

TAP Basics

Technical Assistance Providers Handbook



Technical Assistance Provider (TAP) Basics

PREFACE

In 1999 the Federal Reserve Bank of Chicago, convened the Small Enterprise Capital Access Partnership (SECAP), to explore ways for small and micro businesses to obtain better access to capital. Four task groups addressed issues relating to marketing, technical assistance, access to equity capital, and access to traditional debt capital. *TAP Basics* is the work of the technical assistance task group, which was charged with addressing quality issues related to entrepreneurial training, with help from a panel of business experts.

This reference is divided into four sections and is intended to be a handbook for service providers (counselors, consultants, coaches, trainers, and facilitators) who work with small and micro business owners, helping to prepare them for and guide them through the challenges of successful business development.

Take the time to review the sections of the handbook and spend a few minutes of each client session raising questions and discussing key components of each section with clients to learn where help is needed. Encourage clients to attend workshops or training programs to get more comprehensive information about those areas of need.

Use *TAP Basics* to make sure you are providing quality services to a client every time you work with one. Much knowledge and research and many years of experience went into compiling this handbook. Above all, the purpose of *TAP Basics* is to ensure your clients are better prepared, positioning their businesses to be effective and profitable, and to access capital when they need it. That is only possible if you, the service provider, are committed to providing quality information to your clients.

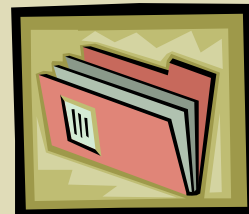
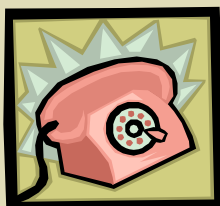
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INTRODUCTION

Every year more and more individuals become technical assistance providers to small and micro business owners. With downsizing in the corporate sector, welfare reform, and the ongoing arrival of new immigrants from many regions of the world, more individuals are starting businesses and operating them without the requisite knowledge that can help to make those ventures successful. Of concern, given this trend, is the fact that technical assistance providers that serve entrepreneurs are not required to have any specific training, reducing the odds for success for new or aspiring entrepreneurs.

The basic task of small business counselors is to assist entrepreneurs in **evaluating business opportunities** for new or existing businesses. A viable opportunity **must combine the capacity of the entrepreneur with a sound business idea**. The quality of this evaluation is perhaps the key factor in determining the risk(s) to which the client is exposed, placing a significant responsibility for providing quality advice on the counselor.

TAP Basics, a desk reference/handbook, has been developed to provide a quick source of information essential to successful business counseling. It is not intended to stand alone, but to be used in conjunction with training and courses designed to meet the needs of often inexperienced entrepreneurs, or those pursuing new or unfamiliar opportunities. This handbook offers technical assistance providers an overview of pertinent information for making a business efficient and profitable. It is written for technical assistance providers, not entrepreneurs with limited business training or understanding of U.S. business culture.

This reference is organized in four sections covering the four essential business disciplines, entitled simply: *Management*, *Marketing*, *Accounting*, and *Finance*. Each section contains an overview of the discipline and a glossary of terms used in explaining important concepts of the subject. When used in conjunction with a certification program for technical assistance providers, or with coursework that will fill in the blanks, *TAP Basics* is a useful and helpful tool.

As a technical assistance provider (counselor, coach, consultant, instructor, or program administrator), you are encouraged to use this reference whenever you assist a business owner or potential owner. Remember that each client expects you to guide him or her in making good choices about a business. Make sure you are prepared to take on that responsibility, and be armed with the information necessary to be effective.

By increasing your knowledge and effectiveness in delivering services, you can help the economy, create jobs, and stimulate more confidence in your client. Thank you for accepting the challenge.

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MANAGEMENT

The term management conjures up two distinct images: the first is management of a business, the process for operating a business, including its systems, structure, policies, procedures, and relationships. The second is the people who facilitate that process. Management involves the coordination of every aspect of a business with the primary purpose being to serve a particular need of the customer/client while staying focused on achieving profitability.

COMMON MANAGEMENT TERMS

Business Plan - a management tool, a road map detailing the goals of the company, and the strategies to achieve them. The most important part of a plan is the thought process used to develop it. The document must be flexible and remain a work in progress, being adjusted at least on an annual basis.

Controls - measures (guidelines) used to monitor progress in particular situations, especially in business, such as periodic reports, time clock/time sheets, records, tracking systems, and more.

Cost Analysis - the accounting function that determines the direct and indirect costs of a project or of operating a business. The analysis takes into consideration all expenses involved in the project or operating the business, and is used as a tool to determine the price or fee of a product or service based on profit goals.

Employee Alternatives - subcontractors, independent contractors, temporary workers, or other sources of workers used to operate the business efficiently. Individuals who provide support to a business such as accountants, attorneys, consultants, etc., considered alternative or “virtual” staff. Advisors of any sort are also considered alternative employees.

Evaluations - written instrument or document, as well as verbal discussion, which measures elements of service or a particular effort to achieve an end. Feedback on work accomplished. Often used for workers or employees, but also a valuable tool to determine customer/client satisfaction.

Exit Strategy - a plan developed to pass on the business to someone else, usually with a rewarding result such as selling or taking the company public (selling to the public via the stock market). Such a plan can also involve turning over control to someone else while maintaining ownership.

Intellectual Property - any invented item, written material, musical composition, specific artwork, photographic image, or similar proprietary items, which qualify to be registered as belonging to a company or individual. Such registrations are handled through several federal offices depending on the function of the property. Copyrights, trademarks/servicemarks, and patents are the forms of registrations available for intellectual property. The Library of Congress (www.loc.gov), handles copyrights, and patents and trademarks/servicemarks are handled by the U.S. Patent and Trademark Office (www.uspto.gov), both in Washington, D.C.

Inventory - a surplus supply of products or items completed and available for sale or other purposes. Also, a listing of every item owned by a company and the accounting of those items. Companies may have several different categories of inventory, such as office supplies, maintenance supplies, furniture/fixtures, merchandise to be sold, and equipment.

Legal Forms of Business Ownership - legal structures for businesses include sole proprietor, partnership, or corporation. Corporations exist in several forms: C Corporation (state based), Sub-chapter S Corporation (federal status, only related to tax payment), Limited Liability Company (LLC) and Professional Corporation (P.C., for professionals such as attorneys, doctors, engineers, or accountants). Sole proprietor and partnerships offer no protection against personal liability, but offer optimal tax benefits. Corporations C and P.C.

create a double-tax situation – the owner pays corporate and individual income taxes. LLC and S Corporations provide protection against personal liability and the opportunity to pay taxes as a sole proprietor or partnership.

Management Team - those individuals in leadership or supervisory roles within a company, focused on its growth and profitability, usually responsible for planning and implementing, and/or the work of employees, contractors, or similar workers. Companies may temporarily employ consultants or subcontractors to assist in development of products, services, or the organization itself.

Manufacturing - the mass production of a product. The process of producing something.

Merchandise - goods bought and sold for the purpose of generating revenue.

Mission Statement - a brief declaration outlining a company's overall objective; its purpose for being in business.

Open-to-buy - merchandising term which indicates the amount of money left in the budget to purchase new stock for a particular season or in a particular category (i.e. ladies wear, household items). The term usually refers to either the fiscal year budget or the budget for a specific season.

Operating Systems - any and all strategies, methods, forms, policies, procedures, processes, guidelines, principles, and structure adopted by a company to facilitate a smoother, more efficient business operation. These systems work best when in writing, but may also be adopted and understood through verbal communication.

Organization Chart - a diagram showing the structure of a business, listing either the employees or the positions of employment, along with the board of directors. The diagram usually shows management/leadership positions with connecting lines to subordinate positions. The organization chart is a visual representation of company employees and the level of their positions with the company.

Policies - guidelines used to set the standards in various contexts of business operations. A credit policy, for example, would set forth the way a company would offer credit to its customers: interest rates charged or how the rates are determined, who qualifies for credit, consequences for not paying on time, collection procedures, and conditions and limitations for establishing credit accounts.

Procedures - processes used as standards of operation, used consistently to create uniformity within a business. Examples include maintaining a written record of all phone messages taken each day or requiring each worker on a particular level to submit a written report of work completed each week.

Product - an item for consumption, something made to be sold.

Production (manufacturing) - the act of developing an item for consumption (to be sold).

Service - work done for and with benefit conferred on another person or company.

SMART Goals - target objectives for an organization incorporating clear guidelines for reaching those objectives. Characteristics of those guidelines include the following: S—specific, M—measurable and manageable, A—attainable, R—realistic, and T—timeline for achievement.

Strategic Plan - a management document describing the actions an organization intends to take to achieve stated growth and profit objectives in identified markets.

Strategies - the methods to be used to reach various business goals.

Succession Plan - strategies developed to ensure the continuation of a business. All business owners should prepare (train) someone from the inception of a business to be able to take over the operation in case of illness, emergencies, vacations, deaths, disabilities and any unforeseen event which would cause the slow-down or stoppage of business.

SWOT - a strategic planning stratagem in which the owners of a business analyze the S—strengths, W—weaknesses, and O—opportunities, of, and T—threats to a business.

Values - guiding principles, shaped by belief systems on a conscious or subconscious level, which determine how a business operates. Those standards which dictate the culture of a business.

Vendors/Suppliers - those who trade products or services for currency or items (products or service) of equal value. Sellers of such products or services are necessary for the profitable operation of a business.

Vision - insight, the ability to visualize the future of a business/project and to plan effectively for its accomplishment.

KEY CONSIDERATIONS

Business Plan

An outline is a key tool when preparing a business plan. A business plan is a road map for the business, and more importantly, it is a process which key individuals in the business can use to think through the various aspects of the business, triggering different and sometimes better strategies along the way. At least as important as the actual plan is the process used to develop it.

A business plan must be fluid and flexible, enabling management to adapt to changing market conditions. Ideally, a plan is reviewed often and adjusted as necessary for each year of operation. Following is a checklist with discussion as to what each section should detail, and is presented with the permission of the author.

Business Plan Elements

- Executive Summary
- The Company
- Purpose Statement
- Mission Statement
- Company Status/History
- Feasibility
- Goals
- Management Team
- Organizational Structure
- Succession/Exit Strategy
- SWOT (Strengths, Weaknesses, Opportunities, Threats)
- Industry Data and Competition
- Market Information
- Marketing Budget
- Product/Service Information
- Fee/Price Structure
- Credit Policy
- Sales Strategies
- Manufacturing Considerations
- Retail Operation
- Operational Systems Design
- Pro Forma
- Financial Projections
- Cash Flow Analysis
- Job Descriptions
- Management Objectives
- Organization Chart
- Tracking Data

Executive Summary

The first section of a business plan is the executive summary. While it appears first, it is always written last, after completing the plan. The executive summary is a snapshot of the plan itself and should give possible investors enough information to determine whether they want to read the entire document. Include the following in the executive summary:

- A brief description of the business: product/service, market, legal form, ownership, locations, and history
- The overall goals of the business
- Its mission
- The strategy for growth, summary of the financial projections (sales and profits), and capital requirements
- Qualifications of the management team

If the business is seeking investors, and/or credit, add the following:

- The amount of money to be raised
- The loan terms you are hoping to secure
- Repayment method
- Return on investment
- Break-even point for the business

The executive summary should be no more than two pages. One page is even better.

The Company

Under this heading, discuss:

- Business you are in
- Category it fits into (e.g., consulting, manufacturing, retail)
- Industry it fits into
- Business purpose

Include your purpose statement and your mission statement. Also describe the legal structure of the business: whether it is a sole proprietorship, partnership, corporation, or limited liability company and why.

Purpose Statement

Your purpose statement should answer four questions. They should be answered strictly in reference to the **business** and not to you personally. Who are you? What do you do? For whom do you do it? What are the benefits? For example, "KMN Growth Consultants is a professional services firm providing business development services to small business owners to assist them in being profitable and efficient in running their businesses." The statement should be no more than two sentences, and easy to remember and repeat. You should plan to use it regularly at networking activities. Memorize this purpose statement for it will help you to easily articulate what it is you do, and convey a sense of professionalism.

Mission Statement

The mission statement outlines what you want to achieve in operating your business. It is a broad goal statement that has no boundaries and no set time limits. It is a goal you are reaching for and working at constantly. However, it is not a SMART goal. You will never fully achieve it, yet it motivates you to keep trying. The mission statement for KMN Growth Consultants is to "stem the rate of failure for micro and small businesses through training and effective business coaching."

Developing your Purpose Statement and your Mission Statement helps you clarify and easily articulate what you are trying to accomplish with the business.

Company Staus/History

Discuss when the business started, using a date such as 1990 or October 1997, instead of stating the number of years since its founding. Next, discuss why the business began. Perhaps you started the business for one reason, but that reason has changed and the business has evolved into something different. Discuss your present focus as well.

Feasibility

In this section, describe your findings under all the different aspects of feasibility. Why did you decide to pursue this business? How did you determine your market and pricing? If it is a retail business, how did you determine where to locate the shop? If surveys or questionnaires were used, list the results and discuss the demographic profile of respondents. In narrative form, discuss in general the feasibility of the business and the demand for what you sell. Cite all evidence uncovered in the research process.

Goals

State short- and long-term goals. Without going into your strategies, indicate the goals and the objectives of each. If your goal is to earn \$50,000 within the first year of operation, your objectives might include generating \$1,000 per week in revenue through clients or customers. Describe the steps. The important thing is to think through the managing and measuring of each goal. Make sure the goal is "SMART."

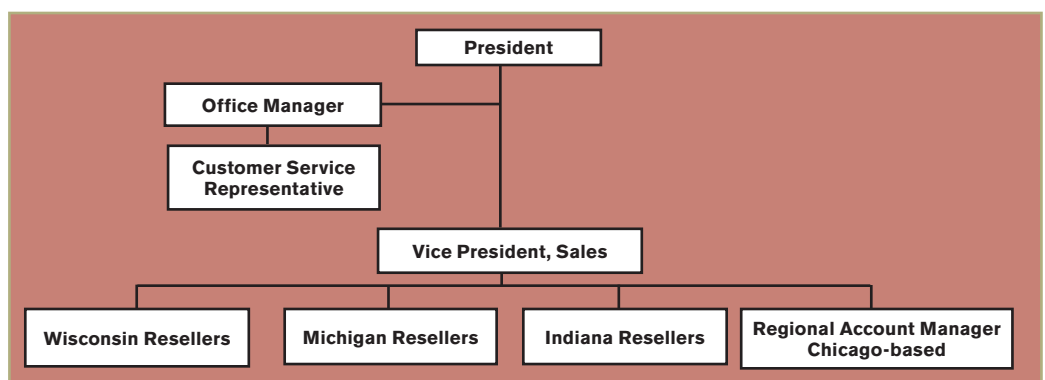
Management Team

Even if you are the only person managing the operation, this is your opportunity to outline all the tasks you perform, such as marketing, administration, sales, record keeping, and accounting. Discuss the qualifications, experience, and separate responsibilities of the owner and other members of your management team, if any. Who does what?

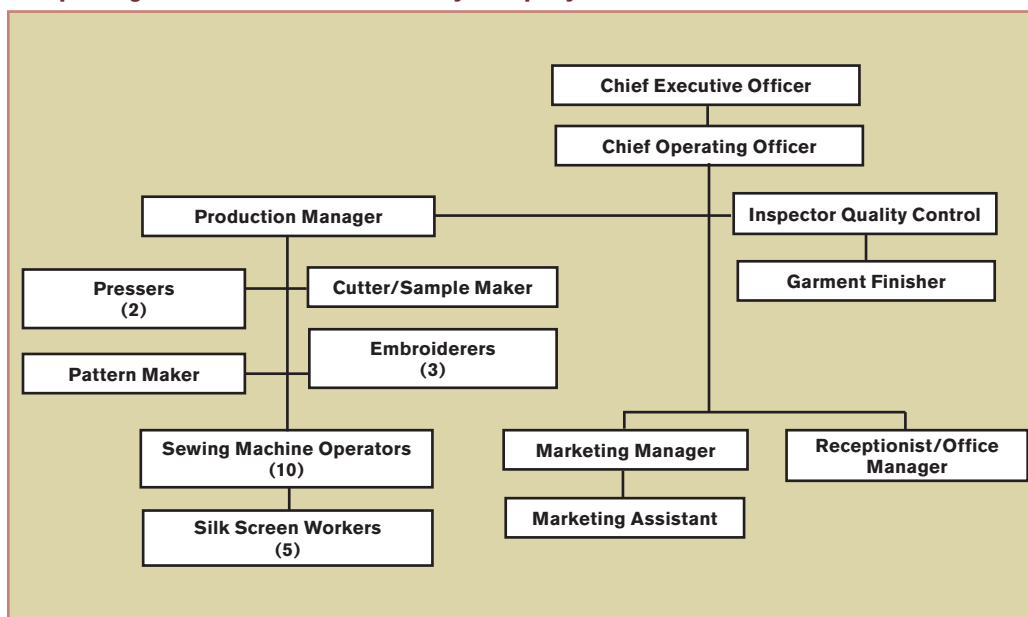
Organizational Structure

In this section discuss employees and your company's anticipated growth. How many employees do you anticipate having in the next year? In two years? In three years? Long-term? How do you see the business growing over the next 10 years? Develop an organization chart and project for at least three to five years your staffing: employees (full- and part-time), contractors, subcontractors, etc. List titles and positions. Include job descriptions for all positions (including yours.) This exercise will provide perspective on steps to grow the organization.

Sample Organization Chart 1: GPS Technology Company



Sample Organization Chart 2: Millenery Company



Succession/Exit Strategy

Too often business owners neglect to plan for the time when they can no longer function in their business. If you were to die or become disabled, how would your business continue? A sole proprietorship, for example, automatically dissolves by law upon the death of the owner. If you are interested in preserving your business, provide in writing, for someone else to take it over, and outline the process in your will.

Regardless of whether you feel you have enough assets to write a will, having one will prove beneficial down the road. Don't wait to address the questions above until you anticipate retiring. Even though you may be young and healthy, it is important for you to train someone else to do what you do in your business. If you need to take a vacation, become ill, or just get tired and need a break, you can have someone else who knows what to do so your business can continue to operate if you are not up to it. Discuss your plan for someone else to operate your business, temporarily or permanently, with that person.

NOTE: A heading of *Exit Strategy* is often included in a business plan. It is often merged into the succession section. The exit strategy should detail how you will eventually exit the business. Will you sell it? Will you pass it on to an heir? Do you intend to go public and sell stock to grow the business (this is rare)? Or will you just retire and continue to own the business? If the last is your intention, consider the ramifications in your estate planning. Discuss your intentions.

SWOT- Strengths, Weaknesses, Opportunities And Threats

In this section, list the traits as well as the strategies you intend to use to improve on the strengths and weaknesses. Discuss how you will use the skills and knowledge of others to supplement your weaknesses and balance your strengths. Speak to the opportunities and threats you see for yourself and your business. How will you deal with them?

Industry Data and Competition

Here is the place to detail the information that you should have gathered about your industry. Discuss the following six points of your industry:

- Its size and nature
- Competition, identify your direct competitors specifically, and your knowledge of them
- Growth prospects

- Structure (suppliers, costs, distribution)
- Market trends and developments
- Impact of technology

You should be aware of how these different areas will affect your business. Research your industry and very importantly, your competition.

Market Information

Include here the results of your market research. Who is your target market? What is your demographic niche? What market surveys have you conducted to substantiate your target market? Once you have identified who is likely to purchase your product or service, detail your marketing strategies to reach them. Remember, you should have at least three strategies in play at any given time, and change those in use on a regular basis.

Marketing Budget

It is advisable to develop a budget for your marketing expenses. In order to do this, you must be aware of your total expenses and how much income is anticipated for your business. Once you have completed your financial projections, you will know how much you can spend on marketing. Don't just guess how much to spend; base it on research, which can help you figure out approximately how much it will cost to make a sale.

After you absorb the information in the following pages about marketing ideas, begin compiling a list of marketing techniques, at least – 15 to 20 – that will work for your target market and your service or product. Figure out your monthly allowance for marketing. Create a large workspace by placing a large sheet of butcher paper or sketch paper on a wall. If no clear wall is available, use the floor or a large surface item such as a desk or work table. The general idea is to have a workspace which enables you to step back and see the big picture. This will allow you to visualize the techniques and see better how the marketing strategies will come together. It will also allow you to cross out items and start over if you need to.

You will need some markers, but be careful that they don't bleed through the paper and stain the walls or flooring! Once you have everything assembled, begin by listing all the choices down the left side of the worksheet or banner. Next, draw 12 columns and label them with the months of the year, starting with the month you expect to start your business. At the top of each column, next to the month, show the amount budgeted for marketing during that month. Now you are ready to start distributing the marketing techniques into each column. Guidelines to follow:

- Use three to five methods per month.
- Never use the same one (other than business cards) for more than three months consecutively.
- Rotate strategies (at least one of them) each month.
- Don't use a strategy for at least three months, once you change it the first time.

An exception to these guidelines: if you are targeting a new or different market, you can use techniques that would otherwise be in a "dormant" phase.

The cost of techniques used in any given month must fit into the organization's overall budget for that month. Determine the action plan for using each strategy. How many people can be reached by it? How effective will the strategy be? What are the measures of effectiveness? Incorporate the marketing budget into your overall projections and list the strategies in the business plan. Refer to the strategies often to make sure you are using them properly. Make adjustments as necessary to maximize effectiveness and profitability.

Product/Service Information

This section allows you to detail what makes your product, service or approach different from that of your competitors. There are only three things that you can do in marketing to make an impression. You can be the best, you can be number one, or you can be different. While it is very difficult to be number one or the best in anything, it is not as difficult to be different. If you choose to be different, first find the niche and then determine what strategies are required to provide the goods or services that are different. Looking for sound opportunities to be different will work to your advantage.

In this section of the business plan, discuss how the business will be managed and why. How will your business methods serve your clients? Discuss how you plan to assess your performance. How will you effect change to address evolving market conditions?

Discuss the economic benefits to your customers. How will you maximize service and/or product quality? How will customers receive your information or products?

Fee/Price Structure

Discuss the pricing structure, reasoning behind it, and how you will go about making adjustments to prices or fees.

Credit Policy

In this section, outline your credit policy, if you plan to have one, with all of the conditions for credit. For example, your return policy, late fees, and interest rate determinants.

Sales Strategies

This is the place to outline, step-by-step, the strategies that will accomplish your goals. Break your goals into manageable segments, and discuss how you will achieve your objectives. How do you plan to measure progress toward goals? Also, discuss any in-house sales support. If a client has a problem beyond the scope of customer service, do you plan any kind of outside technical support to help him or her better understand product instruction? Will you need to spend money to develop a proposal before any service or product is actually sold? Will there be any other pre-sale costs?

Manufacturing Considerations

If you plan to manufacture a product, begin this section of the plan by discussing the type and amount of equipment, layout, and tooling you will need. Layout is critical in terms of being efficient and cost-effective. If you minimize movement in completing a task you will minimize your costs. List production information, such as any manufacturing limitations. Here, for example, you would discuss the fact that your equipment might not be as modern as your competition's, lessening your output in relative terms. Outline any plans to improve/replace your equipment over time.

Discuss in detail your work schedule. Are there second and third shifts? Who handles packaging and how? Discuss who will be responsible for shipping and handling, and whether it will be done in-house or by an outside contractor. Also, detail how you plan to handle inspection systems and quality control. How will you make sure production is done right? How will you factor in mistakes?

If you contract out your production, make sure the job gets done without wasted materials, time, and money. Plan to have a quality control person in the plant monitoring your production. By the same measure, if you manufacture your own product, quality control should be one of your greatest concerns. It is one of the easiest ways to keep costs down. It is usually worthwhile to hire a good quality control person to ensure maximum efficiency and cost-effectiveness.

Detail inventory requirements in this section. How much inventory will you need to maintain at any given time and under changing conditions? Keeping inventory and maintaining

inventory records is as simple or as complex as the particular system you put in place. Discuss the system you will use.

Retail Operation

If yours is a retail business, discuss purchasing and inventory budgets here, including how you will handle inventory control. Is it done through a computerized cash register, another computerized system, or manually? What is your open-to-buy policy? Will purchases be based on a set annual budget or on sales? Describe the system here as well as any other purchasing strategies.

Also discuss your strategy for handling theft and pilferage: security systems, alarms, monitors, cameras, policy for handling employee theft, and any others. Include a discussion of the store itself, such as new and existing fixtures. Detail how your space will change once your business grows, as well as your plans for products that do not sell within a certain time. Most retail operations operate on the basis of revenues generated per square foot of space (making optimal use of every inch). Will you use such a strategy in operating your business?

Operational Systems Design

In this section, discuss the different internal systems you will use to handle day-to-day situations in the business. What kind of forms will you need to maintain good records or to generate reports? How will your informational and record-keeping systems function? What policies and procedures will you put in place? What operational controls will be used?

Controlling how work gets done is vital. Ask yourself what kind of controls you will implement to make sure employees complete work in a timely way. Include yourself in this discussion. Will you have summary reports to indicate work completed on a weekly or a monthly basis? Will you discuss and evaluate the results of goals on a regular basis? How will you institute these controls?

Pro Forma

Examples of the financial statements are included in the *Finance* section beginning on page 24. This is where you project income and expenses, cash flow, and other financial indicators. (If you have been in business for a while, you will need to include the financial history of your business, including start-up costs, financial reports for the time you have been in business, and when you broke even.) Include your start-up budget and plans for an expansion budget separate from the operating budget. If you are currently in business, discuss the financial situation of the business.

Financial Projections

There are plenty of computer spreadsheet programs for doing financial projections. If you do not have a computer, it is a worthwhile purchase, as it will increase your efficiency significantly. Format your computer spreadsheet so that you have 14 columns. The left column is for the line items, then a column for each of the 12 months, and a column on the far right for totals. You can also do projections manually with 13-column accounting paper, which can be purchased at office supply stores. An accountant can help you devise the system that works best for you and can teach you how to do it on your own.

Financial projections should be prepared for at least three years into the future. The first year should be monthly projections, the second and third years quarterly. In projecting income, decide how much you want to earn monthly. You can arrive at these figures in several different ways. One is to estimate your monthly earnings based on the amount of work/sales you expect the amounts spent on marketing. You can also set a goal of annual earnings. Take it through the SMART goal model to make sure it is within your grasp and capacity. Then divide it into monthly segments keeping in mind variations in expenses and

any seasonal or other factors that will impact revenue. When projecting, it is important to realize that not all months will be the same.

It usually takes time for a new business to realize healthy cash income, except in rare instances. Expect to start off slowly. Always project low for income and high for expenses. Be realistic. Put your goals in proper perspective.

For your own benefit, break down the different ways you plan to derive business income. For example, you may have a service that you provide, but you may also sell a product. If you are a service technician who services computers, you may also sell computers or software. Break down the two different sources of income, from service and from sales. Although there are fixed and variable expenses, it is not necessary to break expenses down into these categories. Instead, your accountant can discuss GAAP (Generally Acceptable Accounting Principles) with you. GAAP is published by the Financial Accounting Standard's Board (FASB, a private entity), and is the basic business standard for all accounting. Correlate your financial projections to the goals you have set, principally projected earnings over the three year period. Once you have completed the financial projections, prepare a narrative outlining your thought process.

Cash Flow Analysis

Once you have completed your financial projections, you should prepare a cash flow analysis. The cash flow analysis plots income and expenses according to when they are expected to occur. For example, you make a sale in January, yet because of your client's payment system, you know that you will not receive any income from this project for two months. So while you earned it in January, on the cash flow analysis it appears in March. Similarly, a phone bill received in January, may not be paid until February, and that is where the payment should appear. By plotting income and expenses into the correct months, you gain a sense of how your money will flow.

Job Descriptions

To avoid feeling overwhelmed by all the tasks that must be completed to operate a business effectively, all business owners should complete job descriptions for each position in the business. Even if the owner performs a number of the jobs, each job should have a description to ensure awareness of what roles are required to make the business work effectively. Once developed, complete with the duties, responsibilities, qualifications, title, and any other pertinent information about that job, and as funds are available to hire someone, the job descriptions become the guide for finding the right people.

Having specific job descriptions will give the business owner a better sense of what human resources the business needs to succeed. Without them, work responsibilities will not be clearly defined, and that may lead to unrealistic expectations of employees.

Management Objectives

Managing a business requires the owner to be able to break down that business into parts and understand how to manage each part based on its needs. As a parent must understand each of his or her children individually, so must a business owner be able to understand what the different aspects of the business are and the needs associated with each. Add people to that mix, and challenges emerge. Skillful managers do not control people per se, but create an environment where employees can be creative, productive, and effective, addressing conflicts as they arise according to established policies.

A successful enterprise must have policies, guidelines, procedures and overall systems in place to deal with circumstances as they arise, including discussion of specific responsibilities of individuals. These guidelines must be consistent with the management objectives and organizational goals. It is important to remember that different departments will ultimately have different objectives. An astute owner will communicate with all managers

and understand the personal objectives of each. Procedures and guidelines should include methods to measure progress toward goals and objectives.

Organization Chart

An organization chart is a tool that allows one to visualize the structure of a business. It should be prepared in a manner to indicate future growth, and included as an integral part of the business plan.

Tracking Data (For Making Management Decisions)

Keeping records must involve more than financial information; records should provide enough information to make informed management decisions. Maintaining enough information (systematically) will enable one to: readily develop profiles of current and prospective customers/clients; understand average purchases made; understand where (geographically) customers/clients are drawn from; potentially glean from demographic information why someone chooses to purchase your product or service.

This kind of information can only be gathered, and useful, if procedures are followed routinely. These procedures can be as simple or as complex as desired. For example, if a worker is instructed to ask the question, "How did you decide to call/visit us today?" or "How did you hear about us?" Then that data can be used to help determine where to spend marketing dollars. Tracking systems allow you to be in control of the business, and to make decisions based on supporting data rather than conjecture.

Surveys are another way to compile data for analysis. Occasionally, surveys should be taken of current and prospective customers/clients to determine certain facts such as:

- On what product or service (of yours) do customers/clients spend the most money?
- What is their average income level?
- Where do they live (general area, how far do they travel to purchase from you)?
- What is their ethnicity?
- In what age group are they?
- What do they like or dislike about your product or service?

Surveys can be used in a variety of ways to accomplish different things. Use them to check your thoughts about what people like or dislike about what you offer, to see if opinions have shifted, or if the consumer has changed in some way that would affect what is being sold. In other words, what can you learn from a consumer that will help you be more in tune with that consumer and, ultimately, make your business more profitable?

KNOWING WHAT BUSINESS YOU ARE IN

While the grammar is incorrect, the question is well put! Too often a business owner will try and take on several businesses to eventually deliver a product or service to the consumer, without understanding the ramifications that exist.

For example: *Susie Jones creates a variety of delicious jams and jellies from a family recipe. She decides to market the products and begins to produce the jams and jellies from her home kitchen, which has been modified to accommodate the production. Susie is also approaching companies, restaurants, catalogs and other potential distribution sources to sell the products. She has done her research to create the labels and has secured jars to package the product so that it looks good. Business is starting to pick up, so Susie is preparing to set up production in a larger facility that she will rent. She proceeds to seek a loan to assist in the purchase of equipment to mass produce the products.*

Susie doesn't realize what business she is in – Is it creating products, producing and marketing them, or is it fulfilling orders? You cannot serve two (or more) masters. Chances are Susie knows little about either of the businesses other than production, and may not

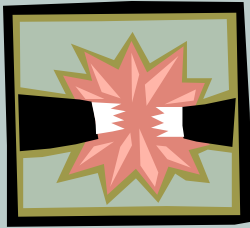
know much about mass production at all. Experienced business person or not, managing the production and marketing of products is a massive responsibility that few do well. Susie should probably focus on creating the recipes and making sure the packaging is all it needs to be. She should find a contractor to produce the product, because the cost and complexity of a production operation makes success unlikely. To justify the cost, the production equipment would have to run continually, and sales would not require that for some time. More important is the fact that Susie would dilute her energy and time trying to handle all aspects of producing and marketing her jams and jellies. She would be well advised to have distributors market her products and find several major accounts in addition to the distributors, such as chain grocery stores or gourmet shops, to stock the products. At that point, Susie should look to create new products while still promoting existing ones. Fulfillment could be handled either by the contractor that produces the product or a warehouse equipped to handle fulfillment, under a contractual agreement.

The answer to the question: what business is Susie in? Her business is the development and marketing of jams and jellies.

Even when you are focused on one business, there can sometimes be confusion about what business you are in. In his book, *Rich Dad, Poor Dad*, Robert Kiyosaki talks about a friend who had a discussion with Ray Kroc, the founder of McDonald's. Mr. Kroc had asked the group of college students what business they thought he was in. Of course they answered the hamburger business. But Mr. Kroc informed them that more accurately, he was in the real estate business. McDonald's franchises are only established in prime locations.

REFERENCES

The business plan information is excerpted from *The Business Planning Guide*, copyrighted by Gerri Norington, 1998.



MARKETING

Marketing is the function that drives any business, from a start-up venture to an established business. Before a business can even exist, the owner must determine what will be sold, to whom, how often, at what price, on what terms, and how to deliver the product or service to the customer. Other factors such as location, the public image of the business and its owner, advertising, promotion, and customer service are also part of what is known as the “marketing mix.”

Simply put, marketing is the dissemination of information about a product or service with the expectation that someone will want to purchase it. To be effective, the business owner must research the six aspects mentioned above, and tailor the marketing program accordingly. It should be noted that marketing is but one aspect of generating revenue, sales is the other necessary part. All the marketing in the world will only produce a fraction of the possible revenues; sales strategies must be used to capture more. Most of us are uncomfortable “asking for the sale.” Getting in touch with your comfort level and learning to function outside of it, will better prepare you to operate a profitable business.

COMMON MARKETING TERMS

Advertising - a marketing strategy, using the purchase of space/time through some media (print or electronic for example) to visually and/or audibly let the selected audience know about a product or service. (Micro businesses usually cannot afford advertising; to be effective it must be used over a wide spectrum of media for extended periods of time, making it expensive if done correctly.)

Channels of Distribution - progressive methods used to deliver a product or service into the hands of the ultimate user; wholesalers, retailers, mass merchandisers, outlet stores, distributors, agents and dealers are examples of distribution channels. Food purchased in a grocery store has usually gone through one or more of the following channels: producer to shipper to distribution center/warehouse; or purveyor/wholesaler to retailer to consumer.

Competition - companies in the same industry who offer the same or similar products or services. It is imperative to understand as much as possible about the competition to determine how to distinguish one's business from competitors. Market, pricing, customer base, and service are a few of the important details to learn.

Competitive analysis - a detailed examination of direct or indirect competitors. This provides an opportunity to identify ways to gain by e.g., offering a superior product, better customer service, value, or pricing, when feasible.

Direct competition - companies that compete for the same market (available revenues, same geographic area) by selling the same or similar products or services.

Indirect competition - companies that exist in the same industry, but offer different products or services to the same market, or companies that offer the same or similar products or services, but in a different geographic area.

Demographics - statistical measures that describe various and relative aspects of a human population, including ethnicity, age, income, gender, household size, geographic area, education, and employment.

Psychographics - the attitudes, opinions, perceived needs, and beliefs that determine the customer's buying behavior. Relying solely on demographics can lead to misidentifying who will actually purchase a product or service. The field of study considers lifestyle, including relative human/ethnic characteristics such as outgoing versus withdrawn, or confident and willing to try new things, versus risk-averse. These factors help to determine target markets for a product or service more accurately.

Feasibility Study - research used to determine whether your product or service is viable and has the potential to generate profit. Pertinent aspects of the study should include: who will buy, how much they will pay, how far will they travel to get it, where the target group lives, and what is particularly appealing about the product or service. Some methods include surveys, focus groups, questionnaires, product sampling, and test marketing.

Market Research - the vehicle used for gathering information that serves as the foundation for the marketing plan. The research may include demographics, psychographics, feasibility, competitive analysis, pricing, and other pertinent information needed to reach business decisions pertaining to marketing.

Market Trends - understanding what is happening in the marketplace, what changes in buying habits are currently generating revenue in the industry. To stay abreast of the trends, and remain competitive, a business may often need to reposition, reprice, or otherwise adjust product or service characteristics.

Marketing Plan - a detailed document that discusses all aspects of marketing for a service, product, or company, including budget, advertising strategies, target market, pricing structure, financial projections (income, expenses, and cash flow analysis), and objectives.

Niche Marketing - a narrow group of consumers may be particularly attracted to a product or service because it fits their lifestyle or needs. Knowing the characteristics of a niche allows the business to focus marketing efforts and to cater a product or service specifically to this profile. Examples include court reporting services, manufacturers of specialized components such as swimming pool tiles, or certain automotive parts.

Promotion - an inducement that may not be part of a general marketing strategy to accomplish one of four primary objectives: provide incentive to purchase (e.g. coupons), reward the customer (e.g. rebates), build good will with the customer (free samples, etc.), or support the advertising message.

Sales - the exchange of goods or service for something of value, usually money. Sales are the source of income for most businesses. Often business owners believe that if they market their product or service, sales will result. Sales comprise the back end of the marketing effort, but a skilled sales staff/person is critical to achieving and growing revenue. A business owner must ask for the sale and consider any interactions that potentially lead to closing the sale as an opportunity to do so.

Target Market - a specific group of customers defined by similar characteristics or needs to which a business directs its advertising and sales efforts.

KEY CONSIDERATIONS

Develop a Marketing Plan

A marketing plan is a well-concieved document that details the following aspects of a company's process for disseminating information about a product or service:

- Feasibility study (includes market research)
- Description of the intended market: who they are, what motivates them to buy, what they will pay, how far they will travel to purchase, demographics and psychographics
- Consumer trends
- Industry profile
 - Size and nature
 - Competition
 - Competitive analysis
 - Growth prospects
 - Structure, suppliers, cost, and distribution
 - Impact of technology
- Discussion of product or service, listing features and benefits

- Spending budget (should cover a year of marketing, sales, customer support, overhead, and demonstrate the income needed to make a profit).
- Strategies should number at least 12 to 24 for the year, alternating methods after two to three months of use. There should be at least three methods in play at any given time – business cards, brochures, and marketing letter, for example – and as many as seven to be effective.

Micro businesses have a greater marketing challenge. Most micro businesses (made up of five or less workers, including the owner) cannot afford to advertise effectively. To be effective, advertising must be repeated over an extended period of time using several media. Therefore, it is incumbent upon the micro business owner to find creative, inexpensive ways to let the target market know what his or her company has to offer. Forever focused on profitability, the micro business owner must be conscious of the “cost” and return of everything pertinent to the growth of the business. Supplies, materials, cost of labor, number of workers required, overhead expenses, distribution channels and all other factors must be researched carefully to determine efficiency and cost effectiveness. Pricing is a key factor in the success of any business, especially the microenterprise.

Elements of Pricing

Intelligent pricing is based on a knowledge of both the total cost to provide a product or service and the prices of the direct competitors of the business. All costs of the business, however minute, must be included in the pricing analysis, and must be projected to support the level of sales forecasted in the business plan. A reasonable allowance for contingencies should be made, since forecasting is not a science.

Following is a checklist of expenses to consider, in addition to the direct costs of materials or products purchased for resale:

- | | |
|--|--|
| • owner's draw | • employee/contractor pay |
| • payroll taxes | • rent |
| • utilities | • phone, fax, DSL, cell, pagers |
| • office expenses | • supplies, office, materials (raw) or other |
| • postage/freight/shipping | • auto expenses |
| • travel, entertainment | • insurance (health, liability, workers' comp, etc.) |
| • distribution costs | • licenses, permits |
| • professional fees | • marketing expenses |
| • dues, subscriptions | • equipment (pro-rated for one month) |
| • loan payment | • contingency |
| • furniture (pro-rated for one month) | • any other pertinent expense |
| • profit (based on industry standards) | |

Also obtain prices of all the direct competition, which means those whose products or services are available to the target market of the business. If these prices result in a loss at the level of sales that the business expects to achieve, then this is not a viable business opportunity. The best tool for evaluating pricing is the cash flow analysis of sales, fixed, and variable costs can be found on pages 24 to 28. This applies to all types of businesses.

For service businesses. There are many types of service businesses in this growing sector. The least complicated are knowledge-based service providers such as lawyers, accountants, and consultants of various kinds that bill clients by the hour. In this case the hourly rate (or rates if there are staff at different skill levels) must cover all the overhead expenses as well as the planned compensation for the owner(s) and staff. The result of this analysis should be compared with the rates of perceived competitors for reasonableness. If pricing proves to be high in relation to competitors, the business can seek a less costly location or reduce other expenses to bring pricing more in line with that of the competition.

Other types of businesses in this growing service sector include contract couriers, carriers of goods, specialized human transport, real estate, insurance and other brokers, travel agencies, automobile and many other types of repair businesses, salons and spas. These varied business are compensated for their services (as well as related products in some cases) in many different ways. Prices in these businesses are developed in the manner outlined at the beginning of this section, employing the cash flow method. It is important to identify in the financial projections the different services or products offered, so that the prices and related costs are constructed at the lowest level of detail possible.

For retail businesses. Here the largest cost for the business is usually the purchase of the products to be sold. In the CASH FLOW and INCOME STATEMENTS this is commonly called the “cost of goods sold” or the “cost of sales”. This total, when subtracted from total sales, becomes the “gross profit” before all other expenses. Most retailers sell a variety of products with different costs, and compute prices for each by adding a margin expressed as a percent of the purchase cost sufficient to cover all other expenses, plus a salary and/or profit for the owner(s). Thus it is very important to have valid quotes at various quantities on all planned products from selected sources. The expense analysis will help determine the margin needed to cover operating expenses and make a profit at a given level of sales, as determined by the cash flow analysis. (See pages 25, 27, and 33 in the FINANCE section). Retailers consider other factors in pricing. A retailer positioned as high-end can charge above market prices if the target market values superior service and atmosphere over price. A low-end retailer competes on price and caters to lower-income, more practical consumers. Retailers who price at market compete on other factors, such as store location, hours, product line, and payment methods.

For a wholesale/distribution businesses. For wholesalers/distributors the pricing principle remains the same: do an analysis of costs at projected levels of unit sales at prices competitive at the wholesale/distributor level, using the cash flow format.

For a product/manufacturing businesses. Determining the cost to manufacture a product in a multi-product business is the most complex, and requires the assistance of an accountant with job cost accounting experience. This cost analysis takes into consideration all materials and labor required to produce a given product, then adds a margin for overhead expenses and profit on a basis proportional to the direct cost, or cost of sales.

SMART Goal Setting

To be successful in marketing there must be a plan, and with any plan there must be goals and objectives. SMART is an acronym for Specific, Measurable/Manageable, Attainable, Realistic, and Time-sensitive.

Goals are generally more achievable if they are SMART. Each goal should have objectives, tasks, and timelines for completion. Break the goal down into manageable parts, and determine the measures of progress. If progress is not achieved in the prescribed time line, reassess the goal and make adjustments, then try again. Goals should always be flexible to accommodate changing situations. The business owner must be willing to put aside a goal temporarily if he or she is not capable of making it happen. “Capable” means physically, financially, and emotionally prepared to execute the business plan.

Consistency

One of the most important rules about marketing is that it must be consistent in order to generate consistent revenues. At least three to five marketing methods must be in play at any given time to be consistent. Too often the small and micro business owner markets only when business is slow. When business is good, the energy of the business is focused on producing the service or product of the business without regard for what will happen once the “rush” is over. In reality, some form of marketing must be ongoing to keep the business name and image in front of the target market at all times. By so doing, revenues will be

more consistent. Lack of funds should never be a reason for not marketing, nor should being too busy, or having an excess of business. Be sure to budget for marketing on a monthly basis, and use the allocated funds for that purpose.

Creative marketing methods

Small and micro business owners must find creative ways to let the target market know about the products or services they offer. Following is a list of marketing techniques proven to be cost effective:

- business cards/letterhead
- catalog sheets
- banners, posters
- internet, website, links, E-mailings
- event sponsorship
- speeches, presentations
- yellow pages
- flyers
- billboards
- brochures
- point-of-purchase displays, tags, headers
- customer evaluations
- networking, business gatherings
- exhibits, display table at events
- press releases, tv-radio guest appearance
- classes, workshops, seminars, articles
- postcards/letters
- MBE/WBE/DBE Certification

REFERENCES

Evans, Joel R. and Barry Boman. *Pricing and Small Retailers: Questions to Consider*. New York, NY: Hofstra University, 2002.

ACCOUNTING

Accounting is an important discipline, or structured body of knowledge, that provides a commonly accepted way of quantifying, or measuring in numbers, the economic activities of a business enterprise. Without it the management, evaluation, and compliance with the legal responsibilities of a business would be impossible. Neither you as a counselor nor entrepreneurs you counsel need to become accountants, but one of the most important responsibilities of a counselor is to **link entrepreneurs that do not have good accountants to one (preferably a CPA) that you know.**



RECORD KEEPING

It is vital that entrepreneurs understand the basic language and concepts of this subject and **understand how to keep the records** that provide the following essential information:

- Sales or other forms of income
- Costs that go into the product or service
- All other expenses incurred in the business
- What the business is owed, and what it owes to others
- Bank balance, cash flow, and what is available to spend
- Inventory status of materials, parts, and/or finished products
- Sales, income, payroll, and other taxes due the city, state, and IRS

Records of this information permit an accountant to construct the financial reports of the business, primarily the **Income Statement** and the **Balance Sheet**, that are important to understanding the profitability of the business, pricing, computing taxes owed, and obtaining credit from suppliers and lenders. These subjects will be covered in more depth in the following section on *Finance*.

There are two generally accepted methods of accounting: the **cash** or **accrual basis**, but only one may be chosen for each business, and any change must be approved by the IRS. **Cash accounting** recognizes only cash (including checks and credit cards) received or paid out, when no accounts receivable or payable, or inventory exist. **Accrual accounting** recognizes income earned but not received, and expenses incurred but not paid for, when accounts receivable and payable do exist. The accrual basis must be used by businesses with product-related inventory that is not “turned-over” (bought and sold) in the same accounting period, usually one month. The purpose of accrual accounting and the related subject of depreciation are discussed in the section on accounting objectives.

Cash accounting - is used primarily by smaller businesses and service enterprises that collect payment at time of sale or service, purchase little from suppliers on credit, have little inventory with rapid turnover, and buy and sell at reasonably constant prices. Technically, a “modified cash basis” is often elected by such firms, allowing them to depreciate assets, if significant. **Accrual accounting** is used by almost all other businesses, in order to **accurately match revenues with costs and expenses.**

Record keeping - the foundation of a good accounting system, whether manual or computer-based. It begins with a **business bank account** and the source documents that record all the physical and monetary transactions of the business. These source documents must be prepared or obtained and recorded in an organized way, then summarized on a regular basis: daily, weekly, or monthly. The business owner is responsible for the completeness and accuracy of the source documents, and the extent to which the business records and summarizes the information will affect the timeliness of reports and the cost of professional accounting. **It is vital that source documents of all transactions reflecting income to, or the expenses of, a business be kept and recorded.** The IRS requires receipts for all expenses over \$25, and the omission of any expenses will increase the taxes of a profitable business. Questionable business expenses should be reviewed with an accountant. Everything possible should be paid by check, or an electronic document,

including employee wages, since a cancelled check provides proof of payment, and credit card interest is costly. **Unreported income is a serious, and sometimes a criminal, offense.** The federal and most state governments assess **both interest and financial penalties** for late tax payments.

Source documents - the basis of business accounting, reporting, and tax filing. They include all records of financial transactions, such as:

- Cash register tapes, which can be programmed to record significant sales categories as well as compute applicable sales taxes.
- Bank checks, check stubs, deposit slips, and statements
- Invoices, and payments received against them
- purchase orders, and payments made against them
- Receipts and withdrawals from inventory (if inventory records are necessary)
- Receipts for any expenses related to the business, such as vehicle fuel and maintenance, if paid by cash or credit card.

Following is an outline of the record-keeping process and the bookkeeping required.

Business bank account - An important rule is to **keep personal and business finances separate**. This begins with a separate bank checking account for the business, in which all business income should be deposited, and from which all expenses should be paid, if possible. If a credit card is used, it should be a separate one for the business. The bank account should be established before the business opens, in order to provide a better record of all start-up expenses. Never use it for personal expenses. The owner should use a check for “cash” only for a personal draw. The account should be balanced monthly upon receipt of the bank statement. The payee/purpose of each check must be noted on the check stub provided in the bank account binder. Unless the entrepreneur has accounting experience, the bookkeeping system should be established with the assistance of a trained accountant.

The system consists of accounts for recording and periodically summarizing the source documents and providing the information described at the beginning of this section. It may be manually or electronically based, depending on the number of transactions and complexity of the business. A choice must be made between the two record keeping methods employed: **single-entry** or **double-entry** systems.

For small start-up businesses selecting the cash basis described above the single-entry system may be adequate. It is based on (1) a daily summary of cash receipts and (2) monthly summaries of cash receipts and disbursements, which are then posted to the accounts necessary to construct the accounting statements. For all other businesses, the double-entry system is recommended, since it provides a method of checking the accuracy of records. If posted daily or weekly either system can provide the owner with the financial information to manage the business well.

Both systems need a **chart of accounts**. This is a list of the categories are needed to manage the business, prepare financial statements, and make tax payments, which will vary with the type of business involved: service, retail, wholesale/distribution, or manufacturing. Each account is assigned a name and number, and is identified with each entry made. The principal documents involved in the double-entry system are as follows:

Journal - A journal is the most basic accounting document, and is simply a written record of business transactions, with entries made in the order in which they occur from the source documents described above. A journal entry **debits** or **credits** (on the left side and right side respectively) the applicable accounts that are basic to double-entry bookkeeping. Double-entry bookkeeping requires that for each account debited another must be credited for an equal amount. This system allows for a check on the accuracy of the accounting records by periodically totaling them to determine if the debits and credits balance – a process called **“balancing the books”**. If this is not done, a review of the entries made since the last balancing will reveal the error

or errors. Journals are typically established for cash receipts, cash disbursements, payroll, the accounts payable or purchase journal, and accounts receivable (if the business operates on the accrual basis, and invoices and purchase orders are used). An example of a journal entry for payment of a month's rent:

Date	Description of Entry	Debit	Credit
Jan 1	Rent Expense	950.00	
	Cash		950.00

Ledger - A ledger details income and expenses for each established account. It is “posted” from the appropriate journals, and provides the entrepreneur important information regarding sales, costs, and cash flow as frequently as required, but only if the posting is up-to-date.

The general ledger - Only one general ledger is established for each business. It contains all the accounts of the business and is posted monthly from the subledger account totals. All the basic financial statements are prepared from the general ledger. With the assistance of an accountant, a part-time bookkeeper paid by the entrepreneur can be trained to do the bookkeeping just described, as well as “balance the books”, at a lower cost than a professional accountant would charge. Preparation of the statements and tax filings, however, are best left to an accountant, as well as decisions requiring experience in interpreting IRS regulations.

ACCOUNTING OBJECTIVES

The two principal accounting objectives are to accurately measure the **value** and **profitability** of the business. A third objective is to provide meaningful tools for managing the business. The first two are reflected in the **balance sheet** and the **profit and loss**, or **income statement**, mentioned at the beginning of the *Record Keeping* section. Timeliness is important for owners/shareholders, as well as creditors of a business. Accuracy depends upon properly matching revenues with expenses, usually by month, which has lead to the practice of **depreciation** and **inventory accounting**.

Depreciation - is a non-cash expense that reduces the value of a fixed asset, such as a business machine, annually, based on the expected life or usefulness of the machine to the business. In effect, depreciation recognizes the decline in value of an asset as a deductible cost to the business over time, and as the asset is used. Such assets are called **fixed** or **capital assets** because they represent a larger investment in the business that is useful over years, not consumed in the short-term. An accountant should advise which purchases are to be capitalized or expensed. Buildings, office furniture, machinery, and equipment must be depreciated, not expensed.

An example of “straight-line” depreciation:

Purchase of a commercial laser printer for \$5,000
 Expected useful life of the printer..... 5 years
 Annual depreciation.....\$1,000

There are other forms of “accelerated “ depreciation that an accountant can employ to the advantage of the taxpayer when allowed by the IRS.

Business inventory - Inventory consists of finished goods, component parts, and raw materials that will physically become a part of merchandise intended for sale. If inventories are required for the efficiency and/or marketing strategy of the business, they must be accounted for in quantity and value. This usually requires the accrual method and an acceptable way of costing inventory called FIFO or LIFO (First-In, First-Out or Last-In, First-Out). When counseling businesses of this complexity, it is essential to link owners with a CPA familiar with methods of cost accounting.

Taxes - Accurate and timely preparation and filing of taxes is an important accounting objective. It always requires the assistance of an experienced accountant to meet all legal requirements at the lowest tax cost to the taxpayer. The form and method of tax payments will vary with the legal form of a business (discussed in the *Management* section), but any business may be subject to the following taxes at the federal, state, or local levels. The applicability code employed below is: A = always, U = usually, O = occasionally, R = rarely or never.

Tax	Federal	State	Local
Income	A	U	O
Sales	R	U	U
Occupation	R	O	U
Property	R	O	U
Employment	A	U	R
Self-employment	A	U	R

The above do not include excise, utility, use, or other taxes that are incorporated in the payments to the provider of products and services consumed by the business. The above taxes are paid monthly, quarterly, or annually, depending on the nature of the business and its location. Employment taxes include federal and state withholding and remittance for business employees, principally for income, Social Security, Medicare, and unemployment. This requires the assistance of an accountant to determine applicability and establish the system for withholding, payment, and reporting of the correct taxes. They do not apply to those working for a business as “subcontractors,” who must meet certain IRS conditions for being considered subcontractors rather than payroll employees.

Accurate and timely tax filing and payment is essential for **obtaining business credit, certification for government business** as a sub or general contractor, and sometimes for licenses and permits required for business purposes. It is also essential in the **purchase or sale of a business**, which is frequently encountered when counseling entrepreneurs. As a small business counselor, you should to be able to read and understand at least the following tax forms at the federal and equivalent state levels:

Sole proprietorship:	1040, and Schedule C or C-EZ 1040, Schedule SE (self employment) Applicable state and local sales tax form(s)
Partnership or LLC:	1065, Schedule K-1 Applicable state and local sales tax form(s)
Partner in a partnership:	1040 and schedule E Others same as sole proprietor
Corporation or S Corporation:	1120 or 1120-A (corporation) 1120S (S Corporation) Applicable state and local sales tax form(s)
S Corporation shareholder:	1040 and Schedule E

All of these forms and instructions, except sales taxes, can be found on: www.irs.gov. The 2004 - 2005 tax rate schedule for business corporations is as follows, based on **taxable income** (on line 30, form 1120, or line 26, form 1120-A):

Over:	But not over:	The tax is:	Of the amount over:
\$0	\$50,000	15%	\$0
\$50,000	\$75,000	\$7,500 + 25%	\$50,000
\$75,000	\$100,000	13,750 + 34%	\$75,000
\$100,000	\$335,000	\$22,250 + 39%	\$100,000
\$335,000	\$10,000,000	\$113,900 + 34%	\$335,000

Income and employment taxes comprise most of the taxes that small businesses pay. Good accounting and tax advice can minimize the total taxes a business owner pays on both business and personal returns.

ACCOUNTING SYSTEMS

Unless entrepreneurs are computer literate and have some understanding of accounting, it is best to begin with a manual system that delivers posted source documents to an accountant for processing. Retail businesses should employ programmable cash registers capable of coding cash, check, and credit card income by product or service, and computing sales taxes when applicable.

As the transaction volume and/or complexity of a business grows, computer software programs are important to reduce the overall cost of accounting, while providing more information for managing the business. Two currently popular programs for smaller businesses are Quickbooks and Peachtree. See the references below.

REFERENCES

For recordkeeping and tax information. The best source for tax information is the IRS Web site and publications that can be downloaded or ordered in hard copy form by fax or regular mail. Comparable services are available from state government (department of revenue or treasury), which generally follow the IRS model for income and payroll taxes.

For IRS forms, instructions, and publications:

Web site: www.irs.gov (forms are in pdf format)
 Fax: (703) 368 - 9694
 Tel: (800) 829 -3676
 Useful publications: 334 Tax Guide for Small Business
 335 Business Expenses
 542 Corporations: Tax Filing
 583 Starting a Business and Keeping Records
 587 Business Use of Your Home
 5- A Employer's Supplemental Tax Guide

For state forms, instructions, and publications (in Illinois, for example):

Web sites: www.Iltax.com and www.commerce.state.il.us
 Fax: (217) 785 - 3400
 Tel: (800) 356 - 6302
 Useful publications: ST -19 Retailer's Tax Booklet
 Pub 8 Taxpayer Services and General Information
 Guide for Illinois Taxpayers (issued annually)

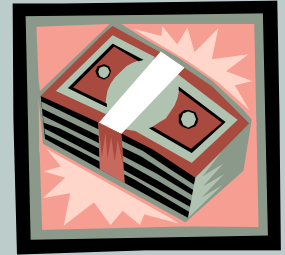
Larger municipalities also have web sites for forms, instructions, and publications relating to taxes, permits, licenses, inspections, zoning, and permitted home-based businesses. In Chicago, for example, it is: www.cityofchicago.org. The city's Small Business Assistance

Center hotline at (312) 744-CITY may be called for those seeking help in navigating the Web site or by those without access to the internet.

For business accounting software: A good site for researching accounting software is:

www.findaccountingsoftware.com. Three popular and well-supported programs are Quickbooks (www.quickbooks.com), Data Pro Accounting Software (www.dpro.com), and Peachtree (www.peachtree.com).

FINANCE



This section builds on the previous *Accounting* section, and is focused on the financial knowledge required to manage a successful business. It describes how the financial community, including lenders, investors, auditors, taxing authorities, and other businesses such as customers and suppliers, evaluate a particular business. Understanding this perspective is essential to the process of **(1) evaluating a business opportunity, (2) preparing a business plan, (3) securing financing, and (4) managing an established business. Common uses of the financial tools involved include:**

- Determining profitability (for the business and by specific product or service)
- Determining the value of a business
- Evaluating a business opportunity: including the start-up or purchase of a specific business (and the start-up cost or purchase price)
- Developing a business plan and budget
- Determining break-even point(s)
- Setting prices
- Managing cash flow
- Managing inventory
- Obtaining credit
- Determining taxes due, at the lowest legitimate level

The tools involved are employed both to capture and **present historical financial information** on a timely basis, **as well as to forecast the future** in the form of a strategic plan or budget. The remaining discussion in this section will be organized around the three principal financial documents involved: (1) cash flow statement, (2) income (or profit and loss) statement, and (3) balance sheet.

THE CASH FLOW STATEMENT

The most important financial document in the evaluation of a business opportunity, whether **a purchase, start-up, or significant expansion** of an existing business, is the cash flow statement. It quantifies (in dollars) all the important assumptions of a business plan, and thus can't be finalized until the research phase is complete. It consists of start-up or acquisition costs, followed by sales or revenues, and all the costs and expenses associated with the business. Constructed by month for one or two years, it illustrates the results of all the assumptions made and provides estimates of:

- The profitability of the business opportunity, and when it occurs (the break-even point)
- The capital (or financing) required, and when it is needed
- The ability of a borrower to repay a loan of the size required to finance the business opportunity

It is best to build the cash flow statement on a computer spreadsheet with formulas programmed to make all the calculations. This permits an analysis of changes in important assumptions, and a better understanding of the risks involved, and adjustments are easy to make with the automatic recalculation of all the affected numbers. Once established in a blank version of Table 1 at the end of this section, it can be used for all clients. It is important to note that **the cash flow statement is an analytical management tool**, and is not governed by generally accepted accounting principles as are the other two statements.

The following description applies to the **Retail Connection, Inc. Cash Flow Projection** (Table 1). It reflects a projection for the first year of a new retail business selling women's and children's clothing. When making financial projections for new or existing businesses, it is important that all significant assumptions be stated in the financial section and defended in the text of the business plan. Please refer to Table 1 in conjunction with the following discussion.

Table 1: Sample Cash Flow Projections

Retail Connection, Inc

CASH FLOW PROJECTION

	START-UP	Month 1	Month 2	Month 3	Month 4	Month 5	Month 6	Month 7	Month 8	Month 9	Month 10	Month 11	Month 12	TOTAL
Beginning Cash	15,000	21,935	15,837	11,219	6,633	4,137	3,226	4,007	6,427	9,949	14,249	20,234	27,844	
Net Sales	0	5,540	8,100	12,000	16,000	19,500	23,000	27,000	30,000	33,000	36,000	40,000	44,000	294,140
Loan proceeds	40,000	0	0	0	0	0	0	0	0	0	0	0	0	
TOTAL CASH	55,000	27,475	23,937	23,219	22,633	23,637	26,226	31,007	36,427	42,949	50,249	60,234	71,844	
Cost of Sales	15,000	2,327	3,402	5,040	6,720	8,190	9,660	11,340	12,600	13,860	15,120	16,800	18,480	123,539
Officer's salary	0	0	0	2,000	2,000	2,000	2,000	2,000	2,000	2,000	2,000	2,000	2,000	20,000
Wages	0	1,200	1,600	2,000	2,400	3,000	3,500	4,000	4,500	5,000	5,400	6,000	6,600	45,200
Payroll taxes	0	90	120	150	180	225	263	300	338	375	405	450	495	3,391
Rent	3,000	1,500	1,500	1,500	1,500	1,500	1,500	1,500	1,500	1,500	1,500	1,500	1,500	18,000
Utilities	800	556	556	556	556	556	556	700	700	700	700	700	700	7,536
Telephone	500	100	100	100	100	100	100	100	100	100	100	100	100	1,200
Maintenance	0	700	700	700	700	700	700	700	700	700	700	700	700	8,400
Security system	0	145	145	145	145	145	145	145	145	145	145	145	145	1,740
Insurance	115	115	115	115	115	115	115	115	115	115	115	115	115	1,380
Supplies	0	70	70	70	70	70	70	70	70	70	70	70	70	840
Advertising	400	1,500	1,250	1,000	750	500	250	200	200	200	200	200	200	6,450
Professional fees	800	250	150	150	150	150	150	150	150	500	150	150	150	2,250
Licenses & permits	450	125	0	0	0	0	0	0	0	0	0	0	0	125
Bank charges	0	150	150	150	150	150	150	150	200	225	150	150	150	1,925
Remodeling	5,000	0	0	0	0	0	0	0	0	0	0	0	0	0
Furniture & fixtures	4,000	0	0	0	0	0	0	0	0	0	0	0	0	0
Loan payment	0	1,810	1,810	1,810	1,810	1,810	1,810	1,810	1,810	1,810	1,810	1,810	1,810	21,720
Contingency	3,000	1,000	1,050	1,100	1,150	1,200	1,250	1,300	1,350	1,400	1,450	1,500	1,500	15,250
Total Cost/Expense	33,065	11,638	12,718	16,586	18,496	20,411	22,219	24,580	26,478	28,700	30,015	32,390	34,715	278,946
ENDING CASH	21,935	15,837	11,219	6,633	4,137	3,226	4,007	6,427	9,949	14,249	20,234	27,844	37,129	
PROFIT ON A CASH BASIS (B.T.)		-6,098	-4,618	-4,586	-2,496	-911	781	2,420	3,522	4,300	5,985	7,610	9,285	15,194

A cash flow statement begins with cash available at the outset of the project as BEGINNING CASH in the Start-Up column from owners, other investors, and credit in the form of a loan or line of credit, if necessary. From TOTAL CASH it subtracts all costs and expenses necessary to open the business, to arrive at ENDING CASH before the business begins. ENDING CASH then becomes the BEGINNING CASH for the following month. The cash flow computation continues by adding BEGINNING CASH to "Net Sales" revenue for TOTAL CASH each month, from which "Total Cost/Expense" is subtracted to determine ENDING CASH. This cycle continues through the twelve months of the first year of a business start-up, acquisition, or major expansion. A second year may be necessary, if the growth rate is slow and the cash flow is not positive by the end of one year.

The TOTAL column on the right and the PROFIT ON CASH BASIS (before taxes or B.T.) line preview what the INCOME STATEMENT will show, with certain adjustments. The TOTAL column does not include the Start-up column, only the 12-month operations of the business. Basically, the cash flow statement contains all elements that affect cash actually received or disbursed, while the income statement ignores certain cash outlays that are *not deductible* as costs or expenses in determining the accepted definition profit or net income, but includes non-cash charges that *are deductible* in determining of profit or net income. These will be noted in the detailed description of the two statements. Otherwise, they are very similar in nature.

The Construction of a Cash Flow Statement

All projections should be made at lowest level of detail based on the information obtained. Back-up schedules for the most significant revenue, cost, and expense line computations of the cash flow statement should be included with financial statements. If the opportunity is the acquisition of an existing business, the projection should begin with an analysis of the historical financial statements and/or tax returns obtained in the evaluation process. If new products, services, or markets are involved, however, the same evaluation must be done as for a new business for the impact of the new factors on projected income.

Net sales - estimated by month, is the first and often most difficult projection to make. In this case, they would be cash register receipts (cash, checks, and credit cards) less returns and adjustments, but excluding sales taxes, which are returned to state and local governments. If business revenues from other sources than product or services sold exist, they should be identified on a separate line for **other income**.

Net sales should be developed from the marketing plan investigation and strategy described in the first section of this manual, based on a defined line of products or services and the target market. In this case, it would be the specific lines of women's and children's clothing to be carried, in terms of lines, style, cost, and selling price. In the case of a restaurant, for instance, sales should be based on the number of customers per day, per tab, which vary per meal served, take-out, snack or refreshment, by the day of the week and hours of service. **Entrepreneurs tend to overestimate** both the level and growth rate of **the sales of new businesses**. The counselor's job is to review the soundness of the research, which should include the start-up experience of businesses that comprise the competition.

Cost of sales - (also called cost of goods sold) includes cost of the specific product sold; sometimes called the **direct cost** or **variable cost** which can be tangibly associated with sales. In this case, it would be the price the business paid for an article of clothing sold in that month. In a manufacturing business, it would be the total cost of all material used in the product as well as the direct labor, which is the cost of the physical labor required to make the product. Thus direct or variable costs usually vary closely with sales, unless the "product mix" changes, since profit margins on different products may vary, or special sales may occur, etc. In this case, the cost of sales averages 42 percent of net sales. The cost of sales of \$15,000 in the Start-up column reflects the initial investment in inventory that must be made before opening.

Cost of sales comes principally from knowledge of supplier prices at the sales volume projected. This is often the largest single business cost, and must be based on hard numbers from suppliers and/or competitors. Using an industry average cost of sales (or gross margin percentage) is not acceptable for a specific business plan projection.

Operating expenses - comprise most of the remaining expenses in the cash flow. They include all other **indirect** or **fixed expenses** that do not vary directly with sales, as cost of sales does. All costs and expenses, however, do not fall neatly into the direct/variable or fixed/indirect categories. Many are semi-variable, irregular, or seasonal, and must be estimated as such. For example, rent and loan payments are usually fixed, while employee wages are semi-variable if the number of employees or their hours of work vary to some extent with the sales level of the business. It is important to examine each expense individually. They cannot be accurately estimated without having identified at least one desirable location that is available for lease or purchase. The importance and expense of the business location varies widely with the type of business: professional, retail (product or service), wholesale, or manufacturing. Following are comments on some of the specific expenses:

Officer's salary (here the owner) should be what the owner needs for personal/family support, during the start-up year, but not more in order to minimize the loan required.

Wages mean the gross wages of employees on the payroll, rather than "subcontractors" not subject to payroll taxes whose wages are reported to state and federal governments on form 1099. There are IRS restrictions as to who qualifies as a subcontractor that are defined in the tax resource material cited in the prior section on *Accounting*. All others must be considered employees.

Payroll taxes are half of the total compulsory payment for government social programs that the company must pay, at the rate of 7.5 percent of gross wages. The other half are deducted from the employees' gross wages.

Professional fees are primarily legal and accounting, for incorporating the business, setting up the accounting system, and providing the financial reports and tax returns as needed.

Loan payment is an assumption based on the amount, term, and risk as reflected in the interest rate. In this case the monthly payment is based on a loan of \$40,000 at 8 percent for a term of two years. Of the total payment of \$21,720 for the first year, \$19,210 is return of principal, and \$2,510 is interest.

Contingency is not always included, but since unforeseen expenses inevitably arise, it suggests a conservative plan, which lenders and investors prefer.

Ending cash - was explained above. It is TOTAL CASH – Total Cost/Expense in each column.

Profit on a cash basis (B.T.) - an estimate of "profit" before income taxes, is not always part of the cash flow statement, but it provides the entrepreneur and prospective lenders or investors an estimate of when the business breaks even on a cash basis. This is the point at which sales or total revenues exceed cash expenses, and the cash flow shifts from negative to positive. In this case, it occurs between month five and month six, or about the end of month 5. At this point the decline of ENDING CASH ends, and it begins to rise in month 6. A formula for calculating the break-even point will follow in this section.

The major difference in this case between the profit on a cash basis and that which will be shown on the income statement (which reflects the accepted accounting method for determining taxable income) is the return-of-principal portion of the loan repayment, totaling \$19,210. Repayment of capital is not considered a business expense, although the interest of \$2,510 on it is. A second difference is depreciation, defined in the *Accounting* section as the non-cash recognition of the decline in value of capital assets, whose life (or value to the business) is longer than one year. Depreciation is a business expense, and therefore found in the *Income Statement*. Both are related to the accounting distinction between capitalized

and expensed items in determining income. In more complex businesses, there are many other non-cash accounting adjustments to income, such as reserves for future liabilities, or charges, called write-offs, for inventory shortages and other unreported losses.

THE INCOME STATEMENT

The INCOME STATEMENT is designed to portray the profitability of a business, in accordance with generally accepted accounting principles over a specified period of time, preferably monthly. It is the basis for determining income tax liability. Although the concept and form of this statement is the same for all businesses, its complexity varies significantly with the type of business. Simple businesses include consultants and other professionals who sell their knowledge based on time expended in analyzing and presenting information of benefit to a client, or a one-product company that purchases it ready to sell, and markets it to the consumer. Manufacturing businesses are most complex, particularly when fully integrated (converting raw materials into finished products and marketing them to the final consumer).

The three key components that all income statements contain are: (1) sales or revenues, (2) costs, and (3) expenses, which are the factors that determine profit. Unfortunately, these terms, as well as some others in accounting, do not contain a precise definition, even among accountants, when used out of context. Here terms will be defined in the discussion of the three statements, as well as in the glossary at the end of this section. Here "income" will mean profit, not sales or other revenues; "costs" are a part of the physical product or service provided, often called direct costs, while "expenses" are all other (indirect) charges incurred by a business.

The following description applies to the **Retail Connection, Inc. Income Statement** in Table 2 at end of this section. It reflects a projection for the first two years of the company. Only the elements not described in the prior discussion of the cash flow statement are addressed here:

- Gross sales** – cash register receipts (including credit card charges) that comprise bank deposits.
- Returns and adjustments** – accepted returns and adjustments of any kind that affect sales income.
- Net sales** – (defined in the cash flow analysis) are considered the base for comparing other income statement numbers to, as in the column beginning with net sales at 100 percent.
- Gross profit** – the result of subtracting the cost of goods sold from net sales. it measures profit before operating expenses, taxes, and certain other charges are considered. Here it amounts to 58 percent of net sales, which is also referred to as the **gross margin**.
- Net income (B.T.)** –or profit before taxes, results from subtracting all operating expenses from the gross profit. Taxes here refer only to income taxes, not payroll or property taxes, which are operating expenses.

Since the income tax calculation is affected by the owner's personal income in the case of the three most common forms of small businesses (sole proprietorship, Sub S Corporation, and Limited Liability Corporation discussed in the *Management* section of this handbook), it is usually not included here.

A reconciliation of the first year profit before tax in the cash flow statement with the income statement is as follows:

Cash Flow	\$15,194
+ loan principal repayments	\$19,210
– depreciation	<u>\$ 1,920</u>
= Net Income (B.T.)	\$32,484

Table 2: Sample Income Statement**Retail Connection, Inc.****Income Statement**

	Year 1 \$		Year 2 \$	
GROSS SALES	295,280		433,674	
Returns and Adjustments	1,140		1,674	
NET SALES	294,140	100%	432,000	100%
COST OF SALES	123,539	42%	173,000	40%
GROSS PROFIT	170,601	58%	259,000	60%
OPERATING EXPENSES				
Officer's Salary	20,000	7%	42,000	10%
Wages	45,200	15%	64,000	15%
Payroll Taxes	3,391	1%	4,860	1%
Rent	18,000	6%	18,900	4%
Utilities	7,536	3%	8,400	2%
Telephone	1,200	0%	1,400	0%
Maintenance	8,400	3%	9,500	2%
Insurance	1,380	0%	1,500	0%
Advertising	6,450	2%	7,000	2%
Supplies	840	0%	900	0%
License	125	0%	250	0%
Bank Charges	1,925	1%	1,925	0%
Professional Fees	2,250	1%	2,000	0%
Security System	1,740	0%	1,900	0%
Depreciation	1,920	1%	2,400	1%
Interest	2,510	1%	912	0%
Contingency	15,250	5%	20,000	5%
TOTAL EXPENSES	138,117	47%	187,847	43%
NET INCOME (B.T.)	32,484	11%	71,153	16%

ASSUMPTIONS:

Depreciation is based on straight line over 5 years

Bank charges include merchant fees

Sales revenue is estimated to average \$36,000 per month in year 2

No product cost or selling price increases are assumed in year 2

A loan of \$40,000 at 8 percent for a two-year term

A 2-year lease of the retail store space for \$1,500 per month

Construction of the income statement should be performed by or under the supervision of an accountant, at least during the first year of the business. Again, the more the entrepreneur/owner understands and is willing to do, the less the assistance of the accountant is necessary. Typically, however, other demands on the owner make this difficult, and professional experience is required to ensure accuracy and compliance with the more complex rules, regulations, and tax filings involved.

Several additional important financial relationships or ratios can be drawn from the cash flow and income statements:

The **break-even point** is the point at which sales or revenues equal the total of all variable costs, or cost of sales, and the “fixed” or operating expenses. It is the point at which the business has neither a profit nor a loss; it “breaks even” when **net revenues = all costs and expenses (before taxes)**. This is calculated by **dividing the total operating expenses** for the first year by the gross **profit margin of .58** to find the annual sales level at which break-even occurs. We then divide the result by 12 to determine the monthly level of sales required to break-even. The following numbers are taken from the income statement in Table 2.

$$\begin{array}{l} \text{Total expenses: } \frac{\$138,117}{\text{Gross profit \%}} = \frac{\$238,133}{.58} = \$19,844 \text{ sales/month} \\ \text{Gross profit \%} \quad .58 \quad 12 \end{array}$$

Looking at the cash flow statement, we can see that this sales level is reached early in the sixth month.

The **inventory turnover**, which is: $\frac{\text{cost of sales}}{\text{average inventory}} = \frac{\$123,539}{\$20,000} = 6.2 \text{ turns per year}$

Assuming an average inventory of \$20,000 and a cost of sales of \$123,539 from the income statement, the inventory turned over 6.2 times in the first year. The higher the turnover, the less inventory (and thus dollars invested) must be carried to support the same level of sales. In this type of retail business, six or more turns a year is good, and reflects accurate sales forecasting by product.

The **return on investment**, which is: $\frac{\text{net income (B.T.)}}{\text{invested capital}} = \frac{\$32,484}{\$51,774} = 62.6\%$

Also referred to as **ROI**, it measures the rate of return on invested capital expressed as a percent. In this case it is the net income from the first year income statement of \$32,484, divided by the start-up costs and working capital consumed (until the break-even point) totaling \$51,774 (both these numbers are taken from the cash flow statement). This equals 62.6 percent, a high rate of return for the first year of a business.

THE BALANCE SHEET

Unlike the cash flow and income statements, the balance sheet is a picture of the “book”, or accounting, value of a business at a point in time, usually at the end of a month or fiscal year. It describes the **assets, liabilities, and net worth** of a business, also called **owner’s equity**. The net worth or owner’s equity always equals **the assets minus the liabilities**, and may be a positive or negative number. It is of particular interest to lenders or investors, since it provides additional information on the **liquidity** (the ability of a company to pay what it owes on time), as well as a measure of its value based on assets. Refer now to Table 3 at the end of this section, that shows a balance sheet for two different points in time for the **Retail Connection, Inc.**

Assets - are shown in two categories, current and fixed. Current assets are those that could be liquidated (converted to cash) with a year. Fixed assets are those that are **capitalized** (as described in the *Accounting* section), and have a life of more than one year. They are **depreciated**, or reduced in value over time, which is reflected in the balance sheet as the book value. Here there are no accounts receivable in current assets, since sales are

Table 3: Sample Balance Sheet**Retail Connection, Inc.****Balance Sheet**

ASSETS		End of 1st Six Months	End of 1st Year
Current Assets:			
	Cash	4,007	37,129
	Inventory	15,000	25,000
	Accounts Receivable	0	0
	Supplies	200	300
	Security Deposit	1,500	1,500
Total Current Assets		20,707	63,929
Fixed Assets			
	Leasehold Improvements	4,500	4,000
	Equipment	2,700	2,400
	Furniture and Fixtures	3,600	3,200
Total Fixed Assets		10,800	9,600
TOTAL ASSETS		31,507	73,529
LIABILITIES			
Current Liabilities			
	Accounts Receivable	0	0
	Lease Payments - rent	18,000	18,000
	Notes Payable - new loan	21,720	21,720
Total Current Liabilities		39,720	39,720
Long-Term Liabilities			
	Lease Payments - rent	9,000	0
	Notes Payable - new loan	10,860	0
Total Long-Term Liabilities		19,860	0
TOTAL LIABILITIES		59,580	39,720
NET WORTH/EQUITY		-28,073	33,809
TOTAL LIABILITIES AND EQUITY		31,507	73,529

made on a cash basis. Leasehold improvements reflect the capitalized cost of remodeling the leased space for a retail clothing business.

Liabilities - are also shown in two categories, current and long-term. They also are based on whether they are payable or due within one year (current), or in more than a year (long-term). Here there is no accounts payable, since required clothing and other material goods are not purchased on credit. The two contractual obligations that Retail Connection, Inc. has are a lease for the space and a bank loan to start the business. Because they are both for two-year terms, the long-term portion of each shift from the long-term to the current category in the second column, at the end of the first year.

Between the middle and the end of the first year projection the business makes a dramatic shift, from its liabilities exceeding assets by \$28,073 to assets exceeding its liabilities by \$23,809, as reflected in the NET WORTH/EQUITY. In this period, the break-even point was reached; the business became profitable and the net worth/equity became positive. By this measure, the value of a business is determined by the value of its assets minus its liabilities, which at any point in time may be positive or negative.

Three important financial relationships, or ratios, are based on the balance sheet in Table 3:

The **current ratio**:

$$\text{which} = \frac{\text{current assets}}{\text{current liabilities}} \text{ or } \frac{\$20,707}{\$39,720} = .52:1 \text{ at 6 months and } \frac{\$63,929}{\$39,720} = 1.61:1 \text{ at 1 year}$$

Thus current assets are about half the current liabilities at six months, but 1.61 x the current liabilities by the end of the first year. A 2:1 ratio of current assets to current liabilities is considered to be high liquidity.

The **quick ratio**:

$$\text{which} = \frac{\text{current assets} - \text{inventory}}{\text{current liabilities}} \text{ or } \frac{\$20,707 - \$15,000}{\$39,720} = .14:1 \text{ at 6 months, and}$$
$$\frac{\$63,929 - \$25,000}{\$39,720} = .98:1 \text{ at 1 year}$$

This is a more stringent measure of liquidity, which removes inventory from the asset value since in some industries inventory is not able to be quickly converted to cash, for which a **1:1** ratio (or higher) is considered acceptable.

The **debt to equity ratio**:

$$\text{which} = \frac{\text{total liabilities}}{\text{net worth}} \text{ or } \frac{\$59,580}{-\$28,073} = \text{N/A at 6 months and } \frac{\$39,720}{\$33,809} = 1.17:1 \text{ at 1 year}$$

Here it is not applicable at six months, since net worth is negative, but is approaching 1:1 by the end of the first year. A ratio of 1:1 (or less) is considered acceptable.

USING FINANCIAL TOOLS

The focus of this handbook is on understanding the process of evaluating a business opportunity, before committing significant financial resources to pursuing it. Whether analyzing the historical accounting records and statements of a business or making financial projections of one, it is essential to understand the sources and meaning of the numbers obtained or developed. Once this knowledge has been assimilated, it can be employed in a number of important ways, both before a business is established or acquired, as well as a tool for managing it successfully. The latter assumes that a business bank account and the necessary record-keeping system is established and statements are prepared on a timely basis, usually monthly.

Profitability - is the underlying goal of all for-profit enterprises. It must exceed the income required by the owners to support themselves, in order to finance the growth and survival of the business in a competitive environment. It is vital to estimate profitability with reasonable

accuracy before a purchase, start-up, or significant expansion, as well act to maximize it over time. An old adage is “build your business to sell it”; in other words, focus on increasing its value to others (and in the process, yourself). The income statement is the accepted tool for measuring profitability, along with any footnotes or qualifying statements that accompany it. Access to statements prepared by a CPA is important when evaluating an existing business of any size. Profitability is invariably the most important component in establishing the value of a business for sale or purchase. Prices usually range between one and five times annual net profit, depending upon the level of opportunity and risk perceived by the buyer.

Virtually all of the components of the income statement are important, in proportion to the dollars involved. What lies behind the key elements of sales, cost of sales, and operating expenses should be examined in detail as to their nature and interdependency. Understanding them is essential to becoming and remaining a profitable business.

Pricing - is an ongoing process that depends on two things: knowledge of the market described in the first section of this handbook, and the management tools discussed in this section. Pricing is clearly a major component of profitability that **must be both competitive and provide a gross profit margin** sufficient to cover operating costs and contribute to net income. To do this, both variable and semi-variable costs by product must be known or closely estimated. There is often a trade-off between price and volume that these tools can measure at various actual or assumed price and sales levels.

Cash flow management - is crucial to business survival, most frequently in the first year or two of business and during periods of rapid sales growth or volatility. Monitoring the bank balance, knowing sales (and other income) and receivables (if billing), inventory levels, and imminent costs and expenses due on a weekly or daily basis, if required, is vital. Making cash flow projections can be done as a part of the ongoing planning process discussed below, and securing the necessary financing before a crisis develops. Research has shown that the largest single reason for small business failure is insufficient cash.

Assets, liabilities, and net worth - as reflected in the balance sheet, also play a role in both valuing and evaluating a business. An alternative to buying a business as a corporation is to buy its assets, called the “purchase of assets” method. It is usually employed when the buyer wants to form a new corporation and reduce the risk of exposure to undisclosed liabilities of the seller. In this case, balance sheet asset value and net worth play a role in establishing the selling or purchase price. Sellers with established name recognition and product or service identity often include a dollar value for “good will” as a balance sheet asset. Although it may have real value, it is not a depreciable asset and therefore a buyer should pay as little for it as possible. The balance sheet and the related ratios described also play an important role in attracting outside investors as well as obtaining credit, the following subject.

Credit - is important, and often essential, to business start-ups, acquisitions, or expansions. Loan packaging, or the organization, completion, and assembly of all the documents required for a commercial loan application is one of the most important services that a business counselor can provide, particularly to those with limited resources, education, and professional support. As noted earlier in this handbook the business counselor's own network is drawn upon in this process, including relationships with lenders in the area served. The components of a loan package required by most lenders include the following:

For new businesses:

- A business plan that includes the subjects covered in the four sections of this handbook, preceded by a one-page executive summary, with financial projections for two or three years
- Resumes of owners/principals of the business, including education, employment, and relevant skills and experience

- The following completed documents, as provided by the lender: the business/ commercial loan application and a personal financial statement containing all assets and liabilities
- The last three years of personal tax returns, signed and dated

For existing businesses, add:

- The last three years of business tax returns, signed and dated
- The last three year-end financial statements for the business, and through the recent quarter of the current year

The credit report - is an important document not submitted, but always obtained by the lender, and is the loan applicant's personal credit report. Early in the process, the counselor should ask the client to obtain a current copy of his or her credit report, which carries considerable weight in all loan applications. Credit (at a reasonable rate) is very difficult to obtain for those with FICO scores below 600. Action to repair a credit record does make a difference, but professional assistance in this area should be engaged well before submission of the loan application. If credit and tangible collateral for the loan are questionable, explore the possibility of a qualified cosigner for the loan. This can make an important difference in borderline cases.

Finding receptive lenders - is often a difficult task, due to the perceived risk in new business start-ups. Non-bank microloan funds are more accustomed to such risk, and those serving your area should be part of your network. The **Small Business Administration (SBA)** is a prime source of lending information in this area, because they partner with both bank and non-bank lenders as guarantors of small business loans. The SBA office in your district can tell you the number of loans they have participated in by lender in your area, which is a good indication of the lender's interest. Counselors should offer to participate in meetings between the client and lenders that have offered to consider the loan application.

In the case of Retail Connection, Inc. the cash flow projection indicates that a loan of \$40,000 is required in addition to the owner's investment of \$15,000 to finance the business start-up. With \$55,000 in start-up capital available cash reaches a low point at the end of month 5, with the small cushion of \$3,226. The \$40,000 loan is assumed to be at 8 percent interest with repayment over 24 months. Unlike home mortgages or other heavily collateralized loans, commercial loans for small, new, or struggling businesses are typically from two to seven years in length, instead of 15 to 30. The result here is a monthly loan payment of \$1,810, or a total of \$43,440. A longer term would reduce the monthly payment, but increase the interest, and therefore the total amount to be repaid.

Planning - Financial reports are critical to the planning process, because they provide the only commonly accepted method of quantifying goals and reporting results in the business world. Planning begins with the first business plan and continues, formally or informally, for the life of the business. As such, **it is a process over time, not just the product of a periodic exercise.** This idea of continually observing the performance of a business, in both formal and informal ways, is important to communicate to clients throughout the period you are in contact with them. True planning is pro-active. With an understanding of what is happening in the market or markets that the business is in, it leads to changes that take advantage of, or minimize losses from, the changes occurring. Planning becomes a framework for budgeting, which focuses those responsible for meeting plan objectives for income, costs, and expenses by reporting results against budget, which good accounting systems and financial reports make possible.

Caution! This handbook, entitled *TAP Basics*, is just that. Much of the counseling in this field is likely to go beyond the basics, and clients should be advised to involve their own accountant, attorney, or other business specialist. If they have none, refer them to someone in your own network. Legal advice is important in the process of selecting and establishing the legal form of a business, as well as in the purchase or sale of one. Accountants are necessary to set up the best system for each client, including payroll and sales tax obligations, as well provide ongoing services such as preparing the financial reports and tax returns.

REFERENCES

(In addition to those listed in the *Management, Marketing, and Accounting* sections)

Publications:

A series of six excellent soft-cover, well-illustrated books authored by David H. Bangs, Jr., a successful entrepreneur with thirty years of experience. Two that apply to this section are: *The Start Up Guide: A One-Year Plan for Entrepreneurs*, and *The Business Planning Guide*.

The others in the series cover additional important aspects of entrepreneurship, and are published by Dearborn Financial Publishing, Inc. in Chicago IL. Call (800) 621-9621, ext. 4384 for more information.

The *SBA Small Business Resource Guide*, usually published in cooperation with the Department of Commerce of each state. This contains information regarding SBA small business assistance programs, as well as those supported by the state, and is issued annually.

Each state department of commerce is likely to publish other material regarding small business assistance, as are larger municipal governments. Check for business assistance sources by phone or their Web sites.

Web sites:

www.sba.gov for information on all SBA programs and services.

www.businessfinance.com for a comprehensive listing of sources of business credit.

www.myfico.com to obtain information on credit scoring: how it works and links to more information.

www.equifax.com, www.experian.com, www.transunion.com for information from the three companies that provide personal credit reports.

www.dunbradstreet.com for information from the primary provider of business credit reports.

