FINANCIAL TOOLS for SMALL BUSINESSES

Omer Carey

Dean Olson

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Omer Carey
Professor,
University of Alaska, Anchorage

Dean Olson
President,
The Macon Company

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Preface

Financial Tools for Small Businesses grew out of the authors' work with the owner-managers of a large number of small businesses. Many of these managers are skilled in the production or service aspects of their businesses but lack the elementary tools of financial planning and analysis. Such managers need help in solving the everyday financial problems confronting their firms, and this book is written for them.

Prior college coursework in business is not necessary to understand this book, although actual business experience will be useful in grasping the significance of the material. The reader is urged to master the chapters one by one rather than reading the text from cover to cover. Take time to study the examples in the text, then work the problems and cases at the end of the chapter. Many of the cases are studies of actual firms; other cases are typical business problems faced by firms and resemble actual cases. The complete solution to each case and problem is contained in the appendix.

The book is intended to be a practical working tool which you can use for ready reference. The use of these tools should improve the profitability of your firm and ease the problems of financing its ongoing operations. The authors would appreciate any comments from users of this book that will improve it as a business tool.

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Students in the Fundamentals of Financial Management class at

Valdez, Alaska, were responsible for finding many errors in the original manuscript. While several members of the class found errors, Candy Baca deserves special recognition for discovering errors in tables, formulas, and other data. We appreciate their patience and diligence.

Various secretaries typed portions of earlier drafts. In particular, Mrs. June Payne worked many evenings and weekends preparing the preliminary and final drafts. And, although they should have been listed first, we thank our families for their patience and forbearance through this project. Without their understanding, the project would not have been completed. Finally, we would like to thank the staff of Reston Publishing Company, especially Fred Easter, executive editor, and Jeanne-Marie Peterson, production editor. They were always helpful and a pleasure to work with in preparing this book.

While we acknowledge our gratitude to each of the above, we must ourselves bear final responsibility for all errors that may have crept into this book. We hope they are few and that the users are forgiving.

Contents

Chapter 1

INTRODUCTION—WHY YOU NEED TO USE THIS BOOK

This book was written for the owners and managers of small businesses, whether a sole proprietorship, a partnership, or a closely held corporation. If you fall into any of the above categories, you have a tough job. Managers of small firms have all the responsibilities of managers of large firms; however, managers of large firms have a specialized staff to prepare reports and to advise them in each area of responsibility. Very few small firms can afford to do this. The manager of a small firm usually must have a working knowledge in all areas of responsibility.

Many skills are required to successfully manage a business firm. You must develop goals and objectives for the firm and communicate these to the people who assist you in managing the firm and, if you are incorporated, to the board of directors. You need skills in managing production processes, in designing advertising and merchandising programs, in implementing good organizational structure, and in selecting personnel. Another skill that you need plays a very important part in the success of the firm and may, in fact, determine whether or not the firm remains in business. This is the financial skill.

The financial skill requires that you understand and evaluate basic financial information. It requires "pushing a pencil"—or perhaps more realistically in this day and age, "pushing a calculator"—to dig out the important information represented by the numbers on the financial statements. Regardless of how "accurately and fairly" the financial statements reflect the financial position of the firm, the information is of little value if you cannot use it to analyze and understand what is happening within the firm.

About 67 percent of small businesses go out of business during the first four years. Many studies have been done to determine the cause of business failures. The most common causes of business failures are inadequate sales, high operating costs, poor credit and collection policies, too many fixed assets, and too much inappropriate inventory.

These problems do not suddenly emerge and throw the business into bankruptcy; rather, they are often the culmination of a steady trend which is not recognized until a crisis is reached. These problems are registered on the income statements and balance sheets each time the statements are prepared. Being "registered" is one thing; being understood by management is another.

You may find it difficult to distinguish between accounting and finance. Both subjects use the same terminology in financial records, and therefore it may appear that accounting and finance are the same. The distinction between the two is that accounting is primarily data gathering, while finance is data analysis for use in decisionmaking. Although accounting is essential in providing the information necessary for good management decisions, management is responsible for analysis, planning, and control, which is what this book is all about.

Using this book, you will learn how to understand financial statements and how to read the signs of impending problems reflected in these statements. It is not enough to be able to recognize the problems reflected on the financial statements. You must be able to dig out the underlying causes for the problems and to develop corrective policies. One of the essential roles of management is the control of the business enterprise. Control means recognizing problems and developing programs for eliminating the problems. Financial statements are one of the most important tools that managers use to establish control.

Another important part of the financial skill that you must develop is the use of budgeting techniques, both in terms of operational budgets and capital expenditures. Again, these techniques are of critical importance if you are to successfully control the firm. If the firm is incorporated, these skills are also important, especially in terms of capital budgeting, for the board of directors.

For example, budgets provide a means of projecting cash requirements and alert you and the board to the need to raise additional capital. In some instances, there may be a need to search for additional investment if an excess in the company's cash flow exists. Budgets also allow for "management by exception." The manager and the board members can quickly focus their attention on potential trouble spots if they are provided information that shows projected budgets in comparison with actual receipts and expenditures. Those items that are out of line with the projected amounts require immediate explanation and attention.

Perhaps the most important responsibility that you have as the owner or manager of a small business is the selection of investments. If you are incorporated, your board has the same responsibility or must share the responsibility. The investments must meet a wide range of criteria—some that deal with the financial aspects of the investment and some that deal with the intangible benefits relating to stockholder welfare. Due to the critical nature of this responsibility, a large portion of this book deals with analyzing the financial considerations of an investment using the tools of break-even analysis and present value. Attention is also given to developing a firm's "cost of capital," which is a prerequisite for proper investment analysis.

As you read this book, take time to study the examples and work the case problems. The cases were developed from practical incidents that faced actual managers of small businesses. The cases require you to use the tools demonstrated in this book. You will not become proficient with these tools by reading about them—you must use and apply them. The more that you apply these tools, the more skillful you will become. If you master these tools and apply them to your own business, you will be rewarded in a way that any *successful* business firm is rewarded—increased profitability.

Chapter 2

INCOME TAXES AND FINANCIAL ANALYSIS

Your study of financial tools must begin with a brief examination of federal income taxes. Income taxes can, and should, affect the form of business organization you choose. While you do not have to use the same accounting methods for your internal planning and control that you do for income taxes, nonetheless, tax laws affect the financial statements you are reviewing and analyzing. Finally, tax laws can have a *major* impact on your decisions to invest in fixed assets.

INCOME TAXES AND YOUR FORM OF BUSINESS ORGANIZATION

The principal forms of business organizations are sole proprietorships, partnerships, and corporations. There are, of course, many factors that enter into the form of organization selected, but the effects of income taxation are certainly among the most important.

Sole proprietorships and partnerships are taxed as if all the money is income of the owners, whether or not they choose to reinvest money into the firm. If the proprietorship or the partnership earns $75,000 per annum, and the proprietorship or the partners withdraw only $50,000, they will still pay personal taxes on $75,000 of income. Thus, the owners of the sole proprietorship and partnership pay taxes on money that is kept in the business.

Under the corporate form, the income remaining after expenses is taxed at a corporate tax rate. For small corporations with before-tax profits of $30,000 to $40,000 per annum, the corporate tax rate may be substantially less than the tax rate for most individuals. But corporate profits are taxed twice, once as corporate income and again when they are paid out as dividends to the owners. This is one of the tax disadvantages of the corporate form. If a corporation paid an amount equal to its net profits to its officers as salaries, there would be little tax benefit to the corporate form. The term "little" is used because company benefit plans, such as medical insurance, are a business expense and are not taxable to the officers, while under the proprietorship or partnership form this would not be the case. The tax advantage to the regular corporate form over the proprietorship and partnership form would appear to lie in those situations where the firm is expected to grow and the owners wish to reinvest part of the profits of the firm into financing growth, or to pay off debts used in starting the firm with income retained from past years.

A second potential tax disadvantage to the corporate form is that if profits are retained in excess of those needed by the corporation for financing its operations, the Internal Revenue Service may assume that the accumulation represents an attempt by the owners to avoid paying taxes. Hence, a tax can be levied on excess accumulations of the corporation. These excess accumulations are defined as earnings retained in excess of the legitimate business needs of the firm.

The third potential problem arises when owners/officers attempt to reduce the double taxation impact in a situation where additional retained earnings are unneeded. Rather than paying these retained earnings as dividends to themselves, the officers may decide to merely increase their salaries and correspondingly reduce the profit subject to taxation. In such cases, if officers' salaries appear to the Internal Revenue Service to be too high, it may contend that part of the salaries paid to the officers are in reality dividends and subject to double taxation.

Congress has been very concerned about the health of small businesses in the United States and has tried various methods of