

# *H*andbook for Small Business

---

By SCORE Chapter 225  
Hyannis, Mass.



Management

and

Planning

Series

*Building America's Future*

---

Copyright © 1989 by SCORE Chapter 225, Hyannis, Massachusetts. All rights reserved. This publication is protected under copyright. No part may be reproduced, transmitted or transcribed without the permission of the author. SBA retains an irrevocable, worldwide, nonexclusive, royalty-free, unlimited license to use this copyrighted material.

While we consider the contents of this publication to be of general merit, its sponsorship by the U.S. Small Business Administration does not necessarily constitute an endorsement of the views and opinions of the authors or the products and services of the companies with which they are affiliated.

---

*All of SBA's programs and services are extended to the public on a nondiscriminatory basis.*

# CONTENTS

<b>PREFACE</b> .....	1
<b>INTRODUCTION</b> .....	1
<b>STARTING A BUSINESS</b> .....	2
<b>NAMING A BUSINESS</b> .....	3
<b>LEGAL STRUCTURE OF A BUSINESS</b>	
Sole Proprietorship .....	3
Partnership .....	4
Corporation .....	5
"Subchapter S" Corporations .....	5
<b>LICENSES AND PERMITS</b> .....	6
<b>MANAGING A BUSINESS</b>	
Management by Objectives .....	7
Keeping Records .....	8
Reviewing Records .....	8
Taking Action .....	8
Getting Help .....	8
Essential Management Practices .....	8
<b>FINANCING A BUSINESS</b>	
Sources of Funding .....	9
The Loan Proposal .....	11
<b>THE BUSINESS PLAN</b> .....	12
<b>RECORD KEEPING</b> .....	12
<b>PRICING SERVICES PROFITABLY</b>	
Types of Costs .....	15
Calculating the Cost of a Service .....	15
<b>PRICING PRODUCTS PROFITABLY</b>	
Types of Costs .....	17
Competition .....	17
Markdowns .....	17
Price Lining .....	17
Markup .....	17
Break-Even Analysis .....	18
<b>ADVERTISING</b>	
Reasons for Advertising .....	19
Objectives of Advertising .....	19
Advertising Media .....	20
Help in Advertising .....	20
<b>MARKETING</b>	
Marketing Before Opening .....	21
Marketing for an Existing Business .....	21

## LOCATING A BUSINESS

Selecting a City or Town .....	23
Selecting an Area Within a City or Town .....	23
Selecting a Specific Site .....	23

<b>INSURANCE</b> .....	24
------------------------	----

## RETAILING TIPS

Image .....	25
Customer Relations .....	26
Credit Cards .....	26
Markdowns .....	26
Loss Leaders .....	26
Pricing Policy .....	26
Leases .....	26
Protecting Against Crime .....	26
Competitors .....	27
Employees .....	27
Suppliers .....	27

## EMPLOYEES AND INDEPENDENT CONTRACTORS

Classes of Employees .....	27
Independent Contractors .....	28
Casual Labor .....	28

## MANAGING HUMAN RESOURCES

Recruiting .....	29
Interviewing .....	29
Wages and Working Conditions .....	30
Training .....	30
Supervision .....	30
Terminating Employment .....	30

## COMPUTERS IN SMALL BUSINESS

What a Computer Can Do .....	31
Areas a Computer Can Improve .....	31
What a Computer Cannot Do .....	31
Buying a Computer .....	31

## FRANCHISES

Definition .....	32
Advantages .....	32
Disadvantages .....	32
Disclosure Document .....	33
Other Considerations .....	33

<b>MANUFACTURING COST ACCOUNTING</b> .....	33
--	----

## INVENTORY

Inventory Record Keeping .....	37
Inventory Control .....	38
Inventory Strategies .....	40

## APPENDIXES

A. Useful IRS Tax Publications .....	41
B. Information Resources .....	43

## PREFACE

SCORE, an acronym for Service Corps of Retired Executives, is an independent, voluntary, nonprofit association. Although SCORE is sponsored by, and receives financial aid from, the U.S. Small Business Administration (SBA), it is not a constituent of that or any other government agency.

The primary purpose of SCORE is to render a community service by providing, without charge, the expert assistance of its volunteer counselors to small businesses. Counselors receive no pay for their services.

SCORE began in 1963 when certain groups of retired persons, almost spontaneously, began offering assistance to owners and operators of small businesses in various localities, such as Worcester, Massachusetts; Wilmington, Delaware; and St. Louis, Missouri. Later in the year, the SBA began to use these volunteers to supplement its own small business assistance programs and to recruit more volunteers for that purpose.

The response was so enthusiastic, and the potential of these volunteers so enormous, that the SBA began to organize local SCORE chapters and administer the program. Today, there are more than 400 SCORE

chapters in the United States and more than 12,000 volunteers.

While its counselors derive tremendous personal gratification from assisting small businesses, SCORE exists solely for the benefit of the small business community. For anyone in, or considering entering into, a small business, SCORE offers many services. These services include private, individual, confidential counseling; training through specialized seminars, workshops and conferences; information from books, pamphlets and SBA publications; and advice on how to approach regulatory organizations, local authorities, lawyers, accountants, town officials, etc. Also, SCORE cooperates closely with other volunteer organizations, government agencies, chambers of commerce, colleges and universities, and other nonpolitical civic associations to enhance the quality of life for the entire community.

To locate the nearest SCORE chapter, call your area SBA office. The number is found in the blue pages under "U.S. Government." You can also call SBA's Answer Desk at 1-800-U-ASK-SBA.

## INTRODUCTION

In this final decade of the 20th century, small business owners continue to demonstrate their extraordinary capacity to mobilize resources and generate new jobs. There are more than 20 million small businesses in the United States, and each year nearly a quarter of a million new ones are started. Small business employs six out of every ten people, accounts for the majority of new jobs, is more flexible than big business in responding to shifting markets and is able to bring new products and services to market much faster than larger companies.

Realizing that small business is the backbone of this country's competitive free enterprise system, Congress, in 1953, created the U.S. Small Business Administration. SBA defines a small business as one independently owned and operated, and not dominant in its field. SCORE is part of the SBA's business development program.

To start a new business and remain in business profitably, one must be able to adapt to changes in the population, work force and technology, and to the demands of a global marketplace. To address these changing conditions, sound management and organizational

practices are more important than ever before. The necessity of increasing productivity of employees, the difficulties in recruiting qualified workers from a shrinking labor force and the importance of devising ways to meet workers' benefits will challenge managers of all small businesses.

America's future depends on the continued emergence of successful small businesses. To be successful, those who start a new business must be prepared. It is the purpose of this *Handbook for Small Business* to provide information in the simplest terms to help new and existing businesses to be successful. The mission of SCORE is to help people get into business, stay in business and make a profit.

More detailed information on the various facets of operating a business is available. Much is contained in the publications and video/audiotapes listed in the SBA booklet, *The Resource Directory for Small Business-Management*, available from SCORE or the SBA.

*Handbook for Small Business* is designed as an extension of the SCORE concept of service to the small business community. It is a comprehensive presentation of general

information. To a considerable extent, its contents reflect the personal and practical experience, which is the hallmark of the SCORE counseling procedure.

*Handbook for Small Business* is not offered as a substitute for in-person counseling, but rather as an enhancement of counseling. It is published with the understanding that the publisher is not engaged in rendering legal, accounting or other professional service.

## STARTING A BUSINESS

Some of the reasons people start new businesses are

- For financial independence
- To be one's own boss
- For creative freedom
- To fully use one's skills
- To be free of other people's policies and procedures
- For personal recognition

Perhaps the most important reason is to make a profit.

Whatever the business, to be successful there must be a need for the particular products or services offered. To determine if your intended business will fill a need, you must first address the who, what, why, where, when and how of your proposed venture. The following questions will help you:

- Is the business practical?
- What is the competition?
- What is the market for my product or service?
- What is the advantage of my business over existing similar businesses?
- Can I furnish a higher quality product?
- Can a demand be created for my product or service?
- What price will I charge, and how will I determine the best price?
- Am I prepared?
- Do I know where I can get help and information?
- What is an accurate description of the business?
- Where will I locate and why?
- Can I get an affordable lease at the best location?

Although this publication has been prepared by competent, knowledgeable and experienced contributors, it should not be used as a substitute for professional or other authentic sources in specific situations. As pointed out repeatedly in the book, legal or other expert assistance should be sought when required.

- Are there zoning or fire regulations or other restrictions that must be considered when choosing a location and opening the business?
- Will I need a permit or license?
- What will be the legal structure of the business?
- What will the business be named?
- What equipment and supplies will I need?
- What insurance will I need?
- What skills or experience do I have?
- What are my financial resources?
- What finances are necessary to start and maintain the business?
- How will I compensate myself?
- How will the business be managed day to day?
- How will I identify customers and how will I reach them?
- How will I hire and pay employees?
- How will I best serve the needs of my customers?

Because going into business is a risk, careful preparation is essential. A business plan is critical to determining if the risk of entering into a business is worth taking. Various chapters of this *Handbook* discuss preparation in much greater detail. Once the decision has been made to open the business, the remaining steps are quite simple.

If the business is to be operated as a sole proprietorship, and you use your name, it is usually unnecessary to register the business with your city, town or state. (See "Naming a Business," page 3.) If you do not use your own name, the business may need to be registered with the municipal or town clerk. Partnerships must be registered locally and corporations with the state.

If you are to have employees, or will be a partnership or corporation, you must obtain a business identification number from the Internal Revenue Service (IRS) by filing Form SS-4. Also, all businesses that have employees must

register with their state division of employment and training, and must pay unemployment insurance taxes to the state as well as to the federal government.

## NAMING A BUSINESS

Every business needs a name. Because a name is an important asset to a business, it should be selected carefully.

Before choosing a name, it is advisable to look at the types of names in use by businesses similar to yours. To prevent choosing a name already in use, check lists of business names available in telephone books, libraries, city and town halls, and trade journals. Names of corporations can also be checked at the corporate division of the office of the Secretary of State. To guarantee availability of your intended corporate name, contact your state's corporate division for an application and fee details.

There are different categories of business names.

- *Trade names* usually identify a company, for example "Coca Cola Company." Any type of business may call itself a company.
- *Trademarks* are any words, names, symbols or devices, or any combination of these, used to identify the goods of a business and to distinguish these goods from the goods of others. The word "Kleenex" is a trademark, as are "Coca Cola" and "SCORE."
- *Service marks* are used to identify and distinguish a business that provides services rather than

goods. "Greyhound" is a service mark for transportation services.

After choosing a name, you may have to file organizational forms with the Secretary of State, or file a business certificate with the municipal clerk at the town hall in which your business is located. This certificate is called a "dba," which means "doing business as." You may need to file a dba if you conduct business under any title other than the real name of the person, corporation or limited partnership. Corporations, limited partnerships and business trusts must be filed with the Secretary of State. Business trusts may need to be filed with a local government office.

A service mark or a trademark can be registered with the Secretary of State and the federal government, although neither registration is required. Trademarks are protected under common law. However, by registering your mark, you do gain certain exclusive ownership under statutory law. State registration is usually processed within several days. Federal registration may take several months. Registering with the state protects your mark during the federal application period. In some states, a mark must be in use before it can be registered. Details and forms for registering a trademark can be obtained by writing to your Secretary of State.

## LEGAL STRUCTURE OF A BUSINESS

Before you open a business, you must select the legal structure that will best suit your needs and those of your particular business. There are three principal types of business structure: the proprietorship, the partnership and the corporation. Each has its advantages and disadvantages, which will be reviewed.

### **Sole Proprietorship**

The sole proprietorship is usually defined as a business owned and operated by one person. To establish this form of business, one need only obtain the required license or

permit and begin operations. This is the most common form of small business organization.

### **Advantages**

*Ease of Formation.* A sole proprietorship is the easiest and least expensive form of a small business to begin, as well the one with the fewest legal restrictions. No government approval is needed to begin operation. If the business is in your own name, just open the door and start. If you have employees, the business must be registered with the federal government on Form SS-4.

State and local government registration may also be necessary.

*Sole Ownership.* The proprietor shares the profits with no one, and the decision making is vested in one person.

*Control.* The sole proprietor is in complete control of his or her business.

*Flexibility.* Management can quickly respond to the needs of the business and can make the day-to-day decisions so often critical to a new business's success.

*Freedom from Government Control.* There are no special taxes for this form of business, including no state or federal taxes. Profits become the owner's personal income and are taxed as such.

#### **Disadvantages**

*Unlimited Liability.* The sole proprietor is responsible for the full amount of business debts. These could exceed the proprietor's total investment. Be aware that this liability extends to all the proprietor's assets, including his or her home.

*Less Available Capital.* Capital is limited to the owner's personal assets and the funds the owner can borrow. Hence, this form of business ordinarily has less capital available than the other forms. Also, it is usually more difficult for a sole proprietor to borrow money for the business.

*Unstable Business Life.* The business may be crippled or terminated upon the illness or death of the owner.

*Experience Limitation.* Single owners operating with no or few employees are often limited in experience and viewpoint compared to those in the other forms of business.

*Limited Business Deductions.* Certain types of business deductions are not available to the sole proprietor. These include workers' compensation insurance and a portion of personal health and injury insurance.

#### **Partnership**

A partnership is an association of two or more people as co-owners of a business for profit.

Although not required by law, written articles of partnership are customary and highly recommended. These articles of agreement state the financial, material and managerial contributions to the business by each owner. The articles should clearly spell out the role of

each partner and the share of the profits each will receive. There should be provisions in the articles both for dissolving the partnership and for buying out one or more of the partners.

Partnerships may also be formed as limited partnerships, in which the limited partner risks only an agreed-upon investment in the business. The liability of limited partners is restricted as long as they do not participate in the management of the business.

The services of an attorney who specializes in drawing up articles of partnership is essential to start this form of business.

#### **Advantages**

*Ease of Formation.* While hardly as easy to form as a proprietorship, a partnership is easier and less costly to form than a corporation.

*Flexibility.* The partnership is more flexible than a corporation, but less flexible than a proprietorship.

*Direct Rewards.* The partnership pays no federal or state taxes. The rewards or profits from the business come directly to the partners.

*Financing.* Capital is easier to obtain for a partnership than for a proprietorship. There is more than one owner to draw upon for funds.

*Freedom from Government Control.* There are no special taxes on a partnership and, like a proprietorship, it pays no state or federal income taxes. The partners pay personal taxes on the profits.

*Skills and Experience.* The skills and experience of all partners are available to assist in decision making.

#### **Disadvantages**

*Unlimited Liability.* Each general partner is liable for the business debts incurred by the other(s) and by the business in general.

*Unstable Business Life.* Upon death of one partner, the partnership terminates. Rights of survival exist, so buy-out terms must be stated in a written agreement.

*Long-Term Financing.* Partnerships cannot obtain long-term or, for that matter, short-term financing as readily as can a corporation.

*Disposal of Interest.* It is often difficult to dispose of a partner's interest in the business. As indicated above, partnership articles should contain a buy-out agreement.



## Corporation

A corporation is a legal entity distinct from the individuals who own it. It is the most complex of the three forms of business.

A corporation can only be formed by authority of a state government. Check with your attorney or your state's agency that supervises corporations for details of registering your business and information on the laws affecting corporations.

As soon as you are notified that your organization has been approved, you must file for a federal identification number using IRS Form SS-4. As noted earlier, check into licenses and permits before doing business.

### Advantages

*Separate Legal Existence.* The corporation is distinct from the individuals who own it.

*Limited Liability.* Individual shareholders are not liable for debts of the corporation.

*Ownership Readily Transferable.* Owners invest in shares of the business, which can be bought and sold.

*Stable and Relatively Permanent.* Death of a shareholder does not end the business.

*Relatively Easy to Secure Funds.* The foundation of investors' stock purchases gives confidence to lenders of the corporation's stability.

*Delegated Authority of Management.* A board of directors and officers give structure to decision making.

*Skills and Expertise Available from Many.* Boards of directors usually are made up of members with a wide variety of perspectives, in addition to their interest in the specific corporation.

### Disadvantages

*Extensive Government Regulation.* Corporations must be registered with state government and are subject to more extensive regulation by local and federal government than are solely owned businesses or partnerships.

*Complicated Tax Reporting.* Taxation of corporations is totally different from taxation of individuals. A corporation's dividends affect tax returns of individual shareholders.

*Double Taxation.* Profits are subject to corporate tax and, if distributed to the stockholders, are taxable as personal income.

*Limited Incentive.* If management does not share in the profits, there is usually less incentive.

*Expensive to Form and Maintain.* Forming a corporation usually requires professional help to draft Articles of Incorporation and other documents, and on tax and legal matters throughout the corporation's existence.

*Excise Tax Paid Each Year.* Various taxes are imposed on corporations by all levels of government that are not imposed on solely owned businesses or partnerships. Taxes, other than federal, vary by locality.

## "Subchapter S" Corporations

One form of corporate structure, known as a "Subchapter S" corporation, allows small business corporations to have their income taxed to the shareholders as if the corporation were a partnership. Using this structure, the company can overcome the double taxation feature of the regular or "C" corporation, yet still retain the other benefits. An "S" corporation also permits business losses to be passed on to shareholders.

To form an "S" corporation, the company must have no more than 35 stockholders, all of whom are individuals or estates (no corporations or other entities), are residents of the United States, and must derive a specified amount of its income from active business. There is also a restriction on the amount of business an "S" corporation can do; at present, that figure is \$35 million.

To summarize, in choosing a legal structure for a business, one must consider the following:

- What is the risk and what is the amount of the investors' liability for debts and taxes?
- How will the continuity of the business be handled if something happens to one of the principals?
- What is the influence of applicable laws?
- Can you attract capital?
- What are the costs of starting and running the business under the different structures?
- Can you afford the extra record keeping and reporting required by some structures?
- What legal structure best serves the purpose and goals of the business?
- What legal structure ensures the maximum adaptability of administration?

Professional advice is often needed to select the legal structure for a business. However, one can always start a business as a sole proprietor and incorporate at a later date.

## LICENSES AND PERMITS

Once you have determined the purpose, type, name and structure of your business, you must find out if a license or permit is required. Many businesses require one or the other. To operate without one may be illegal.

A license is a privilege granted by a legislative body at its discretion. A permit is a right that anyone can obtain if the requirements of the granting agency are met. Licenses and permits may be granted at the town, city, county or state level. Table 1 lists departments that issue licenses or permits at the local level.

**Table 1 – License or permit issuing bodies**

Department	Authority
Building	Construction, renovations, zoning, signs
Health	Food handling, rest rooms, sewer connections, septic systems
Council	Licenses and permits
Town Clerk	Business certificates
Police	Alarm and business registrations
Fire	Safety inspections, alarm registrations
Weights and Measures	Weighing and measuring, packaging and labeling
Conservation Commission	Wetland alterations, building and activity near wetlands
Historic	Signs, building and home alterations, business activities

Exhibits 1 and 2 list types of businesses, trades and professions that often require a license, permit or registration. These lists may not be complete. Check with your attorney or local government for requirements in your area.

### Exhibit 1 – Businesses Frequently Requiring a License or Permit

Alcohol—sales and distribution  
 Amusement parks, carnival rides, music, dancing  
 Appliance testing labs  
 Asbestos abatement  
 Auto body repair  
 Auto sales—new and used  
 Child day care centers  
 Cigarettes—wholesale and retail  
 Collection agencies and finance companies  
 Concrete technicians—testing labs  
 Dairies, milk dealers and plants  
 Dancing schools  
 Detective agencies  
 Diesel fuel trucks  
 Elevators and operators, escalators  
 Employment agencies  
 Engine fuel and lubricants  
 Engineering and related fields  
 Entertainment  
 Firearms, sale  
 Fishing, hunting, trapping  
 Food or beverage service, sale or preparation  
 Fortune tellers  
 Hawkers and peddlers—balloons, souvenirs, arts and crafts, flowers, auctioneers  
 Hazardous chemicals or flammables  
 Insurance agents, adjusters, brokers, advisors  
 Junk dealers  
 Lodging—hotels, motels, inns, bed and breakfasts, guesthouses  
 Motion picture operators  
 Motor vehicle appraisers  
 Notaries public, justices of the peace  
 Nursing homes  
 Outdoor advertising  
 Painters, riggers  
 Pet shops, riding schools, cattle dealers, stables, riding instructors, guard and hearing dog businesses  
 Restricted pesticide dealers and applicators  
 Solid fuel burning, construction supervision

## Exhibit 2 – Professions and Trades Frequently Requiring a License or Registration

---

Allied health professions	Landscape architects
Architects	Nursing
Athletic trainers	Occupational therapists
Attorneys	Optometry
Audiology	Pharmacy
Barbers	Physical therapists
Chiropractors	Physicians
Cosmetologists	Plumbing and gas fitting
Dental examiners	Podiatry
Dispensing opticians	Public accounting
Drinking water supply facility operators	Psychology
Electricians	Radio technicians
Electrolysis	Real estate brokerage
Embalming and funeral directing	Real estate sales
Engineers	Respiratory care therapy
Exterminators (Insect)	Sanitarians
Hairdressers	Social workers
Health officers, certified	Speech pathology
Land surveyors	Television technicians
	Veterinary medicine

---

There are "blue laws" in many states; these pertain mostly to doing business on Sundays and holidays. Check with your police department for restrictions that apply to your area.

One cautionary note: If you are buying a business or leasing a location, do not take the word of the seller or landlord that certain licenses or permits exist or can be grandfathered. Check it out yourself.

## MANAGING A BUSINESS

---

Business is an economic institution whose goal is economic survival and whose activities are dominated by the profit motive. Its primary purpose is to create and satisfy a customer and make a profit. To achieve this purpose, business must be skillfully managed.

Management is defined as the art of conducting and supervising a business or as using judgment in business affairs. A manager is one who actively directs, controls and manipulates his or her business environment in a manner that takes account of the risks involved in order to realize monetary gain.

Successful business leaders have stressed that good management skills, whether in a large corporation or in a one-person business, are vital to the success of a business. Many small business people may be good at launching their venture, but weak in managing the development and later stages of the business. Here are ways to strengthen management skills.

### *Management by Objectives*

Objectives are fundamental to the operation of a business. An objective is a written statement of results to be achieved, defining specific outcomes and establishing performance levels for the business, its manager and its employees. Objectives must be set for both the short and long range. They must be reasonable, attainable, measurable, detailed and time specific. They should be commitments, not facts; directions, not fate. An objective must have a means and a plan of accomplishment.

An example of an objective might be "to increase my business from \$24,000 to \$36,000 in the next 12 months." Another might be "to prepare, have printed and distribute 1,000 flyers to shoppers in the local mall, all within two months." Others might be "to hire and train a new sales clerk before the end of the fiscal year" or "to telephone each account receivable at the end of each month and to personally visit accounts that are more than six weeks delinquent."

Objectives should be written for every phase of a business, such as sales, service, bookkeeping, advertising, employee relations and marketing. Note that objectives should be written and reviewed frequently.

### **Keeping Records**

Know your figures and keep them up to date. Doing this is the only way you will know how the business is faring on a daily, weekly and monthly basis. Stationery and other stores have simplified bookkeeping systems available, or you can engage the services of an accountant or bookkeeper. Accurate records are needed by business owners and managers not only to make informed decisions, but also to support reports required by federal, state and local government agencies. (See the section on record keeping below.)

### **Reviewing Records**

Keeping adequate, accurate records of your business permits you to use them in the daily management of the operation. At the end of each month you should compare the actual profit and loss and cash flow statements with the goals identified in your business plan. This way you can see your progress and take the proper action. You should not only review the financial area, but also evaluate marketing, sales, advertising and other operational goals.

### **Taking Action**

Do not procrastinate! If something is not working as you planned, do something about it—now! Don't become paralyzed by inaction. Every well-developed business plan should detail how the following will be accomplished:

- *Deciding*—Determining what must be done.
- *Planning and scheduling*—Setting time tables.
- *Performing*—Following through on decisions.
- *Controlling*—Monitoring events as they occur.
- *Coordinating*—Ensuring that each objective is in harmony and not at odds with the others.
- *Recording and documenting*—Keeping accurate and complete records.
- *Analyzing and evaluating*—Studying records.

### **Getting Help**

#### **Building a Work Force**

As your business grows there will be a need to build the organization. Some find it easier to turn to relatives or friends for help without considering their work experience and knowledge. This can be a mistake. Carefully consider the requirements of the job and the qualifications of each candidate before hiring the person. Also consider honesty, reliability, education, personality and communication skills.

#### **Professional Help**

One does not have to hire full-time professional help to get certain expertise, such as that of a lawyer, banker or accountant. SCORE counselors are also available for business advice. Using these resources may make it easier for you to plan and execute your goals.

### **Essential Management Practices**

The following are practices that are essential for a successful business.

- Have a written business plan that sets the objectives you want to achieve in the next year and the next five years.
- Analyze progress with hard numbers.
- Know your break-even point and when you are on target in reaching it.
- Have your accountant/bookkeeper prepare and thoroughly explain financial reports, such as profit and loss statements, balance sheets and cash flow sheets, in addition to those related to your tax returns.
- Even though your objective may not be to secure a loan, talk to your banker about your business. Know your numbers.
- Know exactly how much it costs you to make a sale, perform a service, make a repair, etc.
- Know how much inventory is on hand. Inventory is money. Old and obsolete inventory can paralyze your business.
- Solicit regular feedback from customers and make changes based on their suggestions.
- Join a trade association for your industry.
- Read the same publications that your competitors and customers read.

- Constantly scrutinize your competitors' advertisements and read their sales literature.
- Ask yourself the following about your competition: Is their business increasing or decreasing? How do you compare as far as quality, price, product line, exclusivity, service, reliability, location, warranties, delivery and courtesy are concerned?
- Talk regularly about business-related subjects with other small business owners.
- Review financial and marketing strategies often.
- Have regular training sessions for and regular motivation meetings with your employees.
- Recognize your own weaknesses and get help in these areas.
- Review the business plan monthly.
- Tell everyone on the payroll exactly what his or her responsibilities are and what is expected.
- Treat employees as individuals.
- When an employee does a good job, tell him or her.
- Keep as accurate a set of records as possible.
- Analyze your records often and take any appropriate steps that may be indicated.
- Take pride in your business.

## FINANCING A BUSINESS

One of the leading causes of business failure is insufficient start-up capital. Therefore, a crucial element for business success is adequate financing. Not only are funds required for start up, but also to cover initial operating losses and provide for growth.

As a general guide, one should have sufficient cash to cover at least one year's operating expenses, which includes the owner's salary and money to make regular loan payments. Almost all business operators hope their business will grow, yet some fail because, after a successful start, additional capital is not available to meet the increasing financial demands of an expanding business. It is crucial that the business plan contain a detailed analysis of all capital requirements.

Once you have determined the amount of capital required to both start and continue the business until it generates enough cash to sustain itself, it is time to find a source of money.

### Sources of Funding

#### Personal Assets

The best source of funding is your personal resources, such as savings accounts and other marketable securities and investments that are readily converted into cash. Even if you do not have sufficient personal funds to entirely finance the business, plan on using those funds, because most lenders require that you do this before they will commit to a loan. Remember, showing others you are

willing to use your own funds indicates your confidence in your business and your willingness to take the risk.

#### Family and Friends

An excellent source of funding is your family and friends. Either can make a capital investment in the business in return for partial ownership or as a loan. Usually, family or friends will lend their money at a lower interest rate than a commercial lender and with mutually agreeable terms for repayment.

It is very important in your dealings with family and friends that you carefully review your business plan with them so that they understand all the risks involved. Family and friends should not be encouraged to invest in your business if they cannot afford to risk their funds.

For IRS purposes, detailed records should be kept of any financial assistance received from friends or relatives. Also, it is recommended that a written agreement with the individual providing funds be prepared.

#### Banks

Banks are the most common source of borrowed capital. Historically, commercial banks have been the single largest source of loans to business. Today, however, both savings banks and savings and loan associations make business loans.

It is very important to establish a cordial working relationship with your banker. Pick a bank that makes loans to your particular type of business and one with

which you feel comfortable. Your banker can be a valuable partner in helping to determine the right financing package for you.

A bank normally requires that first-time borrowers invest from 25 to 35 percent of their own money before the bank will consider a loan. For example, if the business plan shows a need for \$100,000, the borrower would have to have \$25,000 to \$35,000 of his and her own money in order to obtain \$65,000 to \$75,000 from the bank. In the case of a restaurant, the bank may require the borrower to invest 50 percent of his or her own money.

Banks require that you have a good personal credit record and, in most cases, will require some form of collateral to secure the loan. Collateral can be in the form of assets used in the business or personal assets, including the unused equity in your home.

### **Credit Unions**

Many companies, labor unions and government agencies have credit unions for their employees or members. Credit unions perform functions similar to banks, including making personal loans to their members. If you are a member of a credit union, check it out as a possible source of a business loan.

### **Loan and Finance Companies**

These are companies that specialize in making personal loans for business purposes. Some of the larger companies make business loans as well as personal loans.

### **Life Insurance Companies**

Many life insurance policies have provisions for the accumulation of a "cash value," against which funds may be borrowed. Some policies call it the "loan value." The interest rate, established in the policy, is usually less than the commercial rate. Check to see if you, parents or friends have life insurance with loan values as they can be an excellent source of financing.

### **Small Business Investment Companies**

Small business investment companies (SBICs) are privately owned companies licensed by the SBA to provide capital to small businesses. SBICs look for businesses that have proprietary products with high growth potential. Young, lower-risk, aggressive companies are preferred. Usually, an SBIC wants a share in the business.

### **Community Development Companies**

Many communities have established community development companies (CDCs) to help attract new business to their area. Frequently, they are used to develop commercial or industrial parks. Check to see if your community has a CDC. If so, you should talk to them.

### **Suppliers**

In order to encourage sale of their products, many suppliers provide retailers with shelving, display cases, refrigeration units and so on at very favorable terms. Caution should be used when financing assets through a supplier; be sure you understand any commitment you have to make regarding purchasing the supplier's product in the future.

Also available from many suppliers are extended payment terms, enabling you to sell the merchandise before having to pay for it. A supplier may offer goods on consignment.

### **Leasing Companies**

An alternative to purchasing equipment with borrowed funds is to lease the equipment. Items commonly leased are office furniture, automobiles, trucks, computers and production machinery. The leasing company maintains ownership of the item, although sometimes agreements can be made by which you become the owner after a specified time period.

Leasing allows you to conserve initial capital and offers flexibility in acquiring the use of equipment for only a limited period of time.

### **Private Investors**

Some investors specialize in making loans to businesses. In many cases, the investor(s) will require a partial ownership of the business. Care should be taken in dealing with private investors to see that your interests are properly protected. Investors can sometimes be found in classified advertisements.

### **U.S. Small Business Administration**

The SBA's basic loan guarantee program is generally used to fund the varied long-term needs of small business. The program is designed to promote small business formation and growth by guaranteeing long-term loans to qualified firms that cannot obtain financing on reasonable terms through normal lending channels.

Loans are available for many business purposes, such as real estate, expansion, working capital or inventory. Generally, SBA can guarantee up to \$500,000 -- usually between 70 percent and 90 percent of the loan value -- at an interest rate not to exceed 2.75 percent more than the prime lending rate. Maturities are up to 10 years for working capital and up to 25 years for fixed assets.

Occasionally, SBA will test new loan products or services. Different loan programs may include reduced paperwork, shortened approval periods, or smaller loan amounts. Customers should contact their local SBA District Office to learn what specialized loan programs are available in their area.

Fact sheets explaining the various loan programs that the SBA administers, including fixed lines of credit, are available from the SBA. Also available from the SBA or SCORE are brochures entitled "Business Loans From The SBA."

### **The Loan Proposal**

When you approach a lender or investor for the purpose of obtaining funds for your business, you must have the means of telling your story in a straightforward and convincing manner. The best way to do this is with a written loan proposal, presenting all the pertinent information in a logical format.

Although a well-done proposal requires a considerable amount of work, the effort is usually worthwhile. It indicates to a prospective lender or investor that you thoroughly understand your business and its financial demands. The proposal must be thorough, concise and neat. It may be submitted in longhand, but it is worth the money to have it typed. Cash flow charts may be submitted in writing.

The proposal should answer most of the questions that will be asked by a prospective lender and should present a convincing picture. Tell it like it is, being totally honest. Overstatements of facts and figures will not serve you well in the long run and will be challenged by an astute lender. If you cannot prepare this yourself, get help. It will pay off!

Exhibit 3 provides an outline of a typical loan proposal.

## **Exhibit 3 - Outline for a Loan Proposal**

- 
- I. Cover Page**
    - A. Name, address and telephone number
    - B. Name and title of principal(s)
    - C. Amount of loan (investment) requested
    - D. Purpose of the loan (investment)
    - E. Repayment terms of the loan
  - II. Description and Summary of the Business**
    - A. Length of time the business has been operating
    - B. The business's historical trend
    - C. The nature of the business—What does it do?
    - D. What is unique about your product line or service?
    - E. What or who is your market?
    - F. The business's competition
    - G. The business's long-term growth plan
    - H. Trends in your industry
  - III. Management**
    - A. Your management experience
    - B. Your management team
      - 1. Table of organization
      - 2. Brief résumé of key individuals and their responsibilities
      - 3. Current staff or work force level and future needs
      - 4. Existing backup
    - C. Your accountant and attorney
  - IV. The Loan (Investment) Request**
    - A. Justification of the loan
    - B. Details of the loan request
      - 1. Amount needed
      - 2. How the funds will be used
      - 3. Collateral available for a loan and its value
      - 4. Repayment terms of the loan
      - 5. Ability to repay a loan
  - V. Financial Data**
    - A. Financial statements
      - 1. For an existing business, three years of historical and any interim statements
      - 2. Balance sheets
      - 3. Profit and loss or income statement
    - B. Projected cash flow analysis for at least the next 12 months, including loan (investment)
    - C. Sources and amounts of any other loans or investments to be put into the business
    - D. Personal financial statement
  - VI. Credit Information**
    - A. Banks at which you maintain accounts
    - B. Banks at which you have borrowed money
    - C. Trade suppliers
    - D. Other creditors
  - VII. Miscellaneous**
    - A. If incorporated, copy of articles of incorporation
    - B. If renting, copy of lease
    - C. Type and amount of business insurance coverage
    - D. Aging of accounts receivable
    - E. Copies of business and personal tax returns
-

## THE BUSINESS PLAN

The importance of business planning cannot be over-emphasized. A business plan is an operating tool that forces you to take an objective view of your business and provides the means to identify areas of strengths and weaknesses. It pinpoints needs you might otherwise overlook, spots problems before they arise and points out what must be done to make a profit and increase your business. A business plan can help you avoid entering into a venture that may fail. If the plan shows the business to be marginal, the hours spent writing a plan will save you the high cost of a business failure.

### A business plan

- Clearly states both the short- and long-range objectives of the business.
- Provides the direction or plan for achieving these objectives.
- Provides financial forecasts based on your estimates of the future and your business experience.
- Provides budget guidelines, including projected cash flow analysis and income statements.
- Gives a break-even analysis of your business.
- Helps determine the amount and kinds of financing best for your business.

- Gives banks, investors and suppliers useful information they need to make fast and accurate decisions about your business.
- Forces you to think through every aspect of your business and recognize opportunities for growth and profit.
- Provides financial information so that the past can be compared to the present and future.

It is not possible in this *Handbook* to present an example of a completed business plan. Exhibit 4 contains an outline listing the contents of the plan.

Remember, a business plan is a dynamic, not a static, tool. After it is prepared it must be used often. It is flexible, not rigid, and should be altered as conditions change. Most important is that the owner(s)/manager(s) prepare the report.

If you have trouble understanding how to write a plan, be quick to get help. SCORE can be of great assistance. Also, an accountant can help in preparing the financial reports. However, only you can set the objectives of the business—only you can decide where you want the business to go and what you want it to be. Do it!

## RECORD KEEPING

Experience has clearly demonstrated that for a person about to start a business, an adequate record keeping system will increase the chance of survival and reduce the probability of failure. Similarly, for the established business, experience has shown that a good record-keeping system increases the chances of remaining in business and of earning larger profits. How? Because accounting records can furnish the following timely information:

- Amount of business done in cash and credit.
- Amount of business tied up in receivables.
- Amount of collections and losses from credit sales.
- Aging of accounts receivable and amount of credit given to delinquent accounts.
- Amount of cash on hand and in the bank.
- Whether business records agree with bank statements.
- Amount owed to creditors and suppliers.
- Gross margin.
- Total expenses.
- Amount of weekly payroll.
- Adequacy of payroll records for withholding, etc.
- Payment of taxes and deposits of withholding.
- Net profit earned and taxes owed.
- Which product or service makes a profit.
- Which product or service loses money.
- Amount of money invested in inventory.



## Exhibit 4 – Outline of the Business Plan

**Cover Sheet**—Contains name of the business, names of principal(s), address and phone number of business, name and address of person who wrote the plan.

**Statement of Purpose**—An operating and policy guide for your business. If funds are needed, state how they will be used and what effect these funds will have on the business.

### Table of Contents

#### Part I—The Business

- A. Description of the business
  - 1. Products sold, services offered
  - 2. Capital equipment and value
- B. Market
  - 1. Who buys your product or service
  - 2. Who needs it
  - 3. Size of the market
  - 4. Growth potential
- C. Location of business
  - 1. Physical features of site
  - 2. Whether it is leased or owned
  - 3. Renovations needed
  - 4. Description of neighborhood
  - 5. Zoning restrictions, if any
  - 6. Other businesses in the area
  - 7. Advantages and disadvantages of the location
  - 8. Whether relocation is necessary and, if so, effect on operating costs
- D. Competition
  - 1. Names and addresses of competitors
  - 2. Their share of market
  - 3. What you have that your competitors do not
  - 4. Future effects of competitors
  - 5. Comparison of your site inside and out to competitors'
- E. Management
  - 1. Your background and experience
  - 2. Experience of management employees
  - 3. Analysis of strength and weaknesses of management, including your own
  - 4. Needs for the future and plans to hire
  - 5. Job descriptions and training program
- F. Personnel
  - 1. Number of employees and experience
  - 2. Strengths and weaknesses
  - 3. Skills needed for future
  - 4. Plans to hire and training program

- G. Application and effect of loan or personal funds
  - 1. How much is needed
  - 2. What for—inventory, equipment, renovations, etc.
  - 3. How funds will help business
  - 4. What happens if funds are not available in full
- H. Objectives of business and plans to achieve them
  - 1. List objectives for each part of your business
  - 2. Describe your plan to achieve each objective
- I. Summary—Summarize all thoughts and ideas about the business so that they make sense to you and readers

#### Part II—Financial Data

- A. Sources and application of funding—A restatement of Part I-G. Shows up in cash flow projections
- B. Capital equipment list—but list depreciable assets on income statement
- C. Balance sheet—Shows assets, liabilities, net worth at a given time
- D. Break-even analysis—The sales or income point at which the company breaks even
- E. Income projections (Profit and loss statements)
  - 1. Three-year summary
  - 2. First year detailed by months
  - 3. Second and third years detailed by quarters
  - 4. Notes of explanation
- F. Cash flow projections
  - 1. First year detailed by months
  - 2. Second and third years detailed by quarters
  - 3. Notes of explanation
- G. Deviation analysis—Compares actual income and expenses to projected income and expenses on a month-to-month basis. Spots strengths and weaknesses.
- H. Historical financial reports for existing business
  - 1. Balance sheets for past three years
  - 2. Income statement for past three years
  - 3. Tax returns

#### Part III—Supporting Documents

Includes personal résumés, credit reports, job descriptions, contracts, legal documents, letters of intent and anything that has to do with the plan

Records provide a tremendous amount of information. Most important is that the system be

- Simple to use.
- Easy to understand.
- Reliable.
- Accurate.
- Consistent.
- Able to give information on a timely basis.

The following information must be recorded:

- Cash receipts.
- Cash disbursements (expenditures).
- Sales.
- Purchases.
- Equipment.
- Inventory.
- Accounts receivable (amount customers owe).
- Accounts payable (what business owes).

From the record keeping system, the owner/manager must determine the following information:

#### Daily

- Cash sales and cash receipts.
- Cash on hand.
- Bank balance of business.
- Monies paid out—both cash and check.

#### Weekly

- Accounts receivable.
- Accounts payable.
- Payroll—in detail.
- Taxes—sales, social security, withholding, etc.

#### Monthly

- All journal entries posted as like elements to general ledger.
- Cash flow statement.
- Profit and loss statement.

- Balance sheet.
- Reconciliation of bank statement with own books.
- Petty cash balance.
- All federal taxes deposited and withholding and sales taxes paid.
- Accounts receivable aged to 30, 60 and 90 days.
- Inventory worked to remove dead stock and order new.

Every business needs controls. If you do not control the business, it will control you. Adequate record keeping provides information for preparation of the statements that provide the control.

There are five control statements that give a clear picture of your business:

- *Cash flow sheet*—Shows the cash in compared to the cash out by subtracting disbursements from receipts.
- *Income statement*—Shows total sales and receipts, cost of sales, gross margin, expenses and net profit, all expressed in percentage of sales.
- *Balance sheet*—Shows assets, liabilities and net worth of the business.
- *Break-even analysis*—Shows at what level of sales the business breaks even. Break-even analysis is based on gross margin.
- *Deviation analysis*—Compares actual performance to projected performance.

These are the early warning systems, the problem indicators and the solution indicators. If there is to be only a single statement available monthly, it should be the cash flow statement, because this will show how well cash is managed. Obviously, cash in must be greater than cash out.

Before you open the door of a new business, be certain a good record-keeping system is in place. If you do not understand the need for this, it indicates you do not have enough managerial know-how to run a business.

If possible, do the record keeping yourself. If not, hire a part-time bookkeeper, use a business service or public accountant. SCORE can help you set up a system.

In any case, be sure—absolutely sure—that you understand what records are required for your business. If a system is designed by someone else, understand the system. IRS Publication 583 is helpful for the beginner.

## PRICING SERVICES PROFITABLY

Successful business owners know that the greatest opportunity for success and growth comes through quality of service and customer satisfaction. However, the service must be priced properly or there will be no profit.

Many small businesses do what they consider a good volume of business, but do not make any money. Why? Because of improperly priced services or products. Some make a profit on certain services, lose money on others and do not know which is which. Remember, the right to establish price is yours—100 percent yours.

### Types of Costs

For the purposes of this section, costs are defined as

- **Fixed costs**—Costs that remain the same in any time period despite changes in business activity. These include rent, insurance, utilities, office supplies, salaries, depreciation, legal services, accounting and property taxes. These expenses are usually called *overhead*.
- **Variable costs**—Costs that usually vary in proportion with business activity. These include materials used in manufacturing, goods purchased for resale, labor and commissions. In a service business, labor may not be variable.

### Calculating the Cost of a Service

A simple, easy-to-understand method of calculating the cost of a service is by basing the cost on billable hours. Because services must be provided by people, begin by determining the number of hours available for billing in a year. Then calculate the break-even point by dividing the overhead and labor charges by the billable hours and adding the cost of any materials used. Your desired profit is then added to the break-even point. Two examples are shown below.

#### Example 1

Two people experienced at bookkeeping open a business together. They estimate their overhead expenses as shown in Table 2.

The two entrepreneurs decide they each want a salary of \$25,000. In this case, the salary is actually an overhead expense, but we will treat it separately because the principals decide they want to make a profit of 20 percent on their salaries but only a 10 percent profit on their overhead. These expenses are set out below in Table 3.

Table 2 – Estimated overhead expenses

Expense	Amount per year
Rent	\$9,600
Utilities	1,800
Telephone	1,200
Office supplies	1,200
Insurance	600
Depreciation	2,500
Advertising	2,000
Miscellaneous	1,500
Total	\$20,400

Table 3 – Estimated total revenues required

Expense	Amount per year
Owners' salaries	\$50,000
Profit on salaries (20%)	10,000
Overhead	20,400
Profit on overhead (10%)	2,040
Total	\$82,440

The number of working days per year is 260 (52 weeks  $\times$  5 days). Subtracting holidays, vacations and sick days, the actual number of work days total 230. Two people working 8 hours per day results in 3,680 hours (230  $\times$  2  $\times$  8 = 3,680). However, the bookkeepers estimate 20 percent of these hours (736) will not be spent working for clients. Therefore, the billable hours for this company total 2,944.

To determine what rate to charge, the bookkeepers divide the desired revenue (\$82,440) by the number of billable hours (2,944), resulting in an hourly rate of \$28.00. Profit is then calculated by subtracting total overhead and salaries from the proposed revenue (\$82,440 - \$70,400 = \$12,040). This is the profit to be realized, assuming the billable hours figure is realistic for the first year of operation.

#### Example 2

DWA Repair Service employs ten repair technicians, who are paid \$18,000 each. Social Security tax, unemployment tax, workers' compensation insurance, health insurance and retirement benefits cost an additional \$5,400 each, for a total cost of \$23,400. Because there are ten technicians, the yearly labor charge is \$234,000.

DWA Repair Service's overhead expenses are listed in Table 4.

**Table 4 – DWA repair service's overhead expenses**

Expense	Amount per year
Salaries (including owner)	\$60,000
Payroll taxes and costs	3,700
Insurance	13,000
Utilities	2,600
Rent	10,000
Telephone	1,200
Depreciation	5,000
Miscellaneous	2,500
Total	\$98,000

To break even, DWA Repair must have a total revenue of \$234,000 (labor) plus \$98,000 (overhead) = \$332,000. All of it must come from the income of the repair service based on the hourly rate charged.

The owner of the business has calculated the billable hours as follows:

Work days per year = 52 weeks × 5 days = 260 days. Subtracting 15 vacation days, 7 sick days and 8 holidays leaves 230 work days.

Work hours = 230 work days × 8 hours = 1,840 per year for each repair technician.

However, from experience, the owner knows that he cannot keep his crew working eight hours per day as there is lost time between jobs. He deducts 10 percent of the hours as nonbillable, leaving 1,840 – 184 = 1,656 billable hours per technician. Because there are 10 technicians, the total billable hours = 1,656 × 10 = 16,560 per year.

To determine the hourly labor cost, the owner divides the labor cost per year (\$234,000) by the billable hours (16,560). The result is \$14.13 per hour.

To find total cost, overhead must be added. Total overhead per year is \$98,000. When divided by billable labor hours of 16,560, overhead equals \$5.92 per hour. Thus, the total hourly cost of labor plus overhead is \$14.13 + \$5.92 = \$20.05.

The owner knows that if he charges only the hourly rate based on actual cost, he will merely break even. In order to make a profit so that he can reduce debts, buy new equipment, provide working capital and provide a return on investment, the owner decides to add 25 percent on his labor, and 30 percent on his overhead, as shown in Table 5.

**Table 5 – Calculation of final hourly rate**

Labor cost per hour	\$14.13
Profit on labor (25%)	3.53
Overhead cost per hour	5.92
Overhead profit (30%)	1.78
Total	\$25.36

The owner decides to charge \$25.50 per hour. This hourly rate, multiplied by the billable hours of 16,560, results in an income of \$422,280.00 per year. Thus, the income (\$422,280) minus the expenses (\$332,000) equals profit of \$90,280.

Each year this calculation must be repeated to include any changes in labor or overhead.

If any materials are used in the repairs, they must be figured into the cost per job. A profit percentage is also added to the materials charge.

Remember, the charge for a service equals materials plus labor plus overhead, with a profit built into each component.

## PRICING PRODUCTS PROFITABLY

In setting prices, the objective is to maximize profit. Profit has just three ingredients: costs, selling price and sales volume. In this section we are concerned with selling price, which has about the same elements for all types of businesses. For example, in manufacturing, the elements of the selling price are direct costs, manufacturing overhead, nonmanufacturing overhead and

planned profit. In a service business, the elements are materials and supplies, labor and operating expenses, planned profit and competition. (See "Pricing Services Profitably," page 15.) In a retail business, the elements of price are costs of goods sold, overhead, sales volume, planned profit and, often, competition.

## Types of Costs

In the retail business, there are two types of costs: the cost of acquiring the goods, called *cost of goods*, and the cost of operating the business, called *operating expenses*.

### Cost of Goods (Variable Cost)

Cost of goods is known as a variable cost or expense because it varies depending upon the amount of goods purchased for resale and the price of the goods. Cost of goods includes the price paid for goods, freight charges, import duties, handling charges and any commissions.

### Operating Expenses (Fixed Cost)

Operating expenses are a fixed cost because they usually do not vary with the volume of business. Operating expenses include wages, management salaries, rent, utilities, office supplies, insurance and any other costs attributed to the operation of the business.

### Planned Profit

Planned profit is whatever the owner/manager calculates the business will generate. Usually, return on owner's investment, fruits of labor, plans for expansion or relocation, return to stockholders, demand for the product and competition are considered when calculating the amount of planned profit.

## Competition

In setting prices, small businesses should consider prices charged by competitors for similar or comparable items. A small business should not try to compete pricewise with large stores, discount houses or supermarkets. This type of competitor can charge less because of buying power. Pricing should be based on the quality or type of service offered, as customers will pay higher prices for merchandise to obtain the services they want.

### Pricing Below Competition

Beating the competitor's price is effective only if it greatly increases sales. This strategy reduces the profit margin. Consequently, cost of goods and/or operating expenses must be reduced and inventory must be closely controlled; the product line must be limited to fast moving items; and services must be limited or eliminated.

Pricing below competitors often backfires because every cost component must be constantly monitored and adjusted. Competitors can retaliate by matching the lower prices, at which point both businesses lose.

## Pricing Above Competitors

This strategy depends on whether non-price considerations are important enough to customers to justify higher prices. These considerations include specialized services (such as delivery, product knowledge, exclusive location, brand or designer names), satisfaction in handling complaints, in-home demonstrations and so on.

## Markdowns

A markdown is a reduction in the price of any item brought about by overbuying, overstocking seasonal merchandise, misjudging customer response, poor personal selling or competition. This technique is used to avoid being left with dated merchandise that will be difficult to sell. In setting a markdown price, the original cost of the merchandise should be recovered if at all possible. If the selling price originally was high enough, a small profit is possible.

## Price Lining

This is a marketing strategy based strictly on price. A specific portion of the buying public is targeted by carrying products in a specific price range. For example, a retail store carries an exclusive line of women's undergarments or an expensive designer perfume line.

Price lining is only successful if there is little or no competition. It works to the benefit of the retailer because it limits the merchandise line and makes inventory and buying easier. It is also easier for the customer to select merchandise, so that fewer salespeople may be needed.

## Markup

One technique of establishing price is to mark up goods sold by adding a percentage to the total cost of the goods. For example, a retailer purchases shoes at \$25 per pair and marks them up 60 percent for resale.

Cost of shoes per pair	=	\$25
Markup percentage	=	60%
Markup amount per pair	=	\$15
Selling price per pair	=	\$40

The 60 percent markup must cover all operating expenses, including the owner's salary and profit.

A given markup is satisfactory depending on the sales volume. When beginning a business, it is difficult to determine how much goods must be marked up because the new business has no history of sales on which to base

future sales projections. An experienced retailer usually can use markup successfully, particularly if he or she has historical information regarding the movement of merchandise.

Suppliers often suggest a retail price, which makes it easy for the retailer. If there is a competitor selling the same or comparable merchandise, check the competitor's retail price. It may dictate your price.

### Break-Even Analysis

A break-even analysis can be used by a new or old manufacturing or retail business. It indicates the amount of revenue at which a business will neither lose nor make money. For a retail business, the break-even point is when sales equal the cost of goods plus operating expenses, or

$$S = FC + VC$$

where  $S$  = sales in dollars  
 $FC$  = fixed costs or operating expenses  
 $VC$  = variable costs or cost of goods.

From a strict accounting standpoint, cost of goods cannot be determined until an inventory has been taken, because cost of goods is determined as follows:

$$\begin{aligned} & \text{Inventory at beginning of a period} + \\ & \text{Purchases during the period} - \text{Inventory at end} \\ & \text{of period} = \text{Cost of goods sold} \end{aligned}$$

Thus, the break-even analysis involves a variation in the break-even formula because the total cost of goods is not known. First, gross profit (also known as the *gross margin* or contributing margin) on sales is determined as follows:

$$\text{Cost of sales} - \text{cost of goods} = \text{gross profit}$$

The break-even point is then calculated as

$$FC \text{ (operating expenses)} + GM \text{ (gross margin)}$$

Earlier, an example of a retailer buying shoes for \$25 a pair and selling them for \$40 a pair was used. The gross margin on each pair of shoes sold was

$$\begin{aligned} \text{Selling price} &= \$40.00 \text{ or } 100\% \\ \text{Cost of shoes} &= \$25.00 \text{ or } 62.5\% \\ \text{Gross margin} &= \$15.00 \text{ or } 37.5\% \end{aligned}$$

Note that the gross margin and cost of goods (variable unit cost) are expressed as percentages of the sales price.

Let's assume the shoe retailer has operating expenses (fixed costs) of \$75,000 per year. The break-even point is

$$FC (\$75,000) + GM (37.5\%) = \$200,000 \text{ in sales}$$

Sales of \$200,000 mean the retailer must sell 5,000 pairs of shoes at \$40 per pair to break even. Assume the retailer cannot sell 5,000 pairs of shoes. To break even, he must raise his price, which will raise his gross margin. The question is how much the retailer will have to raise his price to break even.

Assume the retailer determines that he can sell the shoes for \$50 a pair.

$$\begin{aligned} \text{Selling price} &= \$50.00 \text{ or } 100\% \\ - \text{Cost (shoes)} &= \$25.00 \text{ or } 50\% \\ = \text{Gross margin} &= \$25.00 \text{ or } 50\% \end{aligned}$$

With operating expenses of \$75,000, the sales volume to break even is

$$FC (\$75,000) + GM (50\%) = \$150,000 \text{ of sales}$$

At a price of \$50 per pair, the retailer now has to sell 3,000 pairs of shoes to break even. The retailer is confident he can sell this volume, but he will not make a profit selling at \$50 a pair. He would like to realize a profit of 10 percent on his operating or fixed costs (\$75,000  $\times$  10% = \$7,500). To calculate the volume of sales required to earn this profit, he adds the profit to the fixed costs. If he holds the price at \$50 for a gross margin of 50 percent, the sales needed to realize this profit are

$$\begin{aligned} & FC + \text{profit} (\$75,000 + \$7,500) + \\ & GM (50\%) = \$165,000 \text{ in sales} \end{aligned}$$

This level of sales will cover the variable expenses (cost of goods), the fixed expenses (operating expenses) and a profit of \$7,500. To generate \$165,000 in sales, he must sell 3,300 pairs of shoes at \$50 per pair.

Because the retailer has no competition, he is confident he can sell this volume of merchandise and can also raise the unit price of the shoes. He decides to do a calculation using a gross margin of 55 percent.

$$\begin{aligned} & FC + \text{profit} (\$75,000 + \$7,500) + \\ & GM (55\%) = \$150,000 \text{ in sales} \end{aligned}$$

The unit selling price or price per pair of shoes at 55 percent gross margin is determined by dividing the unit cost by the percent of variable costs.

$$\begin{aligned} VC &= 100\% - GM\% \\ &= 100\% - 55\% \\ &= 45\% \end{aligned}$$

$$\begin{aligned} \text{Unit cost of shoes } (\$25) + \text{VC\% } (.45) \\ = \$55.56 \text{ or } \$56 \text{ selling price} \end{aligned}$$

As a check

$$\begin{aligned} \text{Unit selling price} &= 100\% = \$56 \\ - \text{Variable cost} &= 45\% = \$25 \\ \hline \text{Gross margin} &= 55\% = \$31 \end{aligned}$$

Let us determine if \$150,000 of sales at a gross margin of 55 percent will provide a profit of \$7,500.

$$\begin{aligned} \text{Total sales} &= \$150,000 \text{ or } 100\% \\ - \text{Cost of sales} &= 67,500 \text{ or } 45\% \\ \hline \text{Gross margin} &= 82,500 \text{ or } 55\% \\ - \text{Fixed costs} &= 75,000 \\ \hline \text{Profit} &= \$7,500 \end{aligned}$$

If a business manager calculates the gross margin for all merchandise sold, the price structure that will generate a level of revenue to purchase goods, pay operating expenses and make a profit can be determined.

The gross margin percentage can be used as a monitor of the sales/purchasing area of the business. The gross margin calculation allows the manager to buy goods that can be sold at or higher than the desired margin. Pricing policy should be based on gross margin.

If an item of merchandise has a low sales volume, it should have as high a gross margin as possible or else it

will not be profitable. If a business does a high volume of sales, it may be possible to have a pricing policy based on a lower gross margin, subject to calculation.

In review, the break-even point is the level of sales that will just cover fixed plus variable expenses. By determining the gross margin for each item of goods sold, the level of sales needed to break even can be determined as follows:

$$\text{Fixed cost} + \text{gross margin} = \text{break-even sales}$$

By adding planned profit to fixed costs, the level of sales to make the planned profit can be determined. To determine the unit sales price of an item at a desired gross margin the formula is

$$\begin{aligned} \text{Cost of goods per unit} + (100\% - \text{GM}\%) \\ = \text{unit selling price} \end{aligned}$$

Examples: Shoes cost \$25 per pair. What is the selling price at 60 percent and 70 percent GM?

$$\begin{aligned} \$25.00 + (100\% - 60\%) &= \$25.00 + (100\% - 70\%) \\ = \$62.50 &= \$83.33 \end{aligned}$$

Many businesses have gone astray by ignoring the need for break-even analysis. Remember that increased sales do not always mean increased profits. Goods must be priced properly.

## ADVERTISING

No matter how wonderful or unique your product or service is, nothing sells itself. Potential customers must be told about your product or service and how they can purchase it.

Informing potential customers about your product, service or business is called *advertising*, derived from the Latin "ad," meaning "toward," and "vertere," meaning "to turn." Together, the meaning is to turn toward a product or business.

Advertising is a paid communication, the purpose of which is to impart information, develop attitudes and induce favorable action for the advertiser. The means of communication can be as humble as a matchbook, as traditional as a barber's pole or as elaborate as a celebrity-packed commercial. Remember the beer commercials with all the athletes at the bar?

### Reasons for Advertising

Why advertise? The specific purposes of advertising are as numerous as the many different products and services promoted. In general, there are three broad purposes:

- To promote consumer awareness of the business and its products and services.
- To stimulate sales.
- To establish or change a firm's image in the eyes of the consumer.

### Objectives of Advertising

Objectives will vary with each type of business. Usually, one or two will be of most importance to a business. Some typical objectives are to

- Increase store traffic.

- Acquaint customers with new products.
- Promote special events, such as a clearance sale, a new location or the opening of a new business.
- Change the company image.
- Keep the business name and location before the public.
- Inform customers of special services available, such as delivery service, alterations or credit plans.
- Introduce new employees to the public.
- Tie in with a supplier's national promotions.
- Capitalize on the seasonal nature of a product.
- Offer get-acquainted incentives.
- Emphasize quality of product and services.
- *Storefront*—Extremely effective; low cost; shows product and price.
- *Interior or point of purchase display*—Attractive display of merchandise creates impulse buying; low cost.
- *Vehicles*—Can be effective; low cost; wide exposure; can be a painted or a magnetic display.
- *Shopping bags*—Carry name and message into home.
- *Yellow Pages*—Essential for small business; reaches customer who is ready to buy; wide distribution.
- *Direct mail*—Most personalized and pinpointed of all media; tells complete story; rapid feedback; can use coupons, catalogs, letters, brochures or postcards.
- *Local newspapers*—Great flexibility; ad size and position can be varied; great with editorial association, such as food advertisements with cooking column.
- *Local radio*—Expensive but reaches targeted audience; advertisement can be repeated frequently.
- *Television*—Most expensive; reaches the masses; high visibility; instant exposure of pictures or ideas.

The most important asset of a small business is quality, and advertising is the way to let potential customers know that it is the mainstay of your business.

Unfortunately, some small businesses underestimate the value of advertising or are basically uninformed about how to budget money for advertising, how much to spend and where to advertise. A new business should be prepared to spend about 5 percent of projected gross revenue on advertising. An established business should budget 2 to 3 percent of gross revenue.

### Advertising Media

Once the advertising objectives have been established and written, the next step is to select the specific media in which the advertising will appear. Media costs vary from inexpensive, such as business cards, to very expensive, such as television. The selection should be based on cost effectiveness, scheduling, trading area, customer type and frequency of message.

The types of media available are as follows:

- *Telephone solicitation*—Low cost; effective if message is worded carefully.
- *Business card*—Low cost; easily distributed; describes product or service; gives address and phone.
- *Word of mouth*—The cheapest and most effective; a customer praises your business.
- *Business stationery*—Low cost; must be well designed.
- *Business signs*—Very effective; low cost; may be subject to zoning regulations.

There are many other means of advertising, such as calendars, pens, billboards, sky writing and point of presentation (flyers, brochures, samples). To be effective, advertising should be repeated—yes, *repeated*—as often as possible. It should call attention to something the buyer needs or wants.

### Help in Advertising

Carefully, skillfully written advertising copy is essential. Help in writing an advertisement can be obtained from newspapers, suppliers, Yellow Pages and advertising agencies.

For help in planning, producing and measuring the effectiveness of advertising, consider an advertising agency. Often the services of an agency can be obtained at low cost because agencies earn commissions paid by the media (about 15 percent) and take a percentage of the cost of the material they design (also 15 to 20 percent). Before selecting an agency, be sure the agency knows the objectives of your advertising and the size of your budget. Then have the agency describe what it can and will do for you.

Advertising is not merely an item of business expense; rather, it is an investment in building your business. Its objective is to help you sell your product or service. The



copy should attract attention, develop interest, describe the product or service, convince the reader or listener and get action.

Do not advertise something you are stuck with. Advertise what your customers want and like to buy. Show the

benefit of your product or service. Attempt to tell your prospective customers what is in it for them.

Be sure to include the name and address of the business in all advertisements! Finally, be honest!

## MARKETING

Business success ultimately comes from satisfying market needs. Therefore, it is essential that people in small business understand and develop marketing programs for their products and services. What is meant by market and what is marketing?

- **Market**—A body of existing or potential buyers for specific goods or services. It is the demand for a product.
- **Marketing**—The total of activities involved in the transfer of goods from the producer or seller to the consumer or buyer. Marketing activities include buying, storing, selling, advertising, pricing and promoting products as well as managing the business.

A business will not succeed just because the owner wants it to. There must be a market for the merchandise or service being offered or there is no chance of success.

### Marketing Before Opening

Before opening a business, the following information must be obtained:

- Is the product or service to be offered one that people want? How do you know this?
- How many people want it?
- Who are the potential customers?
- Do they live or shop near the place of business?
- Will it be the right business, at the right time, at the right place?
- Can a demand be created for the product or service?
- How many competitors offer the same product or service?
- How will the new business effectively compete in price and quality?
- Who will the suppliers be and how good are their services?

Only after the answers to the above questions are obtained and analyzed should the plan to open the business proceed.

### Marketing for an Existing Business

The marketing concept for an existing business focuses on efforts to identify, satisfy and follow up on customer needs at a satisfactory profit. This concept includes market research, market strategy, target marketing and managing the market mix. It is difficult, if not impossible, to sell people goods or services they do not want or need. It is easy to sell people something they do want or need.

### Market Research

Market research determines what people want by systematically gathering, recording and analyzing information related to marketing goods and services. The information processed can help spot potential problems, find sales opportunities and form plans of action. Such research can be done internally or by companies specializing in market research services.

Many small businesses do market research every day and may not be aware of it. This is accomplished by talking to customers, talking to employees, reading newspapers and trade journals, looking at competitors' and noncompetitors' advertisements and promotional activities, looking for information about trends in the marketing area served and gathering financial and economic information from bankers, suppliers and trade associations.

A small business has an advantage over a large business in learning about its customers because, by being close to the customers, it can learn quickly about their likes and dislikes and, best of all, react rapidly to changes in customers' buying habits. Small business owners and managers can talk to the customers and ask questions about

- The merchandise they like.
- How much they are willing to pay.
- Where they live.

- How they like the business.
- Whether they would recommend the store, product or service.
- Why they came to the business.
- The products they would like that the business does not have.

Listed below are the logical steps in more formal market research:

- Define the problem or area to be investigated.
- Assess all available information.
- Assess additional information if required by
  - Reviewing internal files and records.
  - Interviewing employees.
  - Interviewing customers and suppliers.
- Organize and interpret information.
- Make decisions.
- Observe and evaluate results of the decision.

A good part of marketing research can be done with readily available information. Trade associations constantly report on and analyze pertinent marketing information. If your type of business has a trade association, the membership fee may be money well spent.

### Market Strategy

Market strategy involves identifying customer groups that small businesses can serve better than larger competitors can, and tailoring products, services and promotional efforts to that particular market segment.

Ideally, this strategy should address the customers whose needs are not currently being met in the marketplace and whose needs are great enough to provide a profit. Small business should analyze its market and capabilities, and focus on that part of the market it can serve best.

### Target Marketing

Because small business owners may have limited funds to spend on marketing activities, they should consider

restricting their efforts to one or two key market segments by

- *Geographic targeting*—Specializing in serving the needs of customers in a particular area, thus restricting advertising and promotional efforts to that area.
- *Customer targeting*—Identifying and promoting to those groups of customers most likely to buy, e.g., promoting boat products to boat owners.

### Market Mix

*Product and Services.* Small business owners may use the strategy of concentrating on a narrow product line, selling a highly specialized product or service or providing a product/service package that includes a large amount of skilled or personal service.

*Promotion.* This area includes advertising, sales tactics and other promotional activities. High quality selling is a must for small businesses and is one of the most effective types of promotion. (For a detailed discussion of advertising, refer to the above section on advertising.)

*Location and Product Distribution.* Selecting the proper areas for distribution and sale of certain products is crucial. Successful selling of popcorn requires high traffic areas with high visibility. On the other hand, a plumbing supply house does not require a high traffic area, as people will go out of their way to look for it.

### Additional Marketing Help

Other sources of information to help make marketing decisions include chambers of commerce, bankers and local business journals. Again, do not forget suppliers, as they know what businesses similar to yours are doing.

Keep the following in mind: Most businesses are built around products and services that are already available. Although you may think your products or services are special, that perception is not necessarily shared by your market. Therefore, one of the most important aspects of marketing is to give the consumer reasons to buy your products or services.

## LOCATING A BUSINESS

Small business advisors often say that the success of a retail business depends on three factors: location, location and location. A bad location usually leads to failure while a good location is an integral part of success.

Small businesses fall into three general categories. The first is one in which the customer comes to the place of business. Examples are clothing, food and hardware stores, barber and beauty shops. For this type of business, a good location is vital.

The second is a business in which the customer comes to the business and the business goes to the customer. Examples are a carpet store and a drapery and curtain shop, both of which require that the customer come to the store to select merchandise that will be installed off-site by the business. For this type of business, location is also important.

The third business type is one in which the business comes to the customer, such as plumbers, electricians and landscapers. For this type of business, location is not of primary concern. The only caution that may apply is compliance with zoning laws regarding material storage and truck or other vehicle parking.

Three factors are involved in choosing a business location: selection of a city, town or municipality; choice of an area within a city or town; and choice of a specific site.

### Selecting a City or Town

When selecting a city or town for your business, consider the following:

- Size of the trading area within the city or town.
- Population and population trends.
- Total purchasing power and distribution of the locale.
- Total retail potential within the city or town.
- Number and size of competitors.
- Aggressiveness of competitors.

### Selecting an Area Within a City or Town

Once a city or town has been chosen, consider the following in selecting an area:

- Power of the shopping district to attract customers.
- Number and quality of competitive stores.

- Availability of access routes to the store.
- Nature of zoning regulations.
- General appearance of the area.
- Expansion and rebuilding of the area.

### Selecting a Specific Site

In selecting a specific site for your business, consider the following:

- Adequacy of parking.
- Cost of the site.
- Nature and compatibility of neighboring stores.
- Adequacy of potential traffic passing the site.
- Ability of site to intercept traffic en route from one place to another.
- Accessibility of site to shoppers.

### Consumer Goods Considerations

Consumers' views of the goods or merchandise sold by a store has an effect on site selection. Consumers group products into three categories:

- *Convenience goods*—Goods frequently bought by habit and having a low unit price, such as cigarettes, groceries, etc. Convenience stores are usually close to the consumer's residence and depend on traffic for success.
- *Shopping goods*—Goods with a higher unit price. They are purchased infrequently, such as men's suits and furniture. Stores selling shopping goods usually do better if they are located near a large department store.
- *Specialty goods*—Usually high priced, although customers may not regard price as a consideration. Although sometimes located near shopping goods stores, specialty goods stores may be in isolated areas because they generate their own traffic. Examples are precious jewelry, expensive perfumes and antiques.

### Retail Compatibility

Retail compatibility is important to a new business. Locating next to a store that does not clash with the new business but does bring traffic into the area may be the salvation of the new business.

If a new business offers shopping goods, the best location is near other stores carrying shopping goods. Locating a store selling shopping goods near a convenience store is not recommended. New businesses do better in an established shopping center rather than standing alone.

In choosing a site, there should be adequate traffic, adequate parking and safe, easy access. Parking spaces may be expensive and it may be wise to investigate related charges, such as snow removal, before considering the site.

Zoning laws and regulations regarding business signs should be investigated. The building itself should be attractive because, whether the owner realizes it or not, the business will have an image. What people think of a business is influenced by both the interior and exterior attractiveness of the building. Unclean exteriors, walls that need painting and an overall unattractive site turn customers away. Excellent products and services can be negated by a poor location.

## INSURANCE

Going into business is a risk. To succeed in business, the many potential risks must be managed, i.e., reduced and controlled. One of the methods of controlling risks is with insurance.

For the small firm the most common risks are

- Business fraud and theft.
- Fire.
- Legal liability—injury to customers or employees, defective merchandise, etc.
- Business interruptions.
- Death or loss of key personnel.
- Death or loss of owner or partner.
- Violent weather—hurricanes, floods, etc.
- Damage to or loss of vehicles.

If a business has even one employee, workers' compensation insurance is mandatory. In several states, if a business has five or more employees, health insurance is required. When applying for a loan, banks may require certain types of insurance, depending on the nature of the business and the type of loan.

Each business will have its own particular insurance needs. At business start-up, funds to purchase insurance may be limited. Nevertheless, insurance must be investigated and that which is essential must be purchased. For example, one can imagine a tree surgeon must carry liability insurance when felling a tree.

The general categories of insurance are

- Property.
- Automobile and vehicular.
- General liability.

- Product liability.
- Group life and health.
- Fidelity and surety.
- Workers' compensation.

Before purchasing insurance, find out which types are required, how you can reduce the cost of coverage and which risks you can afford to cover yourself. Also, you must

- Decide which kind of risk protection will work best and be most economical for you.
- Cover your largest loss exposure first, the less severe as your budget permits.
- Make proper use of deductibles. They save premium dollars you may need elsewhere.
- Review your insurance coverage and costs periodically with your agent.
- Always discuss expansion or change of location with your agent.
- Familiarize yourself with insurance terms and provisions so you know exactly what is covered and what it costs.
- Be sure the coverage you buy is adequate to cover the value of the property insured.

Usually, the life savings of a small business owner are invested in the business and often homes are used to secure notes. What happens when the owner dies? Does the business close? Does the family of the owner have to stand by and watch savings and other assets go down the drain?

You can protect both your business and your family with business life insurance. Consult your agent so that a business life insurance policy is tailored to fit the needs of

your family and your business. A suitable business life insurance program can

- Ensure immediate funds to meet taxes, debts and administrative expenses.
- Provide income for heirs.
- Equitably distribute the property value to heirs.
- Enable your executor or administrator to dispose of your business to the best advantage if your family is not taking over.
- Put your family on a sound financial basis if the family is assuming the operation of the business.
- Stabilize the credit of the business.
- Help maintain good employee relations by eliminating uncertainties and hazards.

- If the business is a partnership, provide a prearranged plan for the orderly and equitable dissolution of the partnership and the opportunity for surviving partners to buy out the heirs.
- Provide funds to replace a key employee or train another if the key employee leaves, becomes ill or dies. This is called "Key Employee" insurance.

Insurance is one area of your business where professional help is strongly recommended to obtain proper coverage at the best price. Help is readily available from local insurance agents and brokers, the best choice being one who writes insurance for other small businesses.

One way to determine which insurance agent is best for you is to ask other small business owners whom they use and what kind of service they receive. Also, your banker, accountant or attorney may be able to recommend an agent or broker.

## RETAILING TIPS

### *Image*

Every retail and retail-service business has an image, which can be controlled by the operator. People's impression of a store, office, showroom, beauty shop is based initially on the appearance of the premises, both inside and out, and then by the type of merchandise and services offered. Therefore, each business operator must decide what image he or she wants and then take steps to develop it.

Creating the proper image and environment is particularly important to certain types of businesses and not as critical to others. For example, a junk yard may not be very attractive; but then its customers do not expect it to be. However, most business should create an atmosphere that corresponds to their product line or service. For example, people do not expect carpet in hardware stores; but they do expect clean, uncluttered aisles and easily accessed displays. In a store selling expensive clothing, people will expect carpeting and papered walls. There is no doubt that carpet leaves a different impression than vinyl tile or linoleum and costs more to install and maintain. In this case, the extra cost may be worth it.

### **Window Displays**

A neat, eye-catching window display is an effective way to stop pedestrian traffic and entice people to enter the premises. It takes only two to four seconds to pass a six- or eight-foot window. Therefore the display not only has

to be eye catching, but also must be well lighted day and night. (Good daytime lighting avoids shadows that dull a display.)

Change window displays periodically and keep windows clean. Window displays used for community projects often create good will. Art galleries or individual collectors may lend interesting objects around which to build a display.

### **Parking Areas and Sidewalks**

Keep parking areas and walkways clean and lighted at all times. If your regional climate brings harsh winter weather, be sure snow, and particularly ice, is removed to ensure customer safety. Dirty areas create an unfavorable impression and often result in unfavorable comments.

### **Decor**

Decor is part of the image. Well-maintained building exteriors make customers want to enter. Once inside, the interior decor must be conducive to customer buying. Clean windows, floors, counters and aisles, attractively painted or papered walls and good lighting are a must. Well-planned aisles help customers find and look at merchandise. Gaudy decor reduces customer interest. The decor should make customers feel comfortable. The point is to let the merchandise be the attraction, not the decor.

## **Customer Relations**

Customers not only sustain a business but help it to expand. How a customer is greeted and treated can build or destroy customer relations. The old adage that the customer is always right still applies.

Courtesy is a business byword. Customers who feel they were not treated properly, for whatever reason, usually do not return and have only derogatory comments about the business. As pointed out in the section on advertising, word of mouth advertising is not only the least expensive but also one of the most effective types of promotion. All employees should be constantly reminded of the need for courtesy.

Keep a notebook near the cash register. Jot down customer requests and suggestions for products and services. Customers are a great and inexpensive source of information not only about your business but about your competitors as well. Customers can tell you much about their buying habits and help you detect trends. Ask customers what they like, want, need and read. Without customers, there is no business.

## **Credit Cards**

Credit cards are a service to customers at the expense of the business. However, credit cards do provide instant cash at no risk to the business. Often, credit card terms can be negotiated with the issuing bank. Card companies such as American Express can usually be approached through chambers of commerce or national trade associations if the business is a member.

Some small businesses may want to issue charge cards or charge accounts to special customers. Needless to say, care must be taken if this policy is adopted.

## **Markdowns**

Markdowns on certain items reduce profit margins but usually are an excellent way to sell unsalable or end-of-season goods. Markdowns, if properly done, clear out merchandise quickly, thereby increasing cash flow and reducing inventory.

## **Loss Leaders**

Loss leaders are items sold at a lower price to attract people who will buy other regularly priced items or become regular customers. Loss leaders should have a lower wholesale price, look more expensive, sell at other stores at a higher price and be readily available from the supplier.

Loss leaders are more effective as a strategy when they are associated with another item at regular price and both items are sold together. An example is a shirt and tie, with the tie being the loss leader.

Sometimes loss leaders do not work. With experience, the successful leader will be selected and often can be used over and over again.

## **Pricing Policy**

Pricing may depend on the following:

- Location of the business.
- Physical appearance of the premises.
- Purchase of manufacturer's close outs.
- Volume of sales.

Pricing must take into account fixed or operating costs, owner and manager salaries, variable costs (cost of goods) and profit. Buying practices affect the cost of goods. Attention must be given to quality as well as the quantity of goods purchased. Utilities, rent, services, salaries, employee benefits, etc., affect fixed costs. Unless prices are changed accordingly, increases in either variable or fixed costs will decrease profit.

Often, competition dictates pricing. Therefore, competitors' pricing must be constantly monitored. As pointed out in the section on pricing products, a pricing policy must be examined and reviewed frequently to be certain the desired profit level is maintained. Profit and loss or income statements are most helpful.

## **Leases**

Landlords can be difficult; remember they are trying to make a profit, too. Cordial relationships make it easier to get improvements to the premises and to negotiate late rent payments.

A long-range lease is usually better. If a business owner or operator is inexperienced with leases, the service of an attorney is essential.

## **Protecting Against Crime**

To limit shoplifting, locate the cash register and the telephone near or at the front door. This reduces the chance of people walking out without paying. Also, offer to hold parcels at the register, but be sure to treat them with care, sealing them in the presence of the customer. The business is liable if anything is missing.

If your business is located in a shopping center or mall, contact other small businesses and set up a system to alert each other if a customer tries to pass a bad check or steal. With a phone alert system a description of the person in question is quickly circulated to other businesses in the center or mall, as well as to law enforcement authorities.

### **Competitors**

Always have something constructive to say about competitors. If you are out of an item or do not carry it, recommend a store that does carry it. Customers appreciate this and will usually return to your store.

Watch competitors' advertising by visiting them or sending someone to check displays, windows and prices. Ask salespeople who call on you how your competitors are selling their items.

### **Employees**

Good employees produce more sales and require less training and supervision. Poor employees can ruin a business. Develop a training program for new and old employees and regularly review their performance with them individually and privately. Train employees to treat customers exactly as you would.

Explain the buying system to employees and try to involve them. The more involved employees are, the

more interest they take and the better they work. Listen to employees and ask them for suggestions. Make employees your eyes and ears.

Retired persons offer small businesses an opportunity to get experienced help on a part- or full-time basis. They may teach you and other employees what they have learned over the years. Retirees usually are very loyal and hard workers.

### **Suppliers**

Suppliers, manufacturers, distributors and their respective salespeople can become important adjuncts to a small business. They can alert you to trends, hot items, competitive activity, closeouts, special volume prices, delayed payment terms, etc.

Most important, get to know the credit manager of your supplier. If you need extra time to pay, extra credit or special terms, this is the person to contact. The credit manager can be a valuable ally to your business.

For special promotions, ask manufacturers and suppliers if they have a program to contribute to advertising costs. The way to learn about all the services a supplier offers is to spend time with the supplier and ask questions.

Be sure you know the availability of every item purchased and how long it will take to get to your store. This will help you place orders and keep you from running out of an item.

## **EMPLOYEES AND INDEPENDENT CONTRACTORS**

### **Classes of Employees**

For federal and state tax purposes, small business owners and operators must know who is an employee and who is not, and what their classification is. Employees may be classified as common law or statutory.

#### **Common-Law Employees**

Every individual who performs services that are subject to the will and control of an employer as to both what is to be done and how it is to be done is a common-law employee. Two of the usual characteristics of an employer-employee relationship are that the employer has the right to fire an employee and the employer supplies the tools and the place to work.

Employers must withhold federal income tax, Social Security tax and, where required, state and local income

tax from common-law employees. Also, employers must pay their share of Social Security and federal and state unemployment tax for such employees.

#### **Statutory Employees**

In many states, a statutory employee is one who works for an employer in any one of the following four categories:

1. A driver who distributes meat, vegetables, fruit, bakery products or beverages (other than milk), or who picks up and delivers laundry or dry cleaning, if the driver is your agent or is paid on commission.
2. A full-time insurance salesperson.
3. An individual who works at home on materials or goods that you supply and that

must be returned to you or to a person you name. You also furnish the specifications for the work to be done.

4. A full-time traveling or local salesperson who works on your behalf and obtains orders from wholesalers, retailers, contractors or operators of hotels, restaurants or similar establishments. The goods sold are merchandise for resale or supplies for use in the buyer's business.

Business owners are not required to withhold federal and, where applicable, state or local income taxes from the wages of statutory employees. However, individuals in any of the preceding four categories are employees for Social Security tax purposes if they meet all of the three following conditions:

- a. The service contract states or implies that almost all of the services are to be performed by them.
- b. The investment in the facilities, other than those for transportation, used to perform the services is not substantially that of such employee.
- c. The services are performed on a continuing basis.

For federal unemployment tax purposes, the term employee includes statutory employees in categories 1 and 4 above who perform services for pay under conditions a through c.

### **Independent Contractors**

Generally, people who are in business for themselves are not employees. These include physicians, attorneys, CPAs, construction contractors and others who offer their services to the public.

However, whether such people are employees or independent contractors depends on the facts in each case. The general rule is that an individual is a independent contractor if the employer has the right to direct only the result of the work and not the means and methods of accomplishing the result.

Under the heading of independent contractors, two categories of statutory nonemployees exist for the purpose of federal employment taxes: real estate agents and direct sellers. However two conditions must be met:

1. All remuneration for their services relates directly to sales or output and not to the number of hours worked.

2. Their services are performed under a written agreement that provides they will not be treated as employees for federal tax purposes.

Another test is that when an independent contractor has assistants, they can be fired only by the contractor. Also, if workers are free to take other jobs at the same time they are working for you, then they are generally regarded as independent contractors.

An employer does not have to withhold income tax or Social Security tax from the wages of independent contractors, nor does the employer have to pay the unemployment taxes or workers' compensation insurance.

Because an employer who has hired an independent contractor must file form 1099-MISC with the Internal Revenue Service and, where applicable, state and local government, the independent contractor must provide the employer with an employee identification or a Social Security number. If the independent contractor fails to provide this number, the employer may have to withhold 20 percent of the amount paid as income tax.

### **Casual Labor**

Many small businesses classify certain types of labor as casual labor. In these cases, the employer does not withhold income taxes or Social Security tax, does not pay employment taxes and usually does not cover the worker with any type of insurance.

If one asks either the IRS or a state department of revenue for a definition of casual labor none will be forthcoming. This means that the IRS and other agencies do not recognize the term and will not define it. Federal and state agencies reserve the right to judge each case as to whether or not a worker is a casual employee.

The issue at hand is whether or not an employer must withhold income and Social Security tax, pay unemployment taxes and provide workers' compensation insurance. In some cases, the IRS and other taxing agencies may recognize intermittent and temporary labor, such as in the following cases.

#### **Case 1**

Katie's Catering has two full-time employees. Katie contracts for a job for which she needs extra help, so she hires a person to work for one day for \$50 with no withholdings of any kind. She does not intend to hire this person on a regular basis.



### Case 2

Conwald Construction accepts a contract to frame two houses and agrees to finish both houses within one month. Conwald does not have enough regular full-time employees to accomplish this, so he hires two extra carpenters at an agreed-upon wage of \$300 per week for three weeks. At the end of the job, Conwald pays each carpenter \$900, but does not withhold taxes, etc. However, because the wages were over \$600 to each person, Conwald must obtain the Social Security number of each carpenter and, at the end of the year, submit a 1099-MISC to the IRS, appropriate local agencies and to the carpenters.

### Case 3

Russ's Restaurant has occasional need for an extra bartender during July and August. He hires a person to work one night a week for eight weeks at \$45 per night, with no withholding. The total wages paid are \$360. In

this case, Russ does not report these wages because the amount is less than \$600.

According to some state employment security laws, the workers in each of these cases would be regarded as employees and the employer would have to pay the state unemployment tax.

Often, employers abuse the classification of intermittent or temporary help. Be aware that if the IRS decides the employee is common law and the employer has not withheld taxes, the employer is liable for all the withholding, Social Security taxes and unemployment taxes.

Both the state and federal agencies frequently audit income tax reports, during which the question of who is an employee arises. If there is any question about who is an employee, contact the IRS or state department of revenue. If there is a question as to whether unemployment tax should be paid, contact the IRS and the state department of employment and training.

## MANAGING HUMAN RESOURCES

Successful management of any business, large or small, is based on effective utilization of available resources. People are a primary resource, and people, including managers, can make or break a business.

Managing a work force from a regulatory standpoint has become complicated because there are more than 100 rules and regulations promulgated by local, state and federal authorities that affect employees who make up the work force. It is imperative to seek guidance through this maze by contacting the appropriate government authority when necessary.

Also complicating the management of workers is the new generation whose goals extend beyond the basic maintenance needs of wages and safe, clean working conditions. Many employees are looking for challenge, incentive and opportunity to learn, to be creative and to advance. Small businesses must design management methods to meet the needs of employees as well as the business.

The work force payroll may be the greatest single expense in the budget. This means employee selection, training and supervision are of primary concern. It is estimated that each turnover of an employee costs 500 times the hourly wage; thus, retaining good employees is critical. Employee retention and productivity often depend entirely on the ability of the person supervising the job.

It is essential to define the objectives of the work force and clearly plan the strategy to reach those objectives at the outset. Once employees are on the job, reasonable, attainable objectives should be set for them with their input. If employees are respected members of the team, they will have more incentive to perform at peak level.

### Recruiting

Advertising in the local newspaper is the most direct method of recruiting employees. The most productive method is word-of-mouth referral by a satisfied employee. Schools, trade associations and professional groups are excellent sources for specialized needs. As a rule, it is wise to avoid employing relatives and close friends, as discipline problems often arise. If they bring special expertise, that may be another matter.

A prerequisite to hiring any worker is a well-written, thoroughly thought-out job description, describing the duties and responsibilities of the job. Such a description makes it easier for the employee and supervisor to work together.

### Interviewing

An interview is a two-way communication, during which the participants find out about each other and assess

competence and compatibility. The interviewer must guard against invading the legal right to privacy of the applicant, both on the application form and in direct questioning.

The primary concerns of the interview are the job description, working conditions, standards of performance and the applicant's ability to meet or exceed these standards. All these matters must be clearly understood and agreed upon before a final decision to hire is made. References must be checked, preferably by telephone.

### ***Wages and Working Conditions***

Wages and working conditions are controlled to some degree by labor laws and, to a greater extent, by local practice. The National Bureau of Labor Statistics can provide surveys of conditions in local markets.

Usually, it is wise to set wages at the midpoint of current practice to allow for incentive and future growth. Employee benefits will add from 20 to 40 percent to the cost of the payroll. Careful thought must be given to benefits when planning and budgeting. For businesses experiencing peaks and valleys in work flow, thought should be given to the use of temporary workers and agencies.

### ***Training***

An employee may be considered on probation for an agreed upon length of time—usually three months. During this time, attention must be given to integrating the employee into the work force and bringing the employee's performance up to standard. This is best accomplished by explaining and demonstrating the task, having the employee perform the task and then giving constructive correction and reinforcement. Time spent in

proper training will more than pay for itself in weeding out employees who lack the ability to perform or fit in. Training fosters the success and high performance of those retained.

### ***Supervision***

Both the supervisor and the employee have an interest in the successful performance and stability of the work force. The essence of good employee relations is to treat all equally, and to be fair and consistent in maintaining discipline. Be factual and not subjective. Always let the employee know what is expected and whether or not those expectations have been reached. Both correction and recognition should be given regularly to achieve a healthy and productive work force.

### ***Terminating Employment***

When an employment relationship is to end, it is expected that both the employer and employee will give the other adequate written notice. If it is necessary to terminate employment, the employee should be given an honest explanation of the reason for termination.

When it is termination for cause, except in extraordinary circumstances, the employee should have been warned previously, counseled and given the opportunity to meet the performance standards before the actual separation. When the question of unfair treatment or discrimination is raised, it is important to have a written record of the steps followed in disciplining the employee.

One caution: Because employee relations are so tenuous and hedged by laws and other restrictions, it may be wise to seek expert advice when contemplating any critical action affecting an employee. SCORE can help direct you to the appropriate source of information.

---

## **COMPUTERS IN SMALL BUSINESS**

A question asked frequently by small business operators is "Should I have a computer?" To answer this question, you first must understand the advantages and disadvantages of alternatives to the computer and, second, must know exactly what is to be accomplished with a computer. In other words, consider how much it will cost and what the benefits over a manual system will be. Finally, you should know who is going to operate and become proficient with the computer.

Generally, a well-organized and well-staffed business will benefit from a computer, particularly if the business has large amounts of detailed, repetitious information to be handled with speed and accuracy. Others who will benefit are businesses with large, fast turning inventories and large customer files.

Small businesses just starting out without computer skills should not consider a computer, nor should a business that does not have a good functioning manual system in operation.

### **What a Computer Can Do**

- Organize and store similarly constructed pieces of information, such as names and addresses of customers, suppliers, employees, etc.
- Rapidly retrieve a single piece of information from a file or data base, e.g., name, ZIP code, date of last purchase, amount owed.
- Perform complicated computations quickly and accurately.
- Print information quickly and accurately.
- Perform the same activity indefinitely and precisely, such as printing hundreds of form letters, printing mailing labels, etc.
- Keep transaction records, such as cash receipts, receivables ledger and a general ledger.
- Prepare statements and reports such as cash flow sheets, income statements, balance sheets and inventory status reports.

### **Areas a Computer Can Improve**

- Accounts receivable.
- Accounts payable.
- Sales records.
- Billing.
- Order entry.
- Inventory records.
- Payroll.
- Tax reporting.
- Mass mailings.
- Projections.
- File management.

### **What a Computer Cannot Do**

- Correct errors in an existing manual system.
- Save money by eliminating employees.
- Make business judgments or create logic.
- Solve poorly defined problems.

- Define or describe jobs that should be done.
- Generate information that is not in the system.
- Operate itself.

### **Buying a Computer**

Before selecting a computer (hardware) and the program (software), a prospective buyer should prepare a written statement that includes the following information:

- A description of the business.
- Present and anticipated number of customers.
- If retail, number of transactions per day.
- Size of inventory, if applicable.
- Inventory turnover rate.
- Number of employees.
- Reasons for buying the computer.
- Amount of money available, or affordable price range.
- Potential operators of the computer.

The purpose of this statement is to pinpoint the prospective buyer's need for computerization and to provide concise information on these needs and resources to each vendor approached.

Going to more than one vendor is highly recommended so you can compare prices and recommendations. Also, ask each vendor for the names and telephone numbers of customers who have purchased a system, particularly those with needs similar to yours. Contact several of these customers and ask them if they are satisfied with the hardware, software, training and service received from the vendor. Ask them how long it took until the computer system was operational.

Be sure the vendor has the staff to provide training, answer your questions while you are setting up, solve problems and provide repair service. Visit the vendor's training facilities. Ask about charges for training.

A computer will not operate itself. It must be fed, nurtured and massaged in order to get results. Entering data takes time. It is important to realize that if your record keeping system is incomplete or sloppy, your computer data will be the same. Time and money can be wasted creating data that will not be used. Use good judgment in selecting information to be entered and processed.

Software has been developed for specific types of businesses. Be sure your vendor is knowledgeable about available software and selects the one best suited to your

particular business. Experience indicates that the computer applications most beneficial to a small business are accounts payable, order entry, accounts receivable, inventory control and general ledger.

Getting a computer into operation initially requires the full and total involvement of the owner/manager, which translates into many extra and sometimes frustrating hours. Meanwhile, the regular business functions must be continued. If an employee is to operate the computer, the employee will also have to devote extra hours, at the expense of the owner.

Computers do not save money by eliminating employees. Rather, computers facilitate and complement employees' work by performing certain functions rapidly and efficiently. This may be of great advantage in effecting other savings.

If the business owner/manager has his fingers on the pulse of his business, a computer may not be needed. In any event, the cost, efficiency and adequacy of a manual system should be evaluated before you consider buying a computer.

## FRANCHISES

Franchising has a number of appealing features for prospective business owners. Primarily, the risks of opening a business are reduced because of easy access to an established product and a proven method of marketing.

Franchising has existed in one form or another for over a century; in recent years enormous growth has occurred in the number of franchises. Industries relying on franchised business to distribute their products and services touch every aspect of life, from automobile sales and real estate to fast foods and tax preparation.

As a matter of fact, franchises have the highest success rate of any type of business start-up, which adds to their appeal. However, buying a franchise does not in any way ensure instant success; unless you are prepared for total commitment of time, energy and financial resources, it is not for you.

### Definition

A franchise is a legal and commercial relationship between the owner of a trademark, service mark, trade name or advertising symbol and an individual or group seeking the right to use that identification in a business. The franchise governs the method for conducting the business between the two parties.

In its simplest form, a franchisor owns the right to a name or trademark and sells that right to a franchisee. This is known as *product/trade name franchising*. In the more complex form, *business format franchising*, a broader, ongoing relationship exists between the parties. The franchisor provides a full range of services, including site selection, training, product supply, marketing plans and sometimes financing. Generally, a franchisee sells goods or services supplied by the franchisor or sells goods or services that meet the franchisor's quality standards.

### Advantages

- Franchising offers quick access to an established and well-proven method of marketing, which reduces the risk of opening a business.
- The franchisee purchases, along with the trademark, the experience and expertise of the franchisor's organization.
- The franchisee's standing with local financial institutions is strengthened.
- Franchisors offer training and management assistance.
- The franchisor offers experience in facility design, layouts, displays, fixtures, marketing and advertising.

### Disadvantages

- Franchisors have required, standardized operation and management techniques. If you prefer to be an independent operator or prefer to do business using your own methods, franchising is not for you.
- A franchisee loses his or her identity to the benefit of the franchisor.
- The franchisor does not share in any losses but does share in the profits.
- The franchisee usually has to purchase all goods and supplies from the franchisor only.
- The contract between the parties is usually to the benefit of the franchisor.

## Disclosure Document

The Federal Trade Commission requires that franchise sellers provide certain information in a detailed disclosure document to help a prospective buyer evaluate the franchise opportunity. This information includes

- Names and addresses of other purchasers.
- A fully audited financial statement of the franchise seller.
- The background and experience of the key executives of the franchisor's staff.
- The cost required to start and maintain the business.
- The responsibilities you and the franchisor will share.

A good franchisor usually encourages prospective franchisees to visit and talk to other owners of the franchise. This certainly should be done!

## MANUFACTURING COST ACCOUNTING

Cost accounting, in a broad sense, means accumulating all the costs associated with an activity (manufacturing, retailing, providing a service, etc.) and organizing them in a meaningful way to (1) satisfy financial reporting requirements and (2) achieve understanding of the costs of the activity for control and optimization purposes.

There is a distinction between general accounting and cost accounting. Although costs are of primary concern in both, general accounting is concerned more with the total costs of a business. These costs are usually classified into well-established summary level accounts, such as cost of goods sold, selling expenses, administrative expenses, advertising and research.

Cost accounting details costs of individual products by the types of costs (raw material, direct labor, etc.) and by the departments (cost centers) within each of the business functions (manufacturing, selling, administration, etc.). Cost accounting is used to

- Control business operations by detailing the important costs of the business, permitting analysis of these costs and indicating where corrective action is required if costs are not meeting expectations (budgets, standards, etc.).
- Optimize business performance by using cost details, along with sales revenue details (sales

## Other Considerations

An attorney should assist the prospective franchisee to evaluate the franchise package. An accountant may be needed to determine the full costs of purchasing and operating the business, as well as the potential profit to the franchisee.

Before purchasing a franchise, carefully consider the level of independence you will maintain, how comprehensive the operating controls are, and the full costs of purchasing the franchise. Also, be sure to ask about the terms and conditions for reselling your franchise.

Although the success rate of franchises is high, very independent people with their own concepts of operating a business may not be the type to open a franchise.

price received by product, customer, territory, etc.) to identify the most profitable areas of the business for further development, as well as to ferret out marginally profitable or unprofitable operations for elimination.

- Satisfy financial reporting requirements, particularly in the valuation of inventories in manufacturing businesses.

Although cost accounting is mainly used for manufacturing businesses, it is equally effective in nonmanufacturing businesses. The discipline of detailing costs by type and location, determining whether costs are fixed or variable and comparing costs with expectations (budgets, standards, etc.) provides a sound basis for controlling and more efficiently performing any activity.

When applying cost accounting to a manufacturing function, each cost element is classified generally in two ways:

- Whether the cost is direct or indirect.
- Whether the cost is fixed or variable.

Normally, there are three classification combinations: direct-variable, direct-fixed and indirect-fixed. (Indirect-variable is unlikely).

*Direct costs* are those incurred in the manufacture of the product; they can be readily identified with the product. These costs usually include raw materials and the labor required to convert the raw materials to the finished product. In some situations, direct costs include power, fuel, steam and other significant costs that can be readily identified with the product.

*Indirect costs* are generally the costs of activities required to support the manufacturing operations. These usually include plant administration, quality control, purchasing, insurance, depreciation, property taxes and other similar activities.

*Variable costs* are those that vary directly with the quantity of product produced; a good example is raw materials. Labor spent in processing raw materials may also be a variable cost if the amount of labor required is directly proportional to the quantity of goods produced. Other costs, such as fuel if directly consumed into process operations and if proportional to the quantity of production, can also be classified as variable.

*Fixed costs*, as the term implies, do not vary with the quantity of production. These generally include all of the indirect costs (support costs such as insurance, plant administration, depreciation, etc.). They can also include some direct costs, such as departmental supervisors, utilities required to heat/air condition production areas and maintenance required to service the production equipment.

Fixed costs are "fixed" only for a range of production levels. A significant change in production level can change these costs. Support activities, such as purchasing, employee relations, plant administration and insurance, along with direct costs such as supervisors and maintenance, can vary with substantial changes in production levels. When a cost is considered "fixed," the range of production levels for which the cost is fixed should be understood. This is called the *relevant range*.

There are two other distinctions made concerning the application of cost accounting to manufacturing operations. Two types of manufacturing operations are recognized: job-order and continuous process manufacturing.

*Job-order manufacturing* is based on specific quantities of a product being processed through the operations with all of the costs associated with that particular lot being collected and identified with that lot.

*Continuous process manufacturing* (such as many chemical operations) is a continuing manufacturing operation where costs are collected over time (such as a month) and quantities of materials consumed or produced are measured through inventory changes.

Typical manufacturing costs and their general classification are listed in Table 6.

Manufacturing cost accounting is particularly effective when it includes a *budgeting/standard cost system*. A

**Table 6 – Typical manufacturing costs and their classification**

Cost element	Classification			
	Direct	Indirect	Variable	Fixed
Raw materials	X		X	
Labor	X	X	X	X
Salaries	X	X		X
Supplies	X	X	X	X
Payroll taxes	X	X	X	X
Medical insurance	X	X		X
Heat, light, power	X	X	X	X
Telephone		X		X
Rent	X	X		X
Insurance, property taxes		X		X
Depreciation		X		X
Other				

standard cost system develops a projected unit cost, achievable under controlled conditions, for each product. This unit cost is identified as the standard cost, and includes all the raw materials, labor and other costs incurred in producing the product plus an allocation of the support costs. A sample standard cost (summary) could be as follows:

Direct-variable	\$2.00 per unit
Direct-fixed	1.00 per unit
Indirect-fixed	1.25 per unit
Total	\$4.25 per unit

The standard cost originates from the manufacturing budget. This budget projects the production requirements (from sales and inventory projections), the costs of each of the departments within the plant, the costs of raw materials, the raw material and labor requirements for each product, the production rates and other considerations depending on the particular manufacturing operations.

A sample budget, simplified for illustration purposes, follows in Table 7.

**Table 7 - Sample manufacturing budget**

Annual Budget—ZYX Company		
Production requirements: 10,000 units (for the year)		
Product requirements: Raw materials—\$6.00/unit Labor—5.0 hr/unit Labor rate—\$12.00/hr		
Production department budget:	\$	% variable costs
Labor (10,000 units × 5 hrs × \$12)	600,000	100
Salaries (1 supervisor)	30,000	0
Rent	15,000	0
Utilities	40,000	50
Maintenance	50,000	0
Total	735,000	
Allocation of production costs:		
Variable cost	620,000	
Fixed cost	115,000	
Total	735,000	
Administration department budget:		
Salaries	100,000	0
Rent	12,000	0
Utilities	3,000	0
Depreciation	50,000	0
Total	165,000	
Total budget:		
Raw materials (10,000 × \$6)	60,000	
Production department	735,000	
Administration department	165,000	
Total	960,000	
Standard cost, per unit:		
Raw materials	\$ 6.00	
Direct variable labor and expense	62.00	
Direct fixed	11.50	
Indirect fixed	16.50	
Total	96.00	

Manufacturing cost budgets are divided into periods (month, quarter, etc.) for business planning purposes as well as control purposes (compare actual costs with budget). Table 8 shows quarterly figures for ZYX Company's annual budget.

A budget broken down by periods is extremely important in planning raw material purchases, arranging to have labor available during seasonally busy periods and particularly for ensuring that cash is available to fund the manufacturing operations. It is also essential to control operations during the course of the year. As the year progresses, actual costs are compared to budgeted costs and the variances analyzed. Table 9 shows the first quarter manufacturing cost (or variance) report for the ZYX Company. The manufacturing budget is adjusted for actual production volume. This permits a valid comparison of actual costs with allowable costs based on actual production volume.

The above first quarter report for the ZYX Company indicates that the plant exceeded allowable costs by

\$20,950. Higher volumes than budget would result in higher actual costs compared to budget. However, it is important to compare actual costs to allowable costs (budget adjusted for actual volume) to make a meaningful comparison and analysis. In this case, the analysis revealed that the unfavorable variance of \$20,950 was due mainly to a surge in orders requiring considerable overtime for direct labor. This resulted in a substantial unfavorable labor variance, which could have been avoided by moving more quickly to hire additional labor to handle the increased orders. The variance report, with analysis, provides a much clearer understanding of costs so that actions can be taken when indicated.

The above examples have been simplified. Some issues—such as inventory valuation, raw material purchase price variances, labor rate variances, labor hour variances and the basis for allocating fixed costs—have not been covered. However, the examples illustrate the discipline that cost accounting with a budget system, including standard costs, can provide.

**Table 8 – Sample annual budget, by quarter**

ZYX Company Annual Budget, by Quarter					
	1st qtr	2nd qtr	3rd qtr	4th qtr	Year
Production (units)	3,000	4,000	2,000	1,000	10,000
Raw materials (\$)	18,000	24,000	12,000	6,000	60,000
Production department budget (\$)					
Labor	180,000	240,000	120,000	60,000	600,000
Salaries	7,500	7,500	7,500	7,500	30,000
Rent	3,750	3,750	3,750	3,750	15,000
Utilities	11,000	13,000	9,000	7,000	40,000
Maintenance	12,500	12,500	12,500	12,500	50,000
Total	214,750	276,750	152,750	90,750	735,000
Administration department budget (\$)					
Salaries	25,000	25,000	25,000	25,000	100,000
Rent	3,000	3,000	3,000	3,000	12,000
Utilities	750	750	750	750	3,000
Depreciation/Insurance	12,500	12,500	12,500	12,500	50,000
Total	41,250	41,250	41,250	41,250	165,000
*Total manufacturing costs	274,000	342,000	206,000	138,000	960,000

\*Raw materials + production and administration department budgets.



Table 9 – Sample cost variance report

ZYX Company First Quarter Cost Variance Report				
	Budgeted Costs	Allowable Costs	Actual Costs	Variance Favorable/ (Unfavorable)
Production (units)	3,000		4,000	
Raw materials used (\$)	18,000	24,000	25,000	(1,000)
<b>Production department budget</b>				
Labor	180,000	240,000	260,000	(20,000)
Salaries	7,500	7,500	7,500	—
Rent	3,750	3,750	3,750	—
Utilities	11,000	13,000	12,000	1,000
Maintenance	12,500	12,500	13,000	(500)
Total	214,750	276,750	296,250	(19,500)
<b>Administration department budget</b>				
Salaries	25,000	25,000	25,500	(500)
Rent	3,000	3,000	3,000	—
Utilities	750	750	700	50
Depreciation/Insurance	12,500	12,500	12,500	—
Total	41,250	41,250	41,700	(450)
*Total manufacturing costs	274,000	342,000	362,950	(20,950)

\*Raw materials + production and administration department budgets.

## INVENTORY

In many businesses, the cost of purchasing merchandise for resale (retailing) or the costs of purchasing and converting materials into finished products (manufacturing) represent the business's most significant expenditures. Keeping track of merchandise and materials, known as *inventory*, is important because of the considerable costs involved. This can be accomplished through a good inventory record keeping system.

### Inventory Record Keeping

Inventory record keeping establishes and maintains information on current inventory, the additions and withdrawals to inventory and inventory balances at the end of specified periods (week, month, etc.). These records identify the products/materials, the quantities and the value (cost) of these products/materials. A simple inventory record could look like the one shown in Table 10.

The value is the cost of the product. This would be what a retailer paid for the product or what a manufacturer paid

for materials plus labor and other charges applied in converting the materials into the finished product. In Table 10, the cost of goods sold would be \$100 for this product for the month of May.

There are two different methods used in inventory record keeping: perpetual and periodic.

### Perpetual Inventory

The perpetual inventory method starts with a physical inventory (actual count) and then adjusts this inventory for additions and withdrawals. The inventory at the end of the period is calculated by subtracting the number of units sold from the total of the beginning inventory plus the additional units produced. An example is furnished in Table 11.

The perpetual inventory method is used when reliable sales and production information is readily available and the frequent taking of physical inventories would be burdensome. However, physical inventories must be periodically taken (e.g., quarterly or annually) to check

**Table 10 – Sample inventory record**

Product code: 1020				
Product description: 1 quart bottle, Hi Temp Oil				
Period	Inventory activity			
	Beginning	Sales	Production	End
Month: May				
Quantity (units)	600	(200)	300	700
Value/cost (\$)	300	(100)	150	350

**Table 11 – Sample perpetual inventory**

Activity	Value in units
Beginning inventory	100
Sales	(75)
Production	95
Ending inventory (calculated)	120

**Table 13 – Sample periodic inventory (manufacturing)**

Activity	Value in units
Beginning inventory	1,500
Sales	(800)
Production (calculated)	900
Ending inventory	1,600

the calculated inventories. The inventory records are then adjusted to agree with the physical inventories. The financial effect of these adjustments is reflected in the balance sheet and the profit/loss statement of the business.

#### Periodic Inventory

The periodic inventory starts with the physical inventory taken at the end of each period. Sales or production amounts are then calculated based on the beginning and ending physical inventories. This method is used when reliable sales or production data are not readily available. Consider the examples in Tables 12 and 13.

**Table 12 – Sample periodic inventory (retailing)**

Activity	Value in \$
Beginning inventory	12,000
Purchases	6,000
Cost of sales (calculated)	(8,000)
Ending inventory	10,000

In Table 12, the cost of sales equals the beginning inventory plus the purchases minus the ending inventory.

In Table 13, the number of units produced equals the ending inventory plus sales minus the beginning inventory.

Inventory record keeping is primarily used to determine the cost of goods sold as well as to provide information for financial statements.

#### Inventory Control

Inventory control is the management of inventory and relies heavily on information provided by the inventory record keeping system. Inventory is required to support the operations of the business, whether it be a retailing or manufacturing business. The proper management of inventory helps the business achieve its objectives in sales, costs and profits. The business plan must recognize and define the role inventories will play in achieving the business objectives.

Inventory control consists of the following:

- Setting objectives for inventory: the type, quantity, cost and order/production point (what quantity will initiate action for resupply) of products/materials.
- Recording and reporting actual results (done by the inventory keeping system).
- Comparing actual results with objectives and analyzing the differences.
- Taking action to correct problems or improve business performance.

Inventory supports the sales activity. This means having what the customer is willing to buy, when he or she needs

it, at a price that provides an acceptable profit to the business.

Inventory control is integrated with systems that track sales, production and purchasing activities. The following is a simple example.

The BAC Company plans to produce and sell three products: X, Y and Z as detailed in Table 14.

**Table 14 – Proposed annual sales and production rates for BAC Company**

Product	Annual sales (units)	Production rate (units/day)
X	26,000	200
Y	52,000	300
Z	13,000	100

The business operates five days per week, 52 weeks per year. The minimum economic production run is two weeks. It is planned to have a minimum inventory equivalent to four weeks of the planned sales rate to ensure having enough product for customer needs. The maximum inventory is to be eight weeks of the planned sales rate to limit the investment. The minimum and maximum inventories, based on these plan assumptions, would be as listed in Table 15.

**Table 15 – Minimum and maximum inventory for BAC Company**

Product	Daily sales rate (units/day)	Minimum inventory (units)	Maximum inventory (units)
X	100	2,000	4,000
Y	200	4,000	8,000
Z	50	1,000	2,000

When product X inventory falls to 2,000 units, a production order is issued to bring the inventory level to 4,000 units. If sales continue at 100 units per day and the production rate is 200 units per day, it will take four weeks of production time to raise the product X inventory to 4,000 units.

Various measures are used, for control purposes, to relate inventory amount to sales activity. Two commonly used measures are inventory days (used in manufacturing

businesses) and inventory turnover (used in retailing businesses).

### Inventory Days

Inventory days measure the amount of inventory in terms of days of sales. In the example for BAC Company, where product X sales rate was 100 units per day, the inventory days for the minimum inventory planned of 2,000 units would be 20 days (inventory amount divided by daily sales rate, or  $2,000 \div 100 = 20$ ). The maximum inventory days would be 40 days ( $4,000 \div 100 = 40$ ).

Values (costs) can be used in calculating inventory days. Assume that the units cost \$5.00 each in the above example. For product X, the minimum inventory planned would be \$10,000 (2,000 units  $\times$  \$5.00 per unit) and the daily cost of sales would be \$500/day (100 units/day  $\times$  \$5.00 per unit). Inventory days for the minimum inventory planned would be 20 days (inventory value/cost of sales per day or  $\$10,000 \div \$500/\text{day} = 20$  days).

### Inventory Turnover

Inventory turnover measures the number of times in a year that the inventory "turns over." In the above example, if product X sales are planned at a rate of 100 units per day or 26,000 units for the year and the inventory averages 3,000 units, the inventory turnover would be 8.67 ( $26,000 \div 3,000 = 8.67$ ). Again, values (costs) could be used in calculating inventory turnover similar to that done above.

Although the time period of a year is used as the basis for calculating inventory turnover in most cases, a seasonal business (such as a store in a summer resort) would use the season as the basis. In this case, the business objective is to turn the inventory over as many times as possible and have little or no inventory by the end of the season.

Actual sales activity (sales rate, product preferences, selling prices) must be closely monitored with inventory (products, quantities, costs, resupply limits) to be sure that the inventory control system is properly supporting the sales activity.

Another important objective of inventory control is to keep the financial investment in inventories just sufficient to support the business. Inventory building converts cash into products that may or may not sell or may sell at a price less than cost. Inventories consume cash, increase the investment in the business and can bankrupt the business if not properly controlled.

## ***Inventory Strategies***

Every business competes within an industry and each industry has a life cycle. The strategies employed by the business depend on where in the life cycle the industry is. The management of inventories is influenced by this life cycle.

Generally, there are four stages in the life cycle of an industry. These are as follows:

- *Development*—Uniquely new products are being developed and market tested. Products must be available for market testing. There is little concern about inventory investment, other than to be sure products are available for market testing and development.
- *Growth*—The product has been demonstrated to have significant market potential and the business strives to gain a major market share. Investment

in inventory is heavy to ensure product availability to gain significant market share.

- *Maturity*—Growth has leveled off. Inventories are very closely controlled to keep investment in them just sufficient to maintain market share.
- *Aging*—A period of retrenchment as competitive industries take away or eliminate markets. Inventories decline as unprofitable and marginally profitable segments of the business are weeded out.

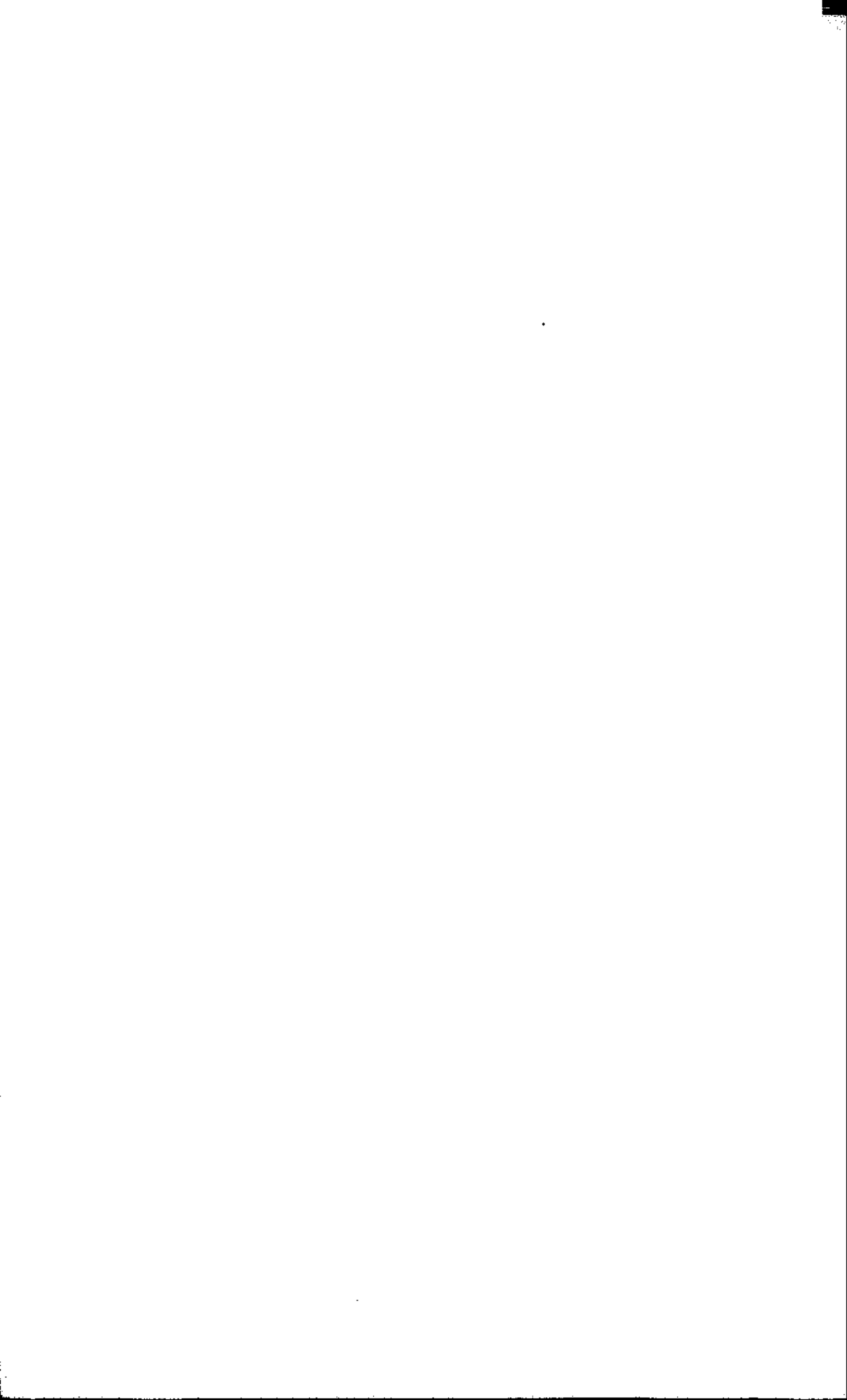
The proper control of inventories is essential to the success of any business in which investment in inventories is significant. Awareness of the competition and the state of new product development is just as important as a finely honed record-keeping system. While the record-keeping system is important, how it is applied will determine the success of the business.

**APPENDIX A: USEFUL IRS TAX PUBLICATIONS**

---

<b>Number</b>	<b>Subject</b>
SS-4	Application for Employer Identification Number
Sch C	Profit or Loss from Business-Sole Proprietor
Sch SE	Computation of Social Security Self-Employment Tax
1040ES	Estimated Tax for Individuals
15	Employers Tax Guide (Circular E)
334	Tax Guide for Small Business
505	Tax Withholding and Estimated Tax
533	Self-Employment Tax
534	Depreciation
535	Business Expense
538	Accounting Periods and Methods
539	Employment Taxes (Defines an Employee)
541	Tax Information on Partnerships
542	Tax Information on Corporations
552	Recordkeeping for Individuals
583	Information for Business Taxpayers
587	Business Use of the Home
589	Tax information on S Corporations
917	Business Use of a Car

---



### **U.S. Small Business Administration (SBA)**

The SBA offers an extensive selection of information on most business management topics, from how to start a business to exporting your products.

This information is listed in *The Small Business Directory*. For a free copy contact your nearest SBA Office.

SBA has offices throughout the country. Consult the U.S. Government section in your telephone directory for the office nearest you. SBA offers a number of programs and services, including training and educational programs, counseling services, financial programs and contract assistance. Ask about

- **Service Corps of Retired Executives (SCORE)**, a national organization sponsored by SBA of over 13,000 volunteer business executives who provide free counseling, workshops and seminars to prospective and existing small business people.
- **Small Business Development Centers (SBDCs)**, sponsored by the SBA in partnership with state and local governments, the educational community and the private sector. They provide assistance, counseling and training to prospective and existing business people.
- **Small Business Institutes (SBIs)**, organized through SBA on more than 500 college campuses nationwide. The institutes provide counseling by students and faculty to small business clients.

For more information about SBA business development programs and services call the SBA Small Business Answer Desk at 1-800-U-ASK-SBA (827-5722).

### **Other U.S. Government Resources**

Many publications on business management and other related topics are available from the Government Printing Office (GPO). GPO bookstores are located in 24 major cities and are listed in the Yellow Pages under the "bookstore" heading. You can request a *Subject Bibliography* by writing to **Government Printing Office, Superintendent of Documents, Washington, DC 20402-9328**.

Many federal agencies offer publications of interest to small businesses. There is a nominal fee for some, but most are free. Below is a selected list of government agencies that provide publications and other services targeted to small businesses. To get their publications, contact the regional offices listed in the telephone directory or write to the addresses below:

#### **Consumer Information Center (CIC)**

P.O. Box 100  
Pueblo, CO 81002

The CIC offers a consumer information catalog of federal publications.

#### **Consumer Product Safety Commission (CPSC)**

Publications Request  
Washington, DC 20207

The CPSC offers guidelines for product safety requirements.

#### **U.S. Department of Agriculture (USDA)**

12th Street and Independence Avenue, SW  
Washington, DC 20250

The USDA offers publications on selling to the USDA. Publications and programs on entrepreneurship are also available through county extension offices nationwide.

#### **U.S. Department of Commerce (DOC)**

##### **Office of Business Liaison**

14th Street and Constitution Avenue, NW  
Room 5898C

Washington, DC 20230

DOC's Business Assistance Center provides listings of business opportunities available in the federal government. This service also will refer businesses to different programs and services in the DOC and other federal agencies.

#### **U.S. Department of Health and Human Services (HHS)**

##### **Public Health Service**

##### **Alcohol, Drug Abuse and Mental Health Administration**

5600 Fishers Lane  
Rockville, MD 20857

Drug Free Workplace Helpline: 1-800-843-4971. Provides information on Employee Assistance Programs.

National Institute for Drug Abuse Hotline:

1-800-662-4357. Provides information on preventing substance abuse in the workplace.

The National Clearinghouse for Alcohol and Drug Information: 1-800-729-6686 toll-free. Provides pamphlets and resource materials on substance abuse.

**U.S. Department of Labor (DOL)  
Employment Standards Administration**

200 Constitution Avenue, NW  
Washington, DC 20210

The DOL offers publications on compliance with labor laws.

**U.S. Department of Treasury  
Internal Revenue Service (IRS)**

P.O. Box 25866  
Richmond, VA 23260  
1-800-424-3676

The IRS offers information on tax requirements for small businesses.

**U.S. Environmental Protection Agency (EPA)  
Small Business Ombudsman**

401 M Street, SW (A-149C)  
Washington, DC 20460  
1-800-368-5888 except DC and VA  
703-557-1938 in DC and VA

The EPA offers more than 100 publications designed to help small businesses understand how they can comply with EPA regulations.

**U.S. Food and Drug Administration (FDA)  
FDA Center for Food Safety and Applied Nutrition**

200 Charles Street, SW  
Washington, DC 20402

The FDA offers information on packaging and labeling requirements for food and food-related products.

**For More Information**

A librarian can help you locate the specific information you need in reference books. Most libraries have a variety of directories, indexes and encyclopedias that cover many business topics. They also have other resources, such as

- **Trade association information**  
Ask the librarian to show you a directory of trade associations. Associations provide a valuable network of resources to their members through publications and services such as newsletters, conferences and seminars.
- **Books**  
Many guidebooks, textbooks and manuals on small business are published annually. To find the names of books not in your local library check *Books In Print*, a directory of books currently available from publishers.
- **Magazine and newspaper articles**  
Business and professional magazines provide information that is more current than that found in books and textbooks. There are a number of indexes to help you find specific articles in periodicals.

In addition to books and magazines, many libraries offer free workshops, lend skill-building tapes and have catalogues and brochures describing continuing education opportunities.