

FINANCIAL MANAGEMENT FOR THE GROWING BUSINESS

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Emerging Business Series

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INTRODUCTION

An expanding business offers the potential for numerous growth opportunities. Employees benefit from business growth through increased earnings and promotions. Customers benefit from expanded products and services. Owners benefit through increased profit potential. Society benefits through the new jobs created. Managing this growth, although rewarding, can challenge your skills and financial resources.

Financial management involves all the activities that enable a company to obtain capital for growth, allocate resources efficiently, maximize the income potential of the business activity and monitor results through accounting documents. Such management requires a well-written, comprehensive financial management plan clearly outlining the assets, debts and the current and future profit potential of your business.

This publication discusses the how to approach to financial management (i.e., a method that makes the growth process easier to understand and implement), in addition to providing general information on the challenge of managing financial growth. It is divided into three sections, with each focusing on important aspects of financial management: Section 1: Obtaining Capital for Growth; Section 2: Managing Capital and Section 3: Documenting Results.

Successfully managing financial resources is important in new and expanding businesses, so take time to develop and implement a financial plan that will ensure the success of your business.

Managing Financial Growth

Managing the finances of a growing business requires persistence and balance. To obtain the funding needed to finance growth, you must understand the roles of these concepts and how to apply them in managing a growing business. A brief discussion of these concepts follows.

Persistence

In a growing business, financial resources are often viewed as the major factor limiting growth potential. There are two methods of improving your financial base: (1) grow gradually and allow profits to fund additional growth and (2) seek outside funds (i.e., debt or equity funding). Either approach will consume time and energy, and you will experience some rejections. This is where persistence is important. Your determination, combined with a willingness to adjust your plans, will carry you through this process.

Sustained growth puts stress on you and the financial resources of your business. Achieving growth goals often takes longer than you initially planned. However, you are not alone in the quest for growth and expansion. Many successful business owners have experienced the same problems and frustrations. To understand the challenge ahead, visit successful local business owners and read articles or books about their experiences. *Inc.*, the *Wall Street Journal* and some of the general business publications, such as *Business Week*, *Forbes* and *Fortune*, all contain stories about successful growing businesses. The business section in your local newspaper features local success stories. Also, area development corporations and chambers of commerce are excellent sources of information on local businesses. Don't hesitate to take advantage of these resources. You can learn valuable techniques and concepts that will enable you to avoid many of the problems other business owners have encountered.

Balance

The financial and operational aspects of growth must be balanced when you expand your business. During a growth phase, for example, the marketing function of the business may extend beyond the business's financial capacity to sustain growth. To avoid this dilemma, devise policies to balance the operational functions of the business with the financial aspects of growth.

Here are several guidelines to help you balance the finances of a growing business.

- ! *Growth should be attempted only in businesses already profitable.* To attain profit potential, a balance must be maintained between asset and liability items that are on the balance sheet and operating items that are on the expense and income reports. For example, if accounts receivable on a balance sheet average \$50,000 and sales average \$500,000 per year, a balance of 10 percent exists between these items. If growth is obtained in part by offering easier credit terms, the balance could be altered if the accounts receivable average \$150,000 and are used to support sales of \$1,000,000. Thus, the balance needed to maintain a profit has been altered. When growth is undertaken, profit will be negatively affected, at least initially.

- ! *The existing debt position of the business must be balanced with equity, or additional equity must be obtained to balance future debt.* The rule of thumb is for the equity position on a balance sheet, expressed as equity divided by assets, to range from 30 to 50 percent. If your business has an equity position of less than 30 percent and you wish to obtain financing for growth, a certain amount of money will have to be

injected as equity to finance additional debt.

- ! *Management skills and abilities must be balanced with the increasing demands on management in a growing business.*

There are several simple examples of balancing opposing forces that can be applied to business. One example is the financial management concept. Financial management compares your company's growth potential when financing the entire growth phase by reinvesting profits to financing through an infusion of cash from outside sources. The latter option accelerates growth; it follows the concept of leverage and allows you to use equity to obtain additional money so the business can grow faster. For example, if you can use a 33-percent equity position and invest \$100,000 in a business, you can borrow \$200,000 for a total investment of \$300,000. This allows the business to grow faster than using only the \$100,000.

When accelerating growth, the financial leverage concept works only as long as the business is profitable or the return on investment exceeds the debt expense. When this happens, the rate of return received on the equity investment is greater. For example, if you invested only the \$100,000 and did not borrow any additional money, the rate of return might be 10 percent. However, if you used the \$100,000 to obtain \$200,000, and if the debt is 12 percent and you make a return of 15 percent on the entire project, the resulting rate of return on the \$100,000 is higher. The 3 percent made on the debt results in a total dollar value of \$6,000. The 15 percent made on the existing equity (which would be \$15,000), combined with the \$6,000 made on the debt would result in a final return rate of 21 percent on the equity portion.

Profitability is important to business growth because it makes it easier to obtain the financing needed to expand. This is the opposite of how accounting systems are normally operated for tax purposes. To reduce taxes, accountants and business owners often try to show a loss or as little profit as possible, which allows the business to retain more cash. From this standpoint, perhaps your business should be profitable for several years before initiating a growth phase. In many cases, however, you will not or cannot take the time to accomplish consistent profitability. If you are planning to expand your business, discuss this process with the accountant who prepares your income statements or taxes in order to legitimately transfer forward some of your current operating expenses, thus increasing your current profits.

Other Considerations

The time you spend preparing for growth can also improve your business in several other areas, including management. Therefore, you should not implement growth procedures without thoroughly examining all aspects of your business operations. Listed below are several factors you should consider before initiating a growth plan.

- ! Expect that your personal involvement and commitment to the business will increase during a growth cycle.
- ! Consider personal sacrifices and the sacrifices of people you associate with,

including family. The rewards of growth can be substantial and, thus, are deemed adequate rewards for these sacrifices.

- ! Expect additional pressure on the time and resources needed to run the business, because it will take time and energy to organize the financial aspects of growth.

Before initiating a growth phase, be sure you have the time, adequate personnel and financial resources to complete the process.

There Is No One Right Way

Before you look at the different categories of financial management for a growing company, remember there is no one right way or easy method. Accept that you operate in a world of uncertainty, in which decisions often are made without complete knowledge of all the consequences. This approach can make managing a growing business challenging and rewarding.

When financing a growth cycle, seek assistance from professionals who know the process. Assistance is available through consultants, accountants and lawyers and through services provided by the government, such as the U.S. Small Business Administration (SBA) and its resources (e.g., the Service Corps of Retired Executives [SCORE], the Small Business Development Centers [SBDCs] and the Small Business Institutes [SBIs] listed in Appendix F: Information Resources).

SECTION 1: OBTAINING CAPITAL FOR GROWTH

Deciding To Actively Pursue Growth

A primary reason for pursuing growth is to increase profit. There are two components that can be increased -- the absolute dollar amounts of sales or the profit as a percentage of sales. If these two can be achieved simultaneously, the resulting growth will be very rewarding. A more careful decision process must be completed in situations where there is a trade-off, such as between decreasing the percentage of profit to sales (through reducing prices) or increasing the dollar volume of sales (through increasing prices).

Reducing prices to achieve growth is a strategy you might not initially plan but must do to sustain growth after commitments have been made. By charging lower prices to increase sales, you usually decrease the gross profit margin. However, lower prices may result in significant increases in the purchase quantity, which then enables the business to earn a profit. The same concept, only reversed, can apply to costs. For example, if you increase costs in order to increase dollar sales volume, you still decrease your profit margin. This latter approach is feasible if you plan to increase marketing expenditures to gain additional business.

Costs also can be increased from an accounts receivable standpoint. A new business activity might increase sales by adding customers with poor credit ratings, thus resulting in a higher accounts receivable cost. Many managers of unprofitable businesses believe the solution to their problem is to grow in order to spread fixed costs over a larger number of units, thereby improving the gross

margin of the business. (A detailed explanation of this concept is provided in the section Determining the Break-even Point.)

Understanding Financial Statements

The balance sheet, income projection statement and the monthly cash flow projection of funds are the statements used to manage and report a business's financial operation. The balance sheet and income statement will be explained in this section. The cash statement is not always completed as the checking account register provides the same information except that it isn't summarized by categories.

The balance sheet and income statement contain meaningful information about the business. The balance sheet indicates the value of the business at a given point in time and is usually prepared for the end of a typical reporting (or accounting) period. The income statement covers a period of time (month, quarter, year) and indicates the level of profit or loss based on sales less expenses. (Examples of a balance sheet and income statement are included in Appendix A.)

Balance Sheet

The balance sheet provides a summary of the owner's net worth at a given time. The first section, labeled *assets*, usually appears on the left side or at the top of the statement and includes the business's assets in declining order of liquidity. The right side or lower portion lists the *liabilities* and the owner's equity or net worth. Liabilities include all commitments or contractual agreements to be paid in the future. Examples of liabilities include loan principal balances and accounts payable (money owed for goods or services already received). The owner's equity is the asset value that actually belongs to the owner. In a corporation, this is usually divided into original capital and retained earnings. The capital assets (i.e., equipment and buildings) are valued at their original cost minus any depreciation that has been taken in the past. This results in a book-value balance sheet, because the real value of capital items could be more or less than this calculation indicates.

Note that on the balance sheet the total assets equal the total liabilities plus the owner's equity. The owner's equity position is the relationship between the total assets and the total liabilities. In the sample balance sheet in Appendix A, the equity position is a percentage, 28.3 percent, that is calculated by dividing the owner's equity (\$57,945) by the total assets (\$204,945).

Income Statement

The income statement (sometimes called profit and loss statement) brings together the income generated and expenses incurred from business activity over a specified period of time. This time period can be a month, a quarter, a year or the year-to-date.

The difficulty in developing an income statement is in allocating certain costs to the period of time covering the statement. One example is depreciation. Many fixed assets, such as equipment and building costs, cannot be included under expenses. To allocate these costs properly, their purchase price must be divided by the expected life in years or months, whichever corresponds to the period covered by the income statement. Using the straight-line method of calculating depreciation, their

purchase price is charged uniformly over the life of the assets. However, the depreciation rate often is accelerated for income tax purposes.

Another difficulty in cost allocations are loans in which payments are divided into interest and principal components. Only interest is included on the income statement; it is treated like a rent or lease payment. The principal is neither income when a loan is received nor an expense when it is paid back.

The balance sheet and income statement are related to each other. Your equity on the beginning balance sheet plus the profit (or minus the loss) from the income statement equals your equity for that period. Profit needs to be adjusted for any withdrawals that are not expenses, such as payment of the loan principal or income tax.

Developing Projections

The first step in undertaking growth is to develop projected income statements, cash flow statements and balance sheets. All potential lenders require these projections before approving loans. These estimates also can be used to help you decide whether to seek outside funding, even though this decision may seem obvious based on your current market activities.

These projection statements, sometimes called *pro forma statements*, should be developed for at least one year and perhaps two to five years into the future. (Examples of pro forma statements are included in Appendix B. Blank forms are included in Appendix C.) You may wonder: How can I know what will happen? To answer this question, divide the projections into steps. The most critical step is balancing costs to sales in order to determine a profit margin.

Profit margins for income projections should always be reasonable, especially if outside financing is used. If the first years of the projections show a loss, it will be difficult to convince potential investors to invest in your business. If, however, the projections show excessive profits, potential investors may feel the project is unrealistic. This means that your figures must be fairly conservative.

What is a reasonable profit margin? It is a profit margin that is in line with the profit margins of the industry. For example, \$80,000 on a projected income statement is a reasonable before-tax profit margin in the following case. First, all income tax is subtracted at an estimated rate of 25 percent, leaving \$60,000. You quit a job that paid \$40,000 to start this business; therefore, you maintain this salary as being consistent with your personal living expenses. This leaves \$20,000 of profit. The next step is to compare the remaining profit to the amount of equity invested or the amount of your equity on the current balance sheet. For this example, we will assume the equity level is \$200,000. The profit of \$20,000 is divided by the equity of \$200,000, which results in a 10 percent rate of return. This rate of return is reasonable for a growing business; however, the rate of return could increase in the future because of the growth process. Phenomenal rates of return, such as 100 to 1,000 percent or higher, are possible in smaller businesses. (See *Inc.*'s list of the 100 fastest growing companies.) Even though this is possible, the rate of return should be conservative on a projection.

Deciding the rate at which your company should grow is challenging and demands flexibility. Flexibility can be difficult if you already have a preconceived idea of the growth level you want.

Your idea may exceed the capacity of the business's management and equity positions. It is helpful to develop several projections because different levels of growth will have different investment requirements and profit results. For example, if a business is expected to grow to \$500,000 in sales per year, you may be able to continue renting a facility. However, if the business is expected to grow to \$800,000 in sales per year, a new facility may be required and its cost will affect the projected profit. The same can be true with items of equipment, which also depend on the relationship between the short- and long-term potential. The addition of a new building can have a short-term, negative impact on profitability, but it also can result in an improved profit margin for the business within three to five years. Because input into a business operation is not always proportional and can come in steps, completing several projections based on different options will help determine which projection is best.

Individual circumstances may require growth to be pursued at a slower pace, yet you can end up with similar profits. For example, you currently operate a business with sales of \$600,000 per year, and you want the business to grow to sales of \$2 million by the third year. You might project both of the following growth trends:

Example A

Year 1	\$1.0 million
Year 2	\$1.5 million
Year 3	\$2.0 million

Example B

Year 1	\$1.8 million
Year 2	\$1.9 million
Year 3	\$2.0 million

As you can see, the result is the same. Example B illustrates an initial high, fixed investment, used to support expansion, with slower growth following. For example, a successful restaurant with sales of \$600,000 may build two more restaurants in different cities and thus triple its total sales. Example A reflects a situation in which growth is obtained more gradually by incurring variable costs and reinvesting profits in the business. For example, a restaurant may attempt to increase its growth by maintaining the same single location, but adding new services or additional operating hours.

You can further control your growth rate by recognizing that all fixed costs are variable over time. Strictly speaking, fixed costs are those costs that are stable for a given period (e.g., one year). However, when you consider growth over a three- to five-year period, fixed costs can be treated more like variable costs. For example, alternatives to purchasing a new, full-size facility may include leasing facilities, constructing a smaller facility or creating unique distribution channels.

Computer spreadsheet programs are excellent to develop projections as they easily allow what if analysis in determining different levels of growth. If such programs are not available, seek help from professionals who provide services to small businesses, such as SBA, SCORE, SBDCs and SBIs.

The costs of a growth cycle can be incurred in blocks or steps. This is especially true for equipment and buildings; however, it can also apply to marketing costs. For example, a manufacturing company may have only one machine that completes a process required of all its products. To double production capacity, the company must decide between adding a second shift or adding a second machine. Adding a second machine doubles costs in the form of depreciation and other operating costs; adding a second shift doubles personnel costs. Either way, the company must consider the marketing option of adding a salesperson in order to increase its sales volume to in turn support higher fixed costs.

Determining the Break-even Point

Break-even analysis can help you make decisions because it allows you to visualize the relationships between costs that are spread over time. Such analysis involves dividing costs into two categories: fixed costs and variable costs.

Fixed costs are those costs that do not vary over a period of time, or generally do not fluctuate with changes in sales volume. These costs include the purchase price of buildings and equipment. *Variable costs* are costs that vary depending on the time period or the sales volume generated. These costs usually include the cost of materials purchased for retail operations and labor costs.

The textbook approach to break-even analysis is based on the units of production. For business activities, it is better to base such analysis on the dollar volume of sales of the business. Break-even analysis can be expressed as a dollar amount and can be displayed on a graph. On a projected income statement, a convenient way of breaking out fixed costs and variable costs is to treat the cost of goods sold and labor as variable costs and all other expenses as fixed costs. Below is a sample income statement:

Sales	\$100,000
Cost of goods sold	\$ 30,000
Wages	\$ 20,000
Fixed expenses	\$ 40,000
Profit	\$ 10,000

The break-even point can be calculated as follows. First calculate the contribution margin, which is defined as the percentage of sales available for use toward fixed costs and profit. In the above sample income statement, the variable costs (goods plus wages) are 50 percent of sales, so the *contribution margin* is 50 percent. The actual break-even point is the fixed costs (\$40,000) divided by the percentage of sales the variable costs represent (50 percent), which equals \$80,000. At this point, all fixed costs as well as variable costs are covered. To verify your answer, multiply 50 percent by \$80,000. The answer is the amount of the fixed costs, or \$40,000. The variable cost at this rate is \$40,000 or 50 percent of \$80,000.

The break-even point can be calculated using different assumptions of what should be included in the fixed-cost portion. If the business needs to generate enough profit to pay the owner's wages plus the recovered debt principal and income tax obligations, these costs should be included with the fixed-cost amount; thus, the break-even point will be higher. The break-even sales level usually

covers a year; however, the time increment can be broken down into months, weeks or days. In the above example, the break-even point of \$80,000 is equivalent to \$266 per day (assuming a 300-day work year). This figure should be set as your average daily goal; however, don't forget to consider seasonal sales and daily fluctuations as well.

It is difficult to assure accurate projections, but if each dollar item in a projection is carefully considered with regard to the volume or capacity of the business, the resulting figure should be relatively accurate. Final income statements tend to show costs higher than what was projected. If plans are made carefully, the result might be that profit is very similar to what was projected; but some of the items will be higher or lower than planned.

In projecting income in order to obtain financing, compile figures conservatively. Bankers know it is very easy to come up with lofty profitability projections and may discount an application on that basis. Projections should indicate the ability of the business to pay off debt while earning a reasonable return on labor and investment.

Decisions on whether to grow and the rate at which to grow should be based on the concept of improved value. Profits can be drawn by the owner or reinvested in the business where they can increase the asset basis of the business. A recommended strategy for the owner-manager is to consider a combination of these options.

Estimating Expansion Costs

An important part of growth is the budget, or the allocation of funds to those activities that will bring about growth. There is a fine line between not having enough money and having too much money. The disadvantages of borrowing too much are (1) the increased interest costs and (2) exceeding equity limitations. The disadvantage of not borrowing enough is getting halfway through a project and discovering there are not enough funds available to complete it. The problem usually associated with expansion is underestimating costs. The following sections address the costs of buildings, equipment and inventory and the cash tied up in accounts receivable and operating capital, as they relate to estimating expansion costs.

Building Costs

To determine the cost of a building, choose a layout that can be reduced to a blueprint or a sketch for contractors to bid on. (Many contractors provide blueprints in conjunction with the bidding process.) After you have blueprints or a layout, obtain competitive bids from several contractors. Bids will allow you to compare the abilities of individual firms to build efficiently and ultimately can help you achieve lower costs. Be sure the contractors are bidding on identical specifications and quality. Many construction companies have specialty projects that may match your company's project, possibly resulting in a lower price.

If you do not know a contractor, check his or her credentials with the bank and other references, such as customers and suppliers of building materials. Reputable contractors are accustomed to working under performance bonds. You should investigate this option. Bonding is a system in which the contractor promises to complete the work at a time, quality and price specified in the contract. If

the work is not so completed, the contractor forfeits the bond and the proceeds are used to reimburse the customer's loss. Bonding is usually handled through an insurance company. If you request a bond, you should receive a copy of the agreement directly from the insurance carrier.

Next, discuss with the contractors their relationship with subcontractors. Usually a general contractor will negotiate and work with subcontractors in the electrical, plumbing, heating, and certain other trades. Subcontractors are usually coordinated by the general contractor and complete and invoice their work through the contractor. Should you choose to directly employ subcontractors, you will be responsible for coordinating their work. This can reduce costs in some cases. If this is done, the subcontractors should also be asked to submit a bond for the work performed. (Also, be sure to check with utility companies to determine hookup costs and whether deposits are required.)

Scheduling is another aspect of construction that should be carefully planned to reduce costs. Often unknown factors -- mainly the weather -- can affect the schedule. Such factors should be figured into the time allowed for the construction process, as increased construction time can result in additional interest charges. It is customary for a construction contractor to receive periodic payments during a project to cover costs. The new building owner usually pays 90 percent of the cost of work completed until the project is done. Thinking through this whole process in advance will reduce the need for any change in orders, which can result in additional costs.

Equipment Costs

New equipment purchases often accompany an expansion. Contact several equipment suppliers to discuss your needs, the capabilities of specific equipment and prices. Other related expenses associated with equipment should be investigated, such as delivery, hookups to utilities, installation costs and unusual operating expenses.

Leasing should be considered as an alternative to purchasing equipment. Usually leases can be obtained from the company that sells the equipment, but there are also leasing companies and leasing divisions at banks. The disadvantage to leasing is that the rate usually is higher than the interest rate for purchasing equipment. The major advantage of a lease, however, is the low down payment or equity position required to initiate the lease. Most leases place the responsibility for repairing equipment with the lessor. This can reduce the risk of having to incur repair expenses at a time when your cash flow is tight and repair costs difficult to cover. Be sure you understand all provisions of the lease agreement. Many companies offer lease-to-purchase plans that enable you to eventually purchase the equipment. This can be a viable option.

Delivery of equipment, whether new or leased, should be carefully timed with completion of other construction activities so the equipment is not sitting idle.

Inventory Costs

Inventory is the product, in its various stages of completion, that is finally sold to generate revenue and receivables. It is an important aspect of a company's operating cycle because it is a window into the company, i.e., it will tell how well the company produces the goods and services it sells. Inventory should always be valued at the lower cost or market value to ensure that its value is not

overstated on the balance sheet.

The level of inventory in an expanding business should be easy to determine because it is based on a comparison of past inventory levels to past sales. The inventory turnover ratio is the cost of goods sold divided by the average inventory and is the ratio that is often used when a growth phase is initiated. The cost of new inventory should be considered because it might be higher than the cost of existing inventory. It is usually assumed in an expansion process that the existing inventory can be easily liquidated and, therefore, the inventory turnover ratio will increase. However, the opposite could occur if you attempt to increase sales by offering an increased inventory. Also, it is usually assumed that, as inventory increases, carrying costs will decrease because of the additional economies of scale gained with the additional inventory. Again, this should be carefully determined by investigating actual carrying costs.

Inventory is important to both new and expanding business because, before it is sold and becomes a receivable, it represents invested cash. When separated into its parts (raw materials, work in process and finished goods), the inventory cycle will identify lags and structural difficulties a company has in the production process.

Accounts Receivable

Like inventory, future accounts receivable are projected from the existing receivables on the balance sheet and are normally in the same proportion to future sales as current receivables are to current sales. For example, past sales of \$100,000 and accounts receivable of \$5,000 represent a relationship of 5 percent of accounts receivable to sales. If growth is projected to \$500,000, then projected accounts receivable at 5 percent would be \$25,000.

It is possible for accounts receivable to increase out of proportion to the existing figure. For example, accounts receivable could easily be a higher proportion if, in the process of increasing sales, relationships with slower paying customers were established. To illustrate this, if actual accounts receivable average \$5,000 when sales are at \$100,000, a variance of 1 percent would result in accounts receivable of \$6,000, a difference of only \$1,000. However, at an operating level of \$500,000 sales, a 1 percent negative variance translates into a \$5,000 difference. If this is not planned for, it would be more difficult for you to come up with \$5,000 than it would be to come up with \$1,000.

Estimated Expansion Expenses

The last and most difficult cost category to project is the additional cash needed to support increased activity. The best method for calculating this amount is to use a cash flow projection. Cash flow forms (see cash flow projection in Appendix B) are available through local SBA, SCORE, SBDC and SBI offices. To complete the form, distribute the cash income over the months when the sales growth should occur (cash expenses are calculated the same way) and then determine the expenses needed to generate the desired increase in income.

During a business expansion, cash balances will normally decrease for a while, and then show a gain. This gain will occur only if the business is profitable. It can be difficult to predict when a

growth in cash flow should begin. As a general rule, it should be within the first operating year, preferably by the third or fourth month; however, this may vary.

Seasonal fluctuations in cash receipts and cash expenditures should be built into the cash flow projection. This will indicate those months cash should be reserved to cover excess expenses when cash out exceeds cash in. If the business is profitable and some portion of profit is reinvested in the business, then the cash flow projection should account for this as well. The impact of income tax on cash flow also should be included.

For each level of sales volume, a certain residual amount of cash should be retained in the business. For example, if sales have been \$50,000 per year, the cash balance carried might be \$1,000; if sales are at \$500,000 per year, the cash amount carried might be \$10,000. These amounts are somewhat arbitrary and depend on the nature of the business; however, each increase does not have to be proportional to sales. Instead, the residual cash amount should be based on the cash flow projection for operating the business.

After determining cash needs, a certain amount could be budgeted to cover unexpected contingent liabilities or to compensate for slow turnover in receivables. Select this figure carefully because investors may be skeptical if it is too large. It is better to estimate a little higher on some of the account categories that have definite needs, thus reducing the need for a large contingency amount.

Purchasing Another Business

At times expansion can be accomplished by purchasing another business. In this situation, the expansion costs equal the costs of purchasing the business plus the amount of money needed for improvements and operating expenses. Many industries have standard rules that should be considered on how to determine the purchase price of a business.

Obtaining Financing

Bank Requirements

To obtain bank financing for your business, the relationship between your company and the banker should be open and honest. If this is not the case, perhaps it is time to consider a different bank. When shopping for a new bank, do not make a decision based upon a particular loan officer, because this relationship can change if the loan officer is replaced. Therefore, consider both the relationship with the loan officer and the relationship with the bank. It is also possible for your business to grow to the extent it does not fit the capacity of its existing bank. If this happens, consider establishing a new relationship with a larger bank that can handle your company's future needs.

The first step in obtaining financing for an expanding business should be to understand and meet the exact requirements and concerns of the bank. To avoid risks and make safe investments, bankers primarily base their decisions on the collateral and equity positions. Other concerns of a banker include cash flow, profitability and management ability.

Collateral

Debt can be either secured by collateral or covered by a firm's assets. A bank considers collateral the final alternative (last resort) for collecting money if payments are not made on loan principal. The Uniform Commercial Code* establishes procedures whereby a bank can seize any collateral pledged in a loan agreement in case of default on the loan. The value of collateral is usually listed in the asset section of the balance sheet; its value should always equal or exceed the amount of the loan.

* American Law Institute, *Uniform Commercial Code*, written by National Conference of Commissioners on Unified State Laws, 1987.

Often in a business start-up, the initial balance sheet will show an adequate collateral position; however, six months to a year later, the balance sheet may show a decreased collateral position. One example of this is getting a loan to purchase a vehicle. The depreciation rate for the first six months to one year will exceed the amount paid on the principal. Thus, depreciation is usually computed on an accelerated basis. If you purchase a vehicle for \$20,000 and borrow the full amount at 10 percent for four years, the monthly payment would be \$507.25 per month. The day you purchased the vehicle and took out the loan, the collateral value matched the loan amount exactly. If you use a straight-line rather than an accelerated method of calculating depreciation, the vehicle will last four years, and cost \$5,000 per year. At the end of the first year, the book value of the vehicle, which often equals its real market value, is \$15,000. However, the amount owed on the principal at the end of one year is \$15,720.36\$720.36 more than the book value. This point clearly illustrates why banks require a down payment on this type of loan. The down payment usually ensures that the asset value always exceeds the loan principal balance.

It is also possible to lose collateral in the first years of a business by borrowing money and then gradually using that money to pay for expenses (such as utility bills and marketing costs) that do not result in asset appreciation. For example, if you are planning to spend \$1,000 to have brochures printed, the cash in the bank before the brochures are printed is good collateral because it can be used by the bank if you default on the loan. However, once this money is spent to buy the brochures, the collateral value is much weaker because the expenditure has value only for your business and cannot be easily transferred to others.

When a bank forecloses on a failing business, it is often unable to recover the full amount the owner paid for the assets, because of depreciation and the nature of a force sale. As a result, foreclosure leaves the banker with assets worth less than the dollar value indicated on your balance sheet. For these reasons, you can understand why it is easier to borrow money to buy fixed assets (such as inventory, equipment, buildings and accounts receivable) than it is to borrow money for marketing expenses or general operating costs.

Equity

Bankers also review the current and projected equity position of a business. Equity is listed as owner's equity or a combination of capital and retained earnings. The owner's equity is usually calculated by subtracting all liabilities from all assets. The important aspect of equity is not so much the dollar amount but the ratio of equity to assets or debt.

A growing business usually shows an equity position of 30 to 50 percent in relation to total assets, i.e., the owners own 30 to 50 percent of the company. Initially, such an equity position may be adequate, but it may become inadequate when additional money is needed for growth. Because of the need to maintain the equity ratio in its relative position, additional equity may need to be brought into the company. For example, suppose a company's total assets are \$100,000; total debt, \$70,000; and owner's equity, \$30,000. The equity-to-assets ratio is 30 percent. For this business to grow to an asset level of \$200,000, the owner needs to provide an additional \$30,000 of equity and then borrow another \$70,000 (debt). Ways to bring equity into a business include

- ! Venture capital funds
- ! State and federal financing programs
- ! Private investment
- ! Owner's personal investment

An alternative to obtaining equity is to wait and reinvest the business's profits to finance the growth.

Cash Flow Projections

For any business growth cycle, cash flow projections that compare cash receipts and cash expenses should be completed. Bankers realize that bank loans are paid from the business's cash flow, so you must convince them that there is adequate potential to repay the loan. A detailed explanation of the cash flow projection is included in the section Effective Cash Flow Management on page 10 or see Instructions for Cash Flow Projection in Appendix C.

Income (Profit and Loss) Projection Statement

The profit and loss statement, more commonly known as an income statement, reflects the dynamic changes that occur over time between two balance sheets. It reflects the company's operation as a result of management's efforts to generate a profit. The income statement matches all revenues with corresponding expenses for a specific period of time and reports the company's ability to generate profits (excess of revenues over expenses).

Income projections should indicate when profitability will occur. Even though profit and cash flow can be unrelated, the possibility of having an adequate cash flow definitely increases when a projected income statement shows a profit. Bankers generally assume that a loan can be repaid if the business is profitable. The banker's concern in this process is, Where is the profit going? If the profit is being reinvested into expansion activities, such as increasing inventory or marketing expenses, the banker's concern is whether or not loan payments can still be made. See Appendix C for Instructions for the Income Projection Statement.

Management Ability

A growing business usually has the advantage over a new business of having records on past

performance that reflect the owner's management ability. Management and the organization must be flexible to allow for growth and change. Consider the following question: If growth occurs, will management be able to handle the new situation? Your answer should help you determine whether you will need to hire additional managers or develop current management skills.

Simply developing and implementing a strategic plan to obtain additional funding will test management's ability to plan and handle growth. The activities involved in obtaining needed financing are in themselves a new challenge to management. Management weaknesses should be addressed as a part of the growth process.

Personal Financial Statement

Usually banks will require personal financial statements from all owners. Personal financial statements are the balance sheets of the business's owners. They are an important part of a business's financial package because (1) they verify the company financial statements, (2) they identify hidden company liability or equity and (3) they reveal other activities vying for an owner's attention. Strong company financial statements are generally reflected in strong personal financial statements; therefore, the stronger an owner's financial statements, the better his or her chances of obtaining the loan.

Wealth accumulated on a personal balance sheet is an informal method of judging an owner's ability to obtain, manage and keep money. Personal financial statements should not include existing business activities; these figures should be supplied separately. As indicated above, the banker is looking at potential collateral and adequate equity.

Market Value Balance Sheet

One of the problems in a growing business is that the existing equity or collateral position can be artificially low because of accelerated depreciation. Using accelerated depreciation results in a book-value balance sheet that has less equity or collateral than a market-value balance sheet. The former shows assets at their depreciated value whereas the latter shows the assets at their current market value. Thus it may be important to provide a banker with a market-value balance sheet.

A typical way to develop a market-value balance sheet is to present your current book-value balance sheet with an additional column for the market value. At the bottom of this balance sheet explain each column. Documentation of market value can be provided through appraisals or advertisements that include prices on similar equipment or assets. The market-value balance sheet usually increases the equity dollar amounts and the equity-to-assets ratio. This should result in a banker's willingness to loan a larger amount for growth activities.

Business Plan

A business plan is the blueprint or road map for the owners to successfully carry out growth in a business. This plan communicates the intentions of the owner to others and can be used to obtain financing. The content of the business plan is determined by the planning process itself, and includes research documenting growth potential. Business plans include

- ! Cash flow projections
- ! Income statements and balance sheets with a detailed narrative of how growth must be attained
- ! Justification for numbers used in financial statements

Details on writing a business plan can be found in many sources. See the outline of How to Write a Business Plan in Appendix E. In addition, the SBA, SBDCs, SCORE chapters and SBIs can provide assistance in developing business plans.

Other Sources of Financing

Small Business Administration Loan Guarantee Program

The SBA Loan Guarantee Program provides financing in cases in which banks feel uncomfortable with the risk by allowing banks to recover their money from the SBA if the borrower defaults. The SBA guarantees 90 percent of the loan up to \$150,000 and 80 percent up to the maximum of \$750,000. Terms for the loan are usually better than those for regular bank loans. Compared to a conventional bank loan, the life of the loan can be longer, the equity position less and the interest rate slightly lower. The interest cost is usually less for two reasons. First, SBA has established an upper limit of 2 percent above the prime rate for the program; second, bankers are usually willing to offer lower interest rates because of the SBA's guarantee.

The life of an SBA loan can be longer than that of conventional bank loans. This results in a lower monthly cash payment, which can enhance the cash flow of the firm during the early years of the loan. The equity position for an SBA loan can be 30 percent compared to the 40 to 50 percent required by banks. (The SBA percentage can vary depending on the type of business and your past credit history.)

The bank loans the money and the SBA guarantees the loan. Because of the guarantee, banks can loan over their normal limit, which can be an incentive for small banks. The guaranteed portion of the loan is not considered part of the banks' regular loans. There is a 2-percent fee for the guarantee, which is sometimes reduced to 1 percent for loans under \$50,000. This fee is paid from proceeds when the loan is allocated. The upper limit for an SBA loan guarantee is \$750,000. There is no lower limit, however, most banks prefer to work with amounts over \$10,000.

Other State Financing

State financial programs are also available to small business owners who need financing. Most programs are justified by the economic development and the jobs created within the state by the business. At times these programs can take a second mortgage position compared to banks or other sources of debt and can charge lower interest rates. Many state programs have special programs for women, minorities or manufacturing businesses.

SECTION 2: MANAGING CAPITAL

Effective Cash Flow Management

Cash flow analysis shows whether your daily operations have generated enough cash to meet your obligations, and if major cash outflows combine with major cash inflows to form a positive cash flow or a net drain. Any significant changes over time will also appear in this analysis.

It is extremely important to have enough cash on hand each month to pay the cash obligations of the following month. A monthly cash flow projection helps to project funds and compare actual figures to those of past months and enables you to eliminate cash deficiencies or surpluses. Cash flow deficiencies indicate a need to alter plans to provide more cash. Cash surpluses may indicate excessive borrowing or idle money that could be invested.

Cash itself does not create new income for the business. Therefore, the cash account balance on a balance sheet actually should be small relative to other assets. The object is to develop a plan that will provide a well-balanced cash flow.

Cash flow analysis establishes a budget for the cash requirements for the business. During stable business conditions, there is little need to develop a budget because future business activity can be predicted from past trends. For growing businesses, the relationship between sales and expenses changes, thus establishing the need for a cash flow projection. The cash flow projection indicates a flow of dollars; therefore, if dollar amount changes early in the year, it is going to affect the remaining months by the same amount. Understanding cash flow and how it is computed is a very important part of cash flow projections.

SBA has an excellent cash flow form (See Appendix B). The SBA's version is a simplified form; it allows for only one sales entry and one accounts receivable entry per month. Completing this form will enable you to compute projections correctly, and better understand the relationship of cash flow in the finances of a company. This form is available at SBA area offices and through SCORE chapters and SBDCs.

Unfortunately, cash flow management is often limited to keeping track of the checkbook balance. The problem with relying on this system is that it can result in your using cash that should be reserved for something else. Some practical steps can be taken to improve your ability to manage cash flow, especially during the changes brought about by growth. These include

- ! Collecting receivables
- ! Tightening credit requirements
- ! Increasing sales
- ! Pricing products

! Securing loans

If your company has multiple divisions, products or locations, develop individual cash flows and then consolidate them to determine the complete cash flow picture. The SBA form has a column for actual results in addition to the estimated column. This allows you to record what you actually have spent and compare it against the estimate. A cash flow projection is usually computed on a yearly basis. To compensate for changes occurring after the projection, it is advisable to update it periodically to determine if there will be a detrimental effect later. If your company's new area of growth is an activity that is seasonal, i.e., opposite the current season, the cash flow projection will help determine the combined impact.

In a cash flow statement it is important that all sales and expenses listed for a particular month are balanced. To compensate for situations in which expenses are due at the first of the month but revenue does not come in until the end of the month, complete a daily or weekly cash flow statement. Another way to compensate in these situations is to change your month's beginning and ending dates; for example, go from the 15th of the current month to the 15th of the next month. This will resolve the problem because it will ensure that one month's cash from sales arrives before expenses are due.

Computer spreadsheet programs can be extremely helpful for computing cash flow projections. They allow for what if analysis, which provides several possible outcomes. If you have the software, you can design your own spreadsheet, or you can get templates from business service providers.

Good accounting records and good projections are important tools for a small business. Qualified accountants are necessary to help keep your records accurate and current. However, you can reduce your accounting expenses by producing your own summary statistics and projections. With the help of a personal computer and a good financial management plan, you can successfully project future activity and use the what if analysis to test various management decisions.

Cash Flow Versus Income Projections

One of the major distinctions between cash flow and income projections is that the two can appear unrelated. The differences result from how principal payments and depreciation are recorded. Loan principal payments are included as cash outflow but are not recorded on the income statement. On the other hand, depreciation is included as a business expense of the income statement but not as cash outflow.

In a business in which sales are growing, the inventory and accounts receivable are also probably growing. These different areas of growth can affect the income and cash flow. For example, if inventory increases during the year, the dollar amount used to purchase materials will increase, and thus the cash flow or available cash will decrease. This can cause an inadequate cash level during a slow period. A similar situation can occur with accounts receivable. If accounts receivable increase, then expenditures to provide services to customers will increase, but there will be no incoming cash to cover these increased costs. The accounts receivable, inventory and cash-on-hand amounts are all represented on a business's balance sheet.

In a growing business in which the accounts receivable and inventory are fairly constant, the cash flow should be adequate if the business is operating profitably. In this situation, any depreciation amounts should be retained for future expansion, and profits should be used to retire the loan principal. Such a strategy is important for a growing business. If depreciation and money from accounts receivable are used for operating cash flow, this can result in a lower equity position, making it difficult to borrow money to replace worn-out assets.

Borrowing Money

Loans from various financial institutions are often necessary for covering short-term cash flow problems. Revolving credit lines and equity loans are common types of credit used in this situation. Short-term borrowing works fine as long as everything goes well. However, if your business experiences a downturn in volume, short-term borrowing can cause a bank to call in a loan or cancel its credit line, leaving your business without adequate operating cash.

Long-term loans amortized monthly can improve a business's operating cash position. Amortized monthly means the monthly payment is constant and includes interest and principal portions that change in proportion as the loan is paid off. During the early stages of the loan, the interest portion is high and the principal is low; however, this situation reverses itself over the life of the loan.

In a situation in which long-term debt is used and the business has a seasonal peak demand, the excess cash should be invested in easily accessible, interest-bearing, low-risk accounts, such as savings accounts, a short-term certificate of deposit or a U.S. Treasury note (commonly called a T-bill). The money should not be used for cash operating expenses or to avoid a shortfall when cash is needed. Keeping excess cash on hand reduces both the growth and the return on investment.

Tax Obligations

Income and payroll tax obligations can also affect cash flow. If a business is profitable and growing, the cash that should be retained for income tax payment and payroll tax can easily be spent for other items that support growth. This results in a cash shortage when income taxes are due. To avoid this shortage, make adequate projections and analyze current income statements to determine future tax obligations. As these obligations are determined, cash should be set aside to meet them.

Managing Credit

The credit a company extends to its customers can be crucial in its impact on cash flow if the customers do not pay on time. New businesses and growing businesses often do not have the advantage of previous experience with their customers and can find themselves extending credit to high-risk customers. Research should be done in advance to determine a customer's ability to pay bills on time. Methods of determining this include obtaining a copy of a Dun & Bradstreet report on a potential customer and requiring potential customers to complete a credit application that asks questions about the business's ability to pay. References should be checked to get others' perceptions of customers and their integrity. (There are several publications available through the U.S. Government Printing Office that discuss credit. *Complying With the Credit Practices Rule and How*

to Write Readable Credit Forms are both published by the Federal Trade Commission and are available through the Superintendent of Documents, U.S. Government Printing Office, listed in the Information Resources in Appendix F.

When working in a business activity that sells directly to customers, it is advisable not to extend store credit but to use charge cards. Information on offering credit card purchases can be obtained through your company's bank. Banks charge businesses different rates for credit card sales, based on the dollar volume of the sales, so check several bank sources. The disadvantage of the credit card is it costs you a specified percentage, ranging from 2 to 5 percent, of the total dollar volume customers charge. On the other hand, customers often expect the convenience of credit cards.

As credit and terms are tightened, more customers will pay cash for their purchases, thereby increasing your cash on hand and reducing your potential for a bad debt expense. While tightened credit is helpful in the short run, it may not be advantageous in the long run. Looser credit allows customers more opportunity to purchase your products or services. Just be certain the increase in sales is greater than the increase in bad debt expenses.

Discounts for Early Payment

The practice of receiving cash discounts for early payment illustrates a major difference between the cash flow and projected income statements. Not taking advantage of a cash discount by paying bills promptly can improve your immediate cash flow, but can also negatively affect profitability. On the other hand, by paying early, your costs will be lower and profit margin higher, but your cash flow could be strained. Certainly a business should consider taking advantage of discounts, but should also know when and how to capitalize on them. Your company might also consider offering these discounts to help its cash flow.

Increasing Sales

Increasing sales appears to increase cash flow, but be careful. For many companies, a large portion of sales are purchased on credit. Therefore, when sales increase, accounts receivable, not cash, increase. Receivables are usually collected 30 days after the purchase date. Sales expenses are most often incurred before receivables are collected. When sales rise, inventory is depleted and must be replaced. Because receivables have not yet been collected, a substantial increase in sales can quickly

deplete a firm's cash reserves. With a computer, you can monitor this critical data and increase the time required to consider alternate what if scenarios.

Techniques for Reducing Costs

Techniques for reducing costs will be discussed in two sections: the first suggests methods for reducing the cost of normal operations and the second shows how to evaluate and deal with risks that can increase costs.

Analyzing Your Costs

Keeping Costs within Industry Averages

There are several studies available comparing industry averages and financial ratios. Three popular ones are *Annual Statement Studies* by Robert Morris Associates, One Liberty Place, Philadelphia, PA 19103; *Almanac of Business and Industrial Financial Ratios* by Leo Troy, PhD, Prentice-Hall, Englewood Cliffs, NJ 07632; and *Financial Studies of the Small Business* by Financial Research Associates, P.O. Box 7708, Winterhaven, FL 33883-7708.

These studies usually are published annually and can be purchased from the publishers, or you can get the information through small business service providers, including libraries, banks, SBDCs, SBIs and SBA offices. Membership in a trade association includes access to financial averages for the industries in that association. Comparing financial ratios allows a business to identify costs and relationships that are out of line with others in the industry. Reducing these costs will produce a more competitive situation.

Determining Highest Costs

All expense categories on an income statement should be reviewed to identify opportunities to reduce expenses. The first place to look for cost reduction opportunities is those cost categories highest as a percentage of sales this is often the cost of sales (COS). For example, if COS is 50 percent of sales, a 10-percent reduction in this category will result in a 5-percent reduction in overall costs. This can be compared with some of the fixed costs in the operation, such as interest, rent or depreciation costs, which are often in the area of 5 to 10 percent of sales. If you reduce an expense item that is only 10 percent of sales by 10 percent, you only reduce your overall expenses by 1 percent. Determining your highest costs can guide you on how to allocate time and resources toward cost reductions and will result in a substantial decrease in costs.

Buying Groups

Often small businesses have trouble purchasing goods at a discounted price because they do not have the volume buying power of larger companies. One method of reducing purchasing costs is to join or create buying groups of like businesses that purchase the same products but are not in direct competition with one another. This type of relationship can result in quantity discounts and a better selection of merchandise.

Inventory

Inventory has several associated costs in addition to its purchase price. This is true for raw materials, work in process, finished goods and retail/wholesale inventory. If inventory can be reduced and sales maintained, the result will have a positive impact on profitability.

The inventory turnover ratio is a good measure of the relationship between inventory and sales. This ratio is calculated by dividing the cost of sales by the average inventory for that period of time. A high ratio normally indicates an efficient use of inventory. However, a high ratio can also mean you are missing sales opportunities because items that customers are requesting are not in stock. The proper relationship must be determined for each situation.

Inventory carrying costs usually include interest, storage, insurance, obsolescence, physical damage and deterioration. These costs can be reduced by applying just-in-time inventory and manufacturing techniques. For a manufacturer, just-in-time techniques involve structuring the flow of materials through the plant to reduce inventory in all categories. The benefit of this technique is that it reduces holding costs. Just-in-time inventory results in better management and scheduling of both raw materials coming into the plant and inventory leaving the plant. These techniques are usually associated with manufacturing but can also be applied to retail/wholesale businesses.

The economic order quantity formula is one method of calculating the optimum amount of inventory to order.

The formula is

x equals the square root of 2 times r times o divided by c

r	=	number of units used/sold per period;
o	=	cost of placing the order and
c	=	cost of carrying the inventory per unit per period.

This formula compares the cost of ordering inventory to the cost of carrying it and identifies the minimum cost point, thus balancing the two costs against each other. The formula indicates the number of units to be ordered. The lead time to place the order can be determined based on usage and the time it takes to receive the order. In a growing business, where inventory is increasing, the economic order quantity formula can help determine the new quantity to order. Economic order quantity is explained in inventory, finance or operations management texts.

Use Contracts

If business activity is generated by contracts, consider negotiating the payment time as well as the price. This technique will improve overall cash flow. It also will affect expenses because less cash is needed to carry the activities of the business, thus reducing interest costs. Instead of requesting payment at the end of the project, schedule monthly or weekly payments for completed work. This is also accomplished by requiring deposits for materials purchased during the production process.

Overhead Costs

Reducing overhead costs, such as rent, utilities and interest, immediately lowers a company's break-even point. When the break-even point is lowered, the company can reach profitability sooner and experience profitability over a larger range of sales. As sales increase, you will be able to retain a greater percentage of sales dollars as profit. One of the keys to managing overhead costs is to keep these costs in balance with the sales level. Often overhead costs are spent up front to generate the desired sales.

Management Compensation

One way to reduce costs during an expansion phase is to reduce the owner's compensation until the business is in a position to pay the owner better. Compensation should match an owner's living expenses. Profit returned to a business that is growing should be a good investment for the owner.

Use of Bar Code

Expanding businesses need to carefully balance the costs associated with increased business activity. The bar code system for inventory and pricing can reduce costs in selling and controlling inventory. When this system is used for checkouts, labor costs are reduced, as are chances for error. Also, through its increased accuracy in controlling inventory, the bar code system can decrease the number of dollars tied up in inventory. This common system is called the Uniform Product Code and is available through the Uniform Code Council, Inc., 8163 Old Yankee Street, Dayton, OH 45458, (513) 435-3870.

Leasing Equipment

Leasing is a way of reducing costs if the equipment can be leased when you need it, or if the time period you need the equipment is less than a normal ownership period. Equity or net worth requirements may be less if leasing is used to expand the business. The disadvantages of leasing are that it does not allow net worth to build over time (unless it is a lease/purchase arrangement) and it is usually more expensive than an equal period of ownership.

Training Employees

An expanding business may need to add employees who lack experience in its business area and need training. There are several ways to reduce training costs. One option is the Job Training Partnership Act (JTPA), a federally funded program that assists in finding employees and that will reimburse up to 50 percent of employees' wages for the first 2 to 26 weeks of employment. People hired must meet certain eligibility criteria because this program is intended to provide an incentive for hiring individuals who either are unemployed or have low income. The program also compensates for training expenses, but only when such training is merited. For specific information on the program's requirements, contact your local JTPA office.

State governments have other job-related training programs based on job specifications. These programs can be researched by contacting local employment agencies, state and federal departments of labor or community colleges. If employees need to learn a specific skill, the U.S. Department of Labor has an apprenticeship program that allows training to be provided at a reduced cost to the employer. You can obtain information on this program by contacting the U.S. Department of Labor office in your state.

Reducing Costs by Changing Business Organization

Expansion

At times an expansion can result in spreading existing fixed costs over a larger sales volume. In this case, the decision to increase size is justified. Whenever you have to increase fixed costs to attain

higher sales levels, investigate the proportion of the increase before proceeding with growth plans.

An example is operating a wholesale business from a warehouse. Once the warehouse is established, it becomes a fixed cost and you can increase sales by adding a salesperson -- a variable cost. The variable cost per unit of sales (i.e., salespeople productivity) should remain constant in order to result in a lower fixed cost per unit sold. Increased variable costs can take away the benefit of lower fixed costs per unit. This is true until the warehouse reaches its capacity to function. One of the concerns here is that variable costs remain constant. For example, if the additional salespeople cover a territory farther from your base operation, there are additional costs associated with travel and unproductive sales time. If the variable costs deplete the advantage, then the decision to expand is unprofitable.

Diversification

Diversification is traditionally considered an option for business growth. One of the major advantages of pursuing diversification is that it can balance seasonal or yearly cycles in your business, or it can be used to balance a multiyear cycle influenced by economic conditions. Usually the area selected for diversification should be related to your current business activity.

There are two types of diversification: vertical and horizontal. *Vertical diversification* involves expanding either up or down the channel of distribution. An example of vertical diversification is a manufacturer who has been selling to independent wholesalers and then starts his or her own wholesale operation. *Horizontal diversification* involves adding other similar products or business lines. An example of horizontal diversification is a business that manufactures and sells ice and then starts bottling water. The bottled water is related to its current activity and uses some of the same equipment, thus reducing overhead costs. These two examples of diversification provide a framework for identifying methods for creating additional business.

Joint Ventures

Joint ventures also can be a method for cutting expansion costs in production processes, purchasing and sales. These relationships should be established carefully so they benefit both parties and allow a way for either party to end the relationship. The cost savings often occur in the area of fixed overhead expenses, as these costs are now shared.

Reducing Costs by Managing Risks

Risk is always associated with business activity. In a stable company risk is manageable, but for a growing company risk can easily become monumental. Unexpected occurrences may result in additional expenses that increase the cash outflow. The following is a list of potential risks and options to help reduce their impact on your business.

Lawsuits

Lawsuits usually can be avoided by complying with regulations or policies and taking appropriate precaution not to harm others. Knowledge of federal and state regulations is the responsibility of

management. Two potential areas for a lawsuit are relationships with employees and the potential for physical harm to people or damage to their property. A major cost with a lawsuit, in addition to legal fees, is the possibility of bad publicity, which may take time, money and extra effort to overcome. Discuss your concern over being sued with an attorney. Talking to a business owner who has been sued may help avoid problems as well as identify the courses of action to take if you are sued. Even if all precautions have been taken, the risk of a suit remains. Liability insurance is one means of reducing the potential impact of the risk. At a time of growth, liability insurance should be evaluated to determine if it is still adequate.

Patent Infringements

Owners of a manufacturing or product development business should investigate the possibility of obtaining patents for new products. Usually patent infringement occurs because owners didn't realize the product was patentable. If there already is a patent on the new product and the patent owners become aware of your product when it is marketed, they could force you to stop production and sue you for patent infringement. Because of this potential, even if obtaining a patent is not being considered, it is prudent to conduct a patent search to assure that no one else has a patent for the product you plan to produce. This can be done through patent attorneys, patent depository libraries or computer data base systems.

Machine Breakdowns

Most business activities use equipment that can break down unexpectedly. Not only is there the possibility of additional repair costs but also there is the likelihood of having to replace the equipment entirely. These kinds of costs can be managed by implementing a preventive maintenance program. The potential for breakdown is related to the age of the equipment and the care it has been given. If you are purchasing new equipment for a growth phase, the potential for unforeseen repair costs should be reduced greatly. When expansion is started with used equipment, the risk of the equipment breaking down increases.

In general, money should be allotted for equipment repair and replacement; depreciation dollars are normally accumulated for the purpose of replacing the depreciated assets. However, in a case in which repair costs will prolong the life of the asset, the dollars set aside for depreciation may be used to cover repairs. This should apply only to unusual repairs, not normal maintenance. In a

business that has just begun to grow, the depreciation account has not accumulated a significant amount; therefore, a reasonable amount should be planned for later financing.

Usually manufacturers are concerned about this type of risk, but retail businesses also have equipment that needs to be examined, including cash registers, computers, air conditioners and delivery vehicles.

Supplier Problems

During an expansion phase, relationships with new suppliers will be established or existing relationships will be expanded, especially for volume purchases. It may be a good policy to consider

using diverse suppliers. Dependence on one supplier can jeopardize your potential sales volume if that supplier develops a problem and cannot produce. As supplier relationships expand, consider formal written relationships instead of relying on verbal understandings. These can clarify any issues that later could cause problems. Pass on to suppliers any obligations you have with your customers in areas in which supplier performance can adversely affect your business.

Customer Credit

In a growing business, establishing relationships with new customers and expanding relationships with existing customers can create the potential for noncollectible accounts. To obtain new customers, it may be tempting to relax past credit policies. A careful determination of a new customer's ability to pay should be considered and follow-up collection procedures implemented. An amount should be set aside in financial projections for bad debt expenses. This can be proportional to the bad debt expense incurred in the past. However, the amount could become higher as a portion of sales if credit terms are relaxed to obtain increased sales.

Bank Failure

Banks are not fail-safe. They have had and will continue to have an impact on businesses, especially when they close. Most banks are insured by the Federal Deposit Insurance Corporation (FDIC), but you should verify this. Banks financial statements are available for public review. A good way to protect your company from the effects of a bank failure is to obtain the bank's financial statements and compare the total deposits to the number of outstanding loans. Even if your company's bank is insured by the FDIC, should it fail, it takes time for the FDIC to release the cash your company had in the bank. This could put a severe strain on the cash flow of the business.

Physical Damage

Even though in most cases physical risks are covered by insurance, whenever a disaster strikes -- whether it is a fire, hurricane, flood, earthquake or tornado -- the disruption to the business will be greater than the damage to the property. The major risk to a business is lost sales because of (1) the business's inability to function and (2) the time it takes to restructure the business.

Personnel Problems

There is insurance to protect against most risks involving people, including you or a key employee becoming disabled or dying. Even with the insurance, there are additional costs associated with the loss. In the case of either death or disablement, the business can be named as the beneficiary, but the dollars recovered cannot repair all of the damage caused by the business's inability to serve its customers' needs.

Also consider the risk involved with losing company secrets. Do you have a system to protect your trade secrets? Is there the potential for one of your employees to share your business secrets? If you don't have procedures to protect trade secrets, take the time to develop and implement such policies.

Unions

If your operation is non-union, employees may vote to establish a union, which is their legal right. Responsible management, however, is one way of deterring employees from forming a union. Unions usually are formed when wage levels or other working conditions are unacceptable to the employees.

Unknown Laws

The best way to avoid costs in this category is to conduct business according to the law. Attorneys or state and federal regulating agencies can help review the requirements that pertain to your business. Trade associations also can be helpful in staying abreast of developments. Two areas particularly important to a business are labor and environmental laws. Violating the law can result in costly fines and penalties.

Tax Requirements

Whenever your business is growing and changing, you should investigate the impact taxes will have on the business, such as property, sales, payroll and federal and state income taxes. Pay particular attention to sales tax if your company is expanding into new geographic areas. Each state has its own sales tax system, and states are cooperating in collecting sales tax from out-of-state businesses.

Warranty Claim Risks

Manufacturing companies have product warranty requirements. These requirements can involve state and federal laws. A warranty claim on a single product may not be devastating, but if a major flaw is detected in your product and all the products sold are recalled, it can be quite a challenge to overcome. For more information, obtain the publication *Product Warranties and Servicing* published by the U.S. Department of Commerce, Office of Consumer Affairs through the Superintendent of Documents, U.S. Government Printing Office, Washington, D.C. 20402.

SECTION 3: DOCUMENTING RESULTS

Your Accounting System

The accounting system of a growing business must change and adapt to new needs after growth. Changes in accounting may be resisted by employees who are comfortable with the existing system. Also, when accounting systems change, it becomes more difficult to compare past trends with current results. Further, a new or improved accounting system can cost time and money to develop and implement, placing an additional strain on limited resources. Despite these negatives, a growing business usually needs additional management information from the accounting system.

The purpose of most accounting systems is to provide management with information, control and

feedback. If your accounting system is used only for providing information to the Internal Revenue Service (IRS), it is not fulfilling its total purpose. If business growth is occurring in existing product or service lines, the current system will apply to the new growth cycle. However, because the number of transactions will increase, the accounting system should be evaluated to ensure the data are accumulated in an efficient manner. This evaluation should include whether certain types of transactions need to be recategorized.

During growth or a change in the form of ownership, all previous accounting standards need to be reconsidered to determine if changes are necessary. Examples include

- ! Cash-based versus accrual accounting
- ! Single- versus double-entry accounting
- ! Fiscal year
- ! Form of ownership

Cash-based Versus Accrual Accounting

If you are using the accrual accounting system, there probably is no need to change. If you have been using the cash-based accounting system, perhaps the accrual system should be considered. In cash accounting, transactions are recorded as income or expenses when the cash has actually been transferred. (For a retail business in which only cash is received on the income side, the cash and accrual systems are the same.) In accrual accounting, transactions are recorded when they occur or when the goods or services are transferred. In this system, payment is usually received after the product or service has been delivered. For example, your business sold and delivered \$10,000 worth of materials on December 28 but was not paid until January 5. If you were operating on a cash-based accounting system, you would record the income in January; if you were on an accrual accounting system, you would record the income in December. The accrual system can affect your tax obligations. However, the main advantage of accrual accounting is that it results in more meaningful information for controlling business activities. This is true because expenses that generate income are brought together in the same time period that the income is reported.

Single- Versus Double-entry Accounting

Growth might be better managed with a double-entry system. Single-entry means that a transaction is entered only once into your system. Double-entry involves entering a transaction twice: first as a debit and then as a credit. For example, in a double-entry system, the payment of an invoice would be recorded as a materials purchased expense and as a deduction from the cash account. Double-entry accounting is more accurate than single-entry accounting because each transaction is entered as a balanced item -- with offsetting increases and decreases on each side of the asset/liability or revenue/expense ledger. Thus, the resulting balances should be identical.

Choosing a Fiscal Year

When you begin a business, you choose the operating fiscal year, whether it is a calendar year or some other 12-month period that is convenient for you. When the business begins to grow, reconsider your fiscal year. Perhaps the new activity will be seasonal, i.e., in a different season than you currently use. You should consider some type of tax year that matches the season and avoids splitting the season into two tax years.

Form of Ownership

The accounting system is slightly different for a sole proprietorship, a partnership or a corporation. During a growth phase, you should perhaps consider other forms of ownership and implement the accounting system that matches that form.

Multiple Accounting Systems

Managers need guidance to make decisions. If you operate with a single or a simple accounting system that produces a single income statement and balance sheet, consider developing two or three separate accounting systems, one for each area of your business, which can then be consolidated into one income statement and balance sheet. The separate systems will enable you to know what is happening.

This is similar to the concept of developing profit centers for a business. If you operate a retail business, profit centers are divided into different functional areas in your store, or, if you are a manufacturer, they are based on your product lines. Accounting systems for each profit center allow you to determine the profitability of each product. If each product line or profit center category is generating a profit, then the overall business will be profitable on a consolidated accounting statement.

An example is a retail hardware store generating one income statement. Management might benefit from dividing the business into functional areas such as household, sports and tools, and developing income statements for each of these areas. This information still must be consolidated into one statement, but the individual statements provide information that will help maximize profitability in each area. This system also works for branch offices, which are often established to increase business activity. Each branch office has its own operating system, then they are pulled together into a consolidated system.

Accounting systems are set up so that information flows from a large number of entries to a final income statement and balance sheet. Income statements allow trends to be tracked by listing a current month's sales and expense amounts, current month's percentages, year-to-date activity and year-to-date percentages. The current month percentage is the expense amount for the month divided by sales. For example, if sales were \$100,000 and wages were \$10,000, the percentage for wages is 10 percent (\$10,000 wages divided by \$100,000 sales). This system must be maintained, although categories may need to be added in a growing business. The owner of a growing business should be able to access reports that track the efficiency of the operation. If the information is compiled appropriately, it will be readily available at minimal cost.

For example, on an income statement for a restaurant, the cost of sales and labor are separate items,

including their dollar amounts and their percentage relative to sales. Combine these and compare them over a time period. If prepared food is purchased, the food cost per meal served will be higher but the labor cost lower. This is particularly true in a restaurant in which the labor and cost of food can be inversely related. The important factor overall may be the combined percentages of labor and material compared to sales. (However, be aware that trends are not always accurate for comparison because they may fluctuate seasonally. Compare trends from the same time frame each year. This can be done by using a table or a graph to express the comparison.)

Management can determine operational efficiency by several factors not measured in dollars. Efficiency means that the business operation is maximizing output levels for a given amount of time or resources. The management information generated by the accounting system results in an accurate measure of efficiency, but there is other information that can be accumulated to measure efficiency. An example is the number of prospect phone calls made over a certain time. By accumulating, recording and tracking this information, the efficiency of the sales staff can be calculated. In a manufacturing business, this can be the number of hours it takes to perform certain tasks or the resulting data collected from a statistical process control system.

Because these reports increase the fixed costs of your business, any report request should be thought through carefully to ensure that the result is of value to the user. With computerized data systems, it is very easy to produce a lot of paper that isn't meaningful or usable for management.

Computer Applications

During growth, many business owners-managers believe a computer is necessary to complete accounting needs for the business. This can be true, but there are certain pitfalls to consider before selecting a system. If you have a system, future growth may cause you to exceed the system's current capacity, which will require a reevaluation of your system.

There can be costs associated with purchasing equipment and hardware, but perhaps the most difficult cost to measure is the hidden cost involved with implementing a computer system. Even though computers are supposed to decrease the use of labor and add to the efficiency of the operation, this often is not the case with a computer system. Before installing a system, become familiar with how the system works and what it produces by developing and implementing a manual or paper accounting system. Once the manual system is completed and transferred to the computer, you will know exactly what the system can and cannot produce.

One of the main criteria for selecting a computer system is that the resulting information be usable based upon the company's needs. There are software packages specifically designed for accounting. Even though they are expensive, they may cost less overall compared to developing a system of your own. There are usually four issues that should be considered in developing a computerized accounting system:

1. Design an accounting system programmed in a computer language.
2. Purchase a software spreadsheet package and program the spreadsheet.

3. Purchase software specifically designed for accounting systems.
4. Purchase software designed for a specific accounting system for a specific type of business.

All of these should be explored and reviewed carefully before you decide to implement a particular system. Assistance should be sought not only from computer and software vendors but also from accountants and professionals with knowledge of accounting and computer applications. It is sometimes tempting to purchase software that employees are familiar with rather than to purchase a system tailored to the business. This may work, but if the employees quit and the software was not the best for the business, it could be challenging to keep the system going.

In addition to considering the computer equipment and software, explore the availability of printing options as they can affect the usefulness of the information produced. Computer printers vary in printing speed, quality of print, cost and page layout and dimensions. All of these factors have an impact on the appearance of your output information.

Relationship with Your Accountants

Changes in the accounting system will cause you to reevaluate your relationship with accountants. If you are doing your own accounting, you may need to consider whether you should hire assistants or seek additional training. Either way, a growing company requires more complex accounting decisions. Growing companies can find themselves in a position of having outgrown their accountant. If this happens, search for a professional service that matches the level of your business activities.

Accountants can design new systems for managing your business information. Be sure you get what you need because, occasionally, accountants design systems for tax purposes and have difficulty considering the broader need for information management in your business. If you feel this happening, rely on the accountant for your tax obligations but consider seeking assistance from others in designing a system consistent with your business needs. Remember, the accounting system should be designed so your business grows into it. When you are making changes, try to anticipate what will be happening in the future to avoid the need for further change in your system. The advantage of this is it will be easier to maintain a consistent method of analyzing trends from year to year.

Tax Consequences of Growth

Growth should produce additional profit, which will result in an increasing tax obligation. Several aspects of taxes affect growth. Tax reduction often does not result in a decreased tax obligation but transfers payment of the obligations to a future time. In a real sense, total tax dollars paid over a long-term period are going to be fairly constant. The idea usually is to reduce taxes now, then invest the money so that as taxes become due more money is available.

One of the primary tasks of tax planning is contemplating profitability over the next 10 to 20 years.

If projections show profits will be low in the first years and higher thereafter, consider transferring profit to the first years. Should projections indicate higher taxes or profit in the first years, arrange to pay tax now. Several factors influence this decision. One possibility is to amortize expansion costs that are unrelated to capital improvements. According to IRS guidelines, a capital improvement can be depreciated based on a determined life span. This span usually involves physical assets that wear out, as compared to expansion costs that can have a positive effect on sales volume in the future. An example is any expenditure used to develop a channel of distribution that is going to be in existence for some time. This cost can be calculated and amortized over a minimum of five years, thus reducing expenses in the current year. A reduction in expenses means more profit, which means paying more tax currently. When higher profits occur, amortization will transfer more expense to that time period, resulting in lower profit and taxes.

The following areas are among those that should be investigated to determine if their costs, when associated with an expansion, can be amortized:

- ! Training for employees
- ! Travel and related expenses
- ! Advertisement related to the expansion
- ! Surveys and market research
- ! Salaries of those involved in the expansion
- ! Organization costs for the form of ownership
- ! Research, experimental and development costs
- ! Agreements not to compete
- ! Cost of acquiring leases
- ! Cost of commissions or finder fees

This list is not comprehensive.

Keep in mind the effect taxes will have on interest and depreciation. During the early part of a business, interest and depreciation are usually high, resulting in increased expenses and, thus, decreased profits. Later, when the principal is paid down, interest is low and depreciation is close to nonexistent, you will owe higher taxes, which will result in a higher tax rate.

The current depreciation system used for all assets placed in service after 1986 is Modified Accelerated Cost Recovery System (MACRS). This system divides capital improvements into time periods of 3, 5, 7, 10, 15 and 20 years. The allowable rate of depreciation should be used when projected income statements are developed to justify the growth potential of a business.

If a change in the ownership structure of the business is contemplated during a growth period, be sure to consider the subsequent tax obligations. If you own several separate businesses (with various situations of profit and loss), it may be more cost effective to control them through a parent holding company so tax losses in one business can be balanced against tax owed in another business. Also, the form of ownership, whether it is a sole proprietorship, a partnership or a corporation, can have an impact on personal income taxes. In certain business situations, the corporation can be a means of reducing taxes and in other cases the sole proprietorship can result in lower income or payroll taxes.

During an expansion, consider the current tax status of programs, such as investment credit, which allows acceleration of deductions for capital improvements. In the past, these accelerated methods were called investment credit. Currently they are available to growing businesses through the Section 179 deduction. This allows an additional deduction in the current year which means lower profits and less tax. This deduction also is available through Section 38 property that has a useful life of at least three years. (Check with the IRS for specifics about the maximum allowance.) The amount of the deduction is subtracted from the basis in order to begin calculating depreciation on the capital assets. There are specific guidelines on the taxable income limit, the carryover of an allowable deduction and the original cost of the asset.

Investigate the impact taxes will have on growth by talking with tax accountants or by studying tax information provided by the IRS. Two IRS publications that address growth issues are Publication 534, Depreciation, and Publication 334, Tax Guide for Small Business. You can obtain copies through your local IRS office or check the listing in Appendix F: Information Resources.

SUMMARY

When future growth is anticipated by business owners, the excitement and challenge often draw the owner's attention away from the financial aspects of the business. Business history is full of examples of businesses that accomplished growth but were unable to sustain their new position, often because of lax attention to managing the finances that support growth. Financial management needs to correspond to the expansion activities being undertaken. Giving proper attention to managing finances will enhance growth potential and sustain levels of sales once they are obtained. Financial planning should be viewed not as an obstacle but as a means of ensuring your success.

The challenge of a growing business should be carefully weighed against your personal drive to achieve what you are attempting. It often seems the time and effort it takes to achieve goals in business increase more than what was originally anticipated. Part of a well-devised plan is to have options open to compensate for possible areas that do not develop as expected. To have these options identified so they can be implemented immediately can often make the difference between success and failure. To a great extent, growth potential is based on your ability to know yourself. You must either have the personal abilities to complete the growth, or you must know your limitations and have resources available to cover them. (See the self-assessment questionnaire in Appendix D.) Also, in some instances, business owners rely too heavily on outside expertise or employees and are misguided or misunderstand their ability to assist in obtaining growth.

The encouraging side of growth is that many others have undertaken and achieved growth successfully in business. There are many success stories in which people have improved their income potential and their net worth.

APPENDIX A: SAMPLE BALANCE SHEET AND INCOME STATEMENT

The following balance sheet and income statement provide examples of the information that should be currently available before attempting to increase a business's sales. These statements are the standard that is acceptable for communication of financial information to banks and are the usual format developed by accountants. These statements result in management information that helps management determine what action should be taken for future business potential.

New Business Balance Sheet (Current Data)

Assets	
Current assets	
Cash	\$ 2,174
Accounts receivable	28,459
Notes receivable	24,216
Inventory	143,000
Total current assets	\$197,849
Property, plant and equipment	
Equipment	17,988
Vehicles	8,000
Furniture and fixtures	
Total cost of PPE	25,988
Less accumulated depreciation	18,892
Book value of PPE	7,096
Total assets	\$204,945
Liabilities and Equity	
Current liabilities	
Accrued expenses	
Accounts payable	71,000
Current portion of long-term debts	11,802
Total current liabilities	82,802
Long-term debt	64,198
Total liabilities	147,000
Owner's equity	57,945
Total liabilities and equity	\$204,945

New Business Income Statement
(Current Year-To-Date)

	Current Month		Year-To-Date	
	\$	%	\$	%
Sales				
Beginning Inventory	38,000	100.00	450,000	100.00
Materials purchased	143,000		138,850	
Ending inventory	23,500		286,150	
Cost of goods sold	23,500	92.00	279,000	62.00
Gross profit	14,400	38.00	171,000	38.00
Operating and fixed expense				
Wages	7,500	19.74	90,000	20.00
Payroll tax	750	1.97	9,000	2.00
Benefits	400	1.05	5,000	1.11
Accounting and legal	0	0.00	1,000	0.22
Advertising	475	1.25	5,265	1.17
Sales expenses	85	0.22	1,000	0.22
Interest	700	1.84	9,000	2.00
Utilities	275	0.72	3,000	0.67
Telephone	330	0.87	4,000	0.89
Supplies	400	1.05	5,000	1.11
Office supplies	140	0.37	1,570	0.35
Repair and maintenance	100	0.26	1,100	0.24
Freight	50	0.13	450	0.10
Insurance	833	2.19	10,000	2.22
Depreciation	425	1.12	5,100	1.13
Vehicles	200	0.53	2,600	0.58
Rent	0	0.00	0	0.00
Outside services	75	0.20	1,000	0.22
Miscellaneous	165	0.43	2,000	0.44
Total operating and fixed expenses	12,903	33.96	156,085	34.69
Operating profit	1,537	4.04	14,915	3.31

APPENDIX B: SAMPLE PRO FORMA STATEMENTS

- ! Income Projection Statement
- ! Cash Flow Projection
- ! Balance Sheets

The following projections are based upon the historical statements provided in Appendix A. These

are based on the actual situation and include obtaining an additional loan amount to finance the growth of the business. The income statement, cash flow and balance sheet items are all balanced or in the proper relationship to the historical statements. In these projections, growth in sales is expected to go to \$685,000 from a level of \$450,000 for the first year; the business is expected to double in size within three years.

Income Projection Statement
Business Name Here

	First Year	Second Year	Third Year
Gross Sales	685,000	753,500	828,850
Beginning Inventory	161,000	177,100	177,100
Materials Purchased	440,800	484,800	533,368
Ending Inventory	177,100	177,100	177,100
Cost of Goods sold	424,700	484,880	533,368
Gross profit	260,300	268,620	295,482
 Fixed Expenses			
Wages	137,000	150,700	165,770
Outside services	0	0	0
Accounting and legal	1,600	1,600	1,600
Advertising	8,000	8,800	9,680
Travel and Freight	400	400	400
Rent	15,456	15,456	15,456
Depreciation	11,600	11,600	11,600
Supplies	10,000	10,000	10,000
Utilities	3,600	3,780	3,969
Telephone	4,700	5,170	5,687
Interest (new loan)	10,294	9,155	7,884
Interest (existing loans)	8,485	6,988	5,342
Repairs	2,000	2,000	2,000
Taxes	0	0	0
Insurance	12,000	13,200	14,520
Other	1,000		
Misc.	3,000	3,000	3,000
 Total	 229,134	 241,849	 256,907
 Net profit	 31,166	 26,771	 38,575
 Income Tax	 6,856	 5,890	 8,486
 Owner's withdrawal	 0	 0	 0
 Profit	 24,309	 20,882	 30,088

!! The Following Table is Presented in Two Sections. To
Red Properly, Please Match Line Numbers!!

Name of Business:

Cash Flow Projection

Months	Start-up	Sept.	Oct.	Nov.	Dec.	Jan.	Feb.
1. Cash on hand	12,174	2,821	1,829	1,248	6,606	28,112	
2. Cash receipts	51,431	9,141	52,997	57,785	71,240	45,895	
Loan or other injection							
3. Notes receivable	2,018	2,018	2,018	2,018	2,018	2,018	
4. Cash available	65,623	53,980	56,844	61,051	79,864	76,025	
Cash paid out							
5. Purchases-goods	43,497	30,273	34,681	34,681	30,273	25,865	
6. Gross wages	11,417	11,417	11,417	11,417	11,417	11,417	
7. Outside services	0	0	0	0	0	0	
8. Supplies	833	833	833	833	833	833	
9. Repair/maintenance	0	400	0	0	0	1,600	
10. Advertising	300	300	1,800	600	600	600	
11. Travel & freight	0	400	0	0	0	0	
12. Accounting/legal	133	133	133	133	133	133	
13. Rent	1,288	1,288	1,288	1,288	1,288	1,288	
14. Telephone	392	392	392	392	392	392	
15. Utilities	240	300	350	400	400	350	
16. Insurance	1,000	1,000	1,000	1,000	1,000	1,000	
17. Taxes	0	0	0	0	0	0	
18. Interest (new loan)	898	891	884	877	869	862	
19. Interest (existing loans)	760	751	741	732	722	713	
20. Miscellaneous	250	250	250	250	250	250	
21. Other	83	83	83	83	83	83	
22. Subtotal	61,091	48,711	53,852	52,685	48,261	45,385	
23. Loan principal (new loan)	780	787	794	801	809	816	
24. Loan principal (existing loans)	931	940	949	959	968	978	
25. Income tax	0	1,714	0	0	1,714	0	
26. Capital purchases							
27. Owner withdrawal	0	0	0	0	0	0	
28. Cash paid out	62,802	52,152	55,596	54,446	51,752	47,180	
29. Cash position	2,821	1,829	1,248	6,606	281,12	28,846	

Part 2 of Above Chart -- Match Line Numbers
Time Period: Year One

	Mar.	Apr.	May	June	July	Aug.	Total
1.	28,846	25,540	24,382	29,347	34,996	38,932	
2.	53,430	61,650	61,650	62,335	62,335	58,225	688,114

3.	2,018	2,018	2,018	2,018	2,018	2,018	24,216
4.	84,294	89,208	88,050	93,700	99,349	99,175	
5.	39,089	43,497	39,089	39,089	39,089	34,681	433,800
6.	11,417	11,417	11,417	11,417	11,417	11,417	137,000
7.	0	0	0	0	0	0	0
8.	833	833	833	833	833	833	10,000
9.	0	0	0	0	0	0	2,000
10.	600	600	600	600	600		8,000
11.	0	0	0	0	0	0	400
12.	133	133	133	133	133	133	1,600
13.	1,288	1,288	1,288	1,288	1,288	12,88	15,456
14.	392	392	392	392	392	392	4,700
15.	300	250	250	250	250	260	3,600
16.	1,000	1,000	1,000	1,000	1,000	1,000	12,000
17.	0	0	0	0	0	0	0
18.	854	847	839	832	824	816	10,294
19.	703	693	683	673	663	652	8,485
20.	250	250	250	250	250	250	3,000
21.	83	83	83	83	83	83	1,000
22.	56,942	61,283	56,857	56,839	56,821	52,605	651,334
23.	824	831	839	846	854	862	9,842
24.	988	998	1,008	1,018	1,028	1,038	11,802
25.	0	1,714	0	0	1,714	0	6,856
26.							0
27.	0	0	0	0	0	0	0
28.	58,754	64,826	58,704	58,704	60,418	54,506	
29.	25,540	24,382	29,347	34,996	38,932	44,669	

Balance Sheet
Business Name Here
First Year of Business Expansion

Assets

Current assets

Cash	12,174
Accounts Receivable	28,459
Notes Receivable	24,216
Inventory	161,000

Total Current Assets 225,849

Property, plant & equipment		
Land	0	
Building	24,000	
Equipment	63,988	
Vehicles	8,000	
Furniture & fixtures	0	
Total property, plant & equipment	95,988	
Less accumulated depreciation	(18,892)	
Total long-term assets	77,096	
Total assets		302,945
Liability & equity		
Current liabilities		
Accrued expenses	0	
Accounts payable	71,000	
Current portion of debt (new)	9,842	
Current portion of debt (existing)	11,802	
Total current liabilities	92,644	
Long-term loan (new)	88,158	
Long-term loan (existing)	64,198	
Total long-term liabilities	152,356	
Total liabilities	245,000	
Owner's equity	57,945	
Total liabilities and equity		302,945

Balance Sheet
Business Name Here
After First Year of Business Expansion

Assets		
Current assets		
Cash	44,669	
Accounts Receivable	25,345	
Notes Receivable	0	
Inventory	177,100	
Total Current Assets	247,144	
Property, plant & equipment		
Land	0	
Building	24,000	
Equipment	63,988	
Vehicles	8,000	
Furniture & fixtures	0	
Total property, plant & equipment	95,988	
Less accumulated depreciation	(30,492)	
Total long-term assets	65,496	

Determine the total number of units or products or services you realistically expect to sell each month in each department at the prices you expect to get. Use this step to create the projection to review your pricing practices.

! What returns, allowances and markdowns can be expected?

! Exclude any revenue that is not strictly related to the business.

Cost of Sales

The key to calculating your cost of sales is that you do not overlook any costs that you have incurred. Calculate cost of sales for all products and services used to determine total net sales. Where inventory is involved, do not overlook transportation costs. Also include any direct labor.

Gross Profit

Subtract the total cost of sales from the total net sales to obtain gross profit.

Gross Profit Margin.

The gross profit margin is expressed as a percentage of total sales (revenues) it is calculated by dividing

gross profits by total net sales

Controllable Expenses

- ! *Salary expenses* -- Base pay plus overtime.
- ! *Payroll expenses* -- Include paid vacations, sick leave, health insurance unemployment insurance and social security taxes.
- ! *Outside services* -- Include costs of subcontracts, overflow work and special or one-time services.
- ! *Supplies* -- Services and items purchase for use in the business.
- ! *Repairs and maintenance* -- Regular maintenance and repair, including periodic large expenditures such as painting.
- ! *Advertising* -- Include desired sales volume and classified directory advertising expenses.
- ! *Car, delivery and travel* -- Include charges if personal car is used in business,

As of _____, 19____

Assets	Liabilities
Current assets	Current Liabilities
Cash _____	Accounts Payable _____
Petty Cash _____	Notes Payable _____
Accounts Receivable _____	Interest Payable _____
Inventory _____	Taxes Payable
Short-term Invest- ments _____	Fed. income tax _____
	State income tax _____
	Self-employment _____
	Sales tax (SBE) _____
Prepaid expense _____	Property tax _____
Long-term invest- ments _____	Payroll accrual _____
Fixed assets	Long-term liabil- ities
Land _____	Notes payable _____
Buildings _____	
Improvements _____	Total liabilities _____
Equipment _____	
Furniture _____	Net worth (owner equity)
Automobiles/ vehicles _____	Proprietorship or Partnership _____
	(name's) equity _____
	(name's) equity _____
	or
Other assets	Corporation
1. _____	Capital stock _____
	Surplus paid in _____
3. _____	Retained earnings _____
4. _____	
	Total net worth _____
Total assets _____	Total liabilities and net worth _____
(Total assets will always equal total liabilities and total net worth)	

INSTRUCTIONS FOR BALANCE SHEET

Figures used to compile the balance sheet are taken from the previous and current balance sheet as well as the current income statement. The income statement is usually attached to the balance sheet. The following text covers the essential elements of the balance sheet.

At the top of the page fill in the legal name of the business, the type of statement and the day, month and year.

Assets

List anything of value that is owned or legally due the business. Total assets include all net values. These are the amounts derived when you subtract depreciation and amortization from the original costs of acquiring the assets.

Current Assets

- ! *Cash* -- List cash and resources that can be converted into cash within 12 months of the date of the balance sheet (or during one established cycle of operations). Include money on hand and demand deposits in the bank, e.g., checking accounts and regular savings accounts.
- ! *Petty cash* -- If your business has a fund for small miscellaneous expenditures, include the total here.
- ! *Accounts receivable* -- The amounts due from customers in payment for merchandise or services.
- ! *Inventory* -- Includes raw materials on hand, work in progress and all finished goods, either manufactured or purchased for resale.
- ! *Short-term investments* -- Also called temporary investments in marketable securities, these include interest- or dividend-yielding holdings expected to be converted into cash within a year. List stocks and bonds, certificates of deposit and time-deposit savings accounts at either their cost or market value, whichever is less.
- ! *Prepaid expenses* -- Goods, benefits or services a business buys or rents in advance. Examples are office supplies, insurance protection and floor space.

Long-term investments

Also called long-term assets, these are holdings the business intends to keep for at least a year and that typically yield interest or dividends. Included are stocks, bonds and savings accounts earmarked for special purposes.

Fixed Assets

Also called plant and equipment. Includes all resources a business owns or acquires for use in operations and no intended for resale. Fixed assets, except for land, are listed at cost less depreciation. Fixed assets may be leased. Depending on the leasing arrangement, both the value and the liability of the leased property may need to be listed on the balance sheet.

- ! *Land* -- List original purchase price without allowances for market value.
- ! *Buildings*
- ! *Improvements*
- ! *Equipment*
- ! *Furniture*
- ! *Automobiles/vehicles*

Liabilities

Current liabilities

List all debts, monetary obligations and claims payable within 12 months or within one cycle of operations. Typically they include the following:

- ! *Accounts payable* -- Amounts owed to suppliers for goods and services purchased in connection with business operations.
- ! *Notes payable* -- The balance of principal due to pay off short-term debt for borrowed funds. Also include the current amount due of total balance on notes whose terms exceed 12 months.
- ! *Interest payable* -- Any accrued fees due for use of both short- and long-term borrowed capital and credit extended to the business.
- ! *Taxes payable* -- Amounts estimated by an accountant to have been incurred during the accounting period.
- ! *Payroll accrual* -- Salaries and wages currently owed.

Long-term Liabilities

Notes payable -- List notes, contract payments or mortgage payments due over a period exceeding 12 months or one cycle of operations. They are listed by outstanding balance less the current portion

due.

Net Worth

Also called owner's equity, net worth is the claim of the owner(s) on the assets of the business. In proprietorship or partnership, equity is each owner's original investment plus any earnings or withdrawals.

Total Liabilities and Net Worth

The sum of these two amounts must always match at of total assets.

APPENDIX D: SELF-ASSESSMENT, DECIDING WHETHER TO PURSUE GROWTH

The following points should be considered when evaluating whether growth is reasonable for your business.

Personal

1. Do you have the time to undertake the activities associated with growth and the time the larger business volume will consume?
2. Does your family support your efforts to expand the business?
3. Is your personal financial position congruent with the financial situation of the company?
4. Does your management ability correspond to that necessary to manage growth?

Finance

1. Does your business have the equity level to justify growth? If not, do you have potential sources of equity?
2. Has your business been profitable or shown the potential for profitability?
3. Will your bank be able to cooperate with you in your growth phase?
4. Is the collateral position of the business adequate to meet the requirements of lenders?
5. Do accounting procedures allow you to maintain control of the business?
6. What contingency plans do you have if your initial attempts fall short?
7. Have you researched sources of government-assisted funding?

8. Do you have a knowledge of how cash flow interacts in your business to ensure future cash flow?
 9. Do you have support people who understand finance?
 10. Will the rate of return justify the commitment of resources?
 11. Will the value of the business grow?
-

APPENDIX E: HOW TO WRITE A BUSINESS PLAN⁸

The following pages provide a suggested outline of the material that should be included in your business plan. Your final plan may vary according to your needs or because of the individual requirements of your lender.

What Are the Benefits?

Every business can benefit from the preparation of a carefully written plan. There are two main purposes for writing that plan:

1. To serve as a guide during the lifetime of the business. It is the blueprint of your business and will provide you with the tools for analysis and change.
2. A business plan is a requirement if you are planning to seek a loan. It will provide potential lenders with detailed information on all aspects of your company's past and current operations and provide future projections.

Business Plan Outline

I. Cover sheet

Serves as the title page of your business plan. It should contain the following:

- ! Name of the company
- ! Company address
- ! Company phone number (include area code)
- ! Logo (if you have one)
- ! Names titles addresses phone numbers (include area code) of owners
- ! Month and year your plan was issued
- ! Name of preparer

II. Statement of purpose

(Same as executive summary.) This is the thesis statement and includes business plan

objectives. Use the key words (who, what, where, when, why, how, and how much) to briefly tell about the following:

- ! What your company is (also who what where and when).
- ! What your objectives are.
- ! If you need a loan why you need it.
- ! How much you need.
- ! Why you will be successful.
- ! How and when you plan to repay your loan.

III. Table of contents

A page listing the major topics and references.

IV. The business

Covers the details of your business. Include information about your industry in general, and your business in particular. Address the following:

- ! *Legal structure* -- Tell what legal structure you have chosen and state reasons for your choice.
- ! *Description of the business* -- Detail your business. Tell about your history present status and future projections. Outline your product or service in terms of marketability. Project a sense of what you expect to accomplish in the next few years.
- ! *Products or services* -- Give a detailed description of your products from raw materials to finished items. Tell about your manufacturing process. If you provide a service tell what it is how it is provided and why it is unique. List future products or services you plan to provide.
- ! *Location* -- Describe site and why it was chosen. (If location is important to your marketing plan focus on this in the marketing section below.)
- ! *Management* -- Describe who is behind the business. For each owner tell about responsibilities and abilities. Support with resumes.

- ! *Personnel* -- Who will be doing the work why are they qualified what is their wage what are their responsibilities?
- ! *Methods of record keeping* -- What accounting system will you use? Who will do your record keeping? Do you have a plan to help you use your records in analyzing your business?
- ! *Insurance* -- What kinds of insurance will you need? What will these cost and who will you use for a carrier?
- ! *Security* -- Address security in terms of inventory control and theft of information.

V. Marketing

Covers the details of your marketing plan. Include information about the total market with

emphasis on your target market. Identify your customers and tell about the means to make your product or service available to them.

- ! *Target market* -- Identify characteristics of your customers. Tell how you arrived at your results. Back up information with demographics questionnaires and surveys. Project size of your market.
- ! *Competition* -- Evaluate indirect and direct competition. Show how you can compete. Evaluate competition in terms of location market and business history.
- ! *Methods of distribution* -- Tell about the manner in which products and services will be made available to the customer. Back up decisions with statistical reports rate sheets etc.
- ! *Advertising* -- How will your advertising be tailored to your target market? Include rate sheets promotional material and time lines for your advertising campaign.
- ! *Pricing* -- Pricing will be determined as a result of market research and costing your product or service. Tell how you arrived at your pricing structure and back it up with materials from your research.
- ! *Product design* -- Answer key questions regarding product design and packaging. Include graphics and proprietary rights information.
- ! *Timing of market entry* -- Tell when you plan to enter the market and how you arrived at your decision.
- ! *Location* -- If your choice of location is related to target market cover it in this section of your business plan. (See location in the business section of this outline.)
- ! *Industry trends* -- Give current trends project how the market may change and what you plan to do to keep up.

VI. Financial documents

These are the records used to show past, current and projected finances. The following are the major documents you will want to include in your business plan. The work is easier if these are done in the order presented.

- ! *Summary of financial needs* -- This is an outline indicating why you are applying for a loan and how much you need.
- ! *Sources and uses of funds statement* -- It will be necessary for you to tell how you intend to disperse the loan funds. Back up your statement with supporting data.
- ! *Cash flow statement (budget)* -- This document projects what your business plan means in terms of dollars. It shows cash inflow and outflow over a period of time and is used for internal planning. Cash flow statements show both how much and when cash must flow in and out of your business.
- ! *Three-year income projection* -- A pro forma income statement showing your projections for your company for the next three years. Use the pro forma cash flow statement for the first year's figures and project the next according to economic and industry trends.
- ! *Break-even analysis* -- The break-even point is when a company's expenses exactly match the sales or service volume. It can be expressed in total dollars or revenue

exactly offset by total expenses or total units of production (cost of which exactly equals the income derived by their sales). This analysis can be done either mathematically or graphically.

Note: The following are actual performance statements reflecting the activity of your business in the past. If you are a new business owner your financial section will end here and you will add a personal financial history. If you are an established business you will include the actual performance statements that follow.

- ! *Balance sheet* -- Shows the condition of the business as of a fixed date. It is a picture of your firm's financial condition at a particular moment and will show you whether your financial position is strong or weak. It is usually done at the close of an accounting period and contains assets liabilities and net worth.
- ! *Income (profit and loss) statement* -- Shows your business financial activity over a period of time (monthly annually). It is a moving picture showing what has happened in your business and is an excellent tool for assessing your business. Your ledger is closed and balanced and the revenue and expense totals transferred to this statement.
- ! *Business financial history* -- This is a summary of financial information about your company from its start to the present. The business financial history and loan application are usually the same. If you have completed the rest of the financial section you should be able to transfer all the needed information to this document.

VII. Supporting documents

These are the records that back up the statements and decisions made in the three main parts of your business plan. Those most commonly included are as follows:

- ! *Personal resumes* -- Should be limited to one page and include work history educational background professional affiliations and honors and special skills.
- ! *Personal financial statement* -- A statement of personal assets and liabilities. For a new business owner this will be part of your financial section.
- ! *Credit reports* -- Business and personal from suppliers or wholesalers credit bureaus and banks.
- ! *Copies of leases* -- All agreements currently in force between your company and a leasing agency.
- ! *Letters of reference* -- Letters recommending you as being a reputable and reliable business person worthy of being considered a good risk. (Include both business and personal references.)
- ! *Contracts* -- Include all business contracts both completed and currently in force.
- ! *Legal documents* -- All legal papers pertaining to your legal structure proprietary rights insurance titles etc.
- ! *Miscellaneous documents* -- All other documents that have been referred to but are not included in the main body of the plan (e.g. location plans demographics advertising plan etc.).

Putting Your Plan Together

When you are finished: Your business plan should look professional, but the lender needs to know that it was done by you. A business plan will be the best indicator he or she has to judge your potential for success. It should be no more than 30 to 40 pages long. Include only the supporting documents that will be of immediate interest to your potential lender. Keep the others in your own copy where they will be available on short notice. Have copies of your plan bound at your local print shop, or with a blue, black or brown cover purchased from the stationery store. Make copies for yourself and each lender you wish to approach. Do not give out too many copies at once, and keep track of each copy. If your loan is refused, be sure to retrieve your business plan. For a more detailed explanation of each section of the business plan outline, see SBA's publication, *How to Write a Business Plan*, which includes step-by-step directions and sample sections of actual business plans. Also available from the SBA is a VHS videotape and workbook, *The Business Plan: Your Roadmap for Success*.

APPENDIX F: INFORMATION RESOURCES

U.S. Small Business Administration (SBA)

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

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

- *SCORE: Counselors to America's Small Business*, a national organization sponsored by SBA of over 11,000 volunteer business executives who provide free counseling, workshops and seminars to prospective and existing small business people. Free online counseling and training at www.score.org.
- *Small Business Development Centers (SBDCs)*, sponsored by the SBA in partnership with state governments, the educational community and the private sector. They provide assistance, counseling and training to prospective and existing business people.
- *Women's Business Centers (WBCs)*, sponsored by the SBA in partnership with local non-government organizations across the nation. Centers are geared specifically to provide training for women in finance, management, marketing, procurement and the Internet.

For more information about SBA business development programs and services call the SBA Small Business Answer Desk at 1-800-U-ASK-SBA (827-5722) or visit our website, www.sba.gov.

Other U.S. Government Resources

Many publications on business management and other related topics are available from the Government Printing Office (GPO). GPO bookstores are located in 24 major cities and are listed in the Yellow Pages under the bookstore heading. Find a "Catalog of Government Publications" at <http://catalog.gpo.gov/F>

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

Federal Citizen Information Center (FCIC)

[Http://www.pueblo.gsa.gov](http://www.pueblo.gsa.gov)

1-800-333-4636

The CIO offers a consumer information catalog of federal publications.

Consumer Product Safety Commission (CPSC)

Publications Request

Washington, DC 20207

http://www.cpsc.gov/cpsc/pub/pubs/pub_idx.html

The CPSC offers guidelines for product safety requirements.

U.S. Department of Agriculture (USDA)

12th Street and Independence Avenue, SW

Washington, DC 20250

<http://www.usda.gov>

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

U.S. Department of Commerce (DOC)

Office of Business Liaison

14th Street and Constitution Avenue, NW

Washington, DC 20230

<http://www.osec.doc.gov/obl/>

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

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

Substance Abuse and Mental Health Services Administration

1 Choke Cherry Road

Rockville, MD 20857

<http://www.workplace.samhsa.gov>

Helpline: 1-800-workplace. Provides information on Employee Assistance Programs Drug,

Alcohol and other Substance Abuse.

U.S. Department of Labor (DOL)

Employment Standards Administration

200 Constitution Avenue, NW

Washington, DC 20210

The DOL offers publications on compliance with labor laws.

U.S. Department of Treasury

Internal Revenue Service (IRS)

1500 Pennsylvania Avenue NW

Washington DC 20230

<http://www.irs.gov/business/index.html>

The IRS offers information on tax requirements for small businesses.

U.S. Environmental Protection Agency (EPA)

Small Business Ombudsman

1200 Pennsylvania Avenue NW

Washington, DC 20480

<http://epa.gov/sbo>

Hotline: 1-800-368-5888

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

U.S. Food and Drug Administration (FDA)

5600 Fishers Lane

Rockville MD 20857-0001

<http://www.fda.gov>

Hotline: 1-888-463-6332

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

For More Information

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

- **Trade association information**
Ask the librarian to show you a directory of trade associations. Associations provide a valuable network of resources to their members through publications and services such as newsletters, conferences and seminars.
- **Books**
Many guidebooks, textbooks and manuals on small business are published annually. To find the names of books not in your local library check Books In Print, a directory of

books currently available from publishers.

- **Magazine and newspaper articles**

Business and professional magazines provide information that is more current than that found in books and textbooks. There are a number of indexes to help you find specific articles in periodicals.

- **Internet Search Engines**

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

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