

CLIFFORD M. BAUMBACK

Basic Small Business Management



BASIC SMALL BUSINESS MANAGEMENT

Clifford M. Baumbach
University of Iowa

Library of Congress Cataloging in Publication Data

BAUMRACK, CLIFFORD MASON (date)
Basic small business management.

Includes bibliographical references and index.
1. Small business—Management. I. Title.
HD62.7.B37 1983 658'.022 82-18110
ISBN 0-13-066415-4

© 1983 by Prentice-Hall, Inc., Englewood Cliffs, N.J. 07632

All rights reserved.

No part of this book may be reproduced in any form or by any means
without permission in writing from the publisher.

Editorial/production supervision and interior design by Maureen Wilson
Cover design by Diane Saxe
Manufacturing buyer: Ed O'Dougherty

Printed in the United States of America

10 9 8 7 6 5 4 3 2 1

ISBN 0-13-066415-4

Prentice-Hall International, Inc., *London*
Prentice-Hall of Australia Pty. Limited, *Sydney*
Editora Prentice-Hall do Brasil, Ltda., *Rio de Janeiro*
Prentice-Hall Canada Inc., *Toronto*
Prentice-Hall of India Private Limited, *New Delhi*
Prentice-Hall of Japan, Inc., *Tokyo*
Prentice-Hall of Southeast Asia Pte. Ltd., *Singapore*
Whitehall Books Limited, *Wellington, New Zealand*

Preface

Since poor management is at the root of most small business failures, and since approximately half of these failed businesses should never have been started in the first place because their owners were not adequately prepared to manage them, this book—unlike others with similar titles—is written primarily from a managerial rather than an entrepreneurial (or how to get started) perspective. This book is exactly what its title says it is: a book on *basic small business management*.

The rationale for this approach is supported further by the fact that not all managers of small enterprises are entrepreneurs. Although hard data are not available to support the premise, it is also probably true that the number of people with some managerial responsibilities in a small business enterprise is far in excess of the number of entrepreneurial managers. In any case sound management practice is basic to the survival or economic health of any business, owner-managed or not, and so this book takes the larger view.

At the same time, however, the entrepreneurial function is not ignored in this volume. It is given particular focus in the final two chapters. Chapter 28, for example, provides a step-by-step procedure for “Starting a Business,” with appropriate cross-references to the body of the text. Instructors and students who wish to teach or study small business management from the perspective of aspiring entrepreneurs can do so, conveniently and without loss of continuity, by starting with this chapter and following its directions; for all others, the chapter serves as a review of what has gone before. Chapter 29 similarly emphasizes the entrepreneurial function by considering the purchase of an ongoing venture as an alternative route to business ownership, as well as the sale of a business from the owner’s point of view.

This book was also written from the student’s perspective. Liberal use has been made of cartoons and other graphics to clarify or emphasize important concepts and to make the text more enjoyable to read. Further, each chapter begins with a statement of learning objectives and concludes with a concise summary and a glossary of key words and phrases, as well as one or more exercises and/or “cases in point” to illustrate real-life problem situations and to help the student *learn by doing*.

As in any large and creative effort, many people have contributed to the preparation and publication of this volume. Many of them are acknowledged in the text and footnotes. The contributions of others, however, have not been similarly acknowledged and I hasten here to express my appreciation to them also. Deserving of special mention are Maureen Wilson, Prentice-Hall production editor, for her precise editing and supervision, which helped to make the book more readable; Wendell O. Metcalf, retired Chief of Management Assistance in the Small Business Administration, for supplying from his personal files reproduction copies of selected out-of-print SBA illustrations; Linda Knowling, for drawing the original art; Kenneth Lawyer, my friend and colleague, for writing many of the short cases; and Phyllis Irwin and Marguerite Knoedel, for supervising the typing of the manuscript.

CLIFFORD M. BAUMBACK

**BASIC
SMALL BUSINESS
MANAGEMENT**

Contents

Preface *ix*

Part One

THE WORLD OF SMALL BUSINESS

Role in the Economy 3

CHAPTER ONE *What Is a "Small" Business. The Predominance of Small Business. The Make-up of Small Business. Economic Contributions of Small Business. The Franchise Boom. From Small Beginnings . . .*

External or Environmental Problems 16

CHAPTER TWO *Capital Shortages. Taxation and Regulations. Product Liability. Patent Abuses. Franchising Abuses. Concern for the Welfare of Small Business. Organized Voices for Small Business*

Success and Failure Factors 28

CHAPTER THREE *Causes of Business Failure. Factors in Successful Small Business Management*

Part Two

THE MANAGEMENT PROCESS IN THE SMALLER BUSINESS

Basic Management Functions 39

CHAPTER FOUR *Planning. Organizing and Staffing. Directing. Controlling*

Differences in Managing Small and Large Firms 53

CHAPTER FIVE *The Strategy of Size. The "One-Man Band" Problem. Education for Small Business Management*

Special Management Concerns 62

CHAPTER SIX *Time Management. Community Obligations. Continuing Management Education. Management Succession and Business Continuity*

Need for Outside Staff Assistance 72

CHAPTER SEVEN *Clarification of Terms and Concepts. Government Sources of Business Information. Nongovernment Sources of Business Information*

Part Three

MANAGING THE PRODUCTION FUNCTION

Providing Physical Facilities 93

CHAPTER EIGHT *Building Requirements. Obtaining the Equipment. Arranging the Layout*

Purchasing Goods and Supplies 107

CHAPTER NINE *Determining Inventory Needs. Locating and Selecting Suppliers. Negotiating Terms. Maintaining Favorable Relations with Suppliers. Receiving, Checking, and Marking Goods. Follow-up after Purchase*

Controlling Inventories 123

CHAPTER TEN *Dollar Control vs. Unit Control. Keeping Track of Inventories. Setting the Quantitative Limits. Merchandise Control Systems*

Acquiring, Training, and Motivating Employees 145

CHAPTER ELEVEN *The Importance of Job Analysis. Recruitment and Selection. Placement. Training. Transfers and Promotions. Remuneration. Morale Building*

Planning and Controlling Factory Production 169

CHAPTER TWELVE *Planning Production Orders. Production Order Control. Flow Control*

Part Four

MANAGING THE DISTRIBUTION FUNCTION

Market Analysis and Business Location 179

CHAPTER THIRTEEN *Selecting the Community. Selecting the Site. The Retail Location. Location Requirements in Other Types of Business*

Pricing Methods and Strategies 204

CHAPTER FOURTEEN *Economics of Pricing. Pricing by Retailers. Pricing by Wholesalers. Pricing by the Service Establishment. Pricing for the Small Factory*

Advertising and Sales Promotion 224

CHAPTER FIFTEEN *Customers' Buying Motives. Advertising. Window and Interior Displays. Special Sales Events. Personal Selling and Customer Relations. Franchising and Other Methods of Distribution. Government Assistance Programs. Public Relations—An Indirect Form of Sales Promotion*

Exporting 249

CHAPTER SIXTEEN *Distribution Channels. Merchandising to Foreign Markets. Government Assistance Programs. Recommendations for Changes in Government Policy. Metric Conversion*

Part Five**MANAGING THE FIRM'S FINANCES****Raising Capital** 261

CHAPTER SEVENTEEN *Estimating Capital Needs. Kinds of Capital. Debt vs. Equity Capital. Sources of Funds*

Credit and Collections 278

CHAPTER EIGHTEEN *Advantages and Disadvantages of Extending Credit. Consumer Credit. Trade Credit*

Accounting Records and Financial Statements 309

CHAPTER NINETEEN *Importance of Financial Records. The Accounting Equation. Basic Accounting Records. Financial Statements and Their Interpretation. Principles of Internal Control. Computerized Accounting and Other Record Keeping*

Depreciation and Inventory Valuation 339

CHAPTER TWENTY *Depreciating Capital Assets. Determining Inventory Values*

Profit Planning and Cost Control 350

CHAPTER TWENTY-ONE *Demand Forecasting. Break-even Analysis. Incremental Costs and Marginal Income. Expense Budgeting*

Cash Flows and Capital Expenditures 372

CHAPTER TWENTY-TWO *Importance of Cash Flow. Investment Decision Criteria*

Insurance and Risk Management	384
CHAPTER TWENTY-THREE	<i>Insurance Planning. Loss Reduction or Prevention</i>

Part Six

THE LEGAL ENVIRONMENT

Types of Legal Business Transactions	401
CHAPTER TWENTY-FOUR	<i>Contracts. Agency. Sales. Negotiable Instruments</i>
Legal Forms of Business Organization	409
CHAPTER TWENTY-FIVE	<i>The Proprietorship. The General Partnership. The Limited Partnership. The Conventional Corporation. The Tax-Option Corporation</i>
Government Regulation of Business	423
CHAPTER TWENTY-SIX	<i>Competition. Price Regulations. Merchandise Regulations. Other Consumer Protection Laws. Environmental Protection. Labor Legislation. Restrictions and Permits. Bankruptcy and Court-approved Debt Settlements</i>
Taxes and Economic Security Legislation	444
CHAPTER TWENTY-SEVEN	<i>Economic Security Legislation. Federal Income Taxes. Federal Excise Taxes. State and Local Sales Taxes</i>

Part Seven

LOOKING BACK AND LOOKING AHEAD

Starting a Business	461
CHAPTER TWENTY-EIGHT	<i>The Marketing Plan. The Organization and Staffing Plan. The Financial Plan</i>
Selling (or Buying) a Business	484
CHAPTER TWENTY-NINE	<i>Setting the Price. Striking a Deal</i>
Glossary: The Language of Business	497

Index	533
--------------	-----

Part One --- ---

THE WORLD OF SMALL BUSINESS

The first section of this book is an introduction to the big world of small business. Few students realize how high the probability is that they will someday become involved, directly or indirectly, with a small business enterprise and its management—either as (1) owners of their own businesses, (2) employees of a small business, (3) employees of a large company, the majority of whose customers and suppliers are small business firms, or (4) economists, bankers, legislators, lawyers, or accountants, among many others, who are concerned for one reason or another with the problems and opportunities of small business and the free enterprise system. The three chapters in this introductory section will help prepare you for these future relationships or concerns. After reading them you should have an increased awareness of the nature of “small” business and of the economic, social, and political environment in which small businesses function.

Role in the Economy

CHAPTER ONE *This is the “what it’s all about” chapter. It defines, describes, identifies, and distinguishes the small business. After reading it you should have a better understanding of the role of small businesses and the reasons for their existence. In particular, you will learn that (1) “the economy” is business serving people, providing food, clothing, shelter, utensils, recreational facilities, and so forth, to the public; (2) there are many kinds of business—service (such as insurance or repairs), merchandising (wholesale and retail stores), and manufacturing; and (3) most businesses are small—some small only at their beginnings, others by their natures always small.*

For some, the word “business” conjures up an image of gigantic multinational corporations. For others, it’s the family next door who operates the shoe store or the partners who run the hardware store down the street. The community in which you live probably has some big business—the major retailer with stores across the country or the local plant of one of the world’s largest firms. But it has vastly more small businesses, and these small businesses are as basic to the local economy as they are numerous.

WHAT IS A “SMALL” BUSINESS?

Thus far the term “small business” has been used generally and without specific and careful definition of what “small” is. But what can we use to accurately measure size? Attempts have been made (as, for example, by the Small Business Administration) to define a small business in terms of (1) employment, (2) asset value, or (3) dollar sales volume. All have proven unsatisfactory in some respect. This irresolution stems largely from the diverse character of varying industries. A firm in one industry may loom large relative to its competitors, yet be small in employment, assets, and sales relative to firms in other industries; or the reverse may be true. And in some circumstances the firm may be small on the basis of employment and large in assets and sales, or vice versa. Additionally, size standards expressed in monetary terms (such as sales and asset value) need to be raised frequently in times of inflation to reflect changes

in the value of the dollar. Furthermore, such *quantitative* definitions of a small business leave undemonstrated its *qualitative* distinguishing characteristics.

For these reasons we will cast aside this lack of precision and establish a definition here by indicating the major attributes of a business which has the financial and managerial difficulties which we usually associate with small business.

Characteristically, a **small business** is one that is (1) actively managed by its owners, (2) highly personalized, (3) largely local in its area of operations, (4) of relatively small size within the industry, and (5) largely dependent on internal sources of capital to finance its growth. There are the characteristics which give rise to most of its problems and special needs.

A small business is any business in which the owner/manager is able to recall the first names of his or her employees.

THE PREDOMINANCE OF SMALL BUSINESS

Despite the shortcomings noted above, employment statistics provide the most complete and reliable measure of the small business population currently available. In Table 1-1 it is noted that more than one-third of all the manufacturing firms in the country employ fewer than five persons, or none at all, and that close to two-thirds employ fewer than twenty workers. The employment-size proportions are even greater in merchandising and the service industries. Of the total number of nonfarm businesses of all kinds, 95 percent employ fewer than fifty workers each!

It can reasonably be inferred that firms of such small employment size are independently owned and operated ventures servicing strictly local markets. Although the giant corporations and mass-production firms loom important in terms of productivity and capital investment, it is the small business that actually constitutes the backbone of the nation's economy.

THE MAKE-UP OF SMALL BUSINESS

It is clear from the data in Table 1-1 that small businesses predominate in all private sectors of the economy. The relative importance of the small firm, however, differs considerably from one type of business to another. We shall consider here only the major areas of business activity—the manufacture of products; the distribution of products of all kinds (however produced); and the rendering of services (some of which may involve the use of a product). Together these industries make up approximately 86 percent of the total number of **business firms** employing fewer than fifty workers, distributed as

TABLE 1-1

Percentage Distribution of Business Firms, by Kind of Business and Employment Size, 1979

INDUSTRY	FEWER THAN 5 EMPLOYEES*	FEWER THAN 10 EMPLOYEES	FEWER THAN 20 EMPLOYEES	FEWER THAN 50 EMPLOYEES
Extractive industries**	48.5	63.1	76.9	89.5
Manufacturing	34.0	48.6	64.0	80.2
Wholesale trade	47.5	69.1	85.7	96.1
Retail trade	53.0	74.6	87.9	96.4
Contract construction	64.4	81.4	91.6	97.5
Selected services***	62.3	79.1	89.4	96.0
All industries	55.3	74.0	86.4	94.9

* Data adjusted to include business firms with no paid employees, estimated by the Social Security Administration at 9 percent of the business population.

** Mining and quarrying, forestry and fisheries.

*** Transportation, communications, and public utilities (such as trucking and warehousing, and local and interurban passenger transit); finance, insurance, and real estate (such as banks and other credit agencies, real estate brokers, and insurance carriers and agents); lodging facilities (such as hotels and motels); personal services (such as laundries and dry cleaning plants, and barber and beauty shops); business services (such as advertising agencies, public accounting firms, credit bureaus, and equipment rental); automobile repair and other types of repair services (including garages and parking lots); amusement and recreational services (such as motion picture theaters, billiard parlors, and bowling alleys); and miscellaneous other services. Not included are persons or organizations providing legal services, educational services, medical and other health services, or other skills not used primarily in business.

SOURCE: *County Business Patterns, 1979*, part I; *U.S. Summary*, as reported by the Social Security Administration.

follows: retailing, 34 percent; services, 34 percent; wholesaling, 11 percent; and manufacturing, 7 percent.¹

Manufacturing

A business is considered a **manufacturing enterprise** if it is engaged primarily in receiving materials in one form and, after working on them, distributes them in an altered form. This would include processors of farm

¹ Excluded from this discussion are the extractive industries, which account for less than 1 percent of the total number of small businesses, and contract construction. Although contract construction is an important sector of the small business economy, accounting for close to 13 percent of the total number of firms, this type of economic activity has characteristics of both manufacturing and the service trades, in varying degrees depending on the type of construction. The operating problems of building contractors, for example, are more nearly like those of manufacturers, whereas the service aspect of their work predominates for plumbers, electricians, and carpenters.

products, local craftsmen or artisans, bottling plants, and similar enterprises.

It is the growing concentration of power in manufacturing which, in recent years, has led to some concern for the welfare of small business. Although more than 80 percent of the companies in manufacturing employ fewer than fifty employees, about 75 percent of the total manufacturing employment is concentrated in only 3 percent of the companies. Also noteworthy is the observation that the increase in the number of manufacturing enterprises in recent years has not kept pace with the growth in population (nor with the overall growth in the number of business firms). Between 1969 and 1979, for example, whereas population increased by more than 26 percent, the number of manufacturing firms in operation increased by less than 1 percent. During this same period, manufacturing employment increased by 14 percent and **value added by manufacture in constant dollars** (that is, after allowing for changes in the price level) increased by more than 44 percent.² Thus, in manufacturing, large firms have become relatively larger.

Despite the growing concentration of power in manufacturing, there is still much room in which the small firm can maneuver. Big business is most effective in well-established industries where large markets for low-unit-cost products exist; where technology and mechanization have been developed to a high degree of efficiency, but where huge capital investments are required; and where standardization and simplification (limitation of variety) are desirable policies. However, the **mass-production** system is often dependent on the small production plant for supplies and components. It is the very existence of the large manufacturers that provides the smaller manufacturers with many of their opportunities.

Some observers comment that our large mass-production industries are essentially assemblers of the products of thousands of small specialized manufacturers. Mass-produced goods such as motor vehicles, airplanes, refrigerators, radios and television sets, and stereophonic equipment have from a few hundred to several thousand component parts, indicating that, on the average, each large concern buys materials and parts from small firms in hundreds of different kinds of businesses.

Thus it is the manufacture of **producers' goods** (products made for other manufacturers) wherein most of the opportunities exist for the small, independent enterpriser. As big business grows, so does small business.

But opportunities exist also for the small manufacturer in local consumer markets. Some of the more common examples of local manufacturing are

² Sources of data: U.S. Bureau of Labor Statistics, *Employment and Earnings* (number of employees); U.S. Social Security Administration, *County Business Patterns* (number of establishments and employment-size classification); U.S. Bureau of Economic Analysis, *Survey of Current Business* (value added); and U.S. Bureau of the Census, *Current Population Reports* (population).

printing shops, bakeries, bottling plants, and processed dairy products. These are the ubiquitous industries present in every community that provide needed products for local consumption. As a community grows, so also do the opportunities for the small local manufacturer.

Merchandising

Merchandisers are middlemen in the channel of distribution who actually sell products to the final consumers (**retailers**), or who buy goods for resale to retailers (**wholesalers**).

There are more retail stores in the United States than any other kind of business enterprise; they account for more than 34 percent of the total number of firms of all kinds. Furthermore, most of them are small; some of them can even be described as tiny. In Table 1-1 it is noted that more than five out of ten retail stores have fewer than five paid employees, or none at all, and that 88 percent of them employ fewer than twenty employees. Despite the deep incursions into the market made in recent years by large department stores, chain stores, and mail-order houses, retailing remains largely the bailiwick of the small, independent enterpriser.

Small firms also predominate in wholesaling, though to a lesser degree. A smaller proportion of them employ fewer than twenty persons (86 percent). However, over 20 percent of the firms employ only one person, and over 69 percent have fewer than ten employees!

As in the manufacturing sector of the economy, growth in wholesale trade has not kept pace with the growth in population. Opportunities for the small businessperson in this field are not as great as they once were, owing principally to the absorption of the wholesaling function by franchising organizations, manufacturer's representatives, and large-scale integrated retailers like chain stores, department stores, and mail-order houses.

Just as the mass-production system is dependent on the small specialized manufacturing plant, so also is it dependent on the small merchant. Each retail store handles from a few thousand to well over twenty thousand different items. These small, independent retailers distribute the products of thousands of small manufacturers and about six thousand large manufacturers (five hundred employees or more). A conclusion that at least five hundred different suppliers and several thousand retail dealers serve each large manufacturer is probably very conservative. In addition, most **consumer goods** go through wholesale establishments, the majority of which are small businesses, and each large producer buys services from numerous small and mostly local establishments. Obviously, the small merchant plays a major role in gathering together America's wealth of production and making it available for use.