractive alternative for small businesses that are short of cash is leasing since it does not require a capital outlay. Equipment lease financing is an option for many cash-starved businesses. Equipment leases give you access to many types of equipment — computers, cars and trucks — without tying up your cash or credit lines. Although it doesn't bring in cash, leasing reduces the amount of cash you otherwise have to raise.

Many large companies, labor unions, and trade organizations have a credit union. They are established to assist employees with loans as well as savings. Some individuals who go into business on a part-time basis finance their small business with a loan from their credit union.

Commercial finance companies provide loans for working capital and inventory financing to small businesses. Typically, the borrower goes to a finance company when he or she is unable to obtain a loan at a bank. Because of the borrower's greater risk profile, the interest rate on a finance company loan is higher than that of a bank loan. In addition, collateral is usually required.

Community development companies are nonprofit organizations established by local communities to revitalize and attract businesses, typically in low-income, underserved/struggling neighborhoods. The most popular are those that develop shopping malls, affordable housing, or industrial parks.

There are many *state business and industrial development corporations* (SBIDCs), supported by state funds that lend money to small businesses, typically for up to 20 years for capital facilities. Each state has its own policy with regard to the degree of risk it will accept and the financing terms. You may contact your local chamber of commerce or the business development office for further information.

Sometimes you can combine debt and equity financing. Called a *convertible debenture*, this instrument begins as a loan and is later converted to a share of the ownership of your business.

When the cost of debt financing is prohibitive, you may opt for equity capital.

Types of Financing

The National Small Business Association's Survey, 2018 Mid-Year Small Business Economic Report revealed the types of financing used by the respondents within the last 12 months for their capital needs:

1. Bank loans including credit union loans, 28%
2. Credit cards, 35%
3. Used no financing, 35%
4. Earnings of the business, 31%
5. Private loan (friends or family), 13%
6. Vendor credit, 12%
7. Other, 7%
8. Online or non-bank lender, 5%
9. Small Business Administration (SBA) loan, 4%

10. Leasing, 3%
11. Private placement of debt, 2%
12. Venture capital/Angel investors, 2%
13. Private placement of stock, 1%
14. Selling/pledging accounts receivable, 1%
15. State/Regional Loan and Incentive Programs, 1%
16. Crowdfunding, 1%

Establishing a Good Business Credit Rating

Establishing good business credit is a key step for a small business, and not just because it paves the way to getting loans at good rates. High credit scores can also lead to better payment terms from vendors and increased sales. Business credit ratings are separate from the personal credit reports of a business owner, although some credit grantors want to see both. Just as with personal credit, a business gets good ratings by making its payments on time. Business credit ratings range from zero to 100, the higher the better. *Experian Information Solutions Inc. and Dun & Bradstreet Inc*. are two well-known business credit rating companies.

Getting started on building credit can be straightforward. After your business has been licensed and your business bank accounts have been set up, get a small-business credit card and make payments on time. Lenders can assess the creditworthiness of your firm based on credit reports and other information they obtain.

Even with good, established business credit, a small-business owner may be required to personally guarantee a major debt. In this case, the owner should try to get an opt-out clause that cancels the personal guarantee when they leave the company or sell it. In addition, it would be good to get a so-called burn-off clause to lower the personal guarantee as the debt is gradually paid off.

Small Business Administration Loans

You should contact your local SBA office to determine if you qualify as a small business. Size standards have been established and are subject to change, and vary by industry (manufacturing, wholesaling, farming, etc.). For example, a retail small business is defined by the SBA in 2022 as one in which annual sales or receipts do not exceed $8 million to $41.5 million, depending upon the type of the industry.

Potential borrowers with an existing business, or those seeking to purchase an existing business, should take their loan proposal, together with the current financial statements and business tax returns, to a lender that makes SBA loans. Potential borrowers who are seeking to start a new business should prepare a business plan, including a 12-month cash flow projection, prior to presenting their loan proposal to the lender. Once a lender reviews and is willing to make the loan, the lender forwards the application to SBA for processing, which normally takes less than two weeks.

Some borrowers may be eligible for prequalification, which entails a different application process. Women, minorities, military veterans, and borrowers in rural areas that have excellent personal credit and need less than

$250,000, may apply directly to their local SBA office for prequalification rather than applying at the lender first. In most cases, the SBA will refer them to a prequalification intermediary that will help them prepare their application. Most borrowers find that prequalification by SBA lends credibility to their proposal and makes it much easier to find a lender willing to make their government loan.

Whether applying to a lender for a regular SBA loan, or directly to SBA for prequalification, all applications are evaluated on the repayment ability of the business itself, management ability and character of the owner, personal investment the owner has made in the business, and adequacy of collateral and working capital. All loan proposals should address these matters. Note: Economic opportunity loans are restricted to low-income or disadvantaged businesses.

To contact the SBA, call 1-800-827-5722 or go online to www.sba.gov. Free assistance is available from SBA's Small Business Development Center (SBDC) network.

Following are some highlights of certain SBA loan types:

Loan type	**Description**
7(a) loan program	• SBA's primary program for providing financial assistance to small businesses • Federally guaranteed term loans of up to $5 million; maximum SBA guarantee varies based on the specific program type • Funds for working capital, expansion, equipment purchases • Processed through banks, credit unions, specialized lenders
504 loan program	• Federally guaranteed loans of up to $5 million • Funds for buying land, machinery, facilities • Processed through nonprofit Community Development Companies and participating lenders (usually banks)
Microloans	• Loans of up to $50,000 • Funds for working capital, inventory, equipment, starting a business • Processed through certain community-based nonprofits
SBA disaster loans	• Loans of up to $2 million • Funds for small-business owners affected by declared disasters and other emergencies • Processed through the SBA

In addition to traditional SBA funding programs, several temporary programs were established by the Coronavirus Aid, Relief and Economic Security (CARES) Act which was signed into law on March 27, 2020. One such program is the Economic Injury Disaster Loan Program, designed to provide economic relief to businesses experiencing temporary losses of revenue due to COVID-19. Proceeds received under this program could have be used for a variety of needs including working capital and normal operating expenses. See https://www.sba.gov/funding-programs/loans/coronavirus-relief-options for additional details.

Equity Financing

Another way to raise money for your small business, if it is a corporation, is to issue stock. In effect, you are selling part of the business to someone else. Stock does not have to be repaid, nor is an interest payment required. A stock issuance improves the credit rating of the company relative to issuing debt. However, you are giving up a percentage of ownership in your business. You may pay dividends to stockholders. Stockholders have limited liability in that they are not personally liable for the debts of the company.

There are several drawbacks to issuing stock. You may be giving up some voting control; your ownership interest is diluted; dividends are not tax-deductible; earnings and dividends are spread over more shares outstanding; and the cost of issuing stock is higher than that of debt.

If you decide to issue stock, you should keep adequate shares to compensate for your input in starting the business. In other words, you should receive a quantity of shares commensurate with the services you provided. The remaining shares may be bought by others at the going rate.

A company may issue different classes of common stock. Class A is stock issued to the public and usually has no dividends specified. However, it does usually have voting rights. Class B stock is usually kept by the company's organizers. Dividends are typically not paid on Class B stock until the company has generated sufficient earnings.

Venture Capital Financing

Venture capital firms generally acquire funds from private sources for the purpose of invest in select companies that have a high, rapid growth potential and a need for large amounts of capital. Venture capital (VC) firms speculate on certain high-risk businesses producing a very high rate of return in a very short time. The firms typically invest for periods of three to seven years and expect at least a 20 percent to 40 percent annual return on their investment.

When dealing with venture capital firms, keep in mind that they are under great pressure to identify and exploit fast growth opportunities before more conventional financing alternatives become available to the target companies. Venture capital firms have a reputation for negotiating tough financing terms and setting high demands on target companies. Three bottom-line suggestions:

- Make sure to read the fine print.
- Watch for delay maneuvers (they may be waiting for your financial position to weaken further).
- Guard your trade secrets and other proprietary information zealously.

Venture capital financing may not be available, nor a good choice of financing, for many small businesses. Usually, venture capital firms favor existing businesses that have a minimum operating history of several years; financing of startups is limited to situations where the high risk is tempered by special circumstances, such as a company with extremely experienced management and a very marketable product or service. The target companies often have revenues in excess of two million dollars and a preexisting capital investment of at least one million.

Venture capitalists research target companies and markets more vigorously than conventional lenders. Due to the amount of money that venture capital firms spend examining and researching businesses before they invest, they will usually want to invest at least a quarter of a million dollars to justify their costs.

Be wary of "shopping" innovative ideas to multiple venture capitalists or private investors. Use caution in revealing any information you consider proprietary even if you already have intellectual property protection (e.g., a patent, trademark, or copyright). Do your best to limit the details of your particular innovation and seek confidentiality arrangements for additional protection of any preexisting legal rights you may have.

The price of financing through venture capital firms is high. Ownership demands for an equity interest in 30 percent to 50 percent of the company are not uncommon even for established businesses, and a startup or higher risk venture could easily require a transfer of a greater interest. Although the investing company will not typically get involved in the ongoing management of the company, it will usually want at least one seat on the target company's board of directors and involvement, for better or worse, in the major decisions affecting the direction of the company.

The ownership interest of the VC firm is usually a straight equity interest or an ownership option in the target company through either a convertible debt (where the debt holder has the option to convert the loan instrument into stock of the borrower) or a debt with warrants to a straight equity investment (where the warrant holder has the right to buy shares of common stock at a fixed price within a specified time period). An arrangement that eventually calls for an initial public offering is possible. Despite the high costs of financing through venture capital companies, they offer tremendous potential for obtaining a very large amount of equity financing and they usually provide qualified business advice in addition to capital.

Venture capitalists expect to receive a very high return for the significant risk they are undertaking. For example, they may expect to double their investment in two years. Historically, about $2 million was the maximum available in venture capital funds for a business. In the last few years, however, VC firms have been willing to fund much larger amounts if they believed that the upside potential was large. This has been especially true for Internet-related firms. Venture capital firms are located nationwide.

In addition, other sources of venture capital can be found through bankers, insurance companies, and business associations.

There are also Small Business Investment Companies (SBICs) that invest in small businesses through equity, debt, or a combination of both. SBICs are privately-owned companies, licensed and regulated by the SBA. Refer to the SBA site at https://www.sba.gov/funding-programs/investment-capital for additional details.

Angel Investors

Angel investors are an excellent source of early-stage financing. They are often willing to tread where there is too much risk for banks and not enough profit potential for venture capitalists. Angels will generally invest for a longer time horizon than other investors --up to five years or more. Angel investors are wealthy individuals, usually with strong business experience, who usually want to work actively with the companies in which they invest. After self-financings, angels are the largest source of seed and start-up capital in the U.S.

Leasing Instead of Purchasing

A lease is a long-term contract for the rental of real or personal property to a lessee. Lessees make periodic rental payments over the life of the lease to the lessor. Information about the leasing industry may be obtained from the Equipment Leasing and Finance Association (www.elfaonline.org) and National Equipment Finance Association (www.nefassociation.org).

Since leasing does not require an immediate cash outlay, many small businesses choose to lease rather than buy office equipment, machinery, automobiles, and computers. This frees up funds for other purposes. However, the total cost of leasing may exceed the cost of buying the asset over the long term.

A lease contract generally contains the following provisions: lease term, renewal option, rental rate, cancellation provision, value of leased item, location where leased item may be used, and who is responsible for maintenance and insurance.

Leasing has several advantages over purchasing, including the following:

- Payments are spread over a longer time period. The lessor may agree to a flexible payment schedule to coincide with the seasonal nature of the lessee's business.
- Typically, a purchase option exists, permitting the lessee to obtain the property at a bargain price at the expiration of the lease. This provides the lessee with the flexibility to make the purchase decision based on the value of the property at the termination date.
- The lessor's expert service is made available.
- There are generally fewer financing restrictions placed on the lessee by the lessor than there are when obtaining a loan to buy the asset.
- In bankruptcy or reorganization, the maximum claim of lessors against the business is three years of lease payments. In the case of debt, creditors have a claim for the total amount of the unpaid financing.

However, there are also several drawbacks to leasing, including the following:

- The interest cost associated with leasing is typically higher than the interest cost on debt.
- If the property reverts to the lessor at the termination of the lease, the lessee must either sign a new lease or buy the property at higher current prices.
- The lessee may have to take ownership of property no longer needed (i.e., obsolete equipment).
- The lessee cannot make improvements to the leased property without the permission of the lessor.

In deciding upon which lessor to use, consider the rental fee and the reliability of the lessor. The lease rate per year is usually lower if you choose a longer rental period. Before using a particular lessor, check their references and credit ratings.

Present value analysis may be used to decide whether it is cheaper to buy or lease. Future cash flows are discounted with the use of present value tables and the cheaper alternative is selected.

Section 3:

Managing Financial Assets

Learning Objectives:

After studying this section, you will be able to:

- Recognize methods for maximizing working capital and improving cash management.
- Identify processes for inventory management and control.

Working Capital

Working capital equals current assets less current liabilities. For example, if your current assets are $250,000 and your current liabilities are $100,000, your working capital is $150,000. If working capital is inadequate, your business may fail because it has insufficient funds to meet short-term obligations. Always analyze and identify the reasons for material changes in working capital.

The major components of working capital, together with some related considerations, are:

- *Cash and Marketable Securities*. These are the most liquid of the current assets. Marketable securities are near-cash items used primarily for short-term investment. Examples include U. S. Treasury bills, Eurodollars, commercial paper, money market mutual funds with portfolios of short-term securities, bankers' acceptances, floating-rate preferred stock, and negotiable CDs of U.S. banks.
- *Accounts Receivable*. These represent balances due to you from customers. What is the age of accounts receivable? Is there a reasonable relationship between accounts receivable and sales? Search out ways to accelerate cash collections, perhaps by offering a discount for early collection. Risky customers should be avoided because of the possibility of uncollectibility.
- *Inventory*. Inventory represents merchandise held for sale. Watch out for inventory buildups – these may indicate problems in selling goods. Is inventory obsolete or perishable? Determine inventory turnover rates by comparing sales to average inventory. Also, identify inadequate stocking as it may lead to lost business.

- *Accounts Payable*. These are amounts you owe trade creditors on account. Accounts payable is a cost-free source of financing. However, if you stretch amounts owed to suppliers too far, you may hurt your credit rating. If you are offered a cash discount for early payment, take it if feasible.
- *Notes Payable due within 12 months*. These represent loans from third parties (usually banks) and possibly the seller of the business. You will have to pay interest on the principal of the loans. Is your debt level excessive, creating potential problems in making loan payments?
- *Accrued Expenses*. Accrued expenses represent amounts incurred for expenses (e.g., utilities, interest, salaries, and taxes) that have not yet been paid. These are obligations of the business at the end of the accounting period. Do you have sufficient funds to pay these expenses when due?

In managing working capital, you have to consider the tradeoff between return and risk.

Holding more current assets than fixed assets means less liquidity risk. However, fixed assets typically earn a greater return than current assets. Long-term financing has less liquidity risk associated with it than short-term debt, but it also carries a higher cost.

Cash Management

Cash refers to currency and demand deposits. *Cash management* involves having the optimum amount of cash on hand at the right time. Proper cash management requires that you know how much cash the business needs, as well as how much the business has, and where that cash is at all times. If you do not keep track of the money, your business may fail.

The objective of cash management is to invest excess cash for a return while retaining sufficient liquidity to satisfy future needs. You must plan when to have excess funds available for investment and when to borrow money.

The amount of cash to be held depends upon the current liquidity position, liquidity risk preferences, schedule of debt maturity, ability to borrow, forecasted cash flow, and the probabilities of different cash flows under varying circumstances. Your business should not have an excessive cash balance since little to no return is earned on those funds.

Cash management also requires knowing the amount of funds available for investments and the length of time for which they can be invested. When cash receipts and disbursements are highly synchronized and predictable, your business may keep a small cash balance. You must accurately forecast the amount of cash needed, its source, and its destination. Forecasting assists you in properly timing financing, debt repayment, and the amounts to be transferred between accounts.

Less cash needs to be on hand when you can borrow quickly from a bank, perhaps under a *line of credit agreement,* which permits you to borrow instantly up to a specified maximum amount. A business may also find some cash unnecessarily tied up in other accounts such as advances to employees. Excess cash should be invested in marketable securities for a return. However, cash in some bank accounts may not be available for investment. For instance, when a bank lends money to a business, the bank often requires the firm to keep funds on hand as collateral. This deposit is called a *compensating balance,* which in effect represents *restricted* cash for the business. Further, interest is not earned on compensating balances.

Holding marketable securities serves as protection against cash shortages. Businesses with seasonal operations may buy marketable securities when they have surplus cash, and sell them when they need cash or cash deficits occur.

The thrust of cash management is to accelerate cash receipts and delay cash payments.

Acceleration of Cash Inflow. To accelerate cash inflow, you must (1) know the bank's policy regarding fund availability (2) know the source and location of company receipts, and (3) devise procedures for the quick deposit of checks.

Cash inflow may be accelerated by having collection centers located near the customers. Local banks should be selected to speed the receipt of funds. As an alternative, strategic post office lockboxes may be used for customer remissions. The local bank collects from these boxes periodically during the day and deposits the funds in the corporate account.

Delay of Cash Outflow. There are various ways to delay cash payments, including:

- Request later payment dates. Payments to vendors should be delayed to the latest date possible, considering the benefits of taking discounts, as long as there is no associated finance charge or impairment of the company's credit rating.
- Using direct EFT payments at the last possible date.
- Using credit cards and charge accounts in order to lengthen the time between the acquisition of goods and payment for those goods.

A business can minimize its cash balances by using probability analysis to estimate the expected date that checks will clear. Deposits, for example, may be made to a payroll checking account based on the dates checks that are not direct deposited are expected to clear. The probability and costs of overdrafts also need to be considered.

Lock in a Line of Credit

One of the most effective tools a small business can use to survive a cash crunch is a line of credit (LOC), a revolving financing tool that you can tap into on an as-needed basis. With a LOC, your lender sets a maximum amount of funds it will make available to you; you can access those funds when your business needs them. Typically, interest accrues only when the funds are drawn, and is charged only on the outstanding balance. The borrower has the option of paying back the balance in full or over time. When you repay the principal, money is made available for future loans.

Investments of Excess Funds

Cash and short-term investments are crucial to a firm's continuing success. Sufficient liquidity must be available to meet payments as they come due. At the same time, liquid assets present significant control risks. *Therefore, liquidity and safety are the primary concerns of the treasurer when dealing with highly liquid assets.* Cash and short-term investments are held because of their ability to facilitate routine operations of the company. These assets are not necessarily held for purposes of achieving investment returns.

Inventory Management and Control

In managing inventory, you should:

- Appraise the adequacy of the inventory level, which depends on several factors, including expected sales and seasonal considerations.
- Forecast future movement in inventory prices; if prices are expected to increase, additional inventory should be purchased at the lower price.
- Discard slow-moving products to reduce inventory-carrying costs and improve cash flow.
- Guard against inventory buildup, since it is associated with substantial carrying and opportunity costs.
- Minimize inventory levels when liquidity and/or inventory financing problems exist or are anticipated.
- Plan for a stock inventory balance that will guard against and cushion the possible loss of business from an inventory shortage.
- Examine the quality of the merchandise received. The ratio of purchase returns to purchases should be examined. A sharp increase in the ratio may indicate that a new supplier is needed.
- Keep a careful record of backorders. A high backorder level may indicate that higher inventory balances are required, at least in the short term, to meet current demand.
- Appraise the acquisition and inventory control functions. Any problems must be identified and rectified. In areas where control is weak, inventory levels should be restricted.
- Closely supervise warehouse and handling staff to guard against theft and to maximize efficiency.
- Minimize the lead-time in the acquisition and distribution functions. The lead-time in receiving goods is determined by dividing the value of outstanding orders by the average daily purchases. This ratio may indicate whether an increase in inventory stocking is required or whether the purchasing pattern should be altered.

Basic recordkeeping is an important aspect of inventory control. Being able to calculate ratios such as inventory turnover time and analyze seasonal fluctuations are important to assessing and maintaining controls over inventory. The basic inventory records must include the date purchased, item purchased, quantity purchased, location, purchase price, date sold, and sale price. These records should be computerized, especially if they are extensive, and must be kept current. (See Internal Controls, for a more detailed discussion.)

You have to consider risks associated with inventory. For example, technological, perishable, fashionable, flammable, and specialized goods usually have a high risk related to their salability over time. The nature of the risks associated with particular inventory items should be taken into account in computing the desired inventory levels.

Inventory management involves a trade-off between the costs and benefits associated with keeping inventory. Higher inventory levels result in increased costs for storage, insurance, spoilage, and potentially interest on borrowed funds if needed to finance inventory acquisition. However, higher inventory levels lower the possibility of lost sales from stockouts. Further, large volume purchases will result in greater purchase discounts.

Inventory should be counted at regular, cyclic intervals; this enables you to check inventory on an ongoing basis as well as to reconcile the book and physical amounts.

Carrying and Ordering Costs.

Inventory carrying costs include those for warehousing, handling, and insurance. A provisional cost for spoilage and obsolescence should also be included in the analysis of inventory. In addition, the opportunity cost of holding inventory balances must be considered. The carrying cost per unit equals:

$$\text{Carrying Cost} = (Q/2) \times C$$

Where Q/2 represents average inventory quantity and C is the average historical carrying cost per unit.

Inventory ordering costs are the costs associated with placing an order and receiving the merchandise. They include freight and shipping charges in shipping the items to the company, setup costs, quantity discounts lost, and the clerical costs to place an order. The ordering cost per unit equals:

Ordering Cost =	(S/Q) x P
Where	S = Total usage
	Q = Quantity per order
	P = Cost of placing an order

The total inventory cost is therefore:

$$QC/2 \; + \; SP/Q$$

A trade-off exists between ordering and carrying costs. A greater order quantity will generally increase carrying costs but lower ordering costs.

Economic Order Quantity (EOQ). The economic order quantity (EOQ) is the optimal amount of goods to order each time an order is placed so that total inventory costs are minimized and is calculated as follows:

$$EOQ = \sqrt{2SP / C}$$

where S = annual or period demand (usage) in units, P = ordering cost per order, and C = carrying cost per unit.

The number of orders to be placed for a period is the usage (S) divided by the EOQ.

Example:

A business needs to know how frequently to place its orders. The following information is provided:

S = 500 units per month

P = \$40 per order
C = \$4 per unit

$$EOQ = \sqrt{2SP/C} = \sqrt{2(500)(40)/4} = \sqrt{10{,}000} = 100 \text{ units}$$

The number of orders required to be placed each month is:

$$\frac{S}{EOQ} = \frac{500}{100} = 5$$

Therefore, an order should be placed about every six days (31/5).

Stockouts. Stockouts of inventory can result in customer dissatisfaction. In order to avoid a stockout situation, a safety stock level should be maintained. Safety stock is the minimum inventory needed for an item based on anticipated usage and the expected delivery time from the supplier. A business maintains safety stocks to protect itself against the losses caused by inventory stockouts. These losses can take the form of lost sales or damage to customer relations. Safety stock is necessary because of the variability in lead time and usage rates. As the lead time increases, a company will tend to carry larger safety stocks.

Reorder Point (ROP). The reorder point is the inventory level that signals the time to reorder merchandise at the EOQ amount.

ROP = Lead time x Average usage per unit of time

If a safety stock is needed, then add this amount to the reorder point.

EXAMPLE

A business needs 6,400 units evenly throughout the year. Lead-time is one week. There are 50 working weeks in the year. The safety stock is 20 units.

$$ROP = 1 \text{ week} \times \frac{6{,}400}{50 \text{ weeks}} = 1 \times 128 + 20 = 148 \text{ units}$$

Credit and Collection Policy

The major decision affecting accounts receivable is the determination of the amount and terms of credit to extend to customers. The credit terms offered have a direct bearing on the associated costs and revenue to be generated from receivables. For example, tight credit terms lead to less investment in accounts receivable and lower bad debt losses, but may also result in lower sales and reduced profits.

A firm may consider offering credit to customers with a higher-than-normal risk rating. Here the profitability on additional sales must be compared with the increase in bad debts, higher investing and collection costs, and the opportunity cost of tying up funds in receivables for a longer period of time.

Your credit policy should be flexible, depending upon the times. In good economic times, you may expand credit; in bad economic times, you may restrict it. As you extend credit, your cash flow should be adequate to support the accounts receivable, buy inventory, and pay operating expenses. Generally, a retailer requires a monthly cash flow of at least three times the balance of its receivables. A manufacturer needs adequate funds to operate during the time lag between billings and payment.

In evaluating a potential customer's ability to pay, consider the firm's integrity and financial soundness, the collateral to be pledged, and current economic conditions. The credit department should carefully analyze the customer's financial position. Check the customer's references, including employer, banks, and vendors. Do not accept a salesperson's word on the credit standing of the customer. Salespeople often extend credit too freely because they are eager to make the sale!

Some sources of credit information on companies and individuals are:

- *Credit Bureaus.* These organizations are in the business of furnishing credit reports on business firms and individuals. In selecting a particular credit bureau, consider its reputation, coverage, accuracy, timeliness, and fee. Examples are Trans Union, Experian, and Equifax. You may obtain credit information and reports instantly by accessing through the internet.

- *Mercantile Credit Agencies.* These private agencies gather and appraise credit information on business firms. An example is Dun and Bradstreet.

- *Suppliers.* Suppliers may furnish information on your potential customers.

You should prepare a credit application form that each customer must fill out before you extend credit. Information required on the form should include the length of employment, position, income, bank accounts, net worth, and other pertinent data.

The credit policy of your business may be based on the type and size of the customer, product or services offered, pricing strategy, cost of the product relative to selling price, overall business strategy, liquidity position, competition, and distribution channels. In establishing a credit policy, consider the following:

- Credit limits should be revised as customer financial health changes.
- Marketing factors are critical since an excessively restricted credit policy will lead to lost sales.
- Seasonality and whether the firm can offer more liberal payments than usual during slow periods in order to stimulate business by selling to customers who are unable to pay until later in the season. This policy is financially appropriate when the return on the additional sales plus the savings in inventory costs is greater than the incremental cost associated with the additional investment in accounts receivable.

As per the federal Truth in Lending Law, the information to be contained in credit agreements must include: cash price for merchandise or services, down payment, amount being financed, method of determining the balance subject to finance charges, annual percentage finance rate, finance charges, total payments, principal and interest portion of payments, number and amount of periodic payments, due dates of payments, penalty charges, and description of collateral.

Periodic statements showing the balances owed should be mailed (paper or electronic) to customers. The statement must include the beginning balance, purchases, customer payments, finance charges, annual percentage rate, unpaid balance, and the closing date of the billing cycle. In many states, the minimum time before you can charge interest on a purchase is 30 days after the purchase.

In a credit card transaction, you will receive payment for the merchandise or services before the customer pays the credit card issuer. By accepting credit cards, you protect yourself against uncollectibility, because the credit card company is taking the risk, and you gain more customers because many people are credit cardholders. You are assessed a fee based on the amount of each purchase charged to a credit card. Because of the recordkeeping involved and possible minimum transaction fees from the credit card merchants (ex. $0.30 per charge), you should set minimum amounts for such purchases. On the plus side, credit card purchasers tend to spend more and are less concerned about the price of the merchandise. However, you must be careful of credit card theft and counterfeiting. Note also that the customer may stop payment on a disputed item and that there is a greater tendency to return merchandise purchased on credit cards.

You may sell seasonal merchandise by accepting installment payments over several months. Installment payment plans are useful for more expensive items, usually durable goods (e.g. furniture) that have high values and long lives. If a customer fails to make payments, you may repossess the item. Because a larger down payment makes the buyer feel more like the owner, a suggested down payment is 25 percent. Also, a larger down payment and higher monthly payments protect against a decline in the value of the item if repossession is necessary. The unpaid balance should be below the market value of the item.

It pays for a firm to give a discount for early payment to customers when the return on the funds received early is greater than the cost of the discount. A term of sale may be 2/10, net/30 which means if the customer pays in 10 days he or she receives a 2 percent discount but must pay the balance in 30 days.

Your collection policy should consider the following:

- Customer statements should be mailed the day after the close of the billing period.
- Large sales should be billed immediately.
- Customers should be invoiced for goods when the order is processed rather than when it is shipped.
- Billing for services should be done on an interim basis as the services are performed. The billing process will be more uniform by maintaining regular billing cycles (i.e. every two weeks, monthly).
- Accelerated collection should be employed for customers experiencing financial problems.

Use the following steps to collect on delinquent accounts:

- *Use a daily accounts-receivable contact report*. Have your accounts-receivable person give you a written daily delinquent accounts report that tracks four critical areas: whom he or she called each day, the outcome of each conversation, when you can expect payment from each customer and whether customers have paid when they said they would. Review this report on a daily basis until you have contacted all customers with a past due balance. Then review it on a weekly or monthly basis, as needed.

- *Start the follow-up process early*. Contact problem accounts within three to five days of their becoming overdue. Waiting 60 or 90 days not only puts a major dent in your cash flow, it puts delinquent customers in an embarrassing situation because they know they are overdue. Often, rather than square pay off the account, they put your receivables at the bottom of their payables pile and take their business to a competitor. To justify their actions, they may start bad-mouthing your company or complain about nonexistent problems with your product or service.
- *Call the largest accounts first*. Many companies call their delinquent accounts in alphabetical order. Instead, you should go after the customers that owe you the big bucks first. Why? Because 20% of your accounts usually represent 80% of the dollars. Do your cash flow a favor by starting with the largest accounts and working your way down to the smaller ones.
- *Keep a log to track systems problems*. Customers often become delinquent because of billing or invoicing errors on your part. By tracking your accounts-receivable systems problems and your solutions to those problems, you can respond to billing glitches in a timely and efficient manner, thereby eliminating a common excuse for late payments. A good tracking system also allows you to upgrade your business processes continually and provide better service to your customers.
- *Call at the right time*. The best time to call commercial accounts is Monday morning. Start calling personal customers Thursday and go through Friday, when people usually get paid.

You may turn a delinquent account over to a collection agency four to six months after the sale date. Of course, a significant fee will be charged by the collection agency upon collection. You may also take a delinquent customer to court for nonpayment. If a small amount of money is involved, you may go to small claims court where a lawyer is not needed and the chance of collection is high.

Section 4:

Legal Considerations

Learning Objectives:

After studying this section, you will be able to:

- Recognize the elements of different business structures.
- Identify items within legal contracts.
- Recognize the value of patents and where to register a trademark.

Deciding upon a Legal Structure for the Business

Your business may be organized as a sole proprietorship, a partnership, or a corporation, of which there are many types.

Sole Proprietorship

In a sole proprietorship, the easiest legal structure to establish, the business is owned and operated by one individual. You have to obtain the appropriate licenses from local governmental authorities. The advantages of a sole proprietorship compared to the other legal forms are that it has greater freedom from governmental regulation; you retain all the profit; it is less expensive to establish and easier to terminate; and you keep full control over the business. Any income or loss from the business is reported on the owner's personal tax return using Schedule C. The disadvantages of a sole proprietorship are that you may have more difficulty obtaining capital; you may have limited access to resources; and you have unlimited personal liability for the firm's debts and actions.

Partnership

In a partnership, two or more persons own the business. An attorney will assist in preparing the written partnership agreement and/or articles of partnership specifying the terms and conditions. The agreement should also address what happens to the partnership in the event of the death of any partner (e.g. does it terminate?).

In a partnership, at least one partner has unlimited liability. Partners generally share in profits and losses, and each partner is legally responsible for the acts of the other partner or partners. A partner may be active or inactive in running the affairs of the partnership. A limited partner can lose only his or her investment in the partnership while a general partner is personally liable for all partnership debts. However, the general partner manages and controls the business.

The advantages of a partnership are that it offers flexibility; each partner's share of partnership income or loss is reported only on his or her personal income tax return, thus there is no double taxation like there may be with corporations (although partnerships must prepare and file IRS Form 1065, U.S. Partnership Return of Income); each partner shares in partnership profits; there is less governmental control than for a corporation; there is generally additional capital available compared to a sole proprietorship; there is access to greater capabilities because more people are involved allowing for the sharing of knowledge, assets, etc.; partnerships are easier to form than corporations and may provide greater stability (for instance if one partner gets sick, others may be available to perform his or her duties) than a sole proprietorship.

The disadvantages of a partnership are that partners are legally responsible for the actions of other partners; there may be personal power conflicts; at least one partner has unlimited liability for partnership debts; it may be difficult to obtain financing compared to a corporation.

Corporation

A Corporation is a legal entity that functions somewhat like an individual, legally and for tax purposes. Liabilities are the obligation of the corporation, minimizing the personal liability of owners. A corporation operates as a business and can be owned wholly or partially by various parties based on ownership of registered certificates called stock. To set up a corporation, you must file an application for a legal name, pay a corporate franchise fee to the state in which you file, appoint a board of directors and corporate officers, and keep minutes of periodic meetings of the board.

Corporations offer the strongest protection to its owners from personal liability, but the cost to form a corporation is higher than other structures. Corporations also require more extensive record-keeping, operational processes, and reporting.

A corporation conducts business, realizes net income or loss, pays taxes, and distributes profits to shareholders. The profit of a corporation is taxed to the corporation when earned and then is taxed to the shareholders when distributed as dividends. This creates a double tax. The corporation does not get a tax deduction when it distributes dividends to shareholders. Shareholders cannot deduct any loss of the corporation.

S Corporation

There's a unique type of corporation called an S Corporation that provides the advantages of a corporation but, unlike a corporation, is treated for income tax purposes as a flow-through entity. Income is reported individually by the owners or stockholders on their personal income tax returns. Also, the owners may deduct the corporation's losses against other sources of income. For an eligible domestic corporation to qualify as an S corporation, it must meet the following requirements:

- It cannot have more than 100 shareholders.
- It cannot have partnerships, corporations, or nonresident aliens as shareholders.
- It cannot have more than one class of stock.
- It must properly elect Subchapter S status.

Limited Liability Corporation (LLC)

A Limited Liability Company (LLC) is a business structure allowed by state statute. Each state may use different regulations. Owners of an LLC are called members. Most states do not restrict ownership, so members may include individuals, corporations, other LLCs, and foreign entities. There is no maximum number of members. Most states also permit "single-member" LLCs, those having only one owner.

An LLC is a corporation in which income is distributed to the owner(s), who are generally referred to as members, but the members are not personally liable for the LLC's debts.

Depending on elections made by the LLC and the number of members, the IRS will treat an LLC as either a corporation, partnership, or as part of the LLC's owner's tax return (a "disregarded entity"). Specifically, a domestic LLC with at least two members is classified as a partnership for federal income tax purposes unless it files Form 8832 and affirmatively elects to be treated as a corporation. For income tax purposes, an LLC with only one member is treated as an entity disregarded as separate from its owner, unless it files Form 8832 and elects to be treated as a corporation. However, for purposes of employment tax and certain excise taxes, an LLC with only one member is still considered a separate entity.

If you are interested in setting up such a corporation, be sure to consult a knowledgeable attorney.

Some of the main advantages and disadvantages of the different types of business entities, or legal structures, are listed below:

	Advantages	Disadvantages
Sole Proprietorship	• Creation: Easy to create and maintain - and business and owner are legally the same entity. • Taxes: Owner may generally deduct a net business loss on their personal income tax return. • Easy to discontinue.	• Liability: Owner is personally liable for any debts, judgments, or other liabilities of the business. • Taxes: Owner must pay personal income taxes on all net business profits.
General Partnership	• Creation: Easy to create and maintain - few fees associated with creation of the business entity. • Taxes: Owners report their share of net business profits and losses on their personal income tax returns.	• Liability: All owners are jointly and personally liable for any debts, judgments, or other liabilities of the business. • Taxes: Owners must pay personal income taxes on all net business profits.
Limited Partnership	• Typically used by businesses such as real estate investment groups or film	• Liability: The general partners are jointly and personally liable for any debts,

	industry financing. The general partners can focus their attention on the business and are able to raise cash without diminishing their control of the business. • Limited partners can leave the business without dissolving the limited partnership • Liability: The limited partners enjoy limited liability for any debts, judgments, or other liabilities of the business. It is easy to attract investors as they are only liable for the total amount of their investment in the business.	judgments, or other liabilities of the business. • Creation: Can be more expensive to create than a general partnership.
Regular Corporation	• Liability: Owners of the business enjoy limited liability for the business' debts, judgments, and other liabilities. • Ability to continue indefinitely and to transfer ownership easily by selling shares. • Some benefits may be deducted as business expenses.	• Creation: More expensive to establish than a sole proprietorship or partnership. Complicated paperwork that must be filed with the secretary of state. • Taxes: Corporations must pay their own taxes as a separate tax entity, so double taxation with dividends could be an issue. • Legal requirements. • Potential loss of control.
S Corporation	• Liability: Owners of the business enjoy limited liability for the business' debts, judgments, and other liabilities. • Taxes: Owners share the net profits of the business and report their share on their personal income tax returns, and owners share the net business loss and can offset other income by reporting this loss on their personal income tax returns.	• Creation: More expensive to establish than a sole proprietorship or partnership. The paperwork can be more complicated than the paperwork required for an LLC. • Income: The ownership interest of the various owners determines their respective incomes from the profits of the business, so salaries should be adjusted to account for any discrepancies in the actual amount of work. • Some benefits are only given to owners that have more than 2% of the business shares.
Professional Corporation	• Liability: Owners are not personally liable for the malpractice of other owners.	• Creation: More expensive to establish than a sole proprietorship or partnership. The paperwork and filings may be a burden. Every owner must be

		in the same profession as all other owners.
Nonprofit Corporation	• Taxes: Corporation does not pay income taxes on money it receives for a charitable purpose. Donors that give for a charitable purpose may deduct their donations from income taxes. • Some benefits may be deducted as business expenses.	• Taxes: The full tax benefits and advantages can only be utilized by businesses that have been incorporated for a charitable, educational, scientific, religious, or literary purpose.
Limited Liability Company (LLC)	• Liability: Owners of the business enjoy limited liability for the business' debts, judgments, and other liabilities, even if the owners engage in significant control of the business. • Income: The business profits and losses can be allocated to the owners along different lines than ownership interest (for example, a 10% owner may be allocated 30% of the business' profits). • Taxes: Owners can choose how the LLC will be taxed, either as a partnership or a corporation.	• Creation: More expensive to establish than a sole proprietorship or partnership.
Professional Limited Liability Company	• Allows state-licensed professionals to enjoy the same advantages as an LLC.	• Same disadvantages as an LLC. • Creation: All members must belong to the same profession.
Limited Liability Partnership	• Commonly used by law, medicine, and accounting entities. • Liability: Partners are not liable for the malpractice of other partners. • Taxes: Partners report their share of loss or gain on their personal income tax returns.	• Liability: Partners remain personally liable for obligations to business creditors, landlords, and lenders. • Creation: Not every state allows limited liability partnerships, and it is often limited to only a select few professions.

Legal Contracts

When purchasing an existing business, you will need an attorney to represent you when negotiating and completing the purchase agreement. The purchase agreement, a written legal contract that transfers ownership of the business from the seller to the buyer, should contain the following items:

- The purchase price and the method of payment. For example, can you borrow money from the seller at a lower interest rate than the bank offers?
- The date the buyer effectively owns the business.

- A detailed description of what is being sold, including all of the assets, particularly inventory.
- The liabilities you will or will not assume.
- Seller warranties.
- Who is responsible for what expenses (e.g. bills, legal and accounting fees, payroll taxes).
- Non-compete clause by the seller, specifying the duration and geographic area.

It is best to close as soon as possible after the contract date to minimize transitional problems and to keep the condition of the business in good working order. For example, the seller is not likely to make needed repairs during the period between the contract date and closing date. You should request that the seller set up an escrow account for unexpected repairs. A quick closing also reduces the chance of inventory problems.

You may ask for a "buy-back" contract in which the seller agrees to buy back the business if you do not do well, perhaps failing to meet a specified sales or earnings objective. It is usually best to pay out the purchase price over an extended time period to assure the continued cooperation of the seller.

Business Licenses

You may have to obtain various business licenses in order to operate. You may need a license to practice particular occupations, such as medicine or law. Contact the Department of Commerce of your domiciliary state to see if there are any licensing requirements for your particular type of business. Additionally, if you are doing business in multiple states, contact each state to see if they have additional licensing and registration requirements.

Typically, you obtain local business licenses from the appropriate state department and/or municipality by contacting the city or county hall. Before such a license is issued, you may have to conform to specific zoning laws, building codes, fire protection specifications, and health regulations. When you obtain your business license, you will be notified if special permits are required.

Since the federal government regulates interstate commerce, you may need a federal license if you will sell your product or services in several states. Further, federal licenses and permits are required for businesses engaged in certain activities, such as common carriers and radio stations.

Obtaining a Patent, Trademark, or Copyright

You may want to patent a product, register a trademark, or obtain a copyright in order to protect what you have from competitive infringement.

Patent. Generally, only the inventor may apply for a patent from the U.S. Patent and Trademark Office. You may obtain a patent granting you exclusive rights to the invention for 20 years for utility patents and 15 years for design patents (filed after May 13, 2015). By the time you are through with all the legal and application fees involved, it will cost at least several thousand dollars.

A patent covers the invention or discovery of a new and useful process, machine, article of manufacture, or composition of matter. The invention must be significantly different from any similar invention that already exists.

It is best to retain a patent attorney or patent agent when applying for a patent because he or she is knowledgeable about the application procedures and your rights. Contact the patent office mentioned earlier in this section for a listing of registered lawyers and agents. The patent application includes a specification and description of the invention, any claims you are making about it, a drawing (where possible), and the filing fee. The specification includes the manner and process of producing and using the item.

When you produce or sell patented products, you must mark the items "patented" along with the patent number. You may sue any other business that infringes upon your patented product.

Copyright. A copyright, which runs for the holder's life plus 70 years after his or her death, is protection given to an author or artist for an original work in the form of exclusive rights to the creation. Examples of items that may be copyrighted are literary works, pictorial works, motion pictures, musical works, and sound recordings.

While a copyright exists from the moment the work is created., it is recommended that you register it so there will be a public record. Registration is a prerequisite in bringing a copyright infringement case. You can do the copyright registration yourself by filling out an application, paying a small application fee, and providing a copy of the work. An application may be completed online or obtained from the Register of Copyrights, Library of Congress, Washington, D.C. 20559. Note that there is a higher fee for paper filings than for online registration.

Trademark. A trademark applies to any word, symbol, name, logo, or device used by a company, manufacturer, or service provided to identify his or her distinguishable company, product, or service. Registration is made with the Commissioner of Patents and Trademarks, Washington, D.C. 20231. The application generally requires submission of a drawing of the mark, five specimens of facsimiles, and the application fee. Even though registration is not required for a trademark to be protected, registration is recommended so you may sue for any infringement. You are giving constructive notice of ownership. Criminal penalties are assessed to those who counterfeit a registered trademark.

The Patent and Trademark Office has made the process of researching and applying for trademarks fairly simple through the Trademark Electronic Application System. The system is online at www.uspto.gov. A serial number will be assigned to the trademark. The notice of trademark is stated as "Registered in U.S. Patent and Trademark Office."

A trademark has no specified expiration date; however, ongoing filings are required to keep the registration active. Between the fifth and sixth year subsequent to registration, the registrant must file a Declaration of Use and/or Excusable Nonuse (DOU) form. Between the ninth and tenth year after registration, and every ninth and tenth year period thereafter, the owner must file another DOU and an Application for Renewal to keep the registration active. Failure to file any of the required maintenance documents will cause the cancellation of the trademark registration.

Protecting Against Criminal Acts

Crime is a serious problem for small businesses and may lead not only to significant financial loss but also to business failure. Crimes, including burglary, robbery, shoplifting, internal theft, and accepting uncollectible checks can also send your insurance rates up, or even make it impossible for you to get insurance.

Shoplifting. Shoplifting is the most common crime perpetrated on small businesses. You have to try to learn how to identify a shoplifter. Shoplifters may appear clumsy or erratic in their behavior. Most shoplifters are juveniles.

Be on guard against these common shoplifting tactics:

- Putting on clothes and walking out with them.
- Switching price tags.
- Putting the item to be stolen in the shoplifter's pocket.
- Using one shoplifter as a decoy to cause a distraction while another steals.

Returned merchandise should come in a bag with the receipt. Make sure the customer has not been walking around the store before coming to the checkout counter.

Ways of deterring shoplifting are:

- Locking display cabinets containing expensive merchandise.
- Using protective equipment such as two-way mirrors, one-way viewing mirrors, peepholes, and convex wall mirrors.
- Using closed-circuit television in the cashier area and aisles.
- Stapling receipts to the outside of packages.
- Using hard-to-break plastic string.
- Having employees patrol the aisles when the store is busy.
- Posting signs warning about the penalties of shoplifting.
- Having a security guard.
- Locking doors not in use unless that would be a violation of the fire code.
- Designing the store's layout and structure to deter shoplifting by having adequate lighting, positioning the cash register where the cashier can see the aisles clearly, and having only one entrance in front of the store.
- Instructing employees on shoplifting tactics, likely shoplifters, and how to identify suspicious shoppers.
- Having an employee stationed at the dressing room. The employee may give the customer a tag showing how many garments he or she is bringing in.
- Allowing only a limited amount of articles into a fitting room at a time.
- Watching for shoppers who are in the store for long time periods, those shopping during lunch, and those handling a lot of merchandise.
- Guarding against switched price labels.

- Marking merchandise with sensitized tags, which cannot be removed without damaging the merchandise. If the item is taken out of the store before a clerk removes the tag, an alarm will sound.

Employees who spot a shoplifter should be able to alert one another by a prearranged signal or code and should also call the police and/or security. You have to be careful when confronting a potential shoplifter because you do not want to disturb your regular customers and you do not want police to arrest an innocent party who can then sue for false arrest. (You should carry insurance for this eventuality.) In order for a shoplifting charge to succeed, you must be able to do the following:

- Positively identify the merchandise as yours.
- Testify that the person intended to steal the item.
- Prove the person did not pay for the merchandise.
- Attest that the shoplifter was seen taking or concealing the merchandise or tags or merchandise was observed on the shoplifter's person or in (or sticking out of) their bags, etc.

If you cannot support each of the above, you will probably lose the case.

Burglary. Burglary is an unlawful entry in order to commit a theft. Ways to help prevent burglary and limit losses include:

- *Alarms*. A silent central station alarm is typically better than a local one with a siren. But if you want to frighten the burglar before entrance, an audio alarm is better. You can also have sensory devices such as ultrasonic, radar motion, or vibration detectors.
- *Lighting*. Lighting your premises, including buildings and parking lots, at night will discourage burglars, who prefer darkness.
- *Key control*. Stamp the door key "Do Not Duplicate." Control over keys, both physical and electronic (e.g. ID swiped to gain access), is necessary; only give keys to authorized users. If an employee is terminated, collect their keys. If a terminated employee does not return their physical key or a key is lost, change the locks. If electronic keys are used and an employee terminates or loses their card, deactivate their access codes by the last day of work or when notified of the lost card. Avoid a master key because it detracts from the overall security system. Use a code number on the key rather than a tag saying what lock it opens. Change locks periodically to prevent the use of old keys by former employees.
- *Burglar-resistant windows*. The use of impact-resistant plastic windows or laminated glass will deter burglaries.
- *Burglar-resistant safes*. An electronic safe may be used. Preferably, the safe should be bolted to the building structure. You should not have the combination or pass code (if using an electronic safe lock) at the store, and when an employee who knows the combination or pass code leaves, the combination or pass code should be changed.
- *Physical Locks*. The best security for a physical lock is the pin-tumbler cylinder lock or a double cylinder deadbolt lock.
- *Watchdogs.*
- *Daily cash deposits*.

Robbery. Robbery is the act of taking a valuable item by using force, violence, or intimidation. This is a serious problem for retail stores. Typically, a weapon is used in a robbery.

To help prevent robberies:

- Use an armored service, where warranted.
- Do not carry money where it can obviously be seen.
- Have silent alarms, such as holdup buttons, installed.
- Carry a properly permitted handgun.
- Vary your routes and hours for going to the bank so there is no consistent pattern.
- Use surveillance cameras.
- Use dual-control safe that can be opened by you and the armored guard.

If you receive a call at home at night that something is wrong at the store, make sure the police accompany you since the robber may be waiting for you.

Uncollectible Checks. Before accepting a customer's check, you should:

- Preferably, know the check passer.
- Make sure the check has not been altered in any way.
- Ensure the amount written on the check is the same as the amount entered in the numerical amount field on the check.
- Set a maximum limit for a check that you will accept
- Compare signatures on the check and on the identification.
- Be wary if the customer shows a lack of concern for the price of the goods.
- Require two pieces of identification. Put the serial number from the driver's license on the check. The best forms of identification are driver's license, credit cards, and automobile registration.

Do not accept a check if:

- The check is dated 30 days or more before the purchase date.
- It is a personal check for more than the purchase price, cashing the difference
- The customer is acting strangely.
- The check is predated by the customer in the store.
- The check has an old date.
- The individual appears to be under the influence of alcohol or drugs.

Section 5:

Accounting, Cost, and Financial Analysis

Learning Objectives:

After studying this section, you will be able to:

- Recognize financial records necessary to improve internal controls.
- Identify different financial ratios useful for financial analysis.
- Recognize major elements in business costs.

Internal Controls

Since employee theft is common, you should carefully screen all job applicants. Try to eliminate or minimize bad feelings about the company among employees by offering promotions, job enrichment, increasing job responsibility, and fair salaries. In addition, look at the employee's behavior.

Types of employee theft include stealing company merchandise or supplies, stealing petty cash and making out false vouchers, taking kickbacks, forging a company check to one's own order and destroying the check when it is returned from the bank, stealing cash payments received by mail, and cashing company checks made out to nonexistent vendors in payment of fictitious bills.

Having one individual in charge of a transaction from beginning to end opens up the possibility of manipulation. To reduce the incidence of employee theft:

- Watch for employees who bypass items when ringing up sales as they could be stealing merchandise.
- Have someone other than cashiers deposit and reconcile cash.
- Do unannounced price checks to see that pricing is correct.
- Allow only authorized employees to set prices and mark merchandise.
- Watch for a salesperson or waiter or waitress who is very popular. Is it because he or she is giving away something for free? Why do customers like the person so much? Perhaps the employee is undercharging for a better tip? Perhaps a salesperson is getting a kickback? Are many customers' relatives or friends of the employee?

- Make sure that all incoming shipments are recorded.
- Match all return vouchers to the items on the stock.
- Do not allow employees to park near the door making it easier for them to steal merchandise.
- Contact customers with return vouchers to make sure they received the refund.

Some internal controls include:

- Retaining a CPA to audit the company's books and records.
- Separating the physical handling of an asset and the recordkeeping for it. For example, the person keeping the cash or inventory records should not have physical possession of the asset.
- Having one employee record a sale and another one charge the customer's account.
- Having one employee receive a collection and another one credits the customer's account.
- Having one employee approve invoices for payment and another one issues the checks.
- Having one employee prepare the payroll and another one issue the checks.
- Clearly stamping invoices paid.
- Having spot checks on the employees' actions.
- Having employee responsible for keeping records take periodic vacations so his or her temporary replacement can uncover any irregularities.
- Requiring multiple signatures on large dollar amount checks.
- Serially numbering checks, purchase invoices, and sales invoices.
- Matching the payee to the list of approved vendors.
- Endorsing checks received "Deposit Only."
- Never make out a check to cash or bearer.
- Never pre-signing a blank check.
- Using a modern cash register.
- Preparing bank reconciliations each month.
- Checking documentation or bills before issuing checks.
- Pre-numbering cash receipt documents.
- Delivering bank statements and deposit slips to an employee other than the one who made the deposit.
- Immediately investigating customer complaints of unfilled orders when payment was received.
- Having a periodic physical count of inventory and reconciling it to the books and records.
- Having employees sign for stockroom items.
- Having cameras in the storage area to guard against employee theft.
- Using a card entry system in top security areas.
- Comparing purchase orders with vendor catalogs.
- Determining the accuracy of pay rates and any changes therein as well as approvals for overtime.
- Determining the proper recording of employee hours, perhaps by examining time cards.
- Personally approving unusual discounts or bad debt write-offs.

A common form of employee theft is embezzlement, in which the employee, without recording the sale, pockets the cash received. The following occurrences may indicate that embezzlement has taken place:

- Inventory shortages
- Slow collection of accounts receivable
- Delays in depositing cash
- Frequent cash shortages by specific employees
- A drop in sales or profit, indicating that cash may have been taken, sales have not been recorded, and/or accounts have been manipulated
- Unusual activity in an inactive account
- Unusual bad debt write-offs. Perhaps the money was collected but the account was written off anyway.
- Increase in sales returns, indicating that accounts receivable payments are being stolen

Encourage employees to tell you about their personal and financial problems. Then you will know who might be experiencing some difficulty and who might therefore be vulnerable to temptation.

Accounting Records

You should not mix your personal and business records; you need a separate bank account for your business. Remember that you can generally deduct only business-related items for tax purposes.

Do not wait until you are licensed or open for business to keep records; begin as soon as you start to refine your ideas. Many people have wonderful ideas for products or services who do not want to be bothered with the boring details of recordkeeping – their businesses are doomed to fail. A competent bookkeeper should be hired, and a CPA should be retained to audit your records periodically and to prepare the necessary financial reports and tax returns.

The records you keep serve two functions. The first is documenting activity for tax purposes, and the second is enabling you to see the financial and other trends in your business and take appropriate action where necessary to improve (or save) your business. Accounting records enable you to monitor financial condition and operating performance. They tell how you are doing financially.

Without accurate, current information, you cannot make well-reasoned business decisions. As your company grows, you must stop depending on your memory and the notes you jot down and instead set up a system for compiling, recording, and analyzing business data. The accounting information needed by a company will vary with its size, volume of activity, regulatory requirements, and the needs of its owners. Without adequate and accurate records, it is nearly impossible for a modern small business to handle buying and selling, inventory control, credit and collection, expense control, personnel, production control, tax obligations, and most other aspects of business management.

An adequate financial recordkeeping system will either provide the required information or assist the small firm operator in obtaining answers to such basic questions like the following:

- How does my profit this year compare to last year?
- How am I doing relative to my competition?

- How can I get my profit up? Are there any expenses that are too high?
- What is my net worth? What do I owe? What do I own?
- What is my cash flow?
- How much do my customers owe me? How long past due are the payments?

A small business typically has the option of being on a cash basis or accrual basis. The cash basis recognizes revenue and expenses only when the related cash is received and disbursed. Thus, the recognition of transactions is tied to cash flow. However, the cash basis may be an inappropriate accounting method when considerable inventory exists. Under accrual accounting, revenue is recognized when it is earned and expenses are recorded when they are incurred. Many small businesses use the cash basis because it is easier, involves less recordkeeping, and is more flexible.

Original (source) documents are the basis for recording transactions in journals as described below. Documents include, but are not limited to, sales slips, purchase invoices, and bills for expenses.

If possible, disbursements should be made by check or electronically so that expenses can be documented for accounting and tax purposes. If a cash payment is necessary, a receipt for the payment, or at least an explanation of it, should be included in the records. All canceled checks, paid bills, purchase invoices, sales slips, duplicate deposit slips, cash register tapes, and other documents that substantiate the entries in the financial records should be filed and stored in a safe place.

Business transactions are recorded in journals from information in the source documents. Journals are formal books of original entry with transactions generally entered daily in chronological order. Thus, the journals reflect in one place information about all financial transactions, including cash receipts, cash disbursements, sales, purchases, sales returns, purchase returns, and general activities. The cash receipts journal records all daily transactions involving all incoming cash. Examples are cash sales, receipt of interest, collections from customers, and cash received from the sale of assets. Typically, there are separate columns/fields for the date, source of the receipt (e.g. customer name), explanation and the amount of the cash debit, sales discount debit, other debit, account credit, accounts receivable credit, and other credit.

The cash <u>disbursements</u> journal contains a daily listing of all outgoing cash. This listing is in addition to, not in place of, the information in the stubs of the owner's checkbook. Cash disbursements include payments for expenses, purchases, acquisition of assets, payment of interest and debt, etc. It lists the date, payee, reason for payment, and check number.

The sales journal contains a daily listing of the amount of credit sales and the names of the customers. Sales may be broken down by major types of marketing segments (e.g., retail sales, wholesale sales).

The purchase journal has a daily listing of the purchases, amounts, and names of vendors. There is also a sales returns and allowances journal and a purchase returns and allowances journal.

The general journal provides a daily listing of all other transactions not in a separate journal. For example, you would record the uncollectibility of a customer's accounts in that journal.

Data is transferred from the journals to the ledger by debiting and crediting the particular accounts involved. This process is termed *posting.*

All accounts of a business are kept in the ledger, which is a separate book (usually computerized or online). The ledger, in effect, classifies and summarizes financial transactions and is the basis for the preparation of the balance sheet and income statement. It is also useful for decision-making because it provides the owner with the balance in a given account at a particular time. For example, if business seems poor, the owner can determine the sales for the reporting period or the ending inventory balance. Similarly, the owner will want to know the cash balance at the end of the reporting period in order to determine whether adequate funds are on hand to meet operating requirements.

Businesses that utilize computers may store the accounts on the computer or online rather than in a ledger binder.

In the general ledger, control accounts exist for accounts receivable and accounts payable. There are separate accounts receivable and accounts payable ledgers to show the individual customer and vendor accounts. For example, the total customer balances in the subsidiary accounts receivable ledger should equal the accounts receivable control account in the general ledger.

The accounts receivable ledger allows the owner to keep track of the money due to him or her. It should include the account name and number, invoice date and number, amount, terms of sale, amount paid, returns, write-offs, and balance. At the end of the period, statements are mailed to all open accounts.

The accounts payable ledger allows the owner to keep track of the money he or she owes to others. It lists the balances owed to vendors and how long the amounts have been outstanding.

Single-entry bookkeeping, although not as complete as double-entry bookkeeping, may be used effectively in a small business, especially during the early years. The single-entry system is relatively simple. The flow of income and expense is recorded through summaries of cash receipts and cash payments (as in a checkbook).

If a petty cash fund exists, a petty cash record/receipt should be kept for all payments made from it for non-check purchases, miscellaneous and minor amount items, such as postage, taxi fare, or minor supplies. A check is drawn to establish the petty cash fund. As cash is paid from it, a voucher is issued. At the end of the period, the petty cash fund is replenished, generally with a check from the company's operating or main cash account.

Payroll records provide information such as employee name, social security number, address, pay rate, hours worked, overtime, gross salary, deductions, and net pay. These records provide the basis for the preparation of federal, state, and local tax returns.

Financial Statements

Financial statements are important because they serve as the basis on which bankers decide whether to lend you money, suppliers determine whether to give you credit and potential investors decide whether to invest in your business. Financial statements are also very important so that you know how your business is doing financially.

The two major financial statements are the income statement and balance sheet. These financial statements summarize the voluminous data contained in the detailed accounting records. Financial statements show your profit, what you own, what you owe, and how much equity you have in the business. The financial statements reveal your financial health and operating performance.

You should keep records (other than for tax purposes) so that you can see the financial and other trends in your business and make necessary changes. Businesspersons who take the time to understand and evaluate their business through financial statements will be ahead of those who concern themselves only with the products and/or services.

Income Statement. The measure of operating performance is the net income (profit) or loss earned for the reporting period. This is reported in the *income statement*, also called the profit and loss (P&L) statement.

Profit is derived by subtracting *total expenses* from *total revenue (income).* The income statement generally breaks down each major type of revenue and expense items. When the owner analyzes the income statement, he or she can identify disproportionately large expenses and other potentially troublesome relationships/trends, investigate and determine the reasons why and whether changes can be made to control or address the issues.

Revenue is the increase in capital arising from normal business operations, such as the sale of merchandise (as in a retail business) or the performance of services (as by a beautician). Earned revenue results in an increase in either Cash or Accounts Receivable. Revenue can also be generated from other sources such as sales of assets or investments.

Expenses decrease capital and result from performing those functions, or incurring costs, necessary to generate revenue. The amount of an expense is equal either to the cost of the inventory sold, the value of the services received (e.g., salary expense), or the expenditures necessary for conducting business operations (e.g., rent expense) during the period.

Net Income is the amount by which total revenue exceeds total expenses for the reporting period. The resulting profit is added to the owner's capital. However, if total expenses are greater than total revenue, a net loss ensues and decreases the owner's capital.

It should be noted that revenue does not necessarily mean receipt of cash and expenses do not automatically result from cash payments. Net income and net cash flow (cash receipts less cash payments) are different. For example, taking out a bank loan will generate cash, not revenue, since the proceeds represent a liability rather than a sale or income item. Further, capital has not changed because of the loan.

Balance Sheet. The measure of your net worth is owner's capital (the difference between your total assets and total liabilities) at the end of the period. *Assets, liabilities,* and *capital* are reported in the *balance sheet*. Each type of asset, liability, and capital account is listed so that the proprietor knows the specific items he or she owns (e.g. cash, inventory) and owes (i.e., accounts payable, loans payable), and the amount of ending equity in the business (capital account). The equity at the end of the period consists of the capital investments made plus the profits or losses earned less any withdrawals and dividends declared.

A *classified* balance sheet generally breaks down assets into four categories: current assets, long-term investments, property, plant, and equipment (fixed assets), and intangible assets.

Current assets are those assets that are expected to be converted into cash or used up within one year. Examples of current assets are cash, accounts receivable, and inventory.

Long-term investments refer to investments in other companies' stocks (common or preferred) or bonds where the *intent* is to hold them for a period greater than one year. Securities that may be held as short-term or long-term investments fall into three categories: held-to-maturity securities, trading securities, and available-for-sale securities. Trading securities are classified as *short-term investments*. Held-to-maturity securities and available-for-sale securities, depending on their length to maturity or management's intent to hold them, may be classified as either short-term or long-term investments.

Property, plant, and equipment includes assets employed in the production of goods or services as well as assets used in the administration of the business that have a life greater than one year. They are tangible in nature, which means that they have physical substance (i.e., you can physically see and touch them); examples are land, buildings, machinery, automobiles, office furniture, and fixtures. These assets are actually being used in business operations and are subject to depreciation; they are not held for sale in the normal course of business like inventory is.

Intangible assets are assets with long-term lives that lack physical substance, such as goodwill. They can also arise from a right granted by the government, such as patents, copyrights, and trademarks, or by another company, such as franchise fees.

Liabilities may be classed as either current or noncurrent. *Current liabilities* are due within one year and will generally be satisfied out of current assets. Examples are accounts payable, short-term notes payable, and accrued liabilities. *Accrued liabilities* are defined as obligations from expenses incurred but not paid at the end of the reporting period. Salaries payable and telephone payable are examples. *Noncurrent liabilities* are due after a period greater than one year. Examples of long-term liabilities are a two-year note payable and a mortgage payable.

Capital equals total assets less total liabilities.

Financial Statement Analysis

Financial statement analysis is an evaluation of both a firm's past financial performance and its prospects for the future. Typically, it involves an analysis of the firm's financial statements and its flow of funds. Financial statement analysis involves the calculation of various ratios and assists the business owner in assessing how the business is doing, its financial health, and what areas may need to be improved upon.

The owner may use ratios to make two types of comparisons:

1. *Industry comparison*. The ratios of the business are compared with those of similar businesses or with industry norms to determine how the business is faring relative to its competitors. Financial services and trade magazines may publish industry norms. One good source is Philadelphia-based Risk Management Association (RMA), which has been compiling statistical data on financial statements for more than 75 years. The RMA Annual Statement Studies provide statistical data from more than 150,000 actual companies in over 750 industries on many key financial ratios, such as gross margin, operating margins, and return on equity and assets. If you're looking to put real authority into the "industry average" numbers that your company is beating, the RMA's Statement Studies are the way to go. They're organized by SIC codes, and you can buy the financial statement studies for your industry for a fee in report form or over the internet. Visit www.rmahq.org. Dun and Bradstreet publishes Industry Norms and Key Business Ratios, which covers over 1 million firms in over 800 lines of business.

2. *Trend analysis.* A firm's present ratio is compared with its past and expected future ratios to determine whether the company's financial condition is improving or deteriorating over time (e.g., five years).

After completing the financial statement analysis, the owner should evaluate his or her plans and prospects, problem areas identified, and possible solutions.

Financial ratios can be classified into four types: liquidity ratios, activity ratios, leverage ratios, and profitability ratios.

Liquidity Ratios. Liquidity is the ability of the business to meet its maturing short-term obligations. Liquidity is essential to conducting business activity, particularly in times of adversity, such as when a business is shut down by a strike or when operating losses ensue due to a recession. If liquidity is insufficient to cover such losses, a serious financial difficulty may result.

Current Ratio. The current ratio is equal to current assets divided by current liabilities. This ratio is used to measure the ability of the business to pay for its current liabilities as they come due using current assets. A company will generally need to have more current assets available, i.e. a higher ratio, when it has difficulty borrowing on short notice.

Current Ratio = Current Assets/Current Liabilities

Quick (Acid-Test) Ratio. The quick ratio, also known as the acid-test ratio, is a more stringent test of liquidity. It is calculated by dividing the most liquid current assets (cash, marketable securities, and accounts receivable) by current liabilities.

Quick Ratio = Cash + Marketable Securities + Accounts Receivable/Current Liabilities

Activity (Asset Utilization) Ratios. Activity ratios are used to determine how quickly various accounts are converted into sales or cash.

Accounts Receivable Ratios. Accounts receivable ratios consist of the accounts receivable turnover ratio and the average collection period, also known as days sales in receivables or days of sales outstanding. The *accounts receivable turnover ratio* gives the number of times accounts receivable is collected during the year. It is calculated by dividing net credit sales by average accounts receivable. *Average accounts receivable* is found by adding the beginning and ending accounts receivable balances and dividing by 2. In general, the higher the accounts receivable turnover, the better, since the business is collecting quickly from customers and these funds can then be invested. However, an excessively high ratio may indicate that the company's credit or collection policy is too stringent and that the business is not tapping the potential for profit especially if its competitors offer more lenient credit terms to their customers. Before changing its credit policy, a business has to weigh the profit potential against the risk inherent in selling to more marginal customers.

Accounts Receivable Turnover = Net Credit Sales/Average Accounts Receivable

The *collection period* (days sales in receivable) is the number of days it takes to collect receivables.

Average Collection Period = 365/Accounts Receivable Turnover

One possible cause for a decrease in the accounts receivable turnover ratio may be that the business is now selling to highly marginal customers as a result of a change in its credit terms. Owners should closely monitor delinquencies after a change in the company's credit terms to identify negative trends so that they can address them as soon as possible. An *aging schedule*, which lists the accounts receivable balance according to the length of time they are outstanding, is helpful for this analysis.

Inventory Ratios. If a business is holding excess inventory, it is missing the opportunity to invest funds elsewhere for a return since the funds are tied up in inventory. In addition, there are high carrying costs for storing the goods and the risk of obsolescence increases the longer the goods are held. On the other hand, if inventory is too low, the company may lose customers because it has run out of merchandise. Two major ratios for evaluating inventory are *inventory turnover* and *average age of inventory* also known as *days of inventory on hand.*

Inventory turnover = Cost of Goods Sold/Average Inventory

Average Age of Inventory = 365/Inventory Turnover

Operating Cycle. The operating cycle is the number of days it takes to convert inventory and accounts receivable to cash. A short operating cycle is desirable.

Operating Cycle = Average Age of Inventory + Average Collection Period

Total Asset Turnover. The total asset turnover ratio helps evaluate the ability of the business to use its asset base efficiently to generate revenue. A low ratio may result from many factors and it is important to identify the underlying reasons.

Total Asset Turnover = Net Sales/Average Total Assets

Leverage (Solvency) Ratios. Solvency is the ability of the business to meet its long-term obligations as they become due. An analysis of solvency concentrates on the long-term financial and operating structure of the business. The degree of long-term debt in the capital structure is also considered. Further, solvency is dependent upon profitability, since, in the long run, a business will not be able to meet its debts unless it is profitable.

Debt Ratio. The debt ratio compares total liabilities (total debt) to total assets. It shows the percentage of total funds obtained from creditors.

Debt Ratio = Total Liabilities/Total Assets

Times Interest Earned (Interest Coverage) Ratio. The times interest earned ratio reflects the number of times before-tax earnings covers interest expense (i.e. the ability of the company to pay its interest obligations from earnings).

Interest Coverage = Earnings before Interest and Taxes/Interest Expense

Profitability Ratios. An indication of good financial health and the effectiveness with which the business is being managed is the ability of the business to earn a satisfactory profit and return on investment.

Gross Profit Margin. The gross profit margin reveals the percentage of each dollar left over after the business has paid for its goods. The higher the gross profit earned the better. Gross profit equals net sales less cost of goods sold.

Gross Profit Margin = Gross Profit/Net Sales

Profit Margin. The ratio of net income to net sales is called the profit margin. It indicates the profitability generated from revenue and hence is an important measure of operating performance. It also provides clues to pricing and cost structure.

Return on Investment. Return of investment (ROI) is an important, but rough, measure of performance. It shows the profitability generated on assets.

Return on Investment = Net Income/Average Total Assets

Residual Income. This is a profitability measure taking into account the opportunity cost of tying up funds in the business.

Residual Income = Net Income – (Minimum Return X Total Assets)

Budgeting

A budget is a quantitative expression of a plan of action for accomplishing goals. Budgets are a vehicle for controlling your business from a financial standpoint. A budget is helpful in making two broad types of decisions: (a) operating decisions (those concerning the acquisition and utilization of resources), and (b) financial decisions (those related to obtaining funds for the acquisition of resources).

A budget is a starting point for planning. You can base projections on historical patterns but you must also take into account any important changes in the current environment, such as new laws or increased competition. The budget may be the basis for planning sales and market share, inventory, or staff requirements. The period for a budget can be any appropriate time frame such as a year, a quarter, a month, a week, or a day.

The use of budgets forces entrepreneurs to quantify their dreams and directly face the uncertainties of their ventures. Whether the budget is properly thought out and prepared may determine the success or failure of the small business. For example, a small business with lofty hopes could quickly move into a large market for school equipment. However, failure to quantify the long collection period, forecast the maximum sales potential, and control the costs from the outset could result in severe cash flow problems within a year.

In the competitive small business environment, the importance of budgeting and forecasting cannot be overemphasized. They provide the opportunity to appraise the overall operation for the coming year(s) through an evaluation of the company's strengths and weaknesses and develop strategies.

A budget begins by forecasting sales, then production, cost of sales, and operating expenses. You should estimate the level of assets required to support the projected sales. After that, you must determine financing needs.

A master budget is classified broadly into two categories – an *operating budget* and a *financial budget*. The operating budget reflects the results of operating decisions. It provides data needed to prepare a budgeted income statement. For a manufacturing company, the operating budget consists of the sales budget, purchase budget, selling and administrative expense budget, and pro forma income statement. For non-manufacturing companies, (e.g. merchandising and service companies) budgets related to manufacturing goods will not be applicable. The financial budget shows the financial decisions of the company and includes the cash budget and the pro forma balance sheet.

The sales budget is the beginning point in preparing the master budget, since estimated sales volume influences nearly all other items. The sales budget ordinarily indicates the expected sales of each product or service. After the sales volume has been estimated, the sales budget is constructed by multiplying the expected unit sales by the expected unit-selling price. Based on the sales budget, you can plan your needs. Further, sales forecast figures determine staffing requirements for reaching targeted goals. For manufacturing companies, after the sales budget comes the purchase budget, in which you determine the quantity you have to buy and what you need in inventory to support the projected sales volume and maintain an appropriate safety stock. After the purchase quantities are determined, they are multiplied by the appropriate unit purchase prices to arrive at the total dollar amount expected to be spent on purchases.

The selling and administrative expense budget lists the operating expenses incurred in selling the products or services and in managing the business.

The budgeted income statement summarizes the various component projections of revenue and expenses for the budgeting period.

In preparing a cash budget, you start with the beginning cash balance and add expected cash receipts to obtain the total amount available to spend. You then subtract expected cash payments to arrive at the projected ending cash balance.

The cash budget usually comprises the following four major sections:

1. The receipts section, which reflects the beginning cash balance, estimated cash collections from customers, and other receipts (e.g., from borrowing money or selling assets). Note that cash receipts are not necessarily the same as revenue (e.g. credit sales).
2. The disbursements section, which shows all estimated cash payments, listed by purpose. Examples are cash payments to vendors for goods and services, purchases of assets, and debt payments. Note that not all expenses are cash payments (e.g., depreciation).
3. The cash surplus or deficit section, which simply shows the difference between the cash receipts section and the cash disbursements section which represents how much of a cash surplus or deficit you have.
4. The financing section, which provides a detailed account of borrowings and repayments expected during the budget period.

A cash budget assists in determining whether cash on hand plus cash expected to be generated from operations and other activities will be sufficient to meet projected cash requirements. Because the cash budget details the expected cash receipts and disbursements for a designated time period, it helps avoid the problem of either having idle cash on hand or suffering a cash shortage. If a cash shortage is projected, the cash budget helps identify whether the shortage is temporary or permanent and whether short-term or long-term borrowing is needed. When will there be peak periods when cash is needed? Is a line of credit necessary? Should capital expenditures and expenses be cut back? When do you have to repay debts, and will there be enough cash to do so? If the cash position is very poor, the company may even go out of business because it cannot pay its bills. If the cash position is excessive, the company may be missing opportunities to earn a higher return by investing in other alternatives.

The budgeted balance sheet is developed by beginning with the balance sheet for the year just ended and adjusting it, using all the activities that are expected to occur during the budgeting period. There are several reasons why a budgeted balance sheet is prepared: disclosing possible unfavorable financial conditions that you may want to avoid, helping you calculate and analyze a variety of ratio calculations, and highlighting future resources and obligations.

At the end of the period, the budget is a control device to measure your performance against the plan to see how you did. You will be able to spot areas requiring correction so that future performance may be improved.

Costs of a Business

To estimate the costs of starting and operating a business, you need to consider capital requirements, start-up, fixed, variable, and semi-variable costs. You have to determine if you have the cash flow and resources needed to meet your costs and obligations and stay afloat. You should not get in over your head! Further, your expected sales volume should be sufficient to cover ongoing expenses.

To be successful in business, you should know what it costs to produce and sell your items or render services so that you can monitor and try to control these costs. In addition, knowing what your costs are can help you formulate a reasonable selling price for your product or service. If your selling price is below cost, you will incur a loss.

You should be familiar with the types of costs and cost behavior. What are your total costs and cost per unit of product or service?

Capital outlays for your new business may include property, plant and equipment, paving, landscaping, parking lots, fixtures, security systems (e.g., safe, burglar alarm), displays, and signs.

Start-up costs include advertising for the opening, architect fees, real estate commissions, professional fees (e.g., accountants, attorneys), and building permits.

You should try to find ways to reduce your cash outflow. For example, if you can work out of your home, you avoid paying rent. Also, rather than hiring salespeople, try to use sales representatives until the commissions they earn exceed the cost of hiring and employing your own salespeople.

In general, for inexperienced businesspeople, a strict estimate of start-up costs should be multiplied by a safety factor of at least two. This number should then be multiplied by a time factor to estimate the company's operating expenses for a minimum of a year. Note that these factors will vary from industry to industry. However, the guidelines for the calculation remain the same – start-up costs multiplied by some safety factor and operating costs covering a certain start-up time period.

If you are running a manufacturing business, you will incur manufacturing and non-manufacturing costs. *Manufacturing costs* are those incurred in producing a product and consist of direct material, direct labor, and factory overhead. Direct material, such as cloth used to make a shirt, becomes an integral part of the finished product. Direct labor is labor involved in making the product; an example is the wages of assembly workers on an assembly line. Factory overhead includes all costs of manufacturing except direct material and direct labor; examples are depreciation, rent, taxes, insurance, and fringe benefits.

Non-manufacturing costs (operating expenses) are expenses related to the period rather than producing the product. The two categories of operating expenses are selling and general and administrative. Selling expenses are incurred to obtain the sale (e.g., advertising, sales commissions, salesperson salaries) or distribute the product to the customer (e.g., delivery charges). Selling costs may be analyzed for reasonableness by product, territory, customer class, distribution outlet, and method of sale. How good are your order-getting and order-filling activities? Marketing costs should be evaluated based on distribution methods such as direct selling to retailers and wholesalers as well as mail order or online sales. The second kind of non-manufacturing costs, general and administrative expenses, are incurred in performing administrative activities and activities that affect the company as a whole. Examples are executive salaries and legal expenses.

From a planning and control standpoint, perhaps the most important way to classify costs is by how they behave in accordance with changes in volume or some measure of activity. By behavior, costs can be classified into three basic categories.

1. *Fixed Cost.* A cost that remains constant regardless of increases or decreases in the amount of goods or services produced or sold, such as rent, property taxes, and insurance. In consequence, holding all other cost relationships constant, profits can increase rapidly during good times since fixed costs do not increase as sales increase. But during bad times fixed costs do not decline as sales fall off, so profits may fall rapidly.

2. *Variable Cost.* A total cost that varies directly with changes in production or sales activity (e.g., direct material, direct labor, sales commissions, warranties repairs, office supplies).

3. *Semi-variable (Mixed) Cost.* This is a cost that is partly fixed and partly variable. Examples are telephone and electricity bills and rental of a car or truck with a fixed rental fee plus a variable charge based on mileage.

Assuming your company has idle capacity (is not using all its capacity), the cost behavior relationships of fixed costs, variable costs, and semi-variable costs are shown in Exhibit 1.

Exhibit 1
Cost Behavior

	Per Unit Cost	Total Cost
Fixed Costs	Goes Up/Down with Volume	Constant
Variable Costs	Constant Does not vary with volume	Up/Down with Volume
Semi-variable Costs	Goes Up/Down with Volume	Up/Down with Volume

EXAMPLE

Your company is operating at idle capacity. The current production is 100,000 units. The total fixed cost is $100,000, and the variable cost per unit is $3. If production increases to 110,000 units, the following results:

a) The total fixed cost is still $100,000.
b) Fixed cost per unit is now $.91 ($100,000/110,000 units); it was $1.00 ($100,000/100,000) prior to increase in production.
c) Total variable cost is $330,000 (110,000 units x $3); it was $300,000 (100,000 units x $3) prior to increase in production.
d) The variable cost per unit is still $3.

Exhibit 2 illustrates the cost behavior for a fixed cost such as rent.

Exhibit 2
Cost Behavior for a Fixed Cost (e.g. Rent)

Volume	Rent	Unit Cost
100,000	$100,000	$1.00
150,000	100,000	.67
200,000	100,000	.50

Exhibit 3 illustrates the cost behavior for a variable cost such as commissions.

Exhibit 3
Cost Behavior for a Variable Cost (e.g. Commissions)

Volume	Commissions	Unit Cost
100,000	$ 10,000	$ .10
150,000	15,000	.10
200,000	20,000	.10

You can estimate the total cost of a product or service by combining the fixed cost and variable cost.

EXAMPLE

The estimated number of units to be produced for product line X is 100. The fixed cost is $600, and the variable cost is $2.25 per unit. The total cost is:

Fixed cost	$600
Variable cost	225 (100 X $2.25)
Total cost	$825

You may determine the average cost per unit (or service) by dividing total cost by total units (or service hours). For example, if the total cost is $10,000 for the production of 1,000 units, the average cost is $10 per unit.

There is other cost terminology you should be familiar with in operating a small business:

- *Incremental cost* is the difference in costs between two or more alternatives. For example, if the direct labor costs to produce products A and B are $10,000 and $15,000 respectively, the incremental labor cost of producing product B is $5,000. The company would factor the incremental cost in labor with other financial factors (sales, profits, etc.) to determine which alternative product to make.

- *Sunk cost* is a cost that has already been incurred and cannot be recovered or changed; therefore, these costs are typically not considered when making future business decisions. An example is the $50,000 cost of a machine paid for three years ago, which now has a book value of $20,000. The $20,000 book value is a sunk cost, which does not affect a future decision.

- *Relevant cost* is any expected cost when evaluating alternatives. Incremental costs are relevant to a decision but sunk costs generally are not.
- *Opportunity cost* is the net revenue forgone by rejecting an alternative. For example, if you have the choice of using your department's capacity to produce an extra 10,000 units or renting it out for $20,000, the opportunity cost of using the capacity is $20,000. This would need to be analyzed with profits or other factors in making the decision.
- *Discretionary cost* is a cost that can be discontinued without affecting the accomplishment of essential business objectives in the short-run (e.g., bonuses).

Cost Analysis

Cost is basically an expenditure incurred to obtain revenue. Cost information is useful in planning and budgetary decisions as well as in gauging performance. Are your budgeted costs sufficient to meet your needs? How do your expected costs compare to your actual costs? What are the reasons for any deviation?

Cost information should be provided and analyzed to the extent it is relevant to the decision-making process. It is important to know all of the costs associated with a product, service, or activity for operational and control purposes.

Cost analysis provides many benefits including determining profitability and aiding in cost control. Further, you should compare actual costs with budgeted costs to evaluate efficiency and potential improvements. You should analyze costs by product, territory, and salesperson to monitor performance. Cost estimates may be developed for alternative methods of selling products. For example, to find the best approach you might compare the increase in sales as a result of distributing samples to the increase in sales as a result of media advertising.

Cost information serves many purposes. It can assist in the analysis of your profit by product, territory, and customer, and the desirability of servicing particular types of accounts through jobbers, telephone, mail order, or online. In addition, it can help you decide which suppliers to deal with based on the total cost of buying the merchandise, including any transportation charges.

Cost information for advertising programs aids in making decisions for future media communications. Special cost structures may be formulated for market test cases to examine cost-effectiveness. The optimal method is the one providing the sales volume with the best return on investment.

You should analyze entertainment expense by customer, salesperson, or territory. Are expenses in line with the revenue obtained? In appraising entertainment expenses, consider the cost per dollar of net sales and the cost per customer. Are these costs reasonable?

For customer and order cost control purposes it is useful to know the following costs so issues/negative trends can be identified and proper action may be taken to address them: cost per order received, cost per order filled, cost per customer account, and handling cost per item.

In evaluating the auto expenses associated with salespeople for reasonableness, you should consider both cost per month and cost per mile.

Material costs per unit may drop as a result of quantity discounts and changes in the suppliers' freight charges and terms. Material costs may also change if you substitute different materials, change suppliers, or buy different quality material. Further, direct labor costs per unit may decline because of increased worker experience in performing the task. Also, material waste should decline as increased maturity in the operation develops.

Compare marketing costs to sales by product, customer, and distribution outlet; a rising ratio may be a negative sign.

Ascertain if large percentages of customers, orders, or products generate only a small proportion of revenue. If that is the case, your marketing costs may be proportionately high because marketing expenses often increase in proportion to the number of customers, orders, and products instead of in proportion to dollar sales. Hence, the marketing expenses may be generating only a small fraction of sales and gross profit.

If your costs, including manufacturing, selling, delivery, order processing, handling, and storage, exceed the sales generated from a particular product, you may want to discontinue that product because you are losing money. On the other hand, even if you are not making money on a product, you may decide to keep it because it opens the door for you to sell other products.

You may have to decide whether to replace an old asset with a new one. Perhaps the old asset is costing a lot more to run then the benefit being realized from it. The factors to consider in a replacement decision include cash outlay for the new asset, net cash flow generated by the new versus old, safety and reliability of the new asset, difference in profitability and sales generated by each asset, increased efficiency and productivity for the new asset, remaining life of the old asset, tax effect, and technological advantages in the new asset.

Are You Breaking Even?

Before your business can realize a profit, you must first understand the concept of breaking even. To break even on your products and/or services, you must be able to calculate the sales volume needed to cover your costs and know how to use this information to your advantage. You must also be familiar with how your costs react to changes in volume and how a change in sales price affects your profits. Further, you must know what effect expense reductions will have.

Break-even is the calculation of the sales needed to cover your costs so that there is zero profit or loss. By knowing the break-even point of each product and service, you can decide which products and/or services to emphasize and which to de-emphasize (perhaps even to drop). This knowledge allows you to improve operating results and facilitates planning because you know how much you must sell of a new item before it becomes profitable before you introduce it.

The assumptions used in break-even analysis follow:

- The selling price is constant.
- There is only one product or a constant sales mix.
- Manufacturing efficiency is constant.
- Inventories do not significantly change from period to period.
- The variable cost per unit is constant.

Changes in the factors used to calculate break-even will generally have the following impacts:

- An increase in selling price only lowers break-even sales.
- An increase in variable cost only increases break-even sales.
- An increase in fixed cost only increases break-even sales.

Your objective, of course, is not just to break-even but also to earn a profit. In deciding which products to push, continue as is, or discontinue, the break-even point is not the only important factor; economic conditions, supply and demand, and the long-term impact on customer relations must also be considered. You can extend break-even analysis to concentrate on a desired profit objective.

The break-even point in sales dollars equals

S = VC + FC

Where S = sales, VC = variable cost, and FC = fixed cost. This approach allows you to solve for break-even in sales dollars or for other unknowns, such as selling price, as well. If you want a desired before-tax profit (P), solve for P in the following equation:

S = VC + FC + P

EXAMPLE 1

A product has a fixed cost of $270,000 and a variable cost of 70 percent of sales. The break-even sales figure is

S = FC + VC
1S = $270,000 + .7S
0.3S = $270,000
S = $900,000

If selling price per unit is $100, break-even units are 9,000 ($900,000/$100). If desired before-tax profit is $40,000 at the break-even point, the sales needed to obtain that profit (P) are

S = FC + VC + P
1S = $270,000 + 0.7S + $40,000

0.3S = $310,000
S = $1,033,333

EXAMPLE 2

Selling price per unit $30 (SP), variable cost per unit $20 (VCU), fixed cost $400,000. Break-even units (U) are

SP = FC + VCU
$30U = $400,000 + $20U
$10U = $400,000
U = 40,000

Break-even sales dollars are

40,000 units X $30 = $1,200,000

EXAMPLE 3

You sell 800,000 units of an item. The variable cost is $2.50 per unit. Fixed costs are $750,000. The selling price per unit should be $3.44 to break even calculated as follows:

S = FC + VC
S = 800,000 SP and VC = VCU (800,000)
800,000 SP = $750,000 + $2.50 (800,000)
800,000 SP = $2,750,000
SP = $3.44

EXAMPLE 4

The following information is given regarding a product: selling price $40, variable cost $24, fixed cost $150,000, after-tax profit $240,000, and tax rate 40 percent. You wish to know how many units to sell to earn the after-tax profit.

S = FC + VC + P
$40U = $150,000 + $24U + $400,000[a]
$16U = $550,000
U = 34,375 units

[a]0.6 x P (before-tax profit) = after-tax profit
0.6P = $240,000
P = $240,000/0.6 = $400,000

EXAMPLE 5

The following data are given about a product: selling price $50, variable cost $30, sales volume 60,000 units, fixed cost $150,000, and tax rate 30 percent. You wish to determine the after-tax profit.

S = FC + VC + P
($50 X 60,000) = $150,000 + ($30 X 60,000) + P
$3,000,000 = $1,950,000 + P
P = $1,050,000
After-tax profit = $1,050,000 X 0.70 = $735,000

Choosing the Fiscal Year

As a new business owner, you will have to select a fiscal year. Most sole proprietorships and partnerships report on a January-to-December year because each individual also reports and pays taxes on that basis. A newly formed corporation makes the initial election simply by closing its first year at the end of any month it selects. An existing company may change its reporting year by seeking approval from the Internal Revenue Service (IRS).

A corporation may elect to report on a non-calendar fiscal year for a number of reasons. One reason may be that such a basis conforms to the natural business cycle. Many retail businesses experience the majority of their sales from August to September or from November to December. Contractors are typically more active in the spring and summer. Many service organizations are subject to their own seasonal swings. Accountants may encourage their clients to select a non-calendar reporting year for their convenience since they are busiest in the first calendar quarter, when most closings and tax reporting occur, and would prefer to have some clients end their years in less hectic periods.

While your accountant's preferences may be considered, you should have a business reason for requesting a change in the fiscal year and you must obtain the IRS's approval to do so. (See the instructions for IRS Form 1128 and the related regulations and publications for additional information.) One reason for requesting a change may be that there is a benefit for closing the accounting period based on the seasonal nature of the business.

Section 6:

Taxes

Learning Objectives:

After studying this section, you will be able to:

- Identify elements of different taxes, including income and sales taxes.

The following discussion is primarily related to federal taxes; however, state and local governments may have their own rules and regulations and you must check with all of your taxing authorities to make sure you are in compliance with all of their requirements.

Individual and Partnership Income Taxes

You have to pay income taxes on the profit from your business. If you are a sole proprietor, your profit or loss is reported on Schedule C (Profit or Loss from Business or Profession) of your personal income tax return, IRS Form 1040. Schedule C contains a space for your social security number, employer identification number, your principal business or profession, gross income, expenses, and net profit (loss). Since you can deduct the losses from your business on the tax return, you are able to reduce your other personal income.

There are “start-up” tax breaks available to you when acquiring or starting your own business. Although the initial expenses in connection with a preliminary investigation of a business (e.g., accounting and legal advice, travel) are typically not deductible, once you concentrate on a particular business you may capitalize and/or deduct the start-up costs. Taxpayers can elect to deduct, rather than capitalize, up to the greater of 1) the cumulative costs for start-up expenses or 2) $5,000 in the first year. Keep in mind that the $5,000 deduction is reduced dollar for dollar, but not below zero, by the amount the taxpayer’s total start-up costs exceed $50,000. The remaining start-up costs can be amortized over a 180-month period (15 years), beginning with the month the business began. The amortization deduction is claimed on Form 4562.

The expenses that may be deducted and/or amortized include professional services, advertising, training, consulting, evaluating potential markets and products, surveying the labor supply, examining transportation facilities, and travel costs to visit potential suppliers or customers. Even if you abandon the specific venture, you may be able to deduct at least a portion of these costs as a capital loss.

If the business is a partnership, you have to file a partnership tax return (Form 1065) reflecting the revenue and expenses of the partnership. The partnership itself does not pay federal income tax. However, you have to report your share of the partnership's net income, generally reported to each partner on a Schedule K-1, on Schedule E (Supplemental Income and Loss) of your personal tax return Form 1040. (Note: the 2017 Tax Act created a QBI/199A deduction for pass-through organizations, such as S Corps, LLCs, and partnerships.)

As a sole proprietor or partner in a business, you may have to pay estimated federal income tax and self-employment tax. Form 1040-ES is used to make quarterly estimated tax payments which are generally due on or before April 15, June 15, September 15, and January 15. However, if you are incorporated, the last estimated tax payment is due December 15 instead of January 15. (Note: in 2020, some of the filing dates were extended due to Covid-19).

Records supporting entries on a federal tax return should be kept until the statute of limitations (ordinarily three years after the return is due) expires. Records relating to depreciable property should be retained for as long as they are useful in determining the cost basis of the original or replacement property.

The records must be accurate, complete and clearly establish income, deductions, tax credits, employee information, and anything else specified by federal, state, and local regulations.

Corporate Taxes

As a regular C corporation, you are required to file Form 1120 and are subject to corporate income taxes. Corporate tax rates until 2018 were higher than most personal tax rates. For example, most companies were taxed at the marginal federal tax rate of 34 percent while most individuals were taxed at the marginal tax rate of 28 percent. Starting with the 2017 Tax Cuts and Jobs Act (TCJA), the non-pass through corporate tax rate dropped to 21 percent.

The corporate tax return is generally due on the fifteenth of the third month subsequent to the company's year-end. A company may elect a calendar year-end December 31 or a fiscal year-end (any other one-year period). For example, if there is a December 31 year-end, the tax return must be filed by March 15.

Although corporate income tax returns are filed at the end of the taxable year, quarterly tax payments are required if the company has to pay estimated tax of $500 or more.

If you have a regular corporation, the net loss from the business is unavailable to offset your non-business income. However, prior to the TCJA, you could carry back the net loss two years and then carry it forward 20 years to reduce profitability. The TCJA, with some exceptions, eliminated carrybacks but allowed losses to be carried forward indefinitely, effective for losses arising in tax years ending after 12/31/17.

If you are incorporated (except as an S Corporation), you are subject to double taxation. The net income of the corporation is taxed (Form 1120), and then you are taxed again on your personal tax return (Form 1040) on the salary and/or dividends received from the corporation.

A capital gain or loss results from the sale of a capital asset (e.g., equity or debt investment, real estate). The gain or loss is the difference between the selling price and cost and is subject to tax.

Fifty percent of the dividends received by a company from a taxable domestic corporation are generally exempt from taxation. Small business investment companies can deduct 100% of dividends received from a taxable domestic corporation.

Fringe benefits paid to employees are tax-deductible. Examples are pension plan contributions and health insurance premiums. Further, food and entertainment related to employee benefits are fully deductible.

Business meal expenses are 50 percent deductible. Promotional items intended for public distribution, such as samples are fully deductible; deductions for business gifts are limited to $25 per individual recipient.

Your company may elect to expense immediately up to $1,000,000 of qualified capital expenditures subject to a dollar-for-dollar phase-out once these expenditures exceed $2.5 million.

A charitable contribution is generally deductible up to 10 percent of taxable income without taking into account the contribution. A charitable contribution in excess of the limitation may be carried forward five years.

Note: The CARES Act temporarily increased the 10 percent limit to 25 percent for certain qualified contributions made on or before 1/1/2020 but before 1/1/2021 and allowed any contributions in excess of the 25 percent limit to be carried forward, provided the taxpayer properly elects application of the modified tax code section with respect to the contributions made.

If you have slow-moving or excess inventory, consider donating it to certain qualified charities for the purpose of caring for the ill, the needy, and infants to obtain a tax deduction. You can deduct the lesser of the basis of the item plus one-half the difference between the cost and market value or two times the basis. For example, if an item costs $1,500 and sells for $2,500, you are eligible for a charitable deduction of $2,000 [$1,500 + .50($1,000)]. Some charitable organizations you may contact in this regard who will supply the necessary tax documentation are The National Association for the Exchange of Industrial Resources (309-343-0704) and Gifts in Kind America (703-836-2121).

Other deductible expenses include depreciation, interest, professional fees, casualty and theft losses, and bad debts. Nondeductible expenses include fines and penalties.

States, cities, towns, and counties may impose their own taxes. The taxes may include income taxes, payroll taxes, unincorporated business taxes, personal property taxes, and real estate taxes. Make sure to contact the appropriate office of your respective state and locality for information.

Subchapter S Corporation and Limited Liability Corporation

A Subchapter S Corporation is a business structure option available only to the small business. It is simple to form and operate. An S Corporation combines the limited liability of a corporation and the single-taxing advantage of a sole proprietorship or partnership. Thus, it avoids double taxation.

You can elect to organize as an S Corporation by filing Form 2553 with the IRS on or before the fifteenth day of the third month of a year the election is to take effect or any time during the tax year preceding the tax year it is to take effect. Most S Corporations report on a calendar year rather than a non-calendar fiscal year since individual shareholders are generally taxed on that basis. The latest an election can be filed for an S corporation who will use a calendar year is March 15.

An S Corporation files an information tax return on Form 1120-S and attaches a Schedule K-1 for each stockholder, showing his or her portion of taxable income or loss for the year as well as any other applicable deductions, credits, etc. This is similar to the partnership return, which reports and assigns income to each partner. Thus, there is no tax to the S Corporation; rather the individual reports his or her share of the S Corporation's income, deductions, credits, etc. on his or her personal tax return Form 1040, Schedule E Part II (Income or Loss from Partnerships and S Corporations). The stockholder is generally able to offset any business losses against his or her personal income. Hence, the protection of incorporation is coupled with tax savings. Note: the 2017 Tax Act created a QBI/199A deduction for pass-through organizations, such as S Corps, LLCs, and partnerships.

If you wish to incorporate as a Subchapter S Corporation, you must meet the following requirements:

- It must be an eligible domestic entity
- All stockholders must agree to S Corporation status
- Its only stockholders are individuals, estates, or certain exempt organizations or trusts
- There cannot be more than 100 stockholders
- A certain percentage of the company's income must be from actual business operations and not from passive sources
- No stockholder can be a nonresident alien
- There must only be one class of outstanding stock

An S Corporation can have any amount of assets or net income. There is no restriction on size.

Once an S Corporation reverses its election, it cannot again decide to be taxed in this manner for five years. You may also elect to organize as an LLC, in which income, deductions, etc. are distributed among members, but the members are not personally liable for its debts. If you are interested in setting up an LLC, be sure to consult a knowledgeable attorney.

Payroll Recordkeeping and Taxes

You should obtain an employer's identification number (EIN) for tax purposes by filing a Form SS-4 with your local IRS office. The employer ID number is used on filed tax returns and is different from your social security number.

An employer, regardless of the number of employees, must maintain all records pertaining to payroll taxes (income tax withholding, social security, unemployment tax) for at least four years after the tax becomes due or is paid, whichever is later.

A new employee must fill out his or her appropriate exemptions and sign Form W-4 (Employee's Withholding Allowance Certificate). You then withhold income tax based on the IRS's withholding tables. If the employee for some reason does not prepare a W-4, treat him or her as a single person with no withholding exemptions. Make sure to tell your employees to prepare a new certificate if their status changes (e.g., there is an increase in the number of their dependents). This new certificate must be filed prior to December 1 of the next year.

On or before January 31, you have to provide employees, the IRS, and state and local tax agencies with copies of Form W-2 (Wage and Tax Statement) which lists salary earned, taxes withheld and many other items for the last calendar year.

If an employee in your business receives tips of $20 or more in a month, they must report these tips to you for tax purposes on or before the tenth of the following month.

You generally have to deduct social security taxes from the employee's salary, and you must pay your own social security tax. You must file form W-3, Transmittal of Wage and Tax Statements, electronically or paper, with the W-2s you file with the Social Security Administration.

Form 941 is used to remit withholding taxes and social security deductions to the IRS. Form 941 must be filed by the last day of the month following the end of the quarter. For example, Form 941 for the first quarter of the year (January 1 to March 1) must be filed by April 30. You may have to deposit the federal income taxes you withheld and both the employer and employee social security taxes and Medicare taxes. If your total taxes after adjustments and refundable credits (line 12) are $2,500 or more for the current and prior quarter you must make deposits according to your deposit schedule. (See IRS Publication 15 for additional details.) You must use EFT to deposit your taxes. EFTs are generally made using the Electronic Federal Tax Payment System (EFTPS), a free service offered by the Department of the Treasury. If you do not want to use EFTPS, you can arrange for your tax professional, financial institution, payroll service, or other trusted third party to make electronic deposits on your behalf.

Unemployment tax is paid to both state and federal governments. The IRS gives a partial credit for unemployment taxes paid to states. You must first register with your state Bureau of Labor and receive an identification number so that your deposits can be credited to your account. Your experience rate will partly determine how much unemployment tax you must pay; the rate will change depending on how many employees you hire and fire. For example, if you terminate a lot of employees, your unemployment tax rate will increase because of the higher demand placed on the state's unemployment fund. Your particular state will inform you how and when to deposit unemployment taxes.

The federal unemployment tax (FUTA) rate is generally less than the state rate. One month subsequent to your taxable year-end, you must file Form 940 with the IRS to show how you computed the unemployment tax. If you have any balance due of $500 or less, you can make a deposit, pay by credit or debit card or pay it when you file your 940 using EFW (if you filed 940 electronically) or you're a check or money order. If your FUTA tax liability for any quarter is greater than $500 then you will have to make a deposit. Deposit payment requirements are the same as described above for Form 941.

If you hire individuals to perform services as independent contractors in connection with your trade or business, you must file an annual information return (Form 1099) to report payments totaling $600 or more made to them during the calendar year. Be sure your records list the name, address, and social security number or tax identification number of every independent contractor you employ, along with pertinent dates and the amounts paid each person. An invoice submitted by the contractor should support each payment you make.

Sales Tax and Other Small-Business Taxes

Sales taxes are levied by many states and cities at varying rates. When you contact the respective sales tax departments for instructions on how to register as a collector of sales taxes, you will be told which buyers are exempt from sales tax, which forms to file, and how to deposit sales tax monies you collect with the state and/or local governmental agency.

Most states provide specific exemptions for certain classes of merchandise or particular groups of customers. Service businesses are often exempted altogether. You can devise a control to identify tax-exempt sales so that they can be properly reported, or excluded, when you file your sales tax returns. If you fail to collect taxes that should have been collected, you can be held liable for the full amount of uncollected tax.

In many states, wholesalers or manufacturers may not sell to you at wholesale prices unless you can show them your sales tax permit or number, also called a seller's permit. You usually have to sign a tax card for their files. The seller's permit allows you to buy tangible personal property for resale without having to pay sales tax to the vendor. In order to get a seller's permit, contact the sales and use department of the state. (You should also remit sales tax to this office.) A fee may be assessed to obtain the permit. You may also have to give a security deposit in the event you fail to remit appropriate sales tax. If the security deposit in your state is very high, try to arrange an installment payout.

When your customers buy from you, add the tax (where applicable) to their purchases. You then submit the sales tax to the appropriate agency by the specified due date with the forms designed for this purpose.

Prior to 2018, when conducting business across state lines, you were not required to collect taxes for any states other than those in which you maintained offices or stores. However, the Supreme Court ruling in South Dakota v. Wayfair Inc., established that individual states can require e-commerce retailers to collect state sales tax on the goods they sell. The ruling overturned previous law which made the consumer responsible for paying sales taxes to the state, rather than through the retailer. Most states established state revenue thresholds to reduce the burden on smaller internet sellers. For example, California expects an internet company to collect the appropriate sales tax if the sales in California exceed a $500,000 threshold.

The IRS collects federal excise taxes. Currently, excise tax must be paid by manufacturers of coal, truck parts, tractors, firearms, tires, lubricating oil, telephone services, and the use of international air travel facilities, along with other items. Form 720 (Quarterly Federal Excise Tax Return) is to be filed to the Department of Treasury, IRS, Ogden, UT, 84201-0009 one month after the end of each calendar quarter, except for certain kinds of excise taxes that are not for the payment of premiums to foreign insurance companies.

Section 7:

Marketing

Learning Objectives:

After studying this section, you will be able to:

- Recognize different components of marketing research.
- Identify the advantages of new product introductions.
- Recognize social media as it applies to marketing.
- Identify key factors in creating a pricing strategy.

Marketing Research and Planning

Marketing research is the process by which marketing data is obtained, recorded, and evaluated. It identifies potential consumers and how to meet their needs and considers pricing strategy, product introduction, and the best means of advertising. Marketing research aids in segmenting your market into specific groups of consumers and in differentiating your product.

Marketing research answers numerous questions including the following:

- What is the degree of competition?
- Who are the potential customers by income, age, and geographical location?
- Are you offering the product at the right time in the right place at the right price?

The major areas of marketing research are:

- *Internal Information*. This is based on your own records, such as sales, cash receipts, aging of accounts receivable, and complaints. Carefully identify your customer profile. What makes your customers tick? Customer addresses are revealing because they tell you where your customers live and their approximate income.

- *Secondary Research*. This involves obtaining information already compiled by or in, other sources, such as private companies, government agencies, websites, books, or periodicals. The cost of obtaining this information is minimal; often the information is free.
- *Primary Research*. This involves either doing the research yourself or retaining an experienced researcher to do it for you. The two types of primary research are exploratory and specific. Exploratory research is directed at trying to define the problem and is usually accomplished by detailed interviews with a restricted number of interviewees. It is an open-ended approach. Specific research is used when the problem has already been defined. It concentrates on solving the problem. Its sample size is significantly larger than that of exploratory research, and the interviews are complete and structured.

You may engage marketing research firms to evaluate which new products to introduce and to provide advice about consumer and industrial research. You can then find out whether your new product idea is feasible.

The steps in the marketing research process follow:

- Identifying and defining the problem (e.g., identifying the customer base).
- Ascertaining whether marketing research will help.
- Specifying objectives.
- Enumerating information to be collected (e.g., sex, age, and employment of potential customers).
- Picking the research method instrument (e.g., random sampling)
- Determining a sample size from the population.
- Collecting the information.
- Tabulating and appraising the data.
- Formulating conclusions (e.g., customer base, best product line).
- Taking the desired action.

A plan is needed for the optimal marketing of your product or service to assure success. This marketing plan should be documented with supporting facts and should be updated as needed. Information in the marketing plan includes segment, size of market, market share, distribution channels, competition, pricing alternatives, product costs, legal issues, geographic locations, production constraints, growth trends, customer profile, and industry trends.

A marketing plan achieves the following objectives:

- It clarifies where resources should be allocated.
- It aids in communicating with current and prospective employees what must be done.
- It serves as a guide to actions and steps to be taken.
- It helps you to take advantage of opportunities.
- It identifies problems.
- If fosters control.

Determine what product image you want to portray. Do you want to be seen as a retailer of high-priced, high-quality goods or services, or as a retailer of low-priced merchandise? Once you have decided upon an image, your actions must then be consistent with that image in such areas as pricing, merchandise selection, packaging, advertising, mode of sale, and dress.

The Ps and Qs of selling that you should practice are these: Plan your sales effort, and be personable, pleasant, persistent, and patient. You should conform to high standards and be proud of your product.

You may need to give discounts and allowances to wholesalers, retailers, and others to induce them to carry your line.

You should use marketing effectiveness measures to gauge your marketing success. This includes determining product profitability by product line, class of customer, size of customer, average order size, age group, industry segment, geographic area, channel of distribution, and type of marketing effort. Potential sales problems and growth opportunities should be noted, and you should compare objectives to actual performance. New product evaluation should be done in terms of risk and return.

Product Introduction

A key area for the survival and success of any new business is the introduction of new products and/or services; this area is especially important in a highly competitive environment. New product introduction involves not only the idea or product itself but also forecasting the cost of developing and manufacturing the product, its profitability, target sector, life expectancy, and selling price and then bringing that idea as a product to the store shelves.

The product life cycle runs from introduction to growth to maturity to decline. Of course, life cycles vary among products. However, generally speaking, old products eventually lose their appeal and may become unprofitable.

Outside professionals can help you as you work to bring a new product to the marketplace. Patent attorneys and agents can assist in finding patents and preparing applications to obtain a patent. Packaging designers can aid in properly designing the packaging and containers for your product. Advertising agencies may be retained to handle promotional efforts. You can hire management and marketing consultants who may aid in appraising potential sales, formulating a selling price, analyzing the competition, developing a marketing program, and examining the cost and availability of raw material sources. Industrial engineers can assist in designing the new product to obtain the greatest efficiency, best appearance, and lowest cost. They can also iron out any product defects.

Advantages of a new product introduction may include:

- Increasing sales and profitability.
- Reducing overall overhead by using idle facilities.
- Strengthening existing products.
- Penetrating new markets and distribution channels.

In deciding on whether to introduce new products and what kinds to introduce, you should ask yourself the following questions:

- How much is your budget for a new product introduction?
- How many units can you sell and at what price?
- What is the cost of the product?
- How profitable do you expect the product line to be?
- What is the expected return on investment, breakeven point, and payback period?
- What is the expected turnover?
- Are there any potential product liability problems and warranty difficulties? What is the ease and safety of use, servicing, and packaging?
- Are there stringent government regulations?
- Who is the competition and what are its strengths?
- What is the product's seasonality?
- Does the product fit the company profile?
- How will the product be promoted?
- Who is your market (e.g., consumer, industry, government)? What is the size of the market?
- What is the probability of the product's success?
- Will product demand be limited geographically?
- What is the expected life cycle of the product?
- Can you maintain product quality control?
- How long will it take to market the product? Is a patent needed to protect the product?
- What are the available distribution channels?
- Will the new product fit into the existing product line easily?
- Does the product have a synergistic effect on other products?
- Are warehouse facilities adequate?
- What is the quality of the salespeople?
- Are production workers skilled?

For answers to new-product development questions that come up, you may contact the *Center For the Advancement of Invention and Innovation of National Science Foundation* (www.nsf.gov).

Advertising, Internet Marketing, Networking, and Social Media Marketing

The objectives of advertising are to positively reflect a company's image, generate sales, and make consumers aware of the product line and/or services. The amount you spend on advertising will depend on your specific business needs and your industry. Some luxury goods companies can spend 40% of their revenue on their marketing budgets, whereas 10 percent is a more realistic number for the average business. New companies will need to spend more in the early years to gain new customers and revenue, while established businesses can rely more on repeat customers and existing brand awareness. Before planning an ad campaign, you should be able to answer these questions: What is your budget, degree of competition, and the expected benefits from the advertising? What is the percent of advertising to sales common in your industry?

Advertising effectiveness can be determined by looking at the sales and profit before, during, and after promotion. Were there any competitive reactions? Response to ads will increase when you provide a business reply card; coupons and games may generate a good response rate. A code number should appear on reply cards so you can identify how the respondent found out about the product.

In evaluating the market, you have to determine who will buy the product or service (e.g., age group, income level). There are different strategies for segmenting the market that may be used, including creative, media, and positioning. In creative, you change the words in different ads depending upon who will read them. In media, you select the best medium to reach the target audience (e.g., online, television, or radio). In positioning, you aim your product at those most likely to be motivated to buy it. A market may be segmented in terms of sex, social class, age, occupation, education, income, marital status, family size, ethnic group, geographic location, subculture, percentage of working women, and health.

Types of advertising include:

1. *Umbrella Advertising*. This is advertising designed to promote a specific brand, and not necessarily the specific product.
2. *Mass Advertising*. This is designed to reach a cross-section of the population.
3. *Advertising by Class of Customers*. This kind of advertising is directed at the type of person who will buy the product (e.g., sports enthusiasts).
4. *Institutional Goodwill Advertising*. This type of advertising gives a message about the company and may not promote a specific product.
5. *Search Marketing*. This type of advertising allows search engines, such as Google or Bing, to show your website in the search results which provides a convenient way to reach your target audience.

Your advertisement should include all the necessary information about the product, including what it is, what it does, when to use it, and how to use it. Emphasize why it is better than competitive products.

The positioning of the advertisement on the page, its size, its layout, and its content will have an effect on consumers' minds. Further, the advertisement should be timely (e.g., tied to a season, holiday, or local event). If you use an advertising agency, select one that has experience with products or services similar to yours. You may obtain a free ad in a publication if you have a new product or service that may influence the general readership.

In selecting a particular media source, you should consider:

1. *Cost*. Is it within your available funding?
2. *Type and Number of Audience*. Does it reach your desired audience?
3. *Frequency of Ad*. How often will the ad be run?
4. *Consistency*. Is the ad consistent in satisfying the desired marketing mix (e.g., product, price, distribution)?

5. *Demographics*. What are the demographics/location of the advertising?

Different types of media include: (1) internet; (2) print (e.g., newspapers, magazines); (3) direct mail; (4) outdoor (e.g., billboards); (5) broadcasts (e.g., television, radio); and (6) movie screen.

Compare the various media sources to select which is best for your particular product or service. For example, while internet ads are cheaper than television ads, and they provide targeted search responses. Put advertisements in different media in different weeks to see which generate the biggest increase in business.

When negotiating with a media source, ask about seasonal discounts, special discounts (e.g., volume ads), barter arrangements, professional assistance, the availability of lowered rates for standby status (in the event available space or time still exists just prior to a television show), and per inquiry charge, by which you pay for only those sales generated directly from the ad.

Improving Your Website

Here are some things you can do to maximize your internet presence.

1. *Continually update your website*. This step is important to bring visitors back again and again. Also, search engines will check your site regularly and if the pages don't change, it can hurt your ranking in web searches.
2. *Add a blog to your website*. Not only does it help solve the problem of how to update your site, but it can also draw more people to your site. Helpful content can help you gain return visitors. Plus, nothing can match a blog for keyword count, so it helps your search engine standing.
3. *Keep it simple*. One of the biggest mistakes website beginners make is creating a site that is too complicated. Forget the animations and dynamic content like stock tickers that increase the time it takes for your pages to open on a visitor's computer. In this same category, buy your own domain name so that your Web address will be easy to remember.
4. *Be responsive to visitors*. If you offer a "contact us" page on your site, make sure someone responds promptly to the e-mails and phone calls that result. Otherwise, your visitor will feel like the woman who walks into a brick-and-mortar store and can't find a sales clerk to help her.
5. *Get help*. Seek professional help if you are not an expert at building or optimizing your website.
6. *Add content*. By adding valuable content, you encourage visitors to return and also increase viral marketing when you share the content and links to your website.

Networking

It is increasingly crucial to pay attention to events put on by business networking groups. You need to join more than one group because each group will have a different added value. You could secure new contracts, bank loans, associates, and even find your accountant through one. Creating strong networks and building those relationships produces positive outcomes out time and time again.

Social Media Marketing

Social media includes the various online technology tools that enable people to communicate easily via the internet to share information and resources. It can include text, audio, video, images, podcasts, and other multimedia communications. Social media is user-generated content, meaning its authors rule in the development and form for which it takes place (channel). Its sheer development is quite remarkable, in that it is manipulated and strategically developed by the user, and its venue is a user-made decision.

Social media is a phenomenon that has grown at an exponential rate and is being used as an alternative marketing tool. Social media are the online means of communication, conveyance, collaboration, and cultivation among interconnected and interdependent networks. Social media marketing generally refers to using the many online services for relationship selling. Social media networks or services make innovative use of new online technologies to accomplish familiar communication and marketing goals. Some were created with consumers in mind but came to be used by thousands of businesses (such as Facebook and Twitter), while others were created specifically with business users in mind (LinkedIn is the largest of these). In addition, business professionals use a variety of specialized social networks, including those that help business owners get support and advice, those that connect entrepreneurs with investors, and those created by individual companies to enhance the sense of community among their customer bases. Some companies have created private social networks for internal use only. For example, the defense contractor Lockheed Martin created its Unity network, complete with a variety of social media applications, to meet the expectations of younger employees accustomed to social media use and to capture the expert knowledge of older employees nearing retirement.

Blogs and Podcasts are a much simpler form of social media and may be better suited for small businesses. A young company or start-up can benefit from these channels. These are simple to maintain, and their content allows a business (particularly smaller businesses) to detail in greater length their story. They are cheap, simple methods of stirring up a base of followers. When the followers of these social media channels engage and follow blogs or podcasts, they are more likely to grow with that company. If consumers feel as though they are the beginning of something, they are more inclined to spread the word and become a volunteer marketing campaign.

Sales Force

Selecting a sales staff involves the following steps: (1) reviewing application forms; (2) checking references; (3) interviewing; and (4) observing performance on a sample run in the field.

In negotiating a compensation package for salespeople, keep in mind that: (1) compensation should include salary plus commission; (2) compensation should include fringe benefits; and (3) compensation should be competitive.

Personal selling involves face-to-face dealing. The advantages of personal selling are that it permits repeated attempts to make the sale, offers quick feedback on the completed sale or flexibility in adjusting sales terms, and allows specific identification of the customer. The drawback of personal selling is its high cost.

Salespeople should be kept current on all product information, including manufacturing and marketing aspects. They must be thoroughly familiar with the product line in order to instill confidence in consumers. Salespeople may do much more than just taking the order; they may push other products, get overall customer feedback (e.g., complaints), and demonstrate how to use the product. Salespeople should communicate all complaints they receive about the product or service to responsible parties, such as manufacturing and marketing managers. There must be cooperation among all members of the organization in handling such complaints.

If your salespeople are on fixed salaries with no commissions, your selling costs will drop as volume increases. You should have specific policies regarding expense reimbursements: What is reimbursable and how much? As part of internal control, you should audit salesperson expenses.

Measures for evaluating the performance of salespeople include: (1) sales volume and dollar sales; (2) comparison of actual sales to budgeted sales; (3) profit generated; (4) number of new accounts; (5) call frequency; (6) percent of sales made to the number of calls (closing ratio); and (7) market penetration.

The plan for compensating and recognizing salesperson efforts should maximize the company's financial interest and motivate salespeople. The plan should preferably provide for: a minimum salary; commission based on a graduated profit; bonus for meeting the sales quota; payment to salespeople only after collection is received; higher commission rate for original business than for repeat sales; higher commission rate for a more difficult territory; some flexibility in setting the selling price depending on competitive factors and customer dealings; and higher commission rate for success in selling slow-moving items. Sales quotas should be based on past experience and amended in light of the current environment.

A customer profile should be developed (e.g., type of business, previous orders, buying history, or personality traits) for each customer.

If you are a manufacturer, you may decide to use an outside sales representative or an independent agent who sells the products of several companies, on a commission basis. Such representatives are managed by in-house sales managers. Sales representatives may be found in trade magazines and industry publications, including directories, and by recommendations from others. Examples of directories are The Directory of Manufacturers Agents (McGraw-Hill) and the Manufacturers Agents National Association's Directory of Members.

An outside sales representative should not carry items that are competitive with yours but may handle items related in terms of type, quality, and price. He or she usually sells to specific areas or industry groups. You should initially limit the sales territory for sales representatives until you can evaluate their commitment and performance. Since sales representatives are generally experienced, you should seriously consider any advice he or she may offer. You will have to give the agent exclusive rights to your product in a particular territory. Sales representatives should preferably be used for high-dollar and high-volume items. Of course, while the agent obtains the order, you ship and bill the customer directly.

Using an outside sales representative may be advisable if you have a limited product line, want to accomplish product acceptability quickly, or have a long salesperson training period. Advantages of using an outside sales agent are that you do not have to pay a fixed salary plus fringe benefits, paying a commission only if there is a sale; you may gain greater expertise and contacts in a specific territory or market, particularly if the market is thin, the territory is widely dispersed, and there is insufficient volume to support a salesperson. Disadvantages of using a sales agent are that a higher commission rate is typically required; you have less control over the individual and his or her selling methods; agents usually are less familiar with your product and give only a part-time selling effort to it; agents have less company loyalty and may "steal" your customers when the contract expires.

A new business may find hiring a sales representative attractive because it provides immediate service without the time and costs involved in hiring and training a sales force. However, if there is a high sales volume, the sales representative may not be able to give the service an in-house sales force is capable of.

Pricing

Pricing must be in line with the style, quality, and service of the product or service. If your price is too low, the sales volume may be high, but the revenue may be inadequate to cover costs. If your prices are too high, the sales volume will be low, and you may not be able to cover operating costs. As you set prices, you should consider the market condition, competitors' prices and proximity, costs, return experience, income of clientele, and sales volume. You should test the market to see the effect on product demand of altering the product's prices; the price quoted for future delivery may be different than that for immediate delivery since market conditions may change.

The selling price of an item affects its profitability. Pricing should always be taken into account but becomes particularly important in the following situations:

- Introduction of a new product. Since no established market yet exists, costs will be the key ingredient in establishing a selling price.
- Product life cycles. New products may warrant higher prices, while older products may need discounts.
- Market penetration. Are lower introductory prices needed to gain market share?
- Inflationary or recessionary periods.
- Competitors change their prices.

The price charged affects the following:

- Profitability of the item.
- Company image. A high price implies in the minds of buyers a higher quality item.
- How long it will take to recover the investment.
- Market attractiveness.

Factors in establishing a selling price are:

- *Rate of sales*. A fast-selling item can have a lower markup, since it brings in money via higher volume, while a slow-moving item may require a higher markup to compensate for lower volume.
- *Manufacturer's fixed price*.

- *Use of leaders*. A leader is a good typically offered at a lower selling price than the competition in order to increase store traffic. It might be sold at a slight profit or even at a loss just to attract business. A loss leader is sold below cost. A good leader is one used daily and bought frequently.
- *Life cycle of item*. A novelty item has a good markup until competition sets in; a fashionable good generates a good markup until the fashion is over. There may be drastic markdowns at the end of the season.
- *Type of item*. A staple item typically has a lower markup and does not benefit from promotion. It is sold because it offers value and price. Lower-priced lines generally sell more quickly and have lower handling costs. If low-priced items are found satisfactory, the same consumer may become a buyer of the popular and high-priced lines the seller offers.

The different basic pricing approaches for a new product line include:

1. *Competitive pricing*. Here, the price is based on what the competition is charging. For consumers to switch to your product or service, you must offer something unique (e.g., better service, higher quality, reliability, more congenial staff).
2. *A low price (penetration)*. This strategy enables you to enter a new competitive market by selling at a low price. The hope is that the low price will result in greater volume. Unfortunately, a low price may imply low quality. Once consumers get used to your product, you may raise the price.
3. *A high price (skimming)*. This strategy may be used for a new product having no competition. It can also be used when you want to give the product an image of quality. As competition enters, or sales decline, you can begin to lower the price.

Three basic pricing policies are:

1. *Single price*. One price is charged to all buyers irrespective of quantity ordered or timing. This policy is easier and consistent in administration. However, large volume buyers will be turned off because they expect a discount or price reduction.
2. *Negotiable (variable) price*. This enables you to modify the price as need be (e.g., competitive reactions, "tough volume," high-volume order, promotional program). The drawbacks are perceived price discrimination that could cause resentment from those paying a higher price, excessive price reduction by salespeople eager to get the sale, and possible violation of the law.
3. *Non-variable price*. The same price is offered under the same conditions; a different price applies under different conditions. This strategy is easily administered and is fair to all buyers within a specified category; all salespeople must stick to the same price so there is no room for possible abuse. In this way, you keep control over pricing and avoid legal exposure.

Often a selling price is based directly on the cost of the item. A markup may be added to cost based on what is typical in the industry. For example, if the cost is $10 and a 50 percent markup on cost is desired, the selling price will be:

Cost	$10
Markup (50 percent X $10)	5
Selling price	$15

The markup may vary depending on the type of product, demand, industry, competition, and marketing factors. For example, if you introduce a new product that is in heavy demand and faces no competition, you may assign a higher markup. On the other hand, you may assign a lower markup to a product with heavy competition.

The retailer may decide to mark down the selling price to make it more attractive for consumer purchase, especially when the item is slow-moving or becoming obsolete. Markdowns may also stimulate sales volume.

If you introduce a new product or service but consumers will not pay the price you charge, you may make a minimal profit or incur a loss. In this case, your options are to:

- Reduce the price; offer a discount. This will lower profits.
- Eliminate the product.
- Lower costs.
- Emphasize product differentiation from competitors' products by promoting higher quality, better service, and quick delivery.

The different kinds of discount policies are:

1. *Quantity*. A discount is given, sometimes graduated, with an increased order size.
2. *Promotional*. A discount is offered to buyers to promote the product or service.
3. *Trade*. A discount is offered in the ordinary course of business within the distribution network. For example, a manufacturer may offer a discount to a retailer.

Pricing should take into account the elasticity of product demand. A company can increase the selling price of an item having inelastic demand (e.g., pharmaceutical items) because a change in price will not have much adverse effect on sales volume. However, if the price is increased on an item with elastic product demand (e.g., fur coats), sales volume may fall significantly.

You can evaluate the demand for a product based on a change in price by surveying customer reactions to different possible prices and comparing the product's price to a similar or replacement product.

A business is prohibited from price discrimination as per the Robinson-Patman Act of 1936, which prohibits a business from selling a product or service at different prices to two or more competing customers engaged in interstate commerce if the activities result in injury to competition. However, a business is permitted to sell at different prices if cost differences exist.

Packaging

Packages should provide protection during transit and should ensure that the product will be delivered to the consumer in good condition. Interior reinforcement and cushioning may be required for fragile items, and boxes containing delicate goods should be marked "Fragile". The packaging should withstand climate and temperature problems and minimize delivery costs.

Do not use extravagant, costly packages such as unnecessary padding and wrapping. Labeling on the package should be informative and distinctive and have all the information required by law.

The packaging cost should be low relative to the selling price of the item. If the packaging is for the ultimate consumer, the packaging should be consistent with the style of the company or merchandise.

Trade Shows

Attending a trade show may enable you to obtain a significant increase in business. However, they are not as important as they once were due to increased use of the internet for product announcements. Attend those trade shows having the highest probability of increasing sales. Check internet sources such as Trade Show News Network (www.tsnn.com) for listings of forthcoming trade shows and related information.

Before finally deciding on a trade show that initially looks good, ask for literature about that show and examine such things as who attends and their job titles, the expected number of attendees, the markets served, and the location of booths.

After selecting a trade show to attend and designing your exhibit, try to do the following before the show:

- Inform the media (e.g., trade magazines), customers, and sales representatives that you will be there.
- Prepare posters and brochures.
- Pack and ship merchandise before the show starts.

Advantages of attending a trade show are that you can:

- Promote your company's image.
- Sell your goods and/or services.
- Demonstrate and distribute information about products or services. You may see if new products are of interest to attendees (a sort of market testing). Get attendees' names and addresses.
- Meet with customers, suppliers, sales representatives, and competitors.
- Develops a new distribution channel.

Section 8:

Operations

Learning Objectives:

After studying this section, you will be able to:

- Recognize factors to consider when selecting insurance policies.
- Identify software useful for a small business.

Managing the Business

Once you have launched your business, you must closely monitor and manage your operations to increase your chances of success. Long-term planning is essential concerning products, additional financing, capital expansion, marketing, and advertising. This can be difficult for the average entrepreneur because many entrepreneurs are not great problem solvers. They tend to put off dealing with potential problems until a crisis arises and they are forced to confront them.

One reason a new business may turn out to be a disaster is that for the first time the entrepreneur must be a true leader and not only a doer. He or she must now manage people and work with them to make this business work!

Owners must be well rounded as they are responsible for supervising employees, planning the direction of the firm, developing new products, controlling costs, and promoting the business.

Products need to be produced with quality workmanship and materials and services need to be rendered professionally; there can be no cutting corners if the entrepreneur wants to succeed. The entrepreneur's continued creativity and dedication are vital to the success of the business.

Office Management

An office manager may be needed to monitor office procedures, assign work, oversee performance and proper use of supplies, prepare and circulate important memos, and assure that office equipment is properly used.

Labor is typically the most expensive part of running an office. Therefore, increasing labor efficiency may lower costs. Time and motion studies may be conducted to ensure that worker operations are cost-effective and time-efficient. Duplication and delays in activities should be avoided. Part-time employees may be hired for short-term, unskilled duties; for example, high school students may work after school at a minimum wage.

Cost savings may be achieved in several ways. Workers can turn off lights and electronically driven machines when they leave their desks for long periods. Obsolete forms may be eliminated or used as scratch paper. Online telecom companies may offer discount rates. You can do the following to save on mailing costs:

- Evaluate options to reduce the price and delivery time of mailing catalogs, or use email to encourage customers to view online catalogs.
- Instead of using stamped, self-addressed envelopes for replies, you may use business reply cards and envelopes that allow you to pay only for those actually returned or encourage online ordering.

To save time and costs in handling, do the following:

- Email invoices and receipts to customers rather than mailing them.
- Use postage scales if your business handles large quantities of mail.
- Outsource mailing operations to third party printers, if feasible, if you send out a large number of catalogs.
- Try to eliminate paper as much as possible, focusing on online forms, storage, and communications.

Do expenses appear reasonable? You may look at the trend in the relationship of cost of supplies to total cost, cost of supplies to sales, and telephone expense to sales.

Documents should support your company's activities. Computerized programs may be used to minimize hard copies as much as possible, which wastepaper and create handling and storage issues.

In the office, planning, execution, and coordination activities occur. Many customers and clients have their initial contact with businesses in their offices; therefore, offices should give a good impression. The physical layout and size of the office depend on the type of business, but they should promote efficiency. The office space should generally contain provisions for a reception area, storage, and vaults. A conference room may also be needed. There should be restrooms and a coffee/beverage area. You need good lighting to reduce workers' eyestrain and fatigue.

Before buying office equipment, try to get a demonstration of it. Also, find out if the employees who will use the equipment are comfortable with it. Will the purchase of used equipment at a lower cost suffice? If your needs for equipment are heavy only during certain times during the year, you may be better off leasing than buying. The desks and chairs should be comfortable. Desks should have sufficient drawer space and compartments, racks for stationery and accessories, and letter and filing trays.

You should have preventive maintenance done for expensive office equipment and take out service contracts for such machinery. Keep a control record for each piece of equipment, including serial number, manufacturer, model, cost, date of purchase, and location. If repairs to a piece of equipment run 20 percent or more of its cost, the equipment should probably be replaced.

Office management software is widely available to empower you and your staff to manage all of your files, documents, and tasks. Many companies use either Microsoft Office or Google Docs to handle all word processing, spreadsheet, and presentation requirements.

Insurance

You will require insurance to protect against various business risks, including casualty loss (fire, hurricane), and illness or death of key personnel, employee strike, and product liability. You should identify the possible risks, appraise the probability of the loss occurring, the dollar amount of potential loss, what dollar amount of insurance you are comfortable with, the premiums required on the policy, how much of the risk you are willing to accept yourself, and the term of the insurance policy.

You should practice risk prevention and/or reduction by having a sprinkler system, fire alarm, and safety equipment. You may also transfer the risk of damage to another party to reduce the need for insurance; for example, you may subcontract the production of your product or rendering of services to pass on risks (e.g., employee injury, water damage). You may decide to lease property, in which case the lessor maintains the insurance.

It is preferable to use one agent to handle your insurance needs since responsibility then rests with one individual and you may lower your overall cost. When you have a package (comprehensive) insurance policy, inquire how the premiums are computed and obtain the price breakdown for each type of coverage. Make sure to keep detailed records of your insurance policies, premiums, and recoveries. Further, a periodic appraisal may be necessary to determine fair market values of your insured items; for example, it may be better to insure your inventory separately so that the insurance rate may be adjusted periodically to tie into its changing carrying value. Review insurance coverage regularly so that you do not pay excessive premiums on property values that have declined!

In deciding which insurer to select, consider the following:

1. *The financial health of the insurance company*. Will the insurance company be around and have the financial resources to pay out a huge settlement?
2. *The insurance services needed*. You may need a specialized type of insurance that is better provided by an insurance company specializing in your industry.
3. *The cost*. You should choose the insurer who charges the least for the coverage and deductible involved. In looking at cost, consider the total premiums to be paid (initially as well as later ones) and any dividends to be received. Beware: If the cost is unrealistically low, perhaps claim settlement may be a problem and/or services may be inadequate.
4. *Ability to modify coverage*. Is the insurance company flexible in tailoring the policy to meet your particular needs? Will the insurance company allow you to insert desired provisions?

In setting premiums, the insurance company will classify the business according to the degree of risk. Businesses that are not very high-risk include children's clothing stores and beauty salons. Moderate-risk businesses include restaurants, auto sales, and grocery stores. High-risk businesses include gas stations and liquor and jewelry stores.

Notify the insurance carrier as soon as a loss occurs. Make sure you can document the loss for insurance reimbursement purposes by having accurate accounting records, death certificates or inventory listings.

If you are in a high-crime area and are unable to obtain insurance privately, you may be able to obtain government insurance through the Fair Access to Insurance Requirements Plan. Rates vary depending upon geographic location, area crime statistics, and gross receipts. You can determine if your state uses this plan and if you qualify by contacting the state insurance commission.

Be watchful of overlapping coverage in insurance policies, which causes a higher than necessary cost and may result in problems in case of a loss if each insurance company denies basic liability and wants to pay only the excess not covered by the other company.

Liability Insurance

You are legally liable for negligence that results in accidents and mishaps causing injury to customers, employees, or any other party connected to your business. An example is an individual who falls and is injured because of a defect in the floor in your store. Liability insurance covers legal costs and payouts for which the insured party would be found liable.

Surety Bond

A surety bond, usually taken out by construction contractors, guarantees that you are honest and capable of performing the contractual obligation. To obtain the bond, you will need to put up collateral. If you do not properly perform, the surety bond company will pay the customer the resulting damages. This bond helps the small contractor compete with large well-known contractors because it guarantees the job to the customer.

Product Liability

Product liability exists for damages caused by the company's products or services to customers. Note that the coverage may be limited to only a certain type of product.

Fidelity Bonds

Fidelity bonds are a form of business insurance most often held by insurance companies, banks, and brokerage firms, which are specifically required to carry protection proportional to their net capital. Fidelity bonds provide an employer protection against losses that are caused by its employees' fraudulent or dishonest actions, such as fraudulent trading, theft, or forgery. The bonding company performs a check on employee honesty. There are different types of fidelity bonds: Individual bonds cover each employee separately, while schedule bonds list the names or positions of those to be covered. Blanket bonds cover the whole workforce. Bonds are continuous unless canceled by either party.

Key Person Insurance

If an owner, partner, or major employee becomes disabled or dies, you are covered for the resulting business losses. If the key man insurance is taken because it is required by a lender as protection for the loan, the insurance cost is not tax-deductible.

Property Insurance

Property insurance provides reimbursement for loss to business property. Business property includes real property (e.g., building) and personal property (e.g., office equipment, machinery, inventory). Property coverage includes comprehensive, theft, fire, sprinkler leakage, flood, hail and windstorm, vandalism, inland marine, and glass. Each of these is discussed below.

> **Comprehensive Property Insurance**. This policy basically covers all risks except those specifically excluded in the policy. Some advantages of this policy are that it offers a lower cost than if the coverage were purchased in separate policies, it avoids duplications in coverage with separate policies, and it enables you to obtain settlement more easily by avoiding the conflict possible among individual policies. Typically, comprehensive policies exclude coverage for automobiles, accounting records, cash, and machinery.
>
> **Theft Insurance**. While comprehensive property insurance may cover some types of crime, other types are excluded and may be separately covered in theft insurance, including employee theft, defalcation, embezzlement, and off-premises robbery. Crime insurance includes burglary and robbery.
>
> **Fire Insurance**. A standard fire insurance policy covers fire and lightning. A special policy is needed for additional risks such as coverage for theft and property protection after a fire.
>
> **Sprinkler Leakage**. This covers losses due to leakage of a fire protection water sprinkler system.
>
> **Hail and Windstorm**. This is usually covered as part of comprehensive, all-risk property insurance.
>
> **Vandalism**. This floater policy is directed toward special types of retail businesses, including jewelers, furriers, and launderers. This type of property is very vulnerable to loss.
>
> **Glass Insurance**. Glass insurance provides reimbursement for breakage in the stores' glass windows.

Credit Insurance

Credit insurance includes credit life and commercial credit. Credit life is designed for retail businesses selling on credit and guarantees that if a customer dies, his or her debt will be paid off. Commercial credit reimburses you if customers default on their balances.

FAIR Plan

If your small business is located in a crime-ridden area vulnerable to significant vandalism and riot, you may not be able to get private insurance; if you can, the fee may be excessive. You may, however, qualify for the Fair

Access to Insurance Requirements (FAIR) Plan sponsored by the U.S. Department of Housing and Urban Development.

Transportation Insurance

Transportation insurance provides coverage for your goods while they are being transported. This coverage provides peace of mind since common carriers are usually not liable for catastrophes such as floods or acts of God. An inland transit policy covers losses from a land shipment not insured by the common carrier's policy; a blanket motor cargo policy is for those who ship by truck.

Automobile Liability Coverage

In addition to being responsible for accidents caused by your own vehicles in the course of business, you may be legally liable for accidents caused by vehicles of others acting on your company's behalf (e.g., employees, suppliers). Coverage usually includes collision, fire, theft, and liability. Note the may be exclusions such as breakage to glass. You can lower the premium cost by having a higher deductible and joining a safe-driver program.

General Liability Coverage

General liability coverage typically includes reimbursement for losses resulting from bodily injury or from damage to property of others, medical costs associated with the accident, and legal and court-related costs. Check the policy for exclusions, such as damages that result from blasting operations or that are related to nuclear energy. Be aware of the liability limitations of the policy; the limit may be per person or per accident. For example, an automobile liability insurance policy may limit you to $300,000 per person injured or to a total of $1,000,000 per accident.

Umbrella Policy

An umbrella policy covers unusually large losses that exceed your basic coverage. An example is an additional coverage for accidents caused on company premises exceeding basic coverage of, for example, $2 million. The umbrella policy may cover an additional $3 million in losses. For a relatively low cost, you may be protected against severe losses.

Workers' Compensation Insurance

Workers' compensation insurance covers the employer if the employee is injured on the job. An employer is required by law to give employees a safe place to work and safe tools and equipment and to warn employees properly about possible dangers they face in the performance of their jobs. An employer who fails to take any of these actions may be legally liable. The employer's liability is less if the employee was careless or if another employee was responsible for the injury.

Business Interruption Insurance

If your business is shut down because of a catastrophe, you will suffer lost earnings. In addition, you will have to continue paying business expenses. This insurance reimburses you for both lost earnings and ongoing expenses.

Profit and Commission Insurance

This insurance reimburses you for lost profits or commissions due to the destruction of the related merchandise.

Valuable Papers Insurance

Valuable papers insurance covers the business against damages resulting from the destruction of important documents.

Malpractice

Malpractice insurance, which helps protect against claims due to errors and omissions such as bad advice, accidental injury, and incorrect information, may be taken out by professionals including accountants, attorneys, insurance agents, engineers, and architects.

Health and Life Insurance

Health and life insurance cover illness or death of the owner and/or employees. Coverage usually includes basic health insurance, major medical insurance, dental insurance, and life insurance. Health and medical insurance typically cover basic hospitalization and laboratory tests. Major medical plans and disability plans are also available. Life insurance provides payment to the employee's beneficiaries if the employee dies. You may be able to use life insurance annuities to provide employee pension benefits. Group insurance coverage will result in lower rates than if the policies were taken out individually.

Important Records

There are many important records needed to keep track of what is going on in your business. These records include sales records, service records, purchase records, and equipment records. In addition, you will need to keep financial records (e.g., cash receipts, cash payments), payroll records, insurance records, and personnel files. These are discussed in other sections.

Safeguard important documents and records against loss by placing duplicates in different locations, either physically or virtually. Then, if one set is destroyed, you have a backup copy somewhere else. Ideally, the records will be digital, and they will be stored in multiple locations or sites or on the cloud.

Sales records can be used to measure the efficiency of individual selling departments or sales staff. The records can reveal which department is making the best profit, which department operates on the lowest margin, which salespeople are generating the most sales, and how their individual sales records compare to their wages and to the sales performance of other salespeople in the department.

Sales records can be obtained by several methods including cash register totals, daily sales slips totals, or individual records of sales kept by sales staff. Department sales can be obtained by using departmental keys on the cash register, by using separate cash registers for each department, or by totaling the sales slips of each department.

Sales records of each salesperson can be obtained by requiring the salesperson to identify himself or herself on each sales record or by using an identification code when ringing up sales on a terminal.

Service records maintain a file on merchandise that has been returned by customers for service or repair. If the item is under warranty, the repair cost will have to be borne by the merchant or the manufacturer; if the repair is not covered by warranty, the cost will be paid by the customer. The purpose of the service record is to ensure efficient and cost-effective handling of transactions, to prevent loss of goods, and to ensure payment by the customer or the manufacturer. A complete record, including a complete description of work performed, should be maintained for each service call, whether under warranty or not. Repair charges should be uniform to facilitate bookkeeping and ensure fair treatment of customers. Obtain suggested repair rates for common repair problems from the manufacturer or similar companies.

Purchases records should be used to maintain control of credit purchases and ensure that payments are made on time. A daily invoice file, paper or electronic, should be kept for each month. Invoices should be filed under the day they will become due, making it easy to check the file on a daily basis to see what invoices need to be paid. Once paid, each invoice should be marked with the check number and date of payment. Typically, purchase records and invoices will be tracked in a software program such as QuickBooks.

Keep equipment records for all equipment owned by the business, and include relevant information such as the purchase date, description, cost of the equipment, fair market value (if known), down payment, monthly payment, balance, and accumulated depreciation. This information is useful for internal control, recordkeeping, insurance, and replacement.

Computerizing the Small Business

Computers have greatly increased the productivity of the business by lowering recordkeeping costs and providing timely and accurate information for decision-making. Initially, if the business owner is not technologically fluent, a computer consultant may be retained to teach the owner and staff how to select and use the hardware and software.

Before deciding on a computer system, the small business owner should consider the needs of the business in terms of volume, types of computer applications, and kinds of software needed. What are the company's information requirements, paper flow, and expected growth? Do not buy a system that you will outgrow in a few years.

Computer programs and apps are useful in many areas, including processing business transactions, recordkeeping, preparing financial statements and tax returns, inventory recordkeeping and control, purchasing, payroll, preparing status reports for customers and salespeople, preparing special reports such as aging customer accounts, financial analysis, storing information such as documents and correspondence, generating electronic mail, scheduling, calculating, and linking files.

Accounting software (such as Quickbooks and Sage) exists to do all the recordkeeping of a business, including recording transactions in the journal and maintaining a ledger. The software has different modules such as cash, accounts receivable, inventory, accounts payable, payroll, and fixed assets. In the newer editions of Quickbooks Pro, customers can use Quickbooks to list their businesses on Google Maps, manage their Google AdWords campaigns, and sync data from popular apps like PayPal, Square, and others. Tools like the Company Snapshot, Invoicing Payroll help you save time and streamline your tasks.

Spreadsheet software such as Excel can assist with the preparation of forecasts, budgets, "what-if" analysis involving alternative assumptions (e.g., the effect of product line strategies on profitability or of change in sales on profitability), cash flow analysis, and breakdown of expenses by category. Small companies continue to use Excel as a primary report generation tool.

A database management system package (such as Access or an online application) is an organized collection of readily accessible related information that may be used on a recurring basis. Examples are records of customers, inventory, and employees. The database program allows you to enter, manipulate, retrieve, display, extract, select, sort, edit, and index data.

Tax preparation and planning software, including software to maintain payroll records, (such as Turbotax for Small Business) are widely available, as are financial analysis packages, such as programs for cash management, anticipating the consequence of a policy change (e.g., increasing selling price), or investing funds.

Also useful are decision software programs that place you in different business scenarios in which you make strategic business decisions. The programs evaluate your decisions, instruct you on the merits of your decision, and make suggestions as to what other alternatives you should have considered.

Word-processing programs, such as Microsoft Word, with a mail-merge feature that individually addresses and changes the text in form letters, are also available. The program also prepares mailing labels and sorts by ZIP code, allowing you to save money on presorting bulk mailings. (Online services are also available, though, and typically provide greater ease and greater functionality.)

Calendar software (such as Microsoft Outlook or Google Calendar) may be used as appointment calendars, task trackers/to-do lists, and/or to record time spent on particular accounts or projects.

Marketing research programs can be used to design your research tool and to analyze the data and interpret the results. For instance, many companies use Survey Monkey to do quick online surveys.

Customer Relationship Management online programs such as SalesForce.com also assist in maintaining customer lists, finding new customers, and tracking orders.

There are graphic packages that put numeric information into such graphic forms as charts, diagrams, and signs. Many times, though, these services can be outsourced to designers, if feasible and critical to your business.

Planning and scheduling software exists to assign work to employees and to keep a record of the customers to be serviced and the type of tasks to be performed.

Time and billing software can be used to keep track of hours spent on an account by type of function performed so you can bill the customer based on an hourly rate.

Online storage and collaboration software is very popular. Employees or customers in different locations can access shared files, and depending on the rights granted to each user, can update the documents as needed from around the world.

You should select your software first because most software is available online and accessible through standard browsers which could reduce or eliminate your hardware needs. Online or off the shelf software should be considered before industry-specific software or custom programming. The software will typically do the job at a significantly lower cost, and be easier to upgrade later on for more features or more users. But be cautious about bargain packages, since the software applications may be limited or the program may be of poor quality, lacking flexibility, or compatibility.

Prepare a list of any special hardware requirements of each software package you intend to buy, including necessary and recommended: memory, extended memory, monitors, operating systems, speed, and peripherals. Based on the list, put together a package of hardware that will adequately run the software you have selected. Make sure the hardware can accommodate the total number of devices. You will need to buy additional units as your needs grow. The hardware requirements for online programs are usually small because the software provider is the one performing any significant processing.

Once the software and hardware have been purchased, it is time to install and implement the system. The implementation process is typically time-consuming, with more work upfront to set up the system correctly for your business. The best way to implement various software and applications is in modules, allowing plenty of time for learning, testing, and implementing each module or task. For example, for accounting packages, accounts receivable may be learned, tested, and implemented in the first month, payroll in the second, and inventory in the third. Make sure to involve the employees who will be using the system early in the process. You should also consider outsourcing your accounting and payroll requirements so that you can focus on the more critical items of your particular business.

Run manual or automatic backups during implementation and in the early days after production because the system may initially result in errors and failures and then continue to perform backups frequently over the life of the system as there could be system crashes or disasters that make the primary system unavailable. Have a second backup of data stored on disk in case the first one is destroyed (e.g., human error, computer malfunction). The files should be kept in different locations, such as www.box.com or Google Drive.

Once a system has been implemented, it should be reviewed for conformity with performance standards, such as processing speed and accuracy of reports.

If data and/or functions should be restricted for use by only certain employees, proper access controls such as unique user IDs and passwords and role-based permissions are needed. Most software solutions require passwords for standard access.

Section 9:

Managing Human Resources

Learning Objectives:

After studying this section, you will be able to:

- Identify the advantages of different staffing strategies.

The Recruitment Process

The steps in recruiting personnel are identifying your staffing requirements, formulating job specifications and minimum employment standards, interviewing, and hiring. In identifying personnel requirements, you should know what your business is going to accomplish and segregate that objective into tasks. You then determine what type of person will best perform each task and how many hours will be required to accomplish each task. Prepare a list of individual positions, needed qualifications, and when the position will begin.

You should prepare a detailed job description for each position, listing what the job entails, the name of the supervisor, previous experience and education required, travel requirements, working hours, and overtime required.

It is always good to promote from within for morale purposes; it also saves money in recruiting.

The hiring process involves the following steps:

1. *Screening applicants*. This involves looking over applicant resumes and selecting those who meet your minimum standards to interview.
2. *Interviewing*. The structure and questions for the interview should be prepared beforehand and a rating sheet used for major categories such as personality, knowledge, and communication skills. Make sure you are not interrupted during the interview. Have the applicant fill out an application form before the interview and review it prior to the meeting to know what areas to concentrate on. Review the ratings and select the candidate(s) you may want to make an offer to.

3. *Making an offer*. Check references and supporting documentation before making a job offer. Try to give the offer in person or on the telephone rather than by letter, since personal contact is best. Offer the applicant a salary about 10 percent below what you think he or she will accept, assuming it is a fair figure. You can always negotiate later. Emphasize other positive aspects about the job besides salary, such as fringe benefits, working environment, and promotion opportunities.

According to equal employment opportunity laws, you cannot discriminate against an applicant on the basis of race, religion, or sex.

Recruitment efforts may be in the following forms:

1. *Word-of-mouth*. This method is easy and is the least costly. Employees and professional associates may recommend suitable candidates. A disadvantage is that you may not reach many potential candidates.
2. *Placement agencies*. You will pay the agency only if you hire a candidate. However, the fee may be significant. The candidates have already been screened by the agency for appropriateness for your job.
3. *The internet for recruiting*. There is no faster, simpler, more convenient or more cost-effective way to reach hundreds of thousands of qualified candidates, 24 hours a day, 7 days a week. Responses occur instantly and the results are measurable. More than two-thirds of human resources professionals use the internet to recruit. Millions of job seekers surf the Web each week, post their resumes, fill out online applications, and even conduct email interviews. Computer-assisted applicant searches take one-third the time of traditional searches. Moreover, some evidence indicates that applicants are more truthful over the internet.
4. *Advertising*. You may advertise in newspapers, journals, and trade publications. You may use a blind ad with only a box number in order not to identify the name of your business. However, blind ads will attract fewer responses than open ones because applicants like to know who they are dealing with. An advantage of advertising is the ability to quickly locate candidates; the response rate is typically high enough to find suitable candidates. The cost will vary.
5. *College campuses*. When recruiting on college campuses, emphasize the level of responsibility, experience, and rapid advancement they could achieve with your firm. College recruitment does not involve a placement fee.
6. *Professional associations*. Some professional associations permit you to place recruitment ads in their publications or websites. This is advantageous because you are targeting a desired audience. There may be a placement fee.

You may use a temporary agency for temporary help. Advantages are that they offer flexibility, can be used on a need basis, and impose no cost for fringe benefits. Disadvantages are a higher hourly rate, a lack of employee long-term commitment, and reduced employee experience in the business.

Management of Employees

The most important resource you have is your capable employee staff. A congenial and professional relationship should exist between you and your employees, and you should meet with your staff on a regular basis. Good employees should be rewarded and recognized financially and with promotions.

You have to pay your employees fair wages. If compensation is too low, the employee's morale will be bad and they may leave. If the salaries are too high, you are rendered less competitive and lose money you should not lose. Typical salaries and fringe benefits in the industry may be obtained from professional organizations, local chambers of commerce, the U.S. Bureau of Labor Statistics, and executive recruiters. Bonuses should be based on employee job performance and/or the profitability of the company. Semi-annual reviews are a good idea. In looking at the compensation package, you have to consider not only salary but also fringe benefits (e.g., health plan, retirement plan). Most fringe benefit payments are tax-deductible. Also important are job security, working conditions, hours, employment terms (e.g., sick leave, vacation time), status (e.g., job title), and treating employees with dignity and respect. Generally, an employee is given two weeks' vacation after one year and three weeks thereafter.

In determining a salary rate, consider these factors:

- The salary should be based on worker productivity and performance.
- Higher salaries should go to employees with more experience and additional years of service.
- Wage rates should be adjusted depending on demand/supply factors.
- A person who is overqualified for a job should be moved to a position more commensurate with their skills.

It is in your interest to try to motivate employees because then they will be more productive and will strive to achieve the firm's goals to the maximum extent possible. A lack of motivation may result in job friction, poor quality work, turnover, absenteeism, and lateness.

You can minimize disciplinary problems by ensuring that all employees know company rules and the reasons for them. There should be goal congruence built on trust and understanding. Rules and guidelines regarding job expectations, absenteeism, lateness, theft, and drunkenness/drug use should be reasonable and clearly stated. The punishment for breaking a rule must be communicated. Preferably, the rules and punishments should be developed in a participative manner between the employer and employees. In extenuating circumstances, you may bend the rules; however, avoid favoritism. Be open to employee suggestions regarding employment terms.

There are many labor laws governing such areas as minimum wages, maximum hours, overtime pay, and job discrimination, so consult with a knowledgeable professional (e.g., labor attorney, personnel officer) when establishing the company's guidelines.

Before terminating an employee for cause, give at least one warning. If an employee must be terminated, do it at the end of the working day in a meeting that is free of interruptions and carefully explain the reason for your action. Remember to be tactful because of the effect the firing and the employee's reaction to it may have on other employees. Preferably, severance pay and unemployment insurance benefits should be provided. If you have confidence in the employee, try to find him or her another job.

Before hiring temporary employees, consider paying overtime to current employees. Temporary employees may be hired when there is a rush order, seasonal demand, employee illness, or if the workload suddenly increases. Some drawbacks exist, however, in that temporary employees do not know your company's operation and may involve a higher cost because of the extra compensation that must be paid to the placement agency.

You may contact a temporary employment agency, which has already hired experienced employees; the employees may already be covered by insurance from the employment agency. Inform the service of your needs and provide full information about the job, length of time help is required, hours required including overtime, qualifications and skills necessary, nature of your business, and office equipment to be operated.

When utilizing temporary employees, you should:

- Be realistic in expectations.
- Inform your permanent workers before the temporary employee's start date.
- Provide proper supervision including demonstrations and/or explanations of what to do.
- Be patient, since it will take time for the temporary employee to get to know the ropes.
- Plan the workload prior to the temporary employee's arrival.
- Ready the equipment prior to the temporary employee's start date.

Contracting Out Services

Keep in mind that it may not be absolutely necessary to hire a long-term employee when the work may only have a short duration or is not critical to the firm. Many projects can be handled out-of-house, which can be a very valuable way to minimize overall employee costs and risks. For instance, it is quite common to outsource marketing work, such as graphic design and placement. Also, development can be outsourced, such as website development and maintenance.

New services such as www.Upwork.com and www.Guru.com allow the small businessperson to outsource contract work around the world. These services allow you to find competitive rates with highly qualified individuals, and they provide convenient and trustworthy methods of payment. In addition to sophisticated scheduling and progress reports, these sites have an extensive rating system to help the small business owner find the right person or company for the job.

Glossary

Acceleration clause - a clause in a credit or loan agreement that states if the borrower does not meet the payment schedule, all remaining payments may become immediately due and payable at once at the demand of the creditor or lender.

Accommodation - a loan without interest, collateral, or other consideration. An example might be a loan between members of the family or friends in order to start a business.

Account - a record of the relationship and transactions between a business and another party (e.g., customer). The account balance is what is receivable from or owed to another party at the end of a reporting period.

Action - a legal proceeding initiated by the business against another party such as for the nonpayment of a customer's account balance.

Adjustment - 1. Changing an account balance because of some happening or occurrence, such as a product defect. 2. In insurance, the settlement of, or change to, a claim.

Advance - 1. Money given to an employee before it is earned, such as an advance against salary. 2. Payment received from customers in advance for work, goods, or services to be delivered or performed. 3. Money given by a banker to a borrower; in advance, usually short term and as a result of an overdraft.

After-tax cash flow - net cash flow (cash revenue less cash expenses) after taxes have been subtracted. It is the cash flow generated from operations.

All risk/all peril - a feature in an insurance policy that covers all risks/all perils unless specifically excluded by the policy.

Allowance - the reduction in price or increase in the quantity of a good or service that the seller gives the buyer. Allowance may be given in special sale, damage, shrinkage, and spoilage situations.

Amortized loan - a loan that is paid off in periodic equal installments and includes varying portions of principal and interest during its term.

Appreciation - increase in the value of an asset such as property.

Approval sale - a sale that is not finalized until the merchandise is accepted by the buyer. The title will pass only when approval is given or when the goods are retained by the buyer for a reasonable time period or the period specified in the agreement.

As is - a term for secondhand or damaged goods sold without an express or implied warranty by the seller. The buyer is warned to inspect the items carefully since the burden of determining their condition falls on him or her and the items are generally not returnable.

Balance sheet - a statement listing the assets, liabilities, and capital of a company on a specific date.

Balloon clause - a provision in an installment sales or loan agreement stating that the final payment by the customer or borrower will be substantially larger than all other payments.

Bank reconciliation - the process of comparing a bank statement balance to a checkbook balance and identifying differences (i.e. reconciling items). The checkbook balance should be the same as the bank balance at the end of the period. Reconciling differences relate to (1) items shown in the checkbook but not on the bank statement (e.g., outstanding checks) and (2) items shown on the bank statement but not in the checkbook (e.g., bank service charges). Accounting entries may be needed (e.g. to record bank service charges) to ensure the cash balance is property stated in the financial records as of the end of the period.

Bargain basement - a physical location in a large retail store where merchandise can be bought at significant discounts.

Bill of sale - a receipt of money paid by the buyer to the seller.

Billing cycle - the time period between periodic billings for merchandise delivered or services rendered, typically one month. It could also be the periodic mailing of statements within a month to distribute the workload efficiently.

Boilerplate - standard language found in contracts and agreements.

Bounced check - a check that has been returned for insufficient funds.

Cash and carry - a requirement that a customer must pay cash for a good or service and either take immediate delivery or arrange for delivery (at a charge).

Cash before delivery - a requirement by a seller that the buyer pays for goods before delivery. A discount may be given for immediate payment. The seller may do this when it feels a risky or questionable buyer is involved.

Cash budget - a budget for cash planning and control that presents anticipated cash inflow and cash outflow for a specified time period. The cash budget helps the owner keep cash balances in reasonable relationship to needs. It assists in avoiding idle cash and possible cash shortages. The cash budget shows beginning cash, cash receipts, cash payments, and ending cash.

Casualty insurance - insurance that protects a business against property loss and damage.

Closed corporation - a corporation in which shares are held by a few individuals, typically family members or management of the company. These shares are not available to the public.

Collateral - the property that must be pledged as security for a loan. If the borrower defaults, the lender can usually seize the collateral.

Commencement of coverage - the date upon which insurance protection starts. Prior to that time, the risk of loss belongs to the owner of the business.

Common stock - a security that represents ownership in a company.

Company car - an auto owned by the business but available to an employee for use.

Compensating balance - the balance a borrower must maintain on deposit in a bank account, representing a given percentage of the loan. No interest is earned on this balance, which increases the effective interest rate on the loan.

Concession - 1. A reduction in the price a seller charges as an incentive for sales. 2. Any deviation from normal terms or previous conditions. 3. Permission, usually in the form of a lease, to conduct a particular type of business in a specific area or place.

Contract of sale - a written agreement between seller and buyer in which the purchaser agrees to buy specified merchandise or services and the seller agrees to sell them upon the terms of the agreement.

Corporation - a form of business organized as a separate legal entity with ownership evidenced by shares of capital stock.

Credit - a loan extended to a business or individual payable at a later date.

Credit application - a form used to record information regarding a credit applicant's ability to repay the debt.

Credit bureau - an agency that gathers credit information about individuals and businesses.

Credit limit - a specified amount beyond which a credit customer may not buy on credit.

Credit memorandum - a form issued by a seller to a buyer indicating that the seller is reducing the amount the buyer owes.

Credit rating - a rating to help businesses determine if a credit applicant should be granted credit. It is based on factors such as the applicant's job history, income, assets owned, and credit history.

Current assets - cash and other assets readily converted into cash, such as accounts receivable, inventory, and prepaid expenses.

Deductible - the amount that an insured *must* pay on any insured loss before payment by the insurance company begins.

Default - failure to meet the conditions of a loan contract. It generally refers to the failure to meet interest and/or principal payments.

Deficit - the net loss of a company because expenditures exceeded income, or the excess of liabilities over assets.

Direct costs - costs that can be traced and allocated directly to a specific product, such as the cost of flour in a loaf of bread.

Discharge of bankruptcy - an order in which a bankrupt debtor is relieved of the responsibility to pay his or her obligations.

Discount loan - a loan in which the whole interest charge is deducted in advance from the face value of a loan reducing the proceeds received. This increases the effective interest cost of the loan.

Diversification - the spreading of risk such as by carrying different product lines.

Dunning letter - notices that insistently demand repayment of debts from customers.

Effective date - the day a contract begins. After the effective date of the agreement, the parties are bound by it.

Effective interest rate - real rate of interest on a loan. It is the nominal interest divided by the loan proceeds.

Employment contract - a legal agreement between the employer and employee specifying the particulars of the arrangement, such as employment terms and compensation.

Entrepreneurial profit - the net income earned by the owner of a business.

Equal credit opportunity act - a federal law making it illegal to discriminate when giving credit.

Equity - the net value of an asset or business, i.e., assets minus liabilities.

Exchange - a customer returns merchandise and obtains merchandise of equal value in return.

Express warranty - a manufacturer's voluntary written warranty that accompanies its product.

Extended coverage - protection over and above that given by an insurance policy.

Extended warranty - a service contract providing protection over and above that given by the warranty available with a new product.

Financial leverage - the ratio of debt to equity.

Fixed assets - assets of a lasting nature such as land, buildings, or equipment that are not usually converted to cash in the course of doing business.

Fixed cost - a cost that remains the same each period in the short run regardless of sales or production. Examples are rent, insurance, and property taxes.

Flexible budget - an estimate of income and costs based on different projections of sales volume.

Full warranty - a type of warranty that entitles consumers to full remedies for defective goods or services for a specified period of time.

General partner - a partner who has unlimited liability for partnership debts in the event the partnership fails. The general partner manages the business.

Gift certificate - a certificate generally paid for by one person, or issued by a seller, that entitles the recipient to obtain merchandise, food, or services at no charge up to the amount stated on the certificate.

Gross profit margin - the ratio of gross profit to net sales. A high gross profit margin is a positive sign since it shows the business is earning an attractive return over the cost of its merchandise sold.

Gross profit or loss - the result of subtracting the cost of goods sold from the revenue or sales achieved.

HUBZone (HTJBZ) - a small business located in a historically underutilized business (HUB) zone, owned and controlled by one or more U.S. citizens and with at least 35% of its employees residing in the HUB zone. You may visit the SBA internet site to locate HUBZones. http://www.sba.gov/hubzone/

Illiquid - 1. Lacking enough liquid assets, like cash and marketable securities, to cover short-term obligations. 2. Current liabilities exceed current assets.

Impaired credit - a reduction in credit given by a business to a customer who has experienced a deterioration in creditworthiness.

Implied warranty - a warranty in effect whether expressed individually or not. It is mandated by state law. It provides the products sold are warranted to be suitable for sale and will work effectively whether there is an express warranty or not.

Income statement - a detailed statement showing revenue less all expenses resulting in a net profit or loss for a specific period.

Installment credit - a type of consumer credit in which the consumer pays the amount owed in equal payments, usually monthly.

Installment loan - a loan that is repaid in a series of periodic, fixed scheduled payments instead of in a lump sum.

Installment sale - a sale in which periodic cash payments will be received over time.

Ironclad contract - a legal contract that will be very difficult to break.

Keogh pension plan - a tax-deferred retirement plan under which self-employed persons have the right to establish retirement plans for themselves and their employees. The contributions are tax-deductible, and earnings are tax-deferred until withdrawn.

Lease - a contract in which the lessee pays rent to the lessor in order to use real or personal property for a designated time period.

Leverage - the use of borrowed money to magnify potential returns from the business. It is hoped that the investment through leverage will earn a rate of return greater than the after-tax costs of borrowing.

License - a legal document given by a regulatory agency to a business to conduct some activity subject to prescribed terms. Typically, a fee is charged. An example is a liquor license.

Lien - a claim of a party, typically a creditor, to hold or control the property of another party to satisfy a debt. It permits the creditor to liquidate the property that serves as collateral in the event of default.

Limited partner - a member of a partnership whose liability for the debts of the partnership is limited to the member's investment. **Line of credit** – an agreement with a bank that makes funds up to a maximum preapproved amount available to a borrower as needed.

Liquid assets - assets that can be readily converted into cash.

Liquid - the state of having sufficient cash and near-cash assets to meet the current debt.

Liquidity - the degree to which a company can produce cash within a short time frame.

List price - the standard published price of a good or service.

Markdown - a reduction in the original retail selling price.

Markup - 1. An increase in the original selling price. 2. Adding a profit to the cost to determine a selling price.

Mechanic's lien - a lien placed against property by an unpaid service business in which the service provider can hold on to the property until the customer pays for services rendered.

Negative cash flow - a situation in which cash inflows are less than cash outflows. This is an unfavorable situation that may result in liquidity problems.

Net profit or loss - total revenues less total expenses. Stated another way, gross profit or loss plus other income minus other expenses.

Net worth - the business owner's equity in a company as represented by the difference between total assets and total liabilities. This represents the owner's equity in the business.

Offer - 1. A proposal to perform some activity or to pay some money in exchange for something, e.g. cash or a good or service. Once an offer is accepted, a contract exists. 2. To offer a good or service for sale.

Open account - 1. An account having a balance, such as one in which a customer still owes the retail store money. 2. A credit relationship between seller and buyer.

Payback period - the number of years it takes to recover your initial investment. The payback period equals the initial investment divided by the annual cash inflow.

Payment plan - a plan specifying the dates and amounts of payments to be made under a financing agreement.

Payroll withholding - the amount taken out of an employee's salary for taxes and other items (e.g., union dues) to be remitted to other parties (e.g., IRS).

Professional liability insurance - an insurance policy taken out by a professional for malpractice coverage. The policy covers legal fees and possible damages.

Profit margin - ratio of net income to net sales. It reveals the entity's ability to generate profit at a given sales level. The ratio gives the owner an indicator of the operating efficiency and pricing strategy of the business.

Recourse - a business owner's right to recover from a customer in the event of nonpayment of amounts owed.

Return - the reward for investing in a business in the form of earnings and appreciation in the value of the business.

Risk - 1. Variability about income, returns, or other financial variables. 2. Possibility of losing value, incurring losses.

Risk adverse - as opposed to risk. It is a subjective attitude against risk-taking.

Risk management - the analysis of and planning for potential risks and subsequent losses. The objective of risk management is to try to minimize the financial consequences of random losses.

Risk capital - see Venture capital.

Risk reduction - an attempt by a business owner to minimize risk by taking some action such as diversifying and obtaining insurance coverage.

Risk-return trade-off - a comparison of the expected return from an investment with the risk associated with it. The higher the risk undertaken, the more ample the return should be. Conversely, the lower the risk, the more modest the return.

Sales contract - an agreement between the seller and buyer specifying the terms of sale.

Sales tax - a state or local tax based on a percentage of the selling price of a good or service that the buyer pays. The seller collects the tax and remits it to the sales tax agency.

Seasonality - a fluctuation in business conditions that occurs on a regular basis. It may be caused by such factors as weather, holidays, and vacations. An example is the toy industry, which has its greatest sales in November and December.

Secured loan - a loan requiring certain assets to be pledged as collateral.

Self-employed income - the net taxable income of a self-employed person reported on Schedule C of IRS Form 1040. The self-employed individual pays a higher social security tax than a regular employee.

Service contract - an agreement in which the seller or other third party will repair merchandise purchased by a buyer for a specified period.

Service disabled veteran (SDV) - a veteran with a disability that is service connected (as defined in Section 101 (16) of Title 38, United States Code).

Simple interest - the interest charge computed on the original principal.

Small business enterprise (SBE) - a small business as defined in Section 3 of the Small Business Act and regulations of the SBA. An SBE is independently owned and operated, not dominant in its field of operation, with 500 or fewer employees (depending upon industry). Refer to Public Law 95-507.

Term loan – intermediate- to long-term secured loan granted to a business by a commercial bank, insurance company, or commercial finance company usually to finance capital equipment or provide working capital. The loan is amortized over a fixed period.

Tight money - a situation in which fewer funds are made available to borrowers by lending institutions and creditors. If available during these times, the loans carry higher interest rates.

Time value of money - value of money at different time periods. In other words, $1 today is worth more than $1 tomorrow. The time of money is a critical consideration in financial decisions.

Title - the legal right of an ownership interest in a property. It is evidence of ownership and lawful possession.

Total return - the return received over a specified time period from periodic income and capital gain on a sale.

Trade association - an organization representing the interests of businesses in the same industry.

Truth in lending act - a federal law protecting credit purchases. The most important provision is the requirement that both the dollar amount of finance charges and the annual percentage rate charged be disclosed.

Turnover - the number of times an asset, such as inventory, turns over (i.e. is sold) during an accounting period.

Underinsurance - the failure to carry sufficient insurance.

Unlimited liability - the amount of risk borne by someone in a sole proprietorship or general partnership. Liability is not restricted to the capital investments, thus, if the business goes bankrupt, the owner risks his or her personal assets to meet creditor claims. In a corporation, however, the stockholder has limited liability up to his/her investment.

Unsecured loan - a loan on which no collateral is provided.

Venture capital - an important source of financing for start-up companies or other endeavors that need an infusion of cash. The ventures usually involve some risk but offer the potential for high profits; sometimes, called *risk capital.*

Women business enterprise (WBE) - businesses at least 51% owned, operated, and controlled by a woman or women.

Index

Advertising, 94
Angel investors, 37
Balance sheet, 66
Budgets, 70
Business license, 55
Business plan, 19
Cash budget, 122
Cash management, 41
Copyright, 56
Corporation, 51
Cost analysis, 76
Credit policy, 46
Debt financing, 30
Discharge of bankruptcy, 124
Express warranty, 124
Financial statement analysis, 67
Financial statements, 65
Franchises, 3
Gift certificate, 124
Implied warranty, 125
Income statement, 125
Income taxes, 83
Installment loan, 125
Insurance, 106
Internal controls, 62
Inventory ratios, 69
Keogh, 125
Lease, 125
Leasing, 37
Leverage, 69, 82, 125, 140
Lien, 125
Limited partner, 126
Line of credit, 42
Liquidity, 68, 82, 126, 140
Marketing research, 91
Mechanic's lien, 126
Negative cash flow, 126
Net worth, 126
Networking, 96
Packaging, 102
Partnership, 50
Patent, 55
Payback period, 126
Payroll taxes, 87
Pricing, 99
Profit margin, 126, 140
Quick ratio, 68
Recruiting, 116
S Corporation, 86
Sales staff, 97
Sales taxes, 88
Seasonality, 127
Short-term bank loans, 30
Small Business Administration (SBA), 33
Small business enterprise, 127
Sole proprietorship, 50
Stockouts, 45
Time value of money, 128
Truth in lending act, 128
Unsecured loan, 31, 128
Venture capital, 35, 36, 127, 128