

SCORE Handbook For Small Business

*Everything you need to start and manage
a successful small business*

9th Edition

Prepared and Published by



| Cape Cod

The 9th Edition of the Handbook for Small Business was prepared by:

SCORE Chapter 225, Hyannis, MA

This manual is dedicated to David W. Anderson, former SCORE counselor, founding editor of the **Handbook for Small Business**.

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PREFACE

SCORE is a nonprofit association dedicated to educating entrepreneurs and helping small businesses start, grow, and succeed nationwide. SCORE is a resource partner with the U.S. Small Business Administration (SBA), and has been mentoring small business owners for more than fifty years.

SCORE began in 1963 when certain groups of retired persons, almost spontaneously, began offering assistance to owners and operators of small businesses in various localities such as Worcester, Massachusetts, Wilmington, Delaware, and St. Louis, Missouri.

Later in the year, the SBA began to utilize these volunteers to supplement its own small business assistance programs and to recruit more volunteers for that purpose. The response was so enthusiastic and the potential of these volunteers so enormous that the SBA began to organize local SCORE chapters and to administer the program. Today, there are more than 300 SCORE chapters in the United States and more than 11,000 volunteers. While SCORE counselors derive tremendous personal gratification from assisting small businesses, SCORE exists solely for the benefit of the small business community. For anyone in, or considering entering into, a small business, SCORE offers many services critical to building a successful business at no cost.

These services include private individual confidential counseling (in person and online) offered at no cost, training through specialized seminars, workshops and conferences, information from books, pamphlets, website and advice as to how to approach regulatory organizations, local authorities, lawyers, accountants, town officials, etc. SCORE cooperates closely with other volunteer organizations, government agencies, chambers of commerce, colleges and universities and other civic associations to enhance the quality of life for the entire community.

SCORE Chapter 225, which serves Cape Cod and the Islands, is located at:

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INTRODUCTION

Small business owners continue to demonstrate their extraordinary capacity to mobilize resources and generate new jobs. There are over 28 million small businesses in the United States¹, and each year nearly a half a million new businesses are started. Small business employs six out of every ten people, accounts for the majority of new jobs, is more flexible than big business in responding to shifting markets, and is able to bring new products and services to market much faster than large companies. *Statistics show the importance of Small Businesses as they:*

- Represent 99.7 percent of all employer firms
- Employ about half of all private sector employees
- Pay 42% of total U.S. private-sector payroll²

Realizing that small business is the backbone of this country's competitive free enterprise system, in 1953 Congress created the Small Business Administration (SBA). SBA defines a small business as one independently owned and operated and not dominant in its field. SCORE is part of the SBA's business development program and provides free, individual counseling to people who are in business and to those seeking help in starting a new business.

To start a new business and remain in business profitably, one must be willing to work hard, demonstrate persistence, possess enough industry and general business experience, have sufficient start-up capital and identify a venture with true market potential. A new business owner must be able to adapt to a changing population and work force demographics, rapid technological changes, e-commerce and the demands of a global market place.

To address these changes, sound management and organizational practices are more important than ever before. The necessity of increasing productivity of employees, the difficulties in recruiting qualified workers and devising the ways to meet workers benefits will challenge managers of small businesses of all descriptions.

America's future depends on the continued emergence of successful small businesses. To be successful, those who start a new business must be prepared. It is the purpose of this *Handbook for Small Business* to provide information that will help new and existing businesses be successful.

¹ Per the Office of Advocacy estimates, U.S. Department of Commerce, Bureau of the Census and U.S. Dept. of Labor, Employment and Training Administration, www.sba.gov/sites/default/files/FAQ_March_2014_0.pdf

² Source: U.S. Dept. of Commerce, Bureau of the Census and International, Trade Administration; Advocacy-funded research by Kathryn Kobe, 2007, <http://www.sba.gov/advo/research/rs299tot.pdf>

The mission of SCORE in simplest terms is to help put people into business, to stay in business, and to make a profit.

Handbook for Small Business is designed to extend the SCORE concept of service to the Small Business Community by providing a comprehensive presentation of general information. To a considerable extent, its contents reflect the element of personal and practical experience that is the hallmark of the SCORE counseling procedure.

Handbook for Small Business does not take the place of personal counseling, but rather is an enhancement to the inherent benefit of counseling. It is, however, published with the understanding that the authors are not engaged in rendering legal, accounting or other professional service. As pointed out repeatedly in the book, if legal or other expert assistance is required, such service should be sought.

STARTING A BUSINESS

Some of the reasons that people start new businesses are for financial independence, to be one's own boss, for creative freedom, to fully utilize one's skills, a dislike of other people's policies and procedures, unable to or dislike working for others, personal recognition and, above all, to make a profit. Whatever the business, to be successful there must be a need for the particular product(s) or service to be offered.

In addition to being an exciting and satisfying life experience, for most, starting up or taking over a business represents a major undertaking. Be sure you are really ready for such a commitment.

SELF ASSESSMENT

The first step on the road to successfully starting up your own business is to begin with an honest and thoughtful evaluation of your own personal situation. A great start might be to update and carefully review your own resume. Chronologically assess your own education, work experiences, interests and hobbies as you contemplate taking the "entrepreneurial plunge." In addition, consider writing a list of your personal strengths and weaknesses and consider where you stand on five key factors that research has shown to be important to entrepreneurial success, as explained below.

Starting a business has often been compared to "having a baby" in terms of the amount of time and energy required to succeed. Because it represents such a big commitment and often involves considerable life change, be totally honest with yourself and your capabilities. Carefully assess yourself considering both the positives and negatives. Write a list of your

personal strengths as well as your personal weakness areas in all aspects of your life.³ You might also ask a couple of other individuals you trust to provide a frank and accurate assessment of you to add to the list. Be open to their constructive criticism and be gracious – ultimately, it is your decision!

Starting and running a business, while fun and exciting is daunting for most and certainly not for the “faint of heart”. Carefully evaluate whether this is really the move you want to make at this juncture in your life and analyze whether you and your family can reasonably handle what it will likely take in terms of time and effort. For example, is there another member of your family who will continue to maintain a job with a steady paycheck and insurance benefits while you start the new venture? Be honest with yourself regarding whether your plans are realistic. It is much better to be very open with all who will be affected by the new venture before you make your final decision to dive in.

Of particular importance, carefully assess the status of both your physical and mental health. Just like having a baby, entrepreneurs tend to run short on sleep. Are you ready for that? Do you have the physical and mental stamina required for this undertaking? Be realistic about the amount of time that will be involved to start up and run the business and assess how this will impact your family goals and other life obligations.

There are many factors that contribute to entrepreneurial success. Five factors that have been shown to be particularly important and especially “telling” regarding potential entrepreneurial success include:

1. Determination
2. Internal locus of control
3. Risk management
4. Tolerance of ambiguity
5. Flexibility

Determination

Knowledge, skill, ability and attitudes (KSAA’s) are all important, but sheer determination can often make up the deficit. Are you someone who keeps on trying and who always “gets back up on the horse when thrown off?” To a great degree, determination can make up for a lack of knowledge and understanding, though many new business owners end up needing to learn things the hard way – be aware that stubbornness is the flip side to determination! Are you someone who tends to “to persevere” when the going gets tough? If so, that is a good sign!

³ This is the first step in compiling what is known as a “SWOT” Analysis. This is an environmental scanning or fact-finding technique for assessing your personal Strengths, Weaknesses, Opportunities and Threats. The technique can be used on both a personal and business level and is also a great tool to later assess your competition as well!

Internal Locus of Control⁴

We tend to be guided (centered) either internally or externally. If you are someone who tends to feel that whether or not you succeed is mostly dependent on outside factors that are beyond your control, then you have more of an “external locus of control.” Those of us who feel that we “make things happen” by sheer force of will tend to have an internal locus of control. Note, that both are really irrational propositions – a “balanced” perspective would be that both internal and external factors have an impact on us. However, more than any other factor, research has shown that internal locus of control correlates with entrepreneurial activity. Whether you are starting a new venture or taking over an existing business, if you are someone who feels that your actions you can bring outcomes (make things happen), then this is a good sign that going into business is for you!

Risk Management

Perhaps one of the biggest myths about entrepreneurs and others who wish to own a business is that they are big risk takers (or gamblers). In actuality, most studies show that people who start up or take over businesses try to take reasonable risks that they can manage, given their particular skills and experiences. Do you feel that given your particular area of expertise and background you have a good chance of succeeding at a particular business? That would be the essence of a “risk management” approach.

Tolerance of Ambiguity

If a situation is “ambiguous” that means that there is a lack of clarity. If you think about it, the more entrepreneurial a situation is, the newer it will be and the less readily available information will be to document and assure a venture’s potential success. If you are *tolerant* of ambiguity you can handle a lack of clarity, sort of like a sailor that is comfortable out in the fog. The riskier the situation, the “foggier” things get for a businessperson. Are you someone who needs everything to be “cut and dry” or are you someone who can make decisions even if all the answers are not readily available? If you are going to own your own business, then you must be tolerant of at least some ambiguity, and the riskier the venture, the more tolerant you will need to be able to sleep at night.

Flexibility

The final factor in our personal assessment “Big 5” is flexibility, or your ability to adapt to new situations. Entrepreneurs and business owners need to have a “helicopter mind.” You need to be able to zoom out and see the “big picture” but also be able to “zoom in” and “sweat the details.” Do you see yourself as being able to quickly adapt to a changing situation such as changing circumstances with a competitor, a problem with an employee or a

⁴ Some of the latest research refers to ESE or “Entrepreneurial Self Efficacy”
<http://www.entrepreneur.com/tradejournals/article/204074791.html>

setback in the economy? In business, you can count on one constant: change. It's inevitable and you need to be prepared to "roll with the punches" and adapt!

Finally, here are some important questions that you need to answer before you attempt to start up or purchase a small business. While this isn't an all inclusive list, it will give you a good idea of the kinds of questions you should ask yourself before committing to any venture:

Personal Assessment Factors:

- Am I prepared?
- Do I have sufficient time to devote to the venture?
- Am I healthy enough to handle the stress of this undertaking?
- Do I know where I can get help and information?
- What skills or experience do I have?
- Is this what I really want to do with my time?

Market-Related Factors:

- What is the competition?
- What is the market for my product or service?
- What is the advantage of my business over existing similar businesses?
- Can I furnish a higher quality product?
- Can demand be created for my product or service?
- What is an accurate description of the business?
- What price will I charge and how will I determine the best price?
- How will I identify customers, and how will I reach them?
- How will I best serve the need of my customers?

Organizational Factors:

- Where will I locate and why?
- Is the business practical?
- What will be the legal structure of the business?
- What will the business be named?
- What equipment and supplies will I need?
- What insurance will I need?
- How will the business be managed day to day?
- How will I hire and compensate employees?
- Will I need a permit or license?
- Are there zoning, fire regulations, or other restrictions that must be considered when choosing a location and opening the business?

Financial Factors:

- How will I hire and compensate employees?
- What finances are necessary to start and maintain the business?

- How will I compensate myself?
- Can an affordable lease be obtained at the best location?
- What are my financial resources?
- Do I understand how to make this a truly profitable venture?
- Do I have a good accountant?

The answers to these questions will be necessary for the preparation of a business plan for your business. The business plan is a great tool to help you determine if the risk of entering into business is worth taking.

Going into business is a risk so preparedness is essential. Various chapters of this handbook discuss preparedness in much greater detail. Once the decision has been made to start a business, the remaining steps are quite simple.

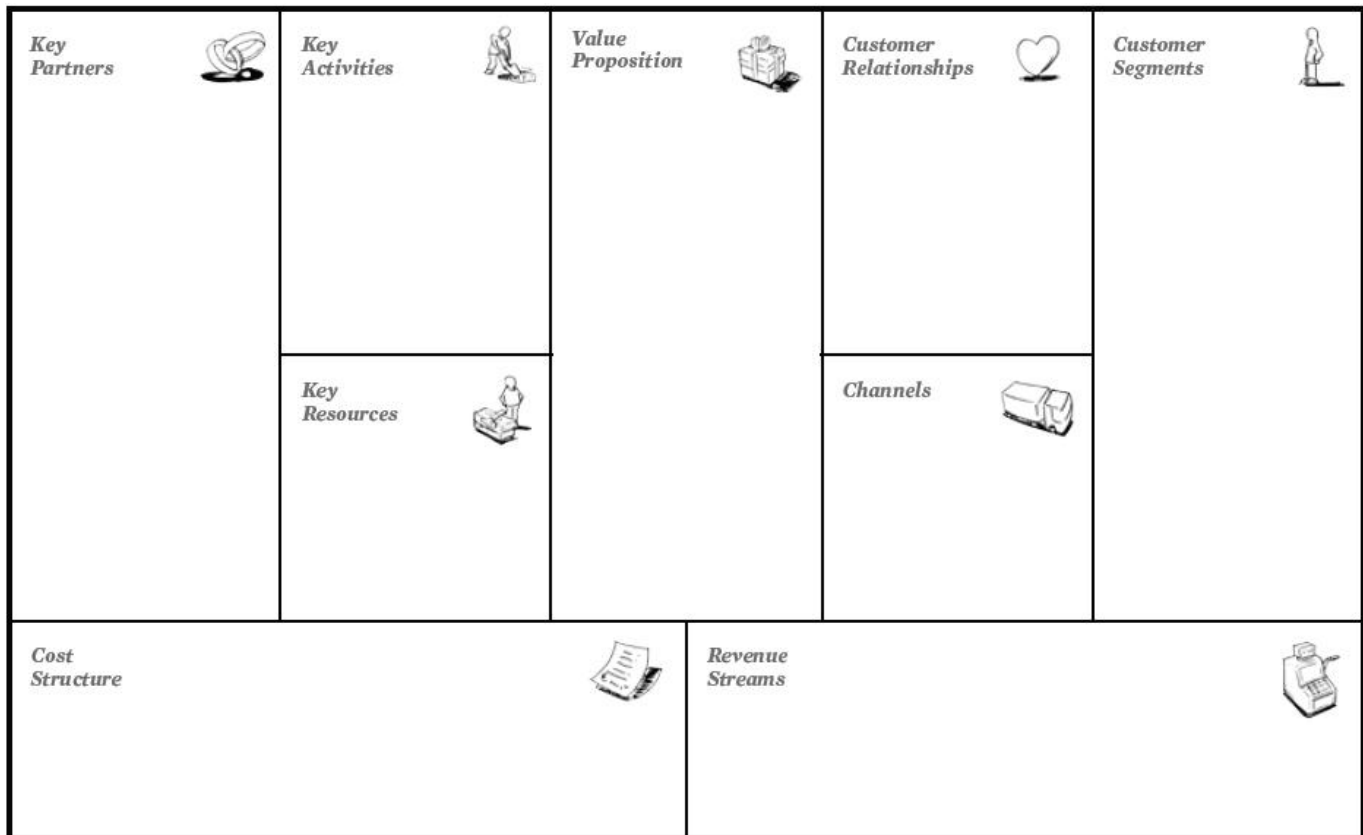
THE BUSINESS PLAN

Winston Churchill has been quoted as saying *“He who fails to plan is planning to fail.”* The importance of business planning cannot be over-emphasized. A business plan is an operating tool that forces you to take an objective view of your business, and provides the means to identify areas of strength and weakness. It pinpoints needs you might otherwise overlook, spots problems before they arise, and points out what must be done to make a profit and increase your business. As such, a business plan is a “living document” that should be updated on a regular basis.

For those considering going into business, a business plan can help you avoid entering into a venture that may fail. If the plan shows the business to be marginal, the hours spent writing a plan will save you the high cost of a business failure.

There are two approaches you can take to business planning. One is the traditional approach to business planning that is best used when seeking funding to capitalize your business. The second is a newer approach, Business Model Canvas, that can be used: 1) as a pre-planning exercise to validate your assumptions before investing the hours it takes to develop a full business plan or 2) if you don't require outside funding as a business planning format that will help you formalize your commercial concept and assumptions.

BUSINESS MODEL CANVAS (for more detail go to www.businessmodelgeneration.com) This is a simple format where you fill in the boxes in the following chart. It will force you to make decisions and will give you a clear picture of your business opportunity.



Business Model Canvas Navigator

| | |
|--|---|
| <p>Key Partners Defines the key network of partners and suppliers that make the model work. Strategic alliances between non-competitors, strategic partnerships between competitors, joint ventures to develop new business, buyer/supplier relationships</p> | <p>Who are our key partners? Who are our key suppliers? What key resources are we acquiring from our partners? What key activities do our partners perform?</p> |
| <p>Key Activities Describes the most important things a company must do to make the model work. What must they do to make the organization operate successfully?</p> | <p>What key activities do our Value Propositions require? Our distribution channels? Customer relationships? Revenue Streams?</p> |
| <p>Key Resources Describes the most important assets required to make the model work. Physical, financial, intellectual or human</p> | <p>What key resources do our Value Propositions require? Our distribution channels? Customer relationships? Revenue Streams?</p> |

| | |
|--|---|
| <p>Value Propositions Describes the bundle of products and services that create value for specific Customer Segments. It is the reason why Customers buy from you – you solve a problem or satisfy a need.</p> | <p>What value do we deliver to our customers? Which one of our customers' problems are we helping to solve? Which customer needs are we satisfying?</p> |
| <p>Customer Relationship Describes the relationship an organization establishes with specific Customer Segments – customer acquisition, retention and upselling</p> | <p>What kind of relationship does our Customer Segments expect us to establish and maintain with them? Which ones do we have established? How are they integrated with the rest of our business model? How costly are they?</p> |
| <p>Customer Segments Defines different groups of people or organizations an enterprise intends to reach and serve</p> | <p>For whom are we creating value?</p> |
| <p>Channels Describes how a company or organization communicates with and reaches its Customer Segments to deliver the Value Proposition. Raises awareness among customers, helps customers evaluate the Value Proposition, allows customers to purchase specific products or services, delivers a Value Proposition, provides post purchase customer support</p> | <p>Through which channel do our customer segments want to be reached? How are they reaching them now? How are our channels integrated? Which channels work best? Which ones are most effective?</p> |
| <p>Cost Structure Defines all the costs incurred to operate the model successfully – Key Resources, Key Partnerships and Key Resources</p> | <p>What are the most important costs inherent in our business? What Key Resources are most expensive? Which Key Activities are most expensive?</p> |

| | |
|---|---|
| <p>Revenue Streams Represents the cash an organization generates from each Customer Segment (costs must be subtracted from revenue to create earnings) It is defined by transaction revenues, i.e., one time sales or recurring revenues</p> | <p>For what value are our customers really willing to pay? For what do they currently pay? How are they currently paying? How would they prefer to pay? How much does each Revenue Stream contribute to the overall Revenue Stream?</p> |
|---|---|

Once you have assessed your business concept and if you determine that you need funding from a commercial lender, you will need a traditional business plan. If you decide to get assistance preparing your business plan, be sure those resources are helping you write *your* plan, not writing the plan *for* you. An accountant can help prepare the financial reports. However, only you can set the objectives of the business; decide where you would like the business to go and what you would like it to be. A typical business plan is 20 to 25 pages with all other information included in the appendices. A well-written business plan is really a well-integrated combination of three “sub plans”: an organization plan, a marketing plan and a financial plan.

PURPOSE OF A TRADITIONAL BUSINESS PLAN

1. Clearly states both the short and long-range objectives of the business.
2. Provides the direction or plan for achieving these objectives.
3. Provides financial forecasts based on your estimates of the future and your business experience.
4. Provides budget guidelines including projected cash flow analysis and income statements.
5. Gives a break-even analysis of your business.
6. Helps determine the amount and kinds of financing best for your business.
7. Gives banks, investors and suppliers useful information they need to make fast and accurate decisions about your business.
8. Forces you to think through every aspect of your business, and recognize opportunities for growth and profit.
9. Provides financial information so that the past can be compared to the present and future.

It is not possible in this handbook to present an example of a completed business plan; however the following is a typical outline for a plan:

OUTLINE OF THE TRADITIONAL BUSINESS PLAN

COVER SHEET

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

STATEMENT OF PURPOSE

An operating and policy guide for your business. State how the requested funds will be used and what affect these funds will have on the business.

TABLE OF CONTENTS

PART I - THE BUSINESS

- A. Description of the business
 - 1. Describe products sold, services offered
 - 2. Describe capital equipment and value
- B. Market
 - 1. Who buys your product(s) or service(s)?
 - 2. Who needs it?
 - 3. Size of the market?
 - 4. What is the growth potential?
 - 5. Market dynamics, such as technological and distribution trends
- C. Location of business
 - 1. Physical features of site
 - 2. Is it leased or owned?
 - 3. Renovations needed
 - 4. Description of neighborhood
 - 5. Zoning restrictions if any
 - 6. Other business in the area
 - 7. What is right or wrong about the location?
 - 8. Should you relocate, and if so, effect on operating costs
- D. Competition
 - 1. Names and addresses of competitors, by tier and by segment
 - 2. Their share of market
 - 3. What do you have that competitors do not have
 - 4. Future effects of competitors
 - 5. Comparison of your site inside and out to theirs
- E. Management
 - 1. Your background and experience
 - 2. Experience of management employees
 - 3. Analysis of management including yourself
 - 4. Needs for the future, and plans for hiring managers
 - 5. Job descriptions and training program

- F. Personnel
 - 1. Number of employees and experience
 - 2. Strengths and weaknesses
 - 3. Skills needed for future
 - 4. Plans to hire and training program
- G. Application and effect of loan or personal funds
 - 1. How much is needed?
 - 2. What for-inventory, equipment, renovations, etc.
 - 3. How will funds help the business?
 - 4. What happens if funds are not available in full?
- H. Objectives of business and plans to achieve them
 - 1. List objectives for each part of your business
 - 2. Describe plan to achieve each objective
- I. Summary

Clearly and succinctly summarize the key thoughts and ideas for the business

PART II. FINANCIAL DATA

- A. Sources and Application of Funding

A restatement of Part I-G. Shows up in cash flow projections
- B. Capital Equipment List

List depreciable assets on income statement
- C. Balance Sheet

Shows assets, liabilities, net worth at a given time
- D. Break Even Analysis

The sales or income point at which the company breaks even
- E. Income Projections (Profit and Loss Statements)
 - 1. Three year summary
 - 2. Detail by month the first year
 - 3. Detail by quarter the second and third year
 - 4. Notes of explanation
- F. Cash Flow Projections
 - 1. Detail by month the first year
 - 2. Detail by quarter the second and third years
 - 3. Notes of explanation
- G. Deviation Analysis

Compares actual income and expense projected on a month-to-month basis. Identify strengths and weaknesses.
- H. Historical Financial Reports for Existing Business
 - 1. Balance sheets for past three years
 - 2. Income statement for past three years
 - 3. Tax returns

PART III. SUPPORTING DOCUMENTS

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

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

If you have trouble developing either the Business Model Canvas or the traditional Business Plan, get help from SCORE.

ORGANIZING A BUSINESS

If the business is to be operated as a sole proprietorship and you use your name, it is unnecessary to register the business with city, town, or state. If you do not use your own name, the business must be registered with the municipal or town clerk. Partnerships have to be registered locally and corporations with the state. However, if the bank sees significant funds flowing through your account (\$10k or above), they are likely to ask that you aggregate the business activity in a separate bank account, which will require you to register the business with your locality (form a DBA) even if in your own name.

If you will have employees, or are a partnership or corporation, you must obtain an Employee Identification Number (EIN) from the Internal Revenue Service by filing form SS-4. Form TA-1 must be filed with the Massachusetts Department of Revenue if you sell retail, serve food, operate a motel or guesthouse, or have employees.

Additionally, all businesses with employees must register with the Division of Employment and Training⁵, Commonwealth of Massachusetts, and pay unemployment insurance taxes to the state as well as to the Federal Government.

NAMING A BUSINESS

Every business requires a name and because a name is an important asset to a business, select it carefully. Before choosing, research for names that are in use by businesses similar to yours. To avoid choosing a name already in use, search online for the same or similar names.

Names of corporations should be checked at the Corporate Division of the Office of the Secretary of State. To guarantee availability of your intended corporate name, a request must be made in writing to the Corporate Division along with a small fee. See full contact information in the appendix. If you want your website to have the same name as your registered business name, make sure the domain name is available (unlike corporate names, domains are based on a world-wide system and are sometimes unavailable).

After choosing a name, file organizational forms with the Secretary of State, or file a business certificate with the municipal clerk (only if you are a sole proprietorship) at the town hall in which your business is located. This certificate is called a "dba" which means, "doing business as". You must file a dba if you conduct business under any title other than the real name of the person, corporation, or limited partnership.

⁵ Division of Employment and Training - See Appendix for contact information.

Corporations, limited partnerships, and business trusts must be filed with the Secretary of State. Business trusts must also be filed with the municipal clerk. If you are forming such an entity, your name should first be researched at the state level to ensure that it is available. The easiest way to do this is to go to the Corporations Division page at the Secretary of State's website and select "Search the Corporate Database."⁶

Corporate names identify corporations, and the word corporation or the abbreviation must appear in the name, e.g. Cabot Corporation or Cabot, Inc. Similarly, Limited Liability Company names should end with LLC, such as Acme Products, LLC.

A Service Mark or a Trademark can be registered with the Secretary of State and the Federal Government, although neither registration is required. In Massachusetts, you cannot register a trade name, nor can this be done with the Federal Government.

There are different categories of business names:

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

Trademarks are protected under common law. However, by registering your mark, you gain certain exclusive ownership under statutory law. State registration is usually processed within several days. Federal registration usually takes several months or longer. Registering with the state protects your mark during the federal application period. In Massachusetts, a mark must be in use before it can be registered.

Forms for registering a trademark may be obtained by writing or calling the Secretary of State or on the website. The current filing fee is \$50.00. Registration is effective for five years, is renewable and provides evidence of ownership. Just as with a business name, you can search for existing trademarks via the Corporate Division database.⁷

LEGAL STRUCTURE OF A BUSINESS

Before opening a business, select the legal structure that will best suit your needs and those of the particular business. There are four principal types of business structures, namely the Sole

⁶ <http://corp.sec.state.ma.us/corp/corpsearch/corpsearchinput.asp>

⁷ <http://corp.sec.state.ma.us/corp/Trademarks/TrademarkSearch.asp>

Proprietorship, the Partnership, the Corporation and the Limited Liability Corporation. While many small businesses start as a sole proprietorship, over time most move to become either an LLC or an S Corp to minimize liability. Speak with your accountant to determine which is best for your business. Each of the structures has its advantages and disadvantages as reviewed below.

SOLE PROPRIETORSHIP

The Sole Proprietorship is a business owned and operated by one person and is the most common form of small business organization. If a license or permit is not required for the business activity and if the business is in your own name, just open the door and start. However, if you have employees, the business must be registered with the Federal Government on IRS Form SS-4 (Application for Employer Identification Number). If you sell retail, collect meal or room tax, or have employees, it must be registered with the state on form TA-1 (Application for Original Registration). If the business is not in one's own name, it must be registered in the municipality in which the business is located.

Advantages

- **Ease of Formation** - The easiest and least expensive form of business as well as the fewest legal restrictions. It needs no government approval to begin operation.
- **Sole Ownership** - The proprietor shares the profits with no one and the decision-making is vested in one person.
- **Control** - The sole proprietor is in complete control of his or her business.
- **Flexibility** - Management can respond quickly to the needs of the business and in making the day-to-day decisions often so critical to a new business.
- **Freedom from Government Control** - There are no special taxes. In fact, the business itself pays no state or federal taxes. Profits become the owner's personal income, and are taxed as personal income.

Disadvantages

- **Unlimited Liability** - The sole proprietor is responsible for the full amount of business debts. These could exceed the proprietor's total investment. Be aware that this liability extends to all the proprietor's assets including his or her home.
- **Less Available Capital** - Capital is limited to the owner's personal assets and the extent to which the owner can borrow funds. Hence, this form of business ordinarily has less available capital than the other forms and it is usually more difficult to borrow money.
- **Unstable Business Life** - The business may be crippled or terminated upon the illness or death of the owner.
- **Experience Limitation** - Single owners operating with no or few employees are often limited in experience and viewpoint as compared to the other forms of business.
- **Limited Business Deductions** - Certain types of business deductions are not available to the sole proprietor. These include worker's compensation insurance.

PARTNERSHIP

A Partnership is an association of two or more people to carry on as co-owners of a business for profit. Although not required by law, Written Articles of Partnership are customary, and highly recommended. These articles of agreement state the financial, material, and managerial contribution to the business. They should clearly spell out the role of each partner, and what share of the profits, losses and partnership equity interest each will receive. There should be provisions in the articles for both dissolving the Partnership, and for a buy-out by one or more of the partners. Partnerships should be registered with the Town Clerk.

A separate Buy-Sell Agreement should be in place to provide for all contingencies such as what price will be paid a partner in the event of trigger events such as death, disability and disagreement. Particulars regarding valuation of partnership interest, terms and funding should be covered. Often, cross purchasing of life insurance on each partner can provide funding of the surviving partner's payment to the deceased partner's estate.

Partnerships may also be formed as Limited Partnerships wherein the limited partner risks only an agreed upon investment in the business. The liability of limited partners is restricted as long as they do not participate in the management of the business. Here there must be one general partner who controls the partnership and its assets. Even by reducing his personal holding to a very small fraction of the units in the general partnership, the general partner still maintains control. Many times this type of entity is used in family limited partnerships whereby transferring assets to family members affords certain creditor protection as well as shifting taxable income to them along with providing planning strategies to the parents.

The services of an attorney who specializes in drawing Articles of Partnership is essential to starting this form of business.

Advantages

- **Ease of formation** - While not as easy to form as Sole Proprietorship, it is easier and less costly to form than a corporation.
- **Flexibility** - The Partnership is more flexible than a corporation, but less than a Sole Proprietorship.
- **Direct Rewards** - The Partnership pays no federal or state taxes. The rewards or profits from the business come directly to the partners as self employed income.
- **Financing** - Capital is easier to obtain than with a Sole Proprietorship. There is more than one owner to draw upon for funds.
- **Freedom From Government Control** - There are no special taxes on a Partnership, and like a Proprietorship, it pays no state or federal income taxes. The partners pay personal taxes on the profits.
- **Skills and Experience** - The skills and experience of all partners are available to assist in the decision-making.

Disadvantages

- Unlimited Liability - Each general partner is liable for the business debts incurred by the other(s) and by the business in general.
- Unstable Business - Upon death of one partner the Partnership terminates. Rights of survival exist, so buy-out terms must be in the agreement.
- Long Term Financing - Partnerships cannot obtain long term, or for that matter, short term financing as readily as a corporation.
- Disposal of Interest - It is often difficult to dispose of a partner's interest in the business. As indicated above, articles should contain a buyout agreement.

CORPORATION

A Corporation is a distinct legal entity—distinct from the individuals who own it. A Corporation can only be formed through the authority of a state government. In Massachusetts, Articles of Organization for domestic corporations can be obtained from the Corporate Division, Office of the Secretary of State. For a corporation up to the first 275,000 shares of stock, the filing fee is currently \$275. Each year there is a minimum state excise tax currently in the amount of \$456. In addition, the corporation must file an Annual Report of Operations with the corporate division, and pay a small filing fee. The services of an attorney are recommended when incorporating.

As soon as one is notified that one's organization has been approved, one must file for a Federal Employer Identification Number (EIN) using form SS-4, obtained from the IRS. As noted earlier, check into licenses and permits before doing business.

Advantages

- Separate legal existence
- Limited liability (known as the corporate veil)
- Ownership readily transferable
- Stable and relatively permanent
- Relatively easy to secure funds
- Delegated authority of management
- Skills and expertise available from many

Disadvantages

- Extensive government regulation
- Complicated and often expensive tax reporting
- Double taxation - Profits are subject to corporate tax and if distributed to the stockholders are taxable as personal income.
- Limited incentive - If management does not share in the profits, there is usually less incentive.
- Expensive to form and maintain
- Excise tax paid each year

For income tax purposes, there are two types of corporate entities, the "C" Corporation and the "S" Corporation. A "C" Corporation is subject to tax at graduated rates on taxable income, and in effect pays its own tax. An eligible corporation may elect to be taxed as an "S" Corporation, which with limited exceptions, is not taxed at the corporate "C" level. Instead, its items of income, loss, income or credit are passed through to, and taken into account by, its shareholders in computing their individual tax liabilities.

Requirements and characteristics of an "S" Corporation are:

- All shareholders must be individuals, estates, or trusts
- Non-resident aliens are excluded. It must be a domestic corporation
- Cannot have more than 100 shareholders
- It must have only one class of stock. Differences in voting rights are permitted.

This election is made by filing Form 2553 with required shareholder consents and must be done by the 15th day of the third month of the tax year in which it will become effective.

- Massachusetts "S" Corporations with total receipts of \$6,000,000 or more will be additionally taxed on their net income as such
- Fringe benefits are less favorable than "C" Corporations.
- Deductible shareholders losses are limited to the sum of their basis in the stock and loans from them to the corporation.

LIMITED LIABILITY CORPORATION (LLC)

The Limited Liability Corporation permits one or more individuals or entities, including other LLCs, corporations, professional corporations, partnerships, associations and trusts to carry on any lawful business, trade, profession or activity. When structured properly, the members and managers (who need not be a member) of the LLC are not liable for the debt, obligations, and liabilities of the LLC solely as a result of being a member or manager of the LLC.

A Limited Liability Partnership (LLP) permits those in professional practice as a general partnership to register as an LLP and thereby protect its partners from debts, obligations and liabilities of the partnership arising while the partnership as an LLP. An LLC and an LLP do not require a general partner with unlimited liability.

Advantages

- Any type of owner
- An unlimited number of owners
- More than one class of owner
- Limited liability to the extent of owner investment
- Partnership classification for tax purposes with special allocations of profits and losses passing directly to personal returns.

To operate as an LLC in Massachusetts a Certificate of Organization must be filed with the Secretary of State. This certificate must contain the name of the LLC, address of the main Massachusetts office, name and address of its resident agent, name and address of each manager (if any), name and address of any person authorized to execute any document filed with the Secretary of State, date of dissolution, and a description of the character of the business. There can be a tax on the conversion from a corporation to an LLC.

Each LLC is required to pay Massachusetts an annual fee of \$500 and to file an annual report with the Secretary of State. All income is considered as self-employment income unless one is a member only without an equity distribution.

The most important feature of an LLC is the operation agreement and articles of organization, which feature the following:

- Provisions for the allocation of profits and losses.
- Provisions for each member's contributions.
- Description of distributions
- Provisions for resignation of a member.
- Describes distributions for resigning members.
- Provisions for member indemnification.
- Accurate description of its activities to differentiate it from a C or S Corporation, or General or Limited Partnership.

It must have more characteristics of a partnership than a corporation and can't have more than two of the following:

- Central management
- Continuity of life
- Free transferability of interests
- Limited liability

SUMMARY

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

- Size of the risk and the amount of the investor's liability for debts and taxes
- Would the business continue if something happened to one of the principals
- What is the influence of applicable laws
- What are the possibilities of attracting capital
- What are the costs of starting and running the business under each of the business structures
- What extra record keeping and reporting can be afforded
- What legal structure would best serve the purpose and goals of the business
- What legal structure assures the maximum adaptability of administration
- Which form of structure permits the most members
- Which structure provides the least liability

- One's marginal tax bracket
- Estate and succession planning

Professional advice is highly recommended to assist in the selection of a legal structure for a business. It's also important to remember that you can always start a business as a Sole Proprietorship, and if desired, revert to a different structure at a later date if it becomes advantageous to do so.

LICENSES AND PERMITS

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

- A license is a privilege granted by a legislative body at their discretion.
- A permit is a right that anyone can obtain if the requirements of the granting agency are met.

Licenses and permits may be granted at the town, city, county, or state level. Below is a partial listing of departments that issue licenses or permits at the local level. For a comprehensive listing of information pertaining to licensing and regulation in the state of Massachusetts, see the web link below.⁸

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

At the state level, the Citizen Information Service provides comprehensive information regarding businesses requiring licenses and permits in Massachusetts. See Appendix for website and telephone number. The following lists are not complete. Should any question arise, contact the Citizen Information Service.

⁸http://www.mass.gov/?pageID=dorterminal&L=3&L0=Home&L1=Businesses&L2=Help+%26+Resources&sid=Ador&b=terminalcontent&f=dor_business_licpermit&csid=Ador#1

Businesses Requiring a License or Permit in Massachusetts

- Alcohol-sales and distribution
- Amusement parks, carnival rides, music, dancing
- Entertainment
- Asbestos abatement
- Auto body repair
- Auto sales- new and used
- Cigarettes-wholesale and retail
- Collection agencies and finance companies
- Appliance testing labs
- Solid fuel burning construction supervision
- Hazardous chemicals or flammables
- Dairies, milk dealers, and plants
- Detective agencies
- Child Day Care Centers
- Dancing schools
- Diesel Fuel trucks
- Engine fuel and lubricants
- Elevators and operators, escalators
- Employment agencies
- Engineering and related fields
- Food or beverage service, sale or preparation
- Firearms, sale
- Fishing, hunting, trapping
- Fortunetellers
- Hawkers & peddlers-balloons, souvenirs, arts/crafts, flowers
- Auctioneers
- Insurance agents, adjusters, brokers, advisors
- Junk dealers
- Motion picture operators
- Lodging-hotels, motels, inns, B&Bs, guest houses
- Motor Vehicle appraisers
- Notaries Public, Justices of the Peace
- Nursing homes
- Outdoor advertising
- Painters, riggers
- Restricted pesticide dealers and applicators
- Pet shops, riding schools, cattle dealers, stables
- Guard and hearing dog businesses

Professions and Trades Requiring License or Registration in Massachusetts

Allied health professions

Landscape architects

Athletic trainers

Nursing

| | |
|---------------------------------|--------------------------|
| Occupational therapists | Optometry |
| Physical therapists | Pharmacy |
| Architects | Plumbing and Gas fitting |
| Barbers | Podiatry |
| Chiropractors | Public accounting |
| Cosmetologists | Psychology |
| Dental examiners | Radio technicians |
| Dispensing opticians | Television technicians |
| Drinking water supply | Real estate sales |
| Facility operators | Real estate brokerage |
| Electricians | Respiratory care therapy |
| Insect Exterminators | Sanitarians |
| Electrolysis | Social workers |
| Embalming and funeral directing | Audiology |
| Hair Dressers | Speech pathology |
| Land Surveyors | Veterinary medicine |
| Engineers | Attorneys |
| Health Officers-certified | Physicians |
| Insurance Agent | Investment Advisor |

There are numerous Blue Laws in Massachusetts that pertain primarily to doing business on Sundays and Holidays. Check with your police department for restrictions that apply to your area.

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

BUSINESS LOCATION ISSUES

Small business advisors often say the success of a retail business depends on three factors: location, location and...location. This indicates the importance of having a business situated in the right place. A bad location usually leads to failure.

Retail businesses fall into three general categories and the type of business will impact the appropriate location. The first is if the customer comes to the place of business and the business is dependent on pass-by traffic. Examples are clothing, food, and hardware stores, barber and beauty shops, etc.

The second is a business where the customer comes to the business, and the business goes to the customer. Examples are a carpet store and a drapery and curtain shop or an office.

The third business type is where the business comes to the customer, examples of which are plumbers, electricians, landscapers, etc. For this type of business, location is not of primary concern. The only caution is zoning laws that may affect parking of trucks and equipment, and storing materials.

Three factors are involved in choosing a business location:

1. Selecting a City Or Town

When beginning a business or moving to another city or town, the following are some items to consider:

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

2. Selecting an Area Within A City

Once a city or town has been chosen, the following should be considered in selecting a location area within the town:

- Customer attraction power of the shopping district
- Number and quality of competitive stores
- Availability of access routes to the store
- Nature of zoning regulations
- General appearance of the area
- Expansion and rebuilding of the area

3. Selecting a site

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

Consumer Goods Considerations

The consumers' view of the goods or merchandise sold by a store will also have an effect on site selection.

1. Convenience goods

- These are goods frequently bought by habit and have a low unit price, such as gum, candy bars, milk, etc. Convenience stores are usually close to consumers' residences and heavily depend on traffic for success.

2. Shopping Goods

- These goods have a higher unit price, and are purchased infrequently. Examples are men's suits, and furniture. Stores selling shopping goods usually do better if located near a large department store or in a major shopping area.

3. Specialty Goods

- Usually high priced. Although sometimes located near shopping goods stores, specialty goods stores may be isolated because they generate their own traffic. Examples are precious jewelry, expensive perfumes, and antiques.

Online/Mail Order and Home-Based Businesses Not Involving Foot Traffic

- Online, mail-order and other home-based businesses typically do not involve the client actually visiting the location of business. As such, businesses do not need to factor customer considerations into the location decision. What may be important for these businesses are access to shipping facilities, inventory storage or ease of commute for employees.

Retail Compatibility

- Retail compatibility is important to a new business. Locating next to a store that does not clash with the new business but will bring in traffic may be the salvation of the new business.
- If a new business offers shopping goods, the best location is near other stores carrying shopping goods. Locating a store selling shopping goods near a convenience store is not recommended. New businesses do better in an established shopping center rather than trying to go it alone.

Other Considerations

- In choosing a site there should be adequate traffic, adequate parking, lighting and safe and easy access. Parking spaces may be expensive. Ask about the cost of snow removal and other charges before considering the site. Be sure that drainage is not a problem.
- Zoning laws and in particular regulations regarding business signs must be investigated via the Town Clerk or through City Hall.
- What people think of a business is influenced by both the interior and exterior attractiveness of the building. Unclean exteriors, walls that need painting, and an overall unattractive site turn customers away. Whether a business realizes it or not, every business has an image.

- Let there be no doubt that even excellent products and services may well be negated by a poor site location.

Leases

Landlords can be difficult. Maintaining a friendly relationship with the landlord is critical to working out potential difficulties. Landlords are trying to make a profit, too. Cordial relationships make it easier to get improvements, and if for some reason the tenant is going to be late making the rent payment it is far better to have a friendly landlord rather than an antagonistic one.

Good communication with a landlord will also be beneficial in learning of the long-range plans for the property being leased. Usually, the longer the lease terms, the better. If a business owner or operator is inexperienced with leases, the services of an attorney are essential.

Note that most business leases are triple net, meaning that the lessee agrees to pay all real estate taxes, building insurance and maintenance on the property in addition to any normal fees that are expected under the agreement (rent, utilities, etc.).

MANAGING A BUSINESS

Business is an economic institution. The goal is economic survival and the activities are dominated by a profit motive. The primary purpose is to create and satisfy a customer, and make a profit.

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

Assuming a business is based on a sound idea, which has been thoroughly investigated and is adequately financed, it will succeed or fail depending on the managerial skills of the owner or manager.

Successful business leaders stress that the development of management skills, whether in a large corporation or in a one-person business, is one of the most important elements in the success of that business. Irrespective of the size of the business, mastering management skills for use in the daily operation is critical. All too often small business owners are good at launching their venture, but weak when it comes to managing through the development and later stages of the business. There are several proven ways to strengthen management skills.

Management by Objectives

Objectives are a fundamental strategy of business and a critical component of a business plan (refer to section in Business Plan). An objective is a written statement of results to be achieved. It defines specific outcomes, and establishes performance levels for the business, its manager, and its employees.

Objectives should be set for both the short-term and the long-term. They must be reasonable, attainable, measurable, specific, and time dated. Objectives allow managers to analyze the performance of the business, their own performance, and that of their employees. Objectives should be commitments, not facts; directions, not fate. An objective must have a means of accomplishing it, and a plan to accomplish it.

An example of a business objective might be "to increase my business from \$24,000 to \$36,000 in the next twelve months." A marketing objective might be "to prepare, print and distribute 1000 fliers to shoppers in the local mall within two months."

Others might be "to hire and train a new sales clerk before the end of the fiscal year." Or "to telephone each account receivable at the end of each month, and to personally visit accounts that are more than six weeks delinquent." Objectives should be developed for every aspect of a business, such as sales, service, bookkeeping, advertising, employee relations, marketing, etc. Note: objectives should be in writing, and reviewed often.

Record keeping

Know your figures and keep them up to date. Doing this is the only way you will know how the business is doing on an ongoing basis. There are several simplified bookkeeping systems and software available—use them. If you're not comfortable with numbers, you can engage the services of an accountant, or bookkeeper. Accurate records are not only needed by business owners and managers, but for the state and federal government.

Follow-up

Keeping adequate, accurate records of your business permits you to utilize them in the daily management of the operation. At the end of each month, you should compare the actual Profit and Loss and Cash Flow statements with the goals identified in your business plan. This way you can see your progress, and take the necessary action. One should not only review the financial area, but also marketing, sales, advertising and other operational goals.

Be Action Oriented

Do not procrastinate! If something is not working as you planned, do something about it now! Don't become paralyzed by inaction. Every well-developed business plan should contain an action plan that includes the following:

- Deciding what must be done, and when
- Planning and scheduling - setting time tables
- Performance - do it!
- Controlling - monitor events as they occur
- Coordinating - be sure each objective is in harmony and not at odds with the others
- Recording and Documenting - keep accurate and complete records
- Analyze and Evaluate - unless records are frequently analyzed and studied, you will never know what is happening or what has happened

Getting help

Know when you need help, and get it! You do not have to hire professional help on a full time basis. At some point, you will probably need the services of a lawyer, an accountant or a banker. Be pro-active in establishing a solid network of experts who can help. SCORE counselors are always available for mentoring and business advice at no cost. Making use of these resources will make it easier to plan, execute and succeed.

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

Essential Management Practices

- Have your accountant or bookkeeper prepare and thoroughly explain financial reports such as profit and loss statements, balance sheets, cash flow sheets and certainly tax returns.
- Know your break-even point and if you are on target in reaching it.
- Talk to your banker about your business even though the objective is not a loan. Know your numbers when talking to a banker.
- Know exactly how much it costs you to make a sale, perform a service, make a repair.
- Know how much inventory is on hand. Inventory is \$\$\$\$. Old and obsolete inventory can paralyze your business. Plan how to move it out.
- Get regular feedback from customers and make changes based on their suggestions.
- Remember, customers want quality and service.
- Join a trade association for your industry and the local Chamber.
- Read the same publications that your competitors and customers read. Stay up to date.
- Constantly scrutinize your competitors' ads and read their sales literature.
- Ask yourself the following about your competition: Is their business increasing or decreasing? How do you compare as far as quality, price, product line, exclusivity, service, reliability, location, warranties, delivery and courtesy?
- Talk regularly about business related subjects with other small businesses.
- Frequently review financial and market strategies.
- Have regular training sessions for and regular motivation meetings with your employees.
- Recognize your own weaknesses. Get help in these areas.
- Review the business plan monthly.
- Tell everyone on the payroll precisely what his or her responsibilities are and exactly what is expected of them.
- Treat employees as individuals. Consider their suggestions.
- When an employee does a good job, tell him or her.
- Keep as accurate a set of records as possible.
- And most importantly, take pride in your business!

EMPLOYER VERSUS INDEPENDENT CONTRACTOR

Please note: the following labor sections are highly technical. Small Business owners are encouraged to seek the assistance of a Certified Public Accountant to guide these decisions.

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

Common-Law Employees

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

Employers have to withhold federal income tax, social security tax, and state income tax from common-law employees. Also, employers have to pay their share of social security, and federal and state unemployment tax for such employees. Employers must also pay for workers compensation insurance.

Statutory Employees

A statutory employee is one who works for an employer for pay in any one of the following four categories:

1. A driver who distributes meat, vegetables, fruit, bakery products or beverages (other than milk), or who picks up and delivers laundry or dry cleaning, if the driver is your agent or is paid on commission.
2. A full time insurance sales person.
3. An individual who works at home on materials or goods that you supply and that must be returned to you or to a person you name, and you also furnish the specifications for the work to be done.
4. A full time traveling or city sales person who works on your behalf and turns orders in to you from wholesalers, retailers, contractors, or operators of hotels, restaurants or similar establishments. The goods sold must be merchandise for resale or supplies for use in the buyer's business.

People who are employees under the statutory rule do not have to have federal and state income taxes withheld from their wages. However, individuals within any of the preceding four categories are employees for social security tax purposes if they meet all of the three following conditions:

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

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

Independent Contractors

Generally, people who are in business for themselves are not employees, e.g. physicians, attorneys, CPA's, construction contractors, and certain others who offer their services to the public.

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

The Department of Revenue has a three - factor test to determine if someone is an independent contractor:

1. The individual is free from control and direction in connection with the performance of a service, both under the individual's contract for the performance of service and in fact; and
2. The service is performed outside the usual course of business of the employer; and
3. The individual is customarily engaged in an independently established trade, occupation, profession or business of the same nature as that involved in the service performed

Separately, under the heading of independent contractors, two categories of statutory non-employees exist for the purpose of federal employment taxes. These are for real-estate agents and direct sellers. However two conditions must be met:

1. All remuneration for their services relate directly to sales or output, and not to the number of hours worked, and,
2. Their services are performed under a written agreement that provides they will not be treated as employees for federal tax purposes.

Another test is that when an independent contractor has assistants, only the contractor can fire them. Also if workers are free to take other jobs at the same time they are working for

you, then they are generally regarded as independent contractors. IRS Publication 15A contains a detailed discussion of independent contractors and industry examples.

An employer does not have to withhold income tax, or social security tax from the wages of independent contractors, nor does the employer have to pay the unemployment tax, or worker's compensation insurance.

The independent contractor must provide the employer with an employee identification number or a social security number because an employer who has hired an independent contractor must file form 1099-Misc with both the State Department of Revenue and the Internal Revenue Service. If the independent contractor fails to provide this number, the employer may have to withhold as income tax twenty percent of the amount paid. See Chapter 20 on Employment Taxes.

Casual Labor

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

If one asks either the Internal Revenue Service (IRS) or the Massachusetts Department of Employment and Training (DET) for a definition of casual labor likely none will be forthcoming. This means that the IRS and the DET do not recognize the term, and chose not to define it. Both agencies reserve the right to judge each individual case as to whether or not a worker is a casual employee.

The issue at hand is whether or not an employer must withhold income and social security tax, pay unemployment taxes, and insurance. Obviously, both agencies want revenue. In some cases, the IRS and the DET may recognize intermittent and temporary labor. Below are some cases that may be recognized as intermittent or temporary labor.

Case 1: Katie's Catering service has two full time employees. Katie contracts for a job for which she needs extra help, so she hires a person to work for one day for \$50.00 with no withholdings of any kind. She does not intend to hire this person on a regular basis.

Case 2: Conwald Construction takes on a contract to frame two houses and agrees to finish both houses within one month. Conwald does not have enough regular full time employees to accomplish this, so he hires two extra carpenters at an agreed upon wage of \$300 per week for three weeks. At the end of the job, Conwald pays each carpenter \$900, but does not withhold, etc. However, because the wages were over \$600 to each person, Conwald must obtain the social security number of each carpenter, and at the end of the year, submit a

1099-Misc to both the IRS and the DOR, and the carpenters. These workers must be covered by workers comp.

Case 3: Russ's Restaurant has occasional need for an extra bartender during July and August. He hires a person to work one night a week for eight nights, at \$45 per night, with no withholding, etc. The total wages paid was \$360. In this case, Russ did not report these wages because the amount is less than \$600.

According to the Massachusetts DET, the workers in each of these cases would be regarded as employees and the employer would have to pay the Massachusetts unemployment tax.

Often, employers abuse the classification of intermittent or temporary help. Be aware that if the IRS decides the employee is common law, and the employer has not withheld, the employer is liable for all the withholding, social security taxes and unemployment taxes. Both the state and federal agencies frequently audit income tax reports, during which the question of who is an employee arises.

If there is ever any question about who is an employee, contact the IRS or the Massachusetts DOR and DET. If there is a question as to whether unemployment tax should be paid, contact the IRS, and the Massachusetts DET. A Form 1099 Misc must be issued by the employer as required by the Internal Revenue Service.

Careful study of the references listed below is recommended:

IRS Publication 15 (Circular E): Employers Tax Guide.
IRS Publication 15A: Employers Supplemental Tax Guide
IRS Publication 911: Tax Information for Direct Sellers.
IRS Publication 926: Employment Taxes for Household Employers
"Simplifying The Employment Security Tax Law for Employees."
"Massachusetts Employment Security Law with Regulations"

The last two publications (above) may be obtained from:
Massachusetts Department of Employment and Training
19 Staniford Street, Boston, MA. 02114
Website: <http://dir.vahoo.com/Business and Economy/Small Business Information>
Click on employment Law

MANAGING HUMAN RESOURCES

Successful management of any business, large or small, is based on effective utilization of available resources. And people, managers and employees alike, are primary component of these resources. Employees can account for twenty to sixty percent of an entrepreneur's budget expense. The manner in which these employees interact with customers, the productivity with which they manage the products or services and the effectiveness with which they operate systems are crucial to the success of a business.

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

It is essential to define the objectives of the work force and to clearly plan the strategy to reach these objectives. Once an employee is on the job, reasonable, attainable objectives should be set for him or her. Employees should be involved in setting their own objectives. As a respected member of the team, there is more incentive for the employee to perform at peak level.

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

Recruiting

Advertising in the local press or through online job sites are the most direct methods. The most productive however, is word of mouth referral by a satisfied employee. Schools, trade associations, and professional groups are excellent sources for specialized needs. As a rule, it is wise to avoid employing relatives and close friends as discipline problems often arise. If they bring special expertise, it may be another matter.

Interviewing

An interview is a two-way communication during which both participants find out about each other and assess competence and compatibility. The interviewer must guard against invading the legal right to privacy of the applicant, both on the application form and in direct questioning. It is important to be familiar with the guidelines of the Massachusetts Commission Against Discrimination (MCAD), the Massachusetts Department of Labor and Industries (DLI), and the United States Equal Opportunity Commission (EEOC) when it comes to interviewing and hiring.

For example, MCAD has a list (3.02) of permissible inquiries on their website, which covers the following topics: Age; Disability/Handicap; National Origin/Ancestry/Citizenship; Medical Examinations; Race/Color; Photograph; Religious Creed; Sex (Gender); Sex Orientation; Criminal Record; Education/Experience/Reference/Organization; Lie detector Test; Family Responsibilities. To avoid being discriminatory in hiring, employers should review this information. See the Appendix for the contact information for MCAD, DLI and EEOC.

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

Wages and Working Conditions

These matters are controlled to some degree by labor laws, and to a greater extent by local practice. The National Bureau of Labor Statistics can provide surveys of conditions in the local market. Usually, it is wise to set wages at the mid-point of current practice to allow for incentive and future growth.

Employee benefits will add 15-25% to the cost of the payroll. Careful thought must be given to benefits when planning and budgeting. For businesses that experience peaks and valleys in workflow, thought should be given to the use of temporary workers and agencies.

Training

A new employee may be considered to be on probation for an agreed upon length of time; usually three months. The employee must be so informed. During this time, attention must be given to integrating the employee into the work force and bringing the employee's performance up to standard. Explaining and demonstrating the task, having the employee perform the task, and then giving constructive correction and reinforcement, best accomplishes this. Time spent in proper training will more than pay for itself in weeding out those without the ability to perform or fit in. Training fosters the success and high performance of those retained.

Sexual Harassment

Sexual harassment in the workplace is unlawful in Massachusetts. The Massachusetts Commission Against Discrimination (MCAD) has adopted a model sexual harassment policy guideline that must be put in force by employers, and explained and made available to all employees. A copy of the guideline may be obtained from MCAD (see Appendix for the telephone number).

It must be the goal of employers to promote a workplace that is free of sexual harassment, and to take all allegations of sexual harassment seriously and respond promptly to any and all allegations of unwelcome sexual harassment.

In Massachusetts, the legal definition for sexual harassment is as follows: sexual harassment means sexual advances, requests for sexual favors, and verbal or physical conduct of a sexual nature when:

1. Submission to or rejection of such advances, requests or conduct is made either explicitly a term or condition of employment or as a basis for employment decisions; or
2. Such advances, requests or conduct have the purpose or effect of unreasonably interfering with an individual's work performance by creating an intimidating, hostile, humiliating or sexually offensive work environment.

The sexual harassment policy must contain the name of the person within the company to whom such allegations will be made, the manner in which allegations are to be made and also contain the telephone number and address of MCAD and the United States Equal Employment Opportunity Commission (EEOC). It is recommended that employers keep careful records of all sexual harassment allegations, and record the action taken in investigating, and the disposition thereof.

Supervision

The workforce may be the greatest single expense in the budget, which means that employee selection, training and supervision are of primary concern. It has been estimated that every employee turnover has a cost of five hundred times the hourly wage. Keeping good employees on the job is critical to success of the business. Keeping the employee on the job and getting peak performance depends on proper supervision.

Most employees are looking for a challenge, incentive, opportunity to learn, and opportunity for advancement. It is essential to define the objectives of the workforce and to clearly plan the strategy to reach these objectives. Reasonable attainable objectives should be set for each employee and employees should be involved in setting their own objectives. As a respected member of a team there is more incentive to perform at peak level.

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

Ending Employment

When an employment relationship ends, it is expected that both the employer and employee will give the other adequate written notice. If it is necessary to terminate employment, the employee should be given an honest explanation of the reason for termination. Terminated employees must be paid in full on the day of termination.

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

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

RECORD KEEPING

Experience has clearly demonstrated that for a person about to start a business, an adequate record keeping system will increase the chance of survival and reduce the probability of failure. Similarly, for the established business, experience has shown that a good record keeping system increases the chances of remaining in business and of earning larger profits. There are excellent proven and cost-effective software solutions such as "QuickBooks" and "Sage Peachtree".

Good record keeping ensures that the following information is always readily available:

- Amount of business done in cash and credit.
- Amount of business tied up in receivables.
- Amount of collections, and losses from credit sales.
- Aging of accounts receivable and amount of credit given to delinquent accounts.
- Amount of cash on hand and in the bank.
- Show if business records agree with bank statement.
- Amount owed to creditors and suppliers.
- Contributing or gross margin.
- Total expenses.
- Amount of weekly payroll.
- Adequacy of payroll records for withholding, etc.
- Payment of taxes, and deposits of withholding.
- Net profit earned and taxes owed.

- Which product or service makes a profit?
- Which product or service loses money?
- Amount of money invested in inventory.

The following information should be recorded:

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

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

Daily

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

Weekly

- Accounts receivable
- Accounts payable
- Payroll - in detail
- Taxes - sales, Social Security, withholding, etc.

Monthly

- All journal entries posted as like elements to general ledger
- Cash flow statement
- Profit and Loss statement
- Balance sheet
- Reconciliation of bank statement with own books
- Petty cash balance
- All federal taxes deposited and withholding and sales taxes paid
- Accounts receivable aged to 30, 60, and 90 days
- Inventory worked to remove dead stock and order new

Every business needs controls. If you do not control the business, it will control you. Adequate record keeping enables business owners to develop the five key financial statements that provide a clear picture of the business:

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

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

For new businesses, before you open the door, be certain a good record keeping system is set up. If you do not understand the need for this, it indicates that you may not have enough managerial know-how to run a business. If possible, initially do the record keeping yourself. If not, hire a part-time bookkeeper, use a business service or engage the services of a public accountant. SCORE can help you set up a system.

In any case, be absolutely sure that you understand what records are required for your business. If someone else sets up a system, make certain that you understand the system. There are several IRS publications that are helpful in determining which type of records must be kept, and what information is required for tax purposes. Publication 583 is particularly useful for the beginner as are the other IRS publications listed below and in a later chapter entitled Useful IRS Publications

Pub 15 Employer's Tax Guide (Circular E)

Pub 15A Employer's Supplemental Tax Guide

Pub 463 Travel, Entertainment, Gift and Car Expense

Pub 535 Business expenses

Pub 538 Accounting Periods and Methods

Pub 583 Taxpayers Starting a Business and Keeping Record

INSURANCE

Going into and operating a business involves risk. There are two types of risk. Business itself is a speculative risk that has the uncertainty of loss, but also the possibility of gain. You can't insure speculative risk. The other type of risk is known as pure risk, defined as the uncertainty of loss without the possibility of gain. Pure risk is insurable.

The insurance industry regards loss from pure risk as any reduction in quality, quantity or value of something. Loss can mean death, property damage, bodily injury, physical disappearance of property, lost income or an obligation to pay for such loss. Peril is a cause of potential loss, and peril can be fire, accident, explosion, flood, theft or negligence. Hazard (slippery floors, ice, etc.) is something that increases the seriousness of loss or increases the likelihood that loss will occur due to peril. Simplified, risk is the uncertain potential for loss, peril causes loss, and hazards are catalysts that trigger or enhance loss. These terms appear in policies and it helps to understand them. Small businesses face risks from fire, violent weather, vehicles, injury to owners, employees and customers, defective merchandise, fraud, legal suits, theft and other perils and hazards. Of course, insurance protection from risk costs money. Therefore, each small business must know what insurance is required by law, by a lender, by common sense, or even for peace of mind.

In Massachusetts, businesses operating as a proprietorship or partnership with no employees are not required by state law to have insurance. However, there are other circumstances that necessitate carrying insurance. If the business has a vehicle, it must be insured. If a business has an employee(s), the state requires that Workers Compensation Insurance be carried on each employee. Partners or proprietors cannot obtain this insurance for or on themselves. In most small corporations, the owner is usually an employee, and is subject to this insurance coverage.

If a business has, or intends to have, a lender, the lender usually specifies the type of insurance coverage required and is listed on the policy as joint loss payer. If a business rents space, the landlord usually requires that he be named as an additional insured on a liability policy. The extent of the protection a business desires above any requirement is left up to the business owner(s) and depends on the ability to pay for protection coverage, and unwillingness to bear risk.

The insurance industry has greatly simplified the process of a businessperson obtaining insurance by having a business owner's policy, known as a BOP policy. The BOP can include wide limits and types of coverage and is easier to understand. Similarly, there is a policy for vehicles known as a BAP. Usually, restaurants, print shops and automobile repair garages

have separate policies. Certain properties such as boilers, machinery and computers are not usually covered in standard policies, but can be included.

It is important that a policy be reviewed and examined carefully by the insured so that the coverage is understood. Always review the Exclusion section of the policy with your agent to learn of losses not covered by the policy.

General categories of insurance are:

- Property
- Automobile and vehicular
- General liability
- Product liability
- Group life and health
- Crime
- Fidelity and surety
- Worker's compensation
- Pension
- Miscellaneous (Glass, Machinery, etc.)

One way to determine which insurance agent or company is best for you is to ask other small business operators who they use, and what kind of service they receive. Usually, your banker, attorney or accountant may be able to recommend an agent or broker. Look for agents that specialize in small business. These agents are better able to help you understand the potential risks and recommend the right coverage at each step of a business's growth.

If you are a homeowner, an important and easy (non-insurance) way to protect your home from claims is to file a Declaration of Homestead at the Registry of Deeds in the town where your home is located. This will protect the value of your property up to \$500,00 per residence, per family.

Often, the life savings of a small business owner are invested in the business, and often homes are used to secure notes. What happens when the owner dies? Does the business close? Does the family of the owner have to stand by and watch savings and other assets go down the drain? This, in large part, depends on what the owner did before the event of death. One can protect both one's business and one's family with business life insurance, if one can afford it. Consult your agent so that a business life insurance policy is tailored to fit the needs of the family, lenders and the business.

A suitable business life insurance program can:

- Assure immediate funds to meet taxes, debts and administrative expenses.
- Provide income for heirs.
- Equitably distribute the property value to heirs.
- Enable your executor or administrator to dispose of your business to the best advantage if your family is not taking over.
- Put your family on a sound financial basis if the family is assuming the operation of the business.
- Stabilize the credit of the business.
- Help maintain good employee relations by eliminating uncertainties and hazards
- If business is a partnership, provide a prearranged plan for the orderly and equitable dissolution of the partnership, and a buy-out of the heirs.
- Provide funds to replace a key employee, or train another if the key employee leaves, becomes ill or dies. This is called "Key Man" insurance.

An important and often overlooked type of coverage is business interruption insurance, especially if the business is conducted in one location such as a store or gym. This insurance compensates for income lost if your business has to vacate the premises due to disaster related damage.

To summarize:

- Find an insurance agent who covers small businesses
- Familiarize yourself with insurance terms and provisions of your policy so that you know exactly what is covered (and excluded) and what it costs
- Decide which kind of risk protection will work best and most economically for you
- Cover your largest loss exposure first, and the less severe as your budget permits
- Make proper use of deductibles, which save premium dollars you may need elsewhere
- Be sure the coverage you buy is adequate to cover the value of the property insured
- Review insurance coverage and costs periodically with your agent and your lender
- Read your policy, especially the exclusion section

The Insurance Information Institute's web site covers insurance issue in a comprehensive manner for small business owners. ⁹

⁹ The site is www.iii.org/

EMPLOYMENT TAXES

EMPLOYERS RESPONSIBILITIES

Please note: the following material is current as of this writing; however, terms and payment amounts for taxes change frequently. Before you proceed, check with the appropriate federal and state sources to confirm information is current.

In regard to proper payroll and insuring proper withholdings, it is usually cost effective for most small businesses to pay a reputable payroll service to handle payroll from the outset of the business. The small monthly cost for the service will quickly pay for itself in terms of eliminating a great deal of stress and concern for taxes being withheld and accrued in accordance with the often complicated IRS and state revenue regulations.

An employer has several responsibilities to the federal and state governments. These responsibilities include the withholding, payment and depositing of taxes, assuring the government that all employees are eligible to work, and ascertaining the business relationship between employer and employee. For a web-based guide to employer tax responsibilities in the state of Massachusetts, please see link below.¹⁰

It is this relationship that determines whether the employer withholds and pays taxes, pays taxes only, or has no tax relationship with the payee. For a detailed discussion of an employer-employee relationship, please refer to IRS Publication 15A “Employer’s Supplemental Tax Guide”, and the preceding chapter of this Handbook.

Before hiring an employee, each new or first time employer must file Form SS-4 (“Application for Employer Identification Number”) with the IRS to obtain an employer identification number (EIN). This number identifies the employer with the IRS, and with the Massachusetts Department of Revenue (DOR) upon completing and filing Massachusetts Trustee Tax Form TA-1 with the DOR. After filing Form SS-4 and TA-1, the applicant will receive coupons and forms from the IRS, and forms and instructions from the DOR.

An employer must verify that each new employee is legally eligible to work in the United States. Before being allowed to work, each employee must fill out the employee part of Form I-9, “Employment Eligibility Verification” obtained from the Immigration and Naturalization

¹⁰<http://www.mass.gov/dor/businesses/current-tax-info/guide-to-employer-tax-obligations/>

Service. The employer must complete the employer section of the form and retain this form during employment and for four years after the cessation of employment.

Each new employee must have a Social Security card, and the employer must record this number. If a person does not have a card, Form SS-5, "Application for a Social Security Card" must be filed. To obtain a card, the worker must appear in person at a local Social Security office. There are penalties for permitting anyone to work without a card.

Each new employee must complete and sign Form W-4, "Employees Withholding Allowance Certificate." Every employee must fill out a new Form W-4 prior to or at the beginning of each annual pay period. Publication 505, "Tax Withholding and Estimated Tax", contains instructions for completing Form W-4 as does Publication 919, "Is My Withholding Correct". Note: a non-resident alien must fill out a Form W-4 as a single person claiming only one allowance, irrespective of marital status.

- If the business relationship between employer (payer) and a person (payee) is determined that the payee is a common-law employee, the payer must withhold state and federal income tax, federal Social Security tax, federal Medicare tax, and pay federal and state unemployment taxes.
- If the payee is a statutory employee, federal and state income taxes are not withheld. However, the employer must withhold and pay Social Security and Medicare tax. Unless the worker is a full-time life insurance agent or commissioned driver delivering food, beverages (except milk), laundry or dry cleaning, or is a traveling sales person (category 2) or works at home (category 3), the federal unemployment tax must be paid by the employer.

It is possible that a small business may have a statutory employee in category 3 (independent contractor). This is a person who works at home on material or goods furnished by the employer to be returned to the employer or to a person the employer names.

No taxes are withheld or paid by a payer for an independent contractor, except in the case where the independent contractor does not furnish a correct Taxpayer Identification Number (TIN) or does not certify that the TIN is correct. In this case, generally the payer is required to withhold 31% of the payment due.

The payee must complete Form W-9, "Request for Taxpayer Number and Certification" to furnish the payer a taxpayers number and certify that the number is correct. Form W-9 includes a list of types of payers exempt from this backup withholding. NOTE: If a payer pays over \$600 to an independent contractor, the payer must file Form 1099-Misc. with the IRS, the DOR and the independent contractor, unless the payee is a corporation.

FEDERAL INCOME TAX

The amount of federal income tax withheld from an employee's wage is directly related to the amount of the gross wage and the allowances declared on the employee's Form W-4. Tips must be included as wages. There are several ways to figure income tax withholding. The most common are the percentage method and wage bracket tables. These and other methods and tables are presented in IRS Publication 15, "Circular E, Employer's Tax Guide."

The money withheld for federal income tax must be deposited by the employer using "Federal Tax Deposit Coupon" 8109 or, by direct withdrawal from the business account in an authorized bank either monthly or quarterly, depending on the amount withheld. Publication 15 contains directions for frequency of filing.

Also Form 941 "Federal Employers Quarterly Tax Return" must be completed and filed quarterly. The employer must keep accurate records of all withholding because every employee paycheck must show each withholding, and cumulative withholdings are required for Form W-2, "Wage and Tax Statement" given to each employee at the end of the year.

SOCIAL SECURITY AND MEDICARE TAX

Every employee must pay Social Security and Medicare and these taxes are withheld from each employee's paycheck. The rate is 6.20% for Social Security and 1.45% for Medicare, based on gross wages. The employer must also match and pay these taxes.

Social Security is not deducted after the first \$118,500 (check for current level) of annual wages is reached. However, all wages are subject to Medicare. These are federal taxes only. Both the money withheld from wages and the employers matching contribution must be deposited in a timely manner along with the income tax withheld using coupon 8019, and reported quarterly to the IRS on Form 941.

FEDERAL UNEMPLOYMENT TAX

The federal unemployment tax, FUTA, is paid for all common-law employees, and statutory employees in category 1 and 4 (Refer to Publication 15A). This is not a deduction from employee's wages. The employer pays FUTA.

The general test used by the IRS to determine if you are subject to FUTA tax on the wages you pay employees who are not farm workers or household workers is:

1. You paid wages of \$1500 or more in any calendar quarter, or
2. You had one or more employees for at least some part of a day in any 20 or more different weeks last year or this year

In Massachusetts, the tax is currently paid on the first \$15,000 of wages at the rate of 0.8%.

When the total FUTA tax to be paid for all employees exceeds \$100, it must be deposited with the other federal taxes, using form 8109, either monthly or quarterly. At the end of the pay year, and before January 31, of the next year, Form 940 or 940 E-Z, "Employer's Annual Federal Unemployment Tax Return" must be filed to report FUTA payments. If all payments were made on time, the filing period is extended to February 10. Refer to Publication 15A for exact deposit schedules and current deduction levels.

Part Time Workers

For federal income tax withholding, social security, Medicare, and FUTA purposes, there are no differences between full-time employees, part time employees, and employees hired for a short period. Even if an employee has another job, withholding and other taxes are handled the same.

Family Members

A child under 21 working for a parent in a trade or business proprietorship, is not subject to social security, Medicare or federal unemployment tax. However, the wages of an individual working for a spouse are subject to federal income tax withholding, Medicare and social security tax, but not FUTA. If the business is a partnership or corporation, both child and spouse are subject to income tax withholding, Medicare, social security and FUTA

MASSACHUSETTS INCOME TAX

The Massachusetts DOR collects several taxes called trustee taxes that include income tax, sales/use tax, meal tax, and room occupancy excise tax. Employers are entrusted to withhold and submit income taxes to the DOR and file forms to account for the taxes on a schedule determined by the DOR.

Employers in Massachusetts must register with the DOR by filing Form TA-1. Usually this is done as soon as the employer has received a federal EIN. Once the Form TA-1 is processed, the DOR sends the employer instructions and printed tax forms.

An employer is held responsible for having each employee fill out and sign a federal Form W-4, and state Form M-4, "Massachusetts Employee Withholding Exemptions". Copies of all W-4 and M-4 forms completed by new employees or those returning to the work force, and must be sent to the DOR within 14 days after hire. Note: copies of W-4 forms are not sent to the IRS.

The amount to be withheld from wages is dependent upon the number of exemptions claimed on Form M-4. "Circular M", a DOR publication, contains wage withholding tables and percentage methods. If an employee has more than one job, the employee can only claim exemptions from the principal employer.

The DOR holds employers responsible for issuing each employee a Form W-2, "Employee Wage and Statement Form" by January 31 of the next year. In addition, the employer must send the DOR a copy of each W-2 along with an annual reconciliation report on Form M-3 or M-3M by February 28 of the next year.

In Massachusetts, full time students who do not earn over \$8000 per year are exempt from income tax withholdings. Children under 18, when working for a parent, are also exempt. Note: an employer need not withhold on wages for Massachusetts workers if federal holding is not required.

Sole proprietors and members of partnerships are not regarded as employees, but must file estimated tax payments if the owner or partner expects to owe more than \$200 in taxes on income received from the business.

Withholdings are sent either monthly or quarterly along with either Form M-941 or M-942 to the DOR, P.O. Box 7038, Boston, MA, 02204. Another requirement is that an employer file Form WR-1, "Quarterly Report of Wages Paid", which is sent the DOR, Room 505, Cambridge Street, Boston, MA 02204. Form M-3 or M-3M is also sent to the Room 505 address. MassTaxConnect the DOR electronic system for filing and paying taxes in the Commonwealth. A list of helpful DOR publications appears at the end of the chapter.

MASSACHUSETTS UNEMPLOYMENT TAX

In Massachusetts, each new employer must register with the Department of Employment and Training (DET) and fill out Form 1110 "Employers Status Report" to establish an employee account, and receive a DET identification number. Recommended reading for employers is DET publication "Simplifying the Employment Training Law-An Employers Guide." It can be obtained at any local DET office. As with FUTA, the state unemployment tax is paid by the employer and is not deducted from wages.

The contributions begin when an employer has people working one or more days for each of 13 weeks or if wages of \$1500 or more are paid in any calendar quarter. Employers pay unemployment contributions on a set wage amount. The DET will determine the rate, which is dependent upon a number of factors.

The DET exempts children under 18 who work for a parent, or a parent who works for a son or daughter, licensed real estate agents, sales people and insurance agents who work on commission only, sole proprietors, members of partnerships, and services provided by an individual who is free from direction and control. An employer of a non-resident alien, and students pay the tax.

Although in Massachusetts a single worker does not pay Massachusetts income tax if less than \$8000 of total wages is reported, the employer does have to pay the unemployment tax. The same applies to a married worker earning less than \$12,000 of total wages.

It should be noted that if an employer lays off or discharges an employee, the employee must be given Form 0509-A, "Separation Notice" which must bear the employer's correct name and DET employer identification number.

For employers, the gray areas are part-time workers, and independent contractors. It is advisable to request assistance from the DET if there are any problems in determining contributions, handling part-time employees, independent contractors, and possible employee exemptions. Upon request, a representative of the DET will come to the place of business to render assistance. To speak with an auditor call the DET.

Payments to the DET, using DET Form 1, are submitted quarterly and are due April 30 for the quarter ending March 31, July 31 for the June 30 quarter, October 31 for the quarter ending September 30, and January 31 for the quarter ending December 31. Payments are sent to: Department of Employment Training, 19 Stanford Street, Boston, MA 02114.

References

1. Massachusetts Department of Revenue Publications

- A Guide to Withholding of Taxes on Wages
- A Guide to the Department of Revenue
- A Guide to Sales Tax on Meals
- A Guide to Sales and Use Tax
- Circular M - Massachusetts Income Withholding Tables

2. Massachusetts Department of Employment and Training Publication Simplifying the Employment Training Law—An Employers Guide

Employment Taxes Chart

| Employment Classification | Federal Income | State Income | Social Security | Medicaid | FUTA + | State DET + |
|---------------------------|----------------|--------------|-----------------|----------|--------|-------------|
| Common Law | Y | Y | Y | Y | Y | Y |
| Statutory Employees | | | | | | |
| • Category 1 | N | N | Y | Y | Y | Y |
| • Category 2 | N | N | Y | Y | N | N |
| • Category 3 | N | N | Y | Y | N | N |
| • Category 4 | N | N | Y | Y | Y | Y |
| Statutory Non-Employees | | | | | | |
| • Direct Sellers | N | N | N | N | N | N |
| • Real Estate Agents | N | N | N | N | N | N |
| • Independent Contractor | N | N | N | N | N | N |
| • Students | Y | Y | Y | *Y | #Y | **N |

+ = Tax paid by employer only

Y = tax must be paid

N = Employer exempt from paying tax

* = If 18 years old

= If 21 years old

** = Exempt if less than \$8000 of wages is earned

MARKETING

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

MARKET OVERVIEW

A market is a body of existing or potential buyers for specific goods or services. It is the demand for a product.

Marketing

Marketing represents the totality of activities involved in the transfer of goods from the producer or seller to the consumer or buyer. Marketing activities include buying, storing, selling, advertising, pricing, promotional methods, and management of the business.

A business does not or will not succeed just because the owner wants it to. There must be a market for the merchandise or service being offered or there is no chance of success. Before devising your marketing strategy, you should first conduct extensive primary and secondary marketing research to understand both the nature of your customers and the competition.

Pre-Business Marketing

Before opening a business, gather the following information.

- Is the product or service one that people want? Is there demand for this product?
- How many people want it (e.g. is the market large enough to build a profitable business)?
- Who are the potential customers?
- Do potential customers live or shop near the place of business? Or is there an online customer base that is easily reachable?
- Will the business be the right business, at the right time, at the right place?
- How many competitors offer the same product or service?
- What will be your point of difference?
- How will the new business effectively compete in price and quality?
- Who will the suppliers be, and how good are their services?

If your target audience is Cape-based take advantage of sources such as Stats Cape Cod (<http://www.statscapecod.org/>) and local Chambers of Commerce to learn about the demographics of consumers and businesses in your planned trading area. Only after the

answers to the above questions are obtained, analyzed and found favorable should the plan to open the business proceed.

Existing Business Marketing

Marketing for an existing business should focus on efforts to identify, satisfy and follow-up on customer needs at a satisfactory profit. This includes market research, market strategy, target marketing, and managing the market mix. It is difficult, if not impossible, to sell people goods or a service that they do not want or need. However, it is easy to sell people something that they want or need.

Market Research

Market research determines what people want by systematically gathering, recording, and analyzing information about problems relating to marketing goods and services. It is the best way to learn about existing and potential customers. Additionally, keep in mind that most businesses are built around products and services that are already available. While you may think your products or services are special, your market does not always share that perception. Market research is one way to uncover reasons why your target customer will buy your products or services.

Primary research is “first hand” information that is received directly from clients/customers, competitors, suppliers, etc. via conversations, emails, visiting home pages, or through direct observation etc. Secondary research is “second hand” information compiled by others, such as through an article, directory or second-hand conversation. Anyone starting up a business would be well advised to conduct both primary and secondary research prior to committing to start a business.

Small businesses actually have an advantage over large businesses in learning about their customers because they are often much closer to their customers. Small businesses can learn very quickly about customers’ likes and dislikes, and can therefore react much more rapidly to changes in their buying habits than their larger competitors.

Market research also provides the information needed to spot current or potential business problems, find sales opportunities, and gathers facts on which to make decisions and plans.

Much market research can be done internally. For example, a good restaurateur often watches what is left on plates to identify menu items that are not eaten. A retail or service business can (and should) watch people. For example, look for the answers to the following questions:

- Are there children with them?
- Are they alone?

- What attracts them?
- What did they buy?

Small businesses have a tremendous advantage in that they have the opportunity to talk to their customers, providing the occasion to ask questions such as:

- How did they learn about your business?
- What merchandise do they like?
- How much are they willing to pay?
- Where do they live?
- How do they like the business?
- Do they recommend the store, products or service?
- Why did they come to the business?
- What products/services would they like that the business does not have?

Conducting Market Research

Market research can be done internally or by companies who specialize in such services. Stay on top of what your competition is doing, read trade journals and track promotional activity. Write down your findings so you have an ongoing history of competitive activity—many companies run the same plan each year, allowing you to plan for a competitor's sale or advertising activity.

Listed below are the steps that make market research effective:

- Define the problem or area to be investigated
- Assess all available information
- Determine if additional information is required
- Review internal files and records
- Interview employees
- Interview or survey customers and suppliers
- Organize and interpret information
- Make decisions
- Observe and evaluate results of the decision

One of the best ways to learn from current customers is to build and maintain a customer database. Always ask customers for their email address. You can use these addresses to not only communicate with customers but to also survey them on issues related to your business.

Other ways to conduct primary research include making calls to potential suppliers, or visiting a competitor's website and ordering a brochure or other information. In that same vein, contact companies similar to yours that are outside your trading area. Most small business owners are very willing to talk about what's going on with their business as long as you are

not in their trading area. Chambers of Commerce and bankers are also good information sources. In addition, visit your local library or the library at Cape Cod Community College where you can access powerful databases to gather secondary research on your market. A reference librarian can be a powerful ally as you devise your marketing plan.

In some categories research is readily available. Trade associations regularly report on and analyze marketing information for the type of business they represent. If your type of business has a trade association, the membership fee may be money well spent.

MARKETING STRATEGY

Marketing strategy relates to the marketing mix (also known as “4P” strategy because it entails making important Product, Price, Place and Promotion decisions). It is how you will best meet the needs of your customer in relation to the existing competition. The process involves identifying target customer groups that your businesses can better serve than competitors, and tailoring products, services and promotional efforts to that particular market segment.

Ideally, try to address the customers whose needs are not currently being met in the market place, and whose needs are great enough to provide for a profit. Analyze the market and capabilities, and focus on that part of the market that has unmet needs.

Target Market

Many small businesses make the mistake of reaching out too broadly, thinking they will get more customers. The result is a plan that doesn't effectively reach anyone. There is no product anywhere for which the target audience is everyone. Small business owners may also have limited funds to spend on marketing. So identifying the best customer segment is the most efficient and effective way to market your product. Potential ways to identify a segment include:

- **Geographic Targeting** - serve the needs of customers in a particular area thus restricting advertising and promotional efforts to a narrower area. For example, a small landscaping business may focus on doing a great job in a few towns instead of the entire Cape.
- **Demographic Targeting** - identify and promote only to those groups of customers most likely to buy; e.g. promoting luxury boat products specifically to wealthy, high-end boat owners, 40+ in professional positions versus all boat owners.
- **Product or Service Attribute Targeting** – Focus on a particular, more specialized product or service niche that larger competitors might disregard or not cater to as

closely. This may mean focusing your efforts on one product/service and using it to draw in traffic for your other products.

- **Psychographic Targeting** – Focus on clients that have a particular lifestyle, such as marketing products to environmentally conscious clients who want to “go green” or activewear products to people who workout 3+ times/week.

PRODUCT/SERVICE STRATEGY

Perhaps no other business decision is more fundamental than determining what products or services are to be offered in the first place. Often, an entrepreneur/new business owner is excited by the idea of offering a particular array of products or services only to be alerted by early customers that their preferences are for something much different. Even the most determined and confident new venture owners find this sort of customer interaction to be quite upsetting. While it's upsetting, pay attention and learn from it.

Remember: the customer is always #1. If you make a decision to go into business, then provide products and services that your target audience is really excited about. Make sure that these products or services offer them a real value. Value does not necessarily mean price; rather it means providing a benefit that potential customers want to pay for.

For example, let's say you want to open a coffee shop that offers a variety of bold flavored coffee beverages and homemade pastries to clients who want to meet or linger to read the paper or a book at some point in their busy day. You enjoy soft jazz and classical music and you have several friends associated with the arts, who have approached you about displaying their work in your proposed café. Suffice it to say that if you proceed with your venture, there will be all sorts of customers that will visit your establishment who will not particularly like the yummy treats, the coffee or the ambiance, or perhaps won't have the time to linger and “hang out” as you had originally intended. Try to have “thick skin” and don't despair. Over time, you'll learn why some stay and some leave and then adjust your business accordingly.

Gradually, you will build a core group of clients who enjoy the café experience you have created and you can then count on them to tell others (word-of-mouth) about it. If you consistently deliver value to this core group of customers, then you will be on the road to success. In this particular case, broader advertising may not even be necessary to build a reliable client base on a scale that is reasonable for your new business. Make adjustments and refinements along the way, but try to implement changes in a manner that is not disruptive and disconcerting to your customer base.

Small business owners may use the strategy of concentrating on a narrow product line, or selling a highly specialized product or service, or providing a product/service package that has a high amount of skilled or personal service. Again, rather than trying to “be all things to all people” most small businesses will have a greater chance of success if they stick close to their core values and consistently and reliably deliver the products and services that meet the needs for their particular target market.

PRICING STRATEGY

The details on how to establish price are in the Finance chapter but it’s important to know there are essentially three pricing strategies: “luxury”, “middle of the road” and “low cost” pricing—all of which run parallel to the perceived value and quality of the service or product offering. A high end product such as a “Rolex” watch would certainly garner a high price and constitute the luxury approach. A middle-of-the-road pricing strategy would include a shopping experience at a department store or your local hardware store, while shopping at Wal-Mart or purchasing supplies for your computer online at a discount would constitute the “low cost” approach. Many small business owners fall into the trap of thinking that a lower price will result in more sales. If you are offering a product that has real value to a customer consider increasing the price and building a brand that connotes true value. There are many products in the marketplace which have a very low cost of goods but which can demand a high price because they offer customer value.

Pricing must take into account, fixed or operating costs, owners and/or managers’ salaries, variable costs (cost of goods), anticipated sales levels and profit. Utilities, rent, services, salaries, employee benefits, etc., affect fixed costs. Buying practices will affect the cost of goods. Attention must be given to the quality as well as the quantity of goods/materials. Unless prices are changed accordingly, increases in either variable or fixed costs will decrease profit.¹¹

Very often, the marketplace (the competition) will impact pricing. Therefore, constantly monitor your competitor's pricing. Don’t cut your price just because your competition does (you don’t really know the dynamics of their particular business situation). It doesn’t make sense for you to offer products and services for sale if you cannot generate a profit. This is why it’s so important for businesses to offer a differentiated product. Know which target customer group you can cater to better than the competition, build your business and then set your price at a level that reflects that value.

¹¹ See the section entitled “Pricing Products and Services Effectively” located under the financial section.

PLACE (DISTRIBUTION) STRATEGY

Distribution or place strategy refers to the manner in which you are going to physically get your products and services to your clients. The means of physically getting your goods and services to your clients are often referred to as “distribution channels.” While distribution typically connotes retail or business-to-business, today online sales have become a major distribution channel for businesses.

Take the example of a pizza shop. What are the ways you could imagine a pizza shop “distributing” the pizza to their clients? You probably have no problem imagining sitting down for a pizza, pick-up service and delivery service as potential options. Sure enough, some pizza parlors have incorporated web ordering as part of their distribution strategy!

Sometimes important intermediaries (middlemen) are critical to the distribution process. For example, if you created a micro-brew beverage and are trying to figure out how to actually make your beer available to consumers, you will soon learn how integral distributors are to the business process. Other “middlemen” include brokers, retailers, wholesalers, franchises and agents. Whether there are important intermediaries involved or not depend upon the industry that you plan to serve.

Be sure to carefully research all prospective intermediaries involved in your “supply chain” prior to committing to your business model.

Selecting the wrong areas for distribution and sale of certain products is often fatal. To sell popcorn requires high traffic areas with high visibility. On the other hand, a plumbing supply house does not require high traffic areas as people will go out of their way to look for it. Additionally make sure that your distribution channels are consistent with the brand image that you want to build.

PROMOTIONAL STRATEGY

This area includes all brand communication – advertising, promotional activities, sponsorships, retail display and more. All communication activities should work together. Consumers don’t separate an ad from a sale offer or a display—they all represent the same brand. Don’t feel obligated to use expensive advertising. Sometimes it’s more effective to rely on lower cost media that creates the powerful impact of word-of-mouth. Today, online advertising and social media are a critical component of all marketing plans and the best way to generate word-of-mouth. Ongoing communication campaigns through email or blogs are also driving today’s businesses. That isn’t to say that placing ads in local community newspapers, making use of

flyers, offering press releases and participating in community service events, etc. aren't great ways to gain a "toehold." Don't underestimate high quality salesmanship. It's a must for small businesses and is one of the most effective types of promotion.

COMMUNICATION (ADVERTISING)

No matter how wonderful or unique your product or service is, nothing sells itself. Potential customers must be told about your product or service and how or where they may purchase it. Informing potential customers about your product, service, or business is called marketing communication.

Reasons for Communication

The specific purposes of communication/advertising are as numerous as the many different products and services promoted. In general, businesses goals include:

- Promote consumer awareness of the business and its products and services.
- Stimulate sales.
- Establish or change a firm's image in the eyes of the consumer.
- Build goodwill for the firm.
- Encourage a long-term relationship with the client¹²

Objectives of Communication Programs

Objectives will vary with each type of business. Some typical objectives are to:

- Increase store traffic.
- Acquaint customers with new products
- Promote special events such as clearance sales, new location, or an opening of a new business
- Change/build the company image
- Generate awareness of the business name and location and maintain at high levels
- Inform customers of special services available such as delivery service, alterations, credit plans, etc.
- Introduce new employees to the public
- Tie in with a supplier's national promotions
- Capitalize on the seasonal nature of a product
- Offer get-acquainted incentives
- Emphasize quality of product and services

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

¹² For more information, search Customer Relations Management online

Media

Unfortunately, some small businesses often underestimate the value of communications and advertising, or are uninformed as to how to budget, how much to spend, and where to advertise. A new business should be prepared to spend about five percent of projected gross revenue on a communications program. An established business should budget two to three percent of gross revenue. Obviously these numbers may be higher when a business is new. Media is likely one of the areas you need to invest in to build your business.

Once communication objectives have been established and written, the next step is to select the specific media and programs. Media costs vary from inexpensive, such as business cards, to very expensive such as television. Use your dollars effectively. Buy only that media that your target audience consumes and compare media based on cost effectiveness, scheduling and ability to fully engage your target consumer. Inexpensive media isn't any good if it's not the media your target consumes.

Communication Tools to Consider:

- Business Card - low cost, easily distributed; describes product or service, gives address and telephone number.
- Word of mouth – cheapest and most effective - a customer praising your business, referring new customers (always feature testimonials on your website and ask positive reviewers to share with their friends)
- Business stationery - low cost, must be well designed.
- Business signs - very effective, one-time cost, subject to zoning regulations.
- Storefront - extremely effective, communicates image, products and price
- Interior or point of purchase display - attractive display of merchandise, creates impulse buying, communicates brand image
- Vehicles - low cost, wide exposure, can be painted or magnetic display
- Shopping bags - carries name and message into home
- Location Directories – today's Yellow Pages is online. Claim your Google My Business page and make sure it's complete with location, hours, phone number and images (confirm that this information is also showing up on Google maps and search)
- Direct mail and email - most personalized and targeted of all media, tells complete story, rapid feedback, can include coupons, catalogs, brochure. Create a customer database so you know you're reaching the right people. Use a service like Constant Contact to manage your online campaigns.
- Local newspapers - great flexibility, ad size can be varied, as well as position, great with editorial association such as food ads with cooking column. Online extensions.
- Local radio – often expensive but effectively reaches audiences such as teenagers, sports enthusiasts, etc. Ads must be repeated frequently.

- Television - most expensive, but mass media with high visibility and instant exposure of pictures or ideas
- Search engine strategies - using key words, Google AdWords and local sites
- Sponsorships – align your product/company with a local event that reinforces your benefit and brand image
- Social media such as Facebook, Twitter, Instagram, Pinterest, blogs and many more. If you use social media, update it regularly. Plan your messages and schedule the publication date.

There are many other means of “reminder” advertising such as calendars, pens, billboards, as well point of presentation (flyers, brochures, samples). To be effective, advertising should be repeated as often as possible. It should call attention to something the buyer needs or wants and define how your product/service meets that need. Advertising must be written carefully and skillfully. There are numerous freelance writers who can help. Also local print shops and office supply stores are often able to assist with the above to offer cost effective solutions.

Help with Advertising

If your advertising plan includes a year-round effort and if advertising/marketing is a significant part of your total budget, consider an advertising agency to help with planning, production and evaluation. Often the services of an agency can be obtained at low cost. Before selecting an agency, the business owner should be sure the agency knows the objectives of the advertising, and the size of the budget. A well-defined project will help control agency fees. Have the agency describe what it can do for you and provide a detailed cost estimate.

Advertising is not merely a business expense; rather it is an investment in building your business. Its objective is to help you sell your product or service. Therefore, the copy should attract attention, develop interest, describe the product or service, convince the reader or listener, and get action.

Do not advertise that slow/non-moving item you are stuck with. Advertise what your customer wants and likes to buy. Show the benefit of your product or service. Attempt to tell your prospective customer what is in it for them. Be sure to include the name and address of the business in all ads!

Spend behind your business. Said another way, it is better to spend during your peak seasonal periods than it is to spend during slow periods. On the Cape, for example, many businesses feel they need to advertise in the winter; however those ads are less likely to

generate profitable sales as there are fewer customers in the area. Find other ways to drive traffic during slow periods.

RETAILING TIPS

Image

Like it or not, every retail and retail-service business has an image. The operator can control what people think of a business. People's impression of a store, office, showroom, and beauty salon is based initially on the appearance of the premises, both inside and out, and then on the type of merchandise and service offered.

Therefore, each business operator must decide what image you want and then take steps to develop this image. Creating the proper image and environment is particularly important to certain types of businesses, and not as critical to others. A junkyard may not be very attractive. It does not have to be because its customers do not expect it to be. Yet junkyards make a nice profit.

Most other businesses should create an atmosphere that corresponds to their product line or service. A hardware store can have linoleum-covered floors. People do not expect carpet in hardware stores. What they do expect is clean, uncluttered aisles and easily accessed displays.

If a business is selling expensive clothing, the image must fit the product. In this case customers expect an inviting, attractively designed environment. This environment may cost more to install but the extra cost will be worth it.

Well-maintained exteriors of buildings make customers want to enter. Once inside, the interior decor must be conducive to customer buying. Clean windows, floors, counters and aisles, attractively painted or papered walls, and good lighting are all part of communicating an image. Well laid out traffic paths and aisles help customers discover merchandise. A gaudy interior or exterior reduces customer interest. The design should make customers comfortable.

Window Displays

A neat eye-catching window display is an effective way to stop pedestrian traffic, and entice people to enter the premises. It takes only 2-4 seconds to pass a 6-8 foot window. Therefore the display has to not only be eye-catching but also well lit day and night. Good daytime lighting avoids shadows that dull a display. Change window displays regularly to create ongoing interest. Window displays used for community projects create good will. Often art

galleries etc. will lend interesting objects around which to build a display. Be sure windows are kept clean.

Parking Areas and Walkways

Always keep parking areas and walkways clean and lit all year long. Be sure snow and particularly ice is removed to make it easy to enter the business, and reduce the chance of people injuring themselves. Dirty areas create an unfavorable impression, and often result in negative comments from customers.

CUSTOMER RELATIONS

Customers not only keep a business going but they build businesses. The old adage that the customer is always right really is the heart of customer relations. Customers must first feel welcome and comfortable in the store or office. How the customer is greeted and treated is of critical importance to ensure repeat business and favorable word-of-mouth promotion for your business by your customers.

Courtesy is a business byword. Customers who feel they were not treated properly, for whatever reason, usually don't return, and have only derogatory comments about the business. As pointed out in Chapter 14, word of mouth advertising is not only the least expensive type of promotion, but also one of the most effective. All employees should be constantly reminded of the need for courtesy.

Keep a notebook near the cash register. Jot down customer requests and suggestions for both products and services. Regularly evaluate that input and be sure to act on good recommendations. Find a way to thank customers who provide that input whether it be in the business or online on your Facebook page or through Tweets. Customers love to be appreciated.

Credit Cards

Allowing customers to use credit and debit cards is an essential service, at the expense of the business. However, credit cards do provide instant cash at no risk to the business. Often, credit card terms can be negotiated with the issuing bank. Cards such as Visa, American Express, and Master Card can usually be approached through Chambers of Commerce or national trade associations, if the business is a member, as well as through local banks.

Markdowns

Markdowns on certain items reduce profit margins but can be an excellent way to sell slow moving goods, or end of season goods. Markdowns, if properly executed, usually clear out

merchandise quickly, thereby increasing cash flow and reducing inventory. Make sure you have planned for markdowns in your cash flow projections. Monitor sales and if you see that that certain items won't sell out, mark them down before the season ends.

Loss Leaders

Loss leaders are items sold at a lower price to attract people who will buy other regular items, or become regular customers. Loss leader items should be lower in wholesale price, look more expensive, sell at other stores at a higher price, and be readily available from the supplier. Loss leaders are more effective as a strategy when they are associated with another item being sold at regular price, and both items are sold together. An example is a shirt and tie, with the tie being the loss leader. Sometimes loss leaders do not work. With experience, the successful loss leader will be selected and can be used over and over again.

Shoplifting

If possible, locate the cash register, along with the telephone, near or at the front door. Install security cameras in key locations. This is to reduce the incidence of people walking out without paying. To reduce shoplifting, offer to hold parcels at the register. Be careful in holding parcels and shopping bags. Seal them in the presence of the customer. The business is liable if anything is missing. If located in a shopping center or mall, contact similar or other small businesses and set up a phone alert system. Alert other stores when you have had a person who tried to pass a bad check or shoplift. In a short time, the description of the person in question is circulated to other business throughout the center or mall. The system works because each business is protecting itself

Competitors

Always have something constructive to say about competitors. If you are out of an item or do not carry it, recommend a store that carries the item. Customers appreciate this and will usually return to your business. Watch competitors' advertising. Visit them or send someone to check displays, windows and prices. Ask vendors or suppliers from whom you buy how your competitors are pricing and selling the same items,

Employees

Good help produces more sales, requires less training and less supervision. Poor help can ruin a business. Develop a training program for new and old employees and review their performance individually and privately on a regular basis. Train employees to treat a customer exactly as you would. Retirees offer small businesses an opportunity to get experienced help on a part or full time basis. They may teach you and other employees what they have learned over the years.

Explain the buying system to employees and try to involve them. The more involved employees are, the more interest they take, and the better they work. Listen to employees and ask them for suggestions. Explain why you do not carry certain items. Make employees your eyes and ears.

Suppliers

Suppliers, manufacturers, distributors and their sales people can be important allies for a small business. They can alert you to trends, hot items, competitive activity, close outs, special volume prices, delayed payment terms, etc.

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

For special promotions, ask manufacturers and suppliers if they have a program to contribute to advertising costs. The way to learn of all the services a supplier has to offer is to spend time with the supplier and ask questions. Be sure to know the availability of every item purchased, meaning know how much is available and how long it will take to get to your store. This will help you in placing orders and prevent you from running out of an item.

FINANCE

BALANCE SHEET

The balance sheet (also known as the statement of financial position) is one of three key financial statements. It shows the status of the firm's assets, liabilities and owner's equity. Assets are things that the firm owns, liabilities are the debts of the firm (what the firm owes) and owner's equity represents the difference between what the firm owns and owes. It is also known as net worth. Unlike the income statement and the cash flow statement, both of which are written for a period of time, the balance sheet is a "snapshot in time" and represents the financial position of the firm for one particular day or on the last day of the year (per the statement on the next page).

Programs such as QuickBooks and other software programs can help you generate your financial statements much more quickly, but they rely on you inputting information correctly to produce correct and meaningful results. It is strongly suggested that you work with an accountant or bookkeeper to ensure that you set up software programs properly as well as periodically have your C.P.A. review your financial system. For example, you can burn a copy of your financial back up program to a flash drive for your accountant to review and adjust when you bring in work to complete your taxes. Prepare an accurate balance sheet on at least a quarterly basis. It's critical that you stay on top of your finances. See the following page for an example of a Balance Sheet for XYZ Company.

Note: sample forms for financial statements that you can use to prepare your own statements are available on the SCORE website (<https://www.score.org/resources/business-planning-financial-statements-template-gallery>).

XYZ Company Balance Sheet
December 31, 2015

ASSETS**Current Assets:**

| | | |
|-----------------------------|------------|-----------------|
| Cash | \$7,500 | |
| Accounts Receivable | 2,500 | |
| Finished Goods Inventory | 16,500 | |
| Raw Materials Inventory | 4,500 | |
| Prepaid Expenses | <u>500</u> | |
| Total Current Assets | | \$31,500 |

Fixed Assets:

| | | |
|---------------------------|---------------|-----------------|
| Vehicles | 11,500 | |
| Furniture and fixtures | 4,500 | |
| Equipment | <u>17,000</u> | |
| Total Fixed Assets | | \$33,000 |
| Total Assets | | \$64,500 |

LIABILITIES AND CAPITAL**Current Liabilities:**

| | | |
|----------------------------------|------------|----------------|
| Accounts Payable | \$2,300 | |
| Sales Taxes Payable | 350 | |
| Accrued Wages Payable | 560 | |
| Payroll Taxes Payable | <u>650</u> | |
| Total Current Liabilities | | \$3,860 |

Long-Term Liabilities:

| | | |
|------------------------------------|---------------|-----------------|
| Long-Term Notes Payable | <u>15,000</u> | |
| Total Long-Term Liabilities | | \$15,000 |
| Total Liabilities | | \$18,860 |

Capital:

| | | |
|--------------------------------|---------------|-----------------|
| Owner's Equity | 24,557 | |
| Net Profit (Retained Earnings) | <u>21,083</u> | |
| Total Capital | | \$45,640 |

| | | |
|--------------------------------------|--|-----------------|
| Total Liabilities and Capital | | \$64,500 |
|--------------------------------------|--|-----------------|

INCOME STATEMENT

The income statement (also known as profit and loss statement or P & L) is the second key financial document. It shows the total sales (revenue) earned by a company less the costs (expenses) associated with generating that revenue. The income statement is prepared for a period of time such as a month, a quarter (three months) or for the year. If the amount of revenue exceeds the amount of costs, then the business is said to have a profit or net income. If the amount of costs exceeds the amount of sales revenue, then the business is said to have a loss.

It is important to understand that a business can be profitable but still have significant cash flow problems. In fact, it is possible for a profitable business to go bankrupt. One of the key reasons for this is often not being able to collect on accounts receivable from customers. In other words, the business may have listed sales to clients as revenue on the income statement but these same clients may not yet have paid for services rendered (or paid in full) which means that cash for such transactions has not yet been received. Cash flow is ultimately the lifeblood of any new or existing business! See the following page for a sample income statement.

In reviewing the example for XYZ company, note that the firm had a profit of \$21,083. Now go back to the balance sheet for XYZ Company. You will see that this profit has been included under the Owner's Equity section as an addition. However, keep in mind that you cannot consider this amount as cash. For example, funds may be tied up in accounts receivable (customers who have not yet paid us for services rendered) or funds could have gone toward raw materials for products we will build in the coming year or gone toward the purchase of capital items such as equipment or furniture. It is strongly suggested that you complete and carefully review your income statement results regularly on at least a monthly basis.

XYZ Company Income Statement
For the Year Ended December 31, 2015

REVENUE

| | | |
|------------------------------------|--|--------------|
| Gross Sales | | \$194,300 |
| Less: Sales Returns and Allowances | | <u>5,432</u> |
| Net Sales | | 188,868 |

COST OF GOODS SOLD

| | | |
|------------------------|---------------|---------------|
| Beginning inventory | \$15,000 | |
| Add: Purchases | 23,000 | |
| Freight-in | 2,300 | |
| Direct Labor | 32,000 | |
| Indirect Expenses | <u>3,100</u> | |
| | 75,400 | |
| Less: Ending inventory | <u>16,500</u> | |
| Cost of Goods Sold | | <u>58,900</u> |

| | | |
|---------------------|--|----------------|
| Gross Profit (Loss) | | <u>129,968</u> |
|---------------------|--|----------------|

EXPENSES

| | | |
|------------------------|---------------|----------------|
| Advertising | 11,400 | |
| Depreciation | 1,450 | |
| Dues and Subscriptions | 120 | |
| Insurance | 3,750 | |
| Maintenance | 1,200 | |
| Office Expenses | 1,320 | |
| Operating Supplies | 1,100 | |
| Payroll Taxes | 13,920 | |
| Postage | 350 | |
| Property Taxes | 125 | |
| Rent | 11,000 | |
| Repairs | 350 | |
| Telephone | 10,420 | |
| Utilities | 4,500 | |
| Vehicle Expenses | 340 | |
| Wages | <u>47,540</u> | |
| Total Expenses | | <u>108,885</u> |

| | | |
|--------------------------|--|------------------------|
| NET INCOME (LOSS) | | <u>\$21,083</u> |
|--------------------------|--|------------------------|

CASH FLOW STATEMENT

The third key financial statement for a small business is the cash flow statement. While the balance sheet and income statement are important gauges for assessing business results, the cash flow statement explains where your cash has come from and where it has gone, over the course of the period in question. Since more small businesses fail due to a shortfall of cash than almost any other financial reason, you are urged to pay particular attention to the cash flow statement and to cash flow projections, which you should prepare monthly.

Statements for more sophisticated firms will break down cash flow into three areas: operating activities, investing activities and financing activities. One common approach is to begin with net income, adding back depreciation expense (because it is a non-cash expense that was deducted on the income statement in the process of arriving at net income), then looking at changes to all current asset and liability accounts to explain cash flow used for operating activities. Investing activities include such activities as investments made in new plant and equipment. Financing activities include activities such as borrowing funds or paying out dividends.

You can construct future projections for all statements (called Pro Forma Statements) but doing so for cash flow on at least a monthly basis is highly recommended and probably the most critical for the entrepreneur/small business manager. When constructing such statements, think of the impact on the operating account – the increases and decreases should show exactly what will happen to your checkbook balance over the coming time periods.

As you are constructing projections, when you see months where there is negative flow, you will need to address this via an alternative source, such as through savings, a reserve account, a line of credit or other loan. Just as it is impossible for you to have a negative balance in your bank account, you need to forecast and plan for such operational shortfalls. This is your most critical business management task from a financial perspective.

See a sample projected 6 month cash budget for the XYZ Company on the following page. Note the cash deficit indicated projected for the month of May that will need to be dealt with.

XYZ Company
Cash Flow Budget Worksheet
For period from January through June, 2011

| | <i>Jan</i> | <i>Feb</i> | <i>Mar</i> | <i>Apr</i> | <i>May</i> | <i>Jun</i> | <i>Total</i> |
|----------------------------------|------------|------------|------------|------------|------------|------------|--------------|
| Beginning Cash Balance | 7,500 | 4,666 | 3,332 | 8,248 | 1,189 | (2,245) | 7,500 |
| Cash Inflows (Income): | | | | | | | |
| Accts. Rec. Collections | 4,000 | 5,000 | 5,500 | 5,750 | 6,000 | 6,250 | 32,500 |
| Loan Proceeds | | | 10,000 | | | | 10,000 |
| Sales & Receipts | 4,000 | 4,500 | 4,750 | 5,250 | 7,500 | 10,000 | 36,000 |
| Other: | | | | | | | |
| Total Cash Inflows | 8,000 | 9,500 | 20,250 | 11,000 | 13,500 | 16,250 | 78,500 |
| Available Cash Balance | 15,500 | 14,166 | 23,582 | 19,248 | 14,689 | 14,005 | 86,000 |
| Cash Outflows (Expenses): | | | | | | | |
| Advertising | 1,000 | 1,000 | 1,000 | 1,000 | 1,000 | 1,000 | 6,000 |
| Dues and Subscriptions | 12 | 12 | 12 | 12 | 12 | 12 | 72 |
| Insurance | 312 | 312 | 312 | 312 | 312 | 312 | 1,872 |
| Inventory Purchases | | | 4,500 | | 6,000 | | 10,500 |
| Maintenance | 120 | 120 | 120 | 120 | 120 | 120 | 720 |
| Office | 130 | 130 | 130 | 130 | 130 | 130 | 780 |
| Operating Supplies | 100 | 100 | 100 | 100 | 100 | 100 | 600 |
| Payroll | 1,200 | 1,200 | 1,200 | 1,300 | 1,300 | 1,300 | 7,500 |
| Postage | 30 | 30 | 30 | 30 | 30 | 30 | 180 |
| Property Taxes | | | | 125 | | | 125 |
| Rent | 950 | 950 | 950 | 950 | 950 | 950 | 5,700 |
| Repairs | 30 | 30 | 30 | 30 | 30 | 30 | 180 |
| Utilities & Telephone | 750 | 750 | 750 | 750 | 750 | 750 | 4,500 |
| Vehicles | 50 | 50 | 50 | 50 | 50 | 50 | 300 |
| Wages | 3,900 | 3,900 | 3,900 | 3,900 | 3,900 | 3,900 | 23,400 |
| Subtotal | 8,584 | 8,584 | 13,084 | 8,809 | 14,684 | 8,684 | 62,429 |
| Other Cash Out Flows: | | | | | | | |
| Capital Purchases | | | | 7,000 | | | 7,000 |
| Loan Principal | 250 | 250 | 250 | 250 | 250 | 250 | 1,500 |
| Owner's Draw | 2,000 | 2,000 | 2,000 | 2,000 | 2,000 | 2,000 | 12,000 |
| Subtotal | 2,250 | 2,250 | 2,250 | 9,250 | 2,250 | 2,250 | 20,500 |
| Total Cash Outflows | 10,834 | 10,834 | 15,334 | 18,059 | 16,934 | 10,934 | 82,929 |
| Ending Cash Balance | 4,666 | 3,332 | 8,248 | 1,189 | (2,245) | 3,071 | 3,071 |

FINANCING A BUSINESS

One of the leading causes of business failure is insufficient start-up capital. Therefore, a crucial element for business success is adequate funding. Not only are funds required for start-up, but also to cover initial operating losses, and provide for growth. Keep in mind that, as a general rule, banks are not in the business of loaning money to take a substantial entrepreneurial risk. However, they are interested in loaning money to new ventures if you have sufficient collateral and a well-prepared business plan.

As a general guide, one should have sufficient cash to cover at least one year's operating expenses, which includes the owner's salary, and money to make regular loan payments. Almost all business operators hope their business will grow; yet some fail because after a successful start, additional capital was not available to meet the increasing financial demands of an expanding business. Capital may be needed to acquire more floor space, equipment, and inventory and to finance higher levels of accounts receivable. Therefore, it is crucial that the business plan contain a detailed analysis of all requirements for funding.

Once the amount of capital required has been determined for both the start and continuation of the business, and until the business generates enough cash to sustain itself, it becomes necessary to obtain or find a source of money.

SOURCES OF FUNDING

Personal Assets

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

Family and Friends

Another excellent source of funding is from your family and your friends. Either can make a capital investment in the business in return for partial ownership, or the funds can be in the form of a loan. Usually, family or friends may lend their money at lower interest than a commercial lender, and mutually agreeable terms can be made for repayment.

It is very important in your dealing with family and friends that you carefully review your business plan with them to ensure that they understand all the risks involved. It is highly

recommended that a written agreement regarding the schedule for repayment of funds be prepared. However, family and friends should not be encouraged to invest in your business if they cannot afford to risk the funds. For Internal Revenue purposes, detailed records should be kept of any financial assistance received from friends or relatives.

Other Equity Sources

Some businesses may be able to attract investment from private investors, sometimes referred to as angel investors. These investors are typically looking for high growth opportunities in specialized areas. They will usually seek at least 30% ownership and some control over business decisions, and tend to be very selective. Angel investors in your geographic area can be located through an internet search.

Crowdfunding may also present another opportunity to attract funding. This currently works best for established businesses that have a strong local following that can be tapped into, and are not very well suited to new businesses that do not have an operating history. Crowdfunding is done through the use of intermediaries referred to as portals, which can also be identified through an internet search.

Banks

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

Establishing a cordial working relationship with your banker is very important. It is a good idea to pick a bank that makes loans to your particular type of business, and one in which you feel comfortable. Your banker can be a valuable partner in helping you determine the right financing package for you.

A bank normally requires that a first-time borrower invest from 25-35% of the necessary funds from their own money and/or from friends and family before they will consider a loan. For example, if the business plan shows a need of \$100,000, the borrower would have to have \$25,000 to \$35,000 of his own money and/or money from friends and family to receive \$65,000 to \$75,000 from the bank. In the case of a restaurant, the bank may require the borrower to invest 50% of the needed funds.

Banks require that you have a good personal credit record, and in most cases will insist on some form of collateral to secure the loan. Collateral can be in the form of assets used in the business or personal assets such as the unused equity in your home. Banks will almost always require a personal guarantee by you of repayment of some or the entire loan.

Credit Unions

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

Loan and Finance Companies

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

Life Insurance Companies

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

Small Business Investment Companies (SBIC)

These are privately owned companies licensed by the United States Small Business Administration to provide capital to small businesses. SBICs look for businesses that have proprietary products with high growth potential. Preferred are young aggressive companies that check out as low risk. Usually, SBICs want a share in the business.

Community Development Companies (CDCS)

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

Suppliers

In order to encourage sale of their products, many suppliers provide retailers with shelving, display cases, refrigeration units, and signage etc., at very favorable terms. Caution should be used when financing assets through a supplier. Understand what commitment you have to make to purchase the suppliers product in the future. Extended payment terms enable you to sell the merchandise before having to pay for it. A supplier may offer goods on consignment.

Leasing Companies

An alternative to borrowing money to purchase equipment for your business is to lease the equipment. Items commonly leased are office furniture, automobiles, trucks, computers, production machinery, etc. Ownership of the item remains with the leasing company. However, some agreements can be made where you become the owner after a specified time

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

Private Investors

Some investors specialize in making loans to businesses. In many cases the investor(s) will require a partial ownership of the business and will continue to share in the profits after the debt is repaid. Care should be taken in dealing with private investors to see that your interests are properly protected. Investors can sometimes be found in classified ads.

Small Business Administration (SBA)

Congress has authorized the SBA to make loans for business purposes, and has authorized a special fund to enable the SBA to make direct loans to eligible Vietnam era and disabled veterans. Certain handicapped individuals may also be eligible for a direct loan. Please note that these special programs are contingent upon the availability of funds, and change frequently.

Mostly, the SBA administers a guaranty loan program. These are loans made by private lenders, usually banks, and such loans are guaranteed up to a significant percent by the SBA. The guaranty percent changes so check with the SBA for current details. In addition, microloans (up to \$50,000) can be obtained through non-profit micro-lenders funded by the SBA.

The lender plays the central role in the loan delivery system. The small business submits the loan application to the lender, who makes the initial review, and if approved for submission to the SBA, forwards the application and analysis to the nearest SBA office. If approved by the SBA, the lender grants the loan and disburses the funds to the applicant.

Fact sheets are available from the SBA that explain the various loan programs that the SBA administers, including fixed lines of credit. Brochures about business loans are also available from the SBA. As stated above, loan programs change often. Detailed information about SBA loans and loan programs can be obtained on the SBA website (www.sba.gov) where you can also use a search tool to assist in identifying participating lenders.

South Eastern Economic Development Corporation (SEED)

Seed is located at 88 Broadway in Taunton, MA 02780-2557. Funded by the state, Seed has micro loan programs for loans under \$25,000. Seed provides assistance to small business people in obtaining loans and has the cooperation of several banks and the SBA

Coastal Community Capital

Coastal Community Capital is a division of Cape and Islands Community Development, Inc. (CDI). This organization's mission is to provide loans to Cape and Islanders who will be creating businesses and jobs in our region. Strategies include participating loans, with traditional lenders, federal loan guarantees and direct lending.

THE LOAN PROPOSAL

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

Although a well-written proposal requires a considerable amount of work, the effort is well worthwhile. It indicates to a prospective lender or investor that you thoroughly understand your business and its financial demands. The proposal must be thorough, concise and neat. It should consist of both spreadsheets and content.

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

ESTIMATING CAPITAL REQUIREMENTS

The procedure for starting a small business involves a two-part feasibility analysis. The first part consists of:

- Delineating the reasons for going into business.
- Self-analysis to determine if one has the personal characteristics to operate and manage a business.
- Identifying the necessary personal skills and experience.
- Conducting a market analysis to determine the demand for the business's merchandise or services.
- Assessing competition.
- Investigating the timing or business climate.
- Thoroughly evaluating the location of the business.

The self-assessment section of this manual lists several additional questions to answer and points to consider relating to starting a business. It is strongly recommended that these initial questions be asked seriously as a “reality check” before continuing further.

Assuming that the “reality check is positive”, and it is decided to proceed further, the second step is to determine the capital requirements (money needed) to open the business (start-up costs) and to operate it (operating capital or fixed costs).

The remaining information to calculate is the point in time where the business will breakeven or a positive cash flow occurs (breakeven point). The breakeven point is the point in time and sales volume where the business begins to generate a profit. Of critical importance, breakeven analysis can assist in determining the point of positive cash flow for the new venture.

The capital requirements may differ for a service business as compared to a retail or manufacturing business particularly in regards to the start-up and variable costs. Capital is the money or cash needed to start and operate a business. There are two types of costs, Variable and Fixed. Variable costs (VC) are those which vary with the volume of sales, (e.g., inventory), or the cost of items sold, commissions, etc. Fixed costs (FC) do not usually fluctuate with the sales volume and includes rent, utilities, salaries, loan payments, accounting, legal, insurance, etc.

To illustrate, the capital required to start-up a fictional retail business is presented in Table 1.

Table 1: Start-Up Capital for a Retail Business

| Expense Item | Capital Amount |
|-------------------------------------|-----------------------|
| Inventory | \$40,000 |
| Furniture and Fixtures | 10,000 |
| Equipment | 5,000 |
| Vehicles | 10,000 |
| Remodeling | 6,000 |
| Rent Deposit | 2,000 |
| Utilities Deposit | 1,000 |
| Insurance | 1,000 |
| Advertising | 2,000 |
| Accounting and Legal | <u>1,000</u> |
| Total Initial Start-Up Costs | \$78,000 |

Once the start-up costs have been determined, the next step is to ascertain the capital needed to cover operating expenses until the business generates enough income from sales revenue to cover these costs.

The difference between the cost of items sold (Variable Cost) and the sales price of the items is known as the Contribution or Gross Margin. It is the Contribution Margin (CM) dollars that pay operating or Fixed Costs (FC). Cash remaining after paying Fixed Costs becomes profit. Contribution Margin (CM) then is sales dollars minus Variable Costs (VC).

$$\text{Sales} - \text{VC} = \text{CM}$$

To express either variable costs or Contribution Margin as percent of sales, divide by the sales amount (S) and multiply by 100. Contribution Margin when expressed as percent of sales is known as the Contribution Rate (CR).

$$\frac{\text{VC}}{\text{S}} \times 100 = \text{VC\%} \qquad \frac{\text{CM}}{\text{S}} \times 100 = \text{CR\%}$$

The point at which the income from sales is sufficient to cover both fixed and variable costs is known as the sales breakeven point. The formula is:

$$\text{S} = \frac{\text{FC}}{\text{CR (expressed as a decimal)}}$$

Breakeven Point is important because it can be used to determine not only the sales level required to breakeven but also to calculate losses that may occur until the breakeven sales level is reached. To continue the capital requirements determination, we must estimate the monthly fixed costs that will occur once the business begins to operate. For our fictional business, the Fixed Cost estimates are shown in Table 2:

Table 2: Monthly Fixed Costs

| Item | Amount |
|-------------------------|---------------|
| Employee wages | \$13,000 |
| Payroll taxes | 1,300 |
| Outside services | 500 |
| Office supplies | 200 |
| Repairs and maintenance | 200 |
| Advertising | 3,000 |
| Vehicle delivery | 800 |
| Accounting and legal | 300 |
| Rent | 1,500 |
| Utilities | 800 |
| Telephone/internet | 1,000 |
| Insurance | 700 |
| Other supplies | 300 |
| Loan payments | <u>1,400</u> |
| Total Fixed Costs | \$25,000 |

Now that we know the estimated monthly Fixed Costs are \$25,000, it is possible to prepare the projected Cash Flow statement shown in Table 3. To do this, it is necessary to estimate the monthly sales volume in dollars and to know the variable cost for the items to be sold. For Table 3, the assumption is that the variable cost is 40%, and the contribution rate is correspondingly 60% (Remember to express the variable cost as a decimal for this calculation). Estimate sales at three levels: the worst case, expected case, and best case. For this example, we have used only the expected case.

| Table 3. Projected Cash Flow for Fictional Retail Business | | | | | | | | | | | | | |
|--|------------|------------|------------|------------|------------|------------|------------|------------|------------|------------|------------|------------|------------|
| ITEM | Month 1 | Month 2 | Month 3 | Month 4 | Month 5 | Month 6 | Month 7 | Month 8 | Month 9 | Month 10 | Month 11 | Month 12 | Total |
| Sales | \$5,000 | \$10,000 | \$15,000 | \$20,000 | \$25,000 | \$30,000 | \$35,000 | \$40,000 | \$41,667 | \$45,000 | \$50,000 | \$55,000 | \$371,667 |
| Variable Cost,%* | 0.40 | 0.40 | 0.40 | 0.40 | 0.40 | 0.40 | 0.40 | 0.40 | 0.40 | 0.40 | 0.40 | 0.40 | 0.40 |
| Variable Cost,\$ | \$2,000 | \$4,000 | \$6,000 | \$8,000 | \$10,000 | \$12,000 | \$14,000 | \$16,000 | \$16,667 | \$18,000 | \$20,000 | \$22,000 | \$148,667 |
| Contribution Rate,%* | 0.60 | 0.60 | 0.60 | 0.60 | 0.60 | 0.60 | 0.60 | 0.60 | 0.60 | 0.60 | 0.60 | 0.60 | 0.60 |
| Contribution Margin,\$ | \$3,000 | \$6,000 | \$9,000 | \$12,000 | \$15,000 | \$18,000 | \$21,000 | \$24,000 | \$25,000 | \$27,000 | \$30,000 | \$33,000 | \$223,000 |
| Fixed Cost | \$25,000 | \$25,000 | \$25,000 | \$25,000 | \$25,000 | \$25,000 | \$25,000 | \$25,000 | \$25,000 | \$25,000 | \$25,000 | \$25,000 | \$300,000 |
| NetLoss/month | (\$22,000) | (\$19,000) | (\$16,000) | (\$13,000) | (\$10,000) | (\$7,000) | (\$4,000) | (\$1,000) | \$0 | \$2,000 | \$5,000 | \$8,000 | |
| Projected Cash Flow | (\$22,000) | (\$41,000) | (\$57,000) | (\$70,000) | (\$80,000) | (\$87,000) | (\$91,000) | (\$92,000) | (\$92,000) | (\$90,000) | (\$85,000) | (\$77,000) | (\$77,000) |

| |
|--|
| Accumulated loss to Breakeven Point = \$92,000 |
| Loss for first 12 months = \$77,000 |
| Breakeven Point in sales for 12 months = \$500,000 |
| * Expressed as decimal |

From Table 3, it can be seen that the retail business will show a cumulative loss for the first eight months of operation of \$92,000. The breakeven point does not occur until the ninth month (see chart immediately below). It is not until month 10 that the sales volume per month is high enough to result in a profit. It is important in calculating the capital requirements for a new business that anticipated operating losses be taken into account.

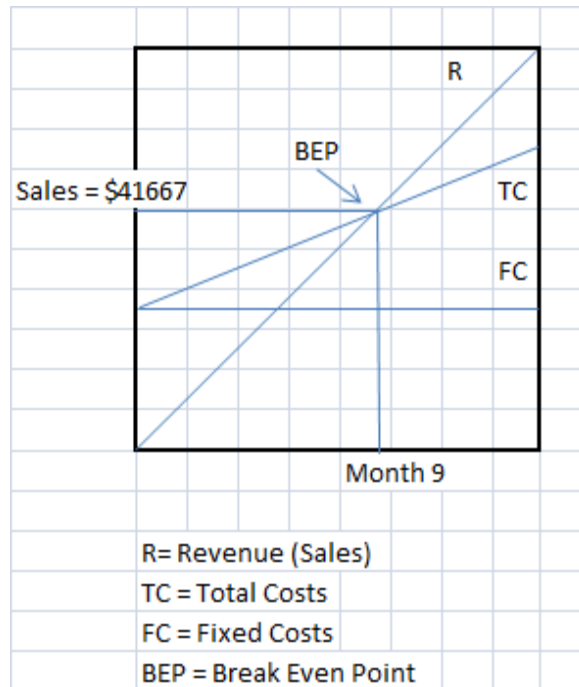


Table 4 summarizes the total capital requirements using the numbers previously calculated in Tables 1 and 3 and assuming that the entrepreneur has \$45,000 of personal capital invested in the business.

Table 4: Preliminary Capital Requirement Estimation

| | |
|---|-----------|
| Initial start requirements from Table 1 | \$78,000 |
| Plus cumulative YTD loss from Table 3 | 92,000 |
| Total capital needed | 170,000 |
| Less personal funds | 45,000 |
| First-cut borrowings need | \$125,000 |

All lenders require that a borrower invest a certain amount of his or her own funds. The amount varies with the lender, type of business, risk involved, business climate, etc. In

case, we assumed an applicant has \$45,000 of personal funds or 25% of the total capital needed for investment in this retail business. The first-cut borrowing requirement would be \$170,000 minus \$45,000 or \$125,000. Referring again to Table 3, analysis shows that for the second 12 months of operation, the volume of sales must be \$500,000 to breakeven, that is \$500,000 of sales at a 60% gross margin yields \$300,000, which is the expected level of fixed costs.

$S = FC \div CR$ (decimal) or $\$300,000 \div 0.60 = \$500,000$ sales per year.

One can question if it is realistic to assume that a monthly sales level of \$41,667 can be maintained or exceeded. In addition, once a business begins to operate, it is important to closely monitor monthly cash flow. The fictional example presented here does not allow for increases in fixed or variable costs and these must be monitored to assure that additional operating capital is not required. The entrepreneur and perhaps a lender are now in a position to determine if it is feasible to proceed further. The procedure used above applies to a service, construction, manufacturing, restaurant or any mercantile business.

The advice of a SCORE counselor can be of great assistance in preparing all phases of a feasibility study. A lender is usually impressed when an applicant can present this type of study demonstrating capital requirement estimations. With an encouraging outcome, the entrepreneur is now ready to prepare a loan package or a more detailed business plan if desired. A loan package outline follows in the next chapter. See www.capecod.score.org for more on feasibility quick test.

THE LOAN PACKAGE

When applying for a business loan the more information that you provide the lender the easier it is for the lender to make a decision as to granting the loan. Most lenders require a business plan or, at minimum, the information outlined below, which typically can be assembled in 10 to 15 total pages.

- I. Cover Page
 - A. Name, address, and telephone number
 - B. Name and title of principal(s)
 - C. Amount of loan (investment) requested
 - D. Purpose of the loan (investment)
 - E. Repayment terms of the loan

- II. Description and Summary of the Business
 - A. Length of time the business has been operating
 - B. Describe its historical trend
 - C. What is the nature of the business-what does it do
 - D. What is unique about your product line or service?
 - E. What or who is your market
 - F. Describe your competition
 - G. What is your long-term growth plan?
 - H. What are the trends in your industry?

- III. Management
 - A. Describe your management experience
 - B. Describe your management team
 - 1. Table of organization
 - 2. Brief resume of key individuals and their responsibilities
 - 3. Current staff or work force level and future needs
 - 4. What back-up exists
 - C. List your accountant and attorney

- IV. The Loan (Investment) Request
 - A. Justify the loan to the bank
 - B. Explain the loan request in detail
 - 1. The amount needed
 - 2. Exactly how the funds will be used
 - 3. Describe the collateral available for a loan and give its value
 - 4. The repayment terms of the loan
 - 5. Demonstrate your ability to repay a loan

- V. Financial Data
 - A. Financial statements: for existing business provide...
 - 1. Three years of historical statements and any interim statements
 - 2. Balance sheets
 - 3. Profit and Loss or income statement
 - 4. Projected cash flow analysis for at least the next 12 months including loan (investment)
 - 5. Sources and amounts of any other loans or investments to be put into the business
 - 6. Personal financial statement

VI. Credit Information

- A. List banks where you maintain accounts
- B. List banks where you have had prior borrowings
- C. List trade suppliers
- D. List other creditors

VII. Miscellaneous

- A. If incorporated, provide copy of articles of incorporation
- B. If renting, provide copy of the lease
- C. List of type and amount of business insurance coverage.
- D. Aging of accounts receivable
- E. Copies of business and personal tax return

PRICING - SERVICES

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

Many small businesses do what they consider a good volume of business, but don't make any money. Improperly priced services or products may be the reason. Some make a profit on certain services, lose money on others, and don't know which is which. Remember, the right to establish price is yours, 100% yours. Services need to be priced in consideration of market factors (the competition), but consider why a customer should pay more for your product if you have a true differentiating feature.

COSTS

Fixed Costs

Costs that remain the same in any time period despite changes in business activity, such as rent, insurance, utilities, office supplies, salaries, depreciation, legal services, accounting, property taxes. These expenses are usually called overhead.

Variable Costs

Variable costs include materials used in manufacturing, goods purchased for resale, labor, commissions, etc. Variable costs usually vary in proportion with business activity. In a service business labor may not be variable.

Calculating the Cost of a Service

A simple easy to understand method of calculating the cost of a service is by basing the cost on billable hours. Since people must provide service, the number of hours that are available for billing in a year can be calculated.

If the overhead and labor charges are divided by the billable hours, and added together with any materials used, the breakeven point can be calculated. The profit is then added to the breakeven point. Two examples are shown below. Example 1 is two experienced bookkeepers people open a business together. They estimate their overhead expense to be as follows:

| Expense Item | Amount Per Year |
|---------------------|------------------------|
| Rent | \$9,600 |
| Utilities | 1,800 |
| Telephone | 1,200 |
| Office supplies | 1,200 |
| Insurance | 600 |
| Depreciation | 2,500 |
| Advertising | 2,000 |
| Miscellaneous | 1,500 |
| Overhead | \$20,400 |

The two entrepreneurs decide they each want a salary of \$25,000. In this case the salary is actually an overhead expense, but we will treat it separately because the principals decide they want to make a profit of 20% on their salaries and a 10% profit on their overhead.

| | |
|-------------------------------|-----------------|
| Owners salaries | \$50,000 |
| Profit on salaries | 10,000 |
| Overhead | 20,400 |
| Profit on overhead | 2,040 |
| Total revenue required | \$82,440 |

The number of working days per year is $52 \times 5 = 260$. Subtracting holidays, vacations and sick days, the actual workdays in this example total 230. Two people working 8 hours per day results in 3680 hours. ($230 \times 2 \times 8 = 3680$). However, our bookkeepers realize that a portion of these hours will not be spent working for clients, estimated at 20%, or 736 hours. Therefore, the billable hours for this company are 3680 minus 736 or 2944 hours.

To generate the desired revenue of \$82,440, divide by the billable hours.

$$\$82,440 \div 2944 = \$28.00 \text{ per hour}$$

Expressed as billable hours times the hourly charge ($2944 \times \$28.00$), the income for the business is \$82,400. Total overhead and salaries were \$70,400.

Profit is $\$82,440 - \$70,000 = \$12,040$, assuming the billable hours figure is realistic for their first year of operation.

In example 2, the DWA Repair Service employs ten repairmen who are paid \$18,000 each. Social Security tax, Medicare, unemployment tax, worker's compensation insurance, health insurance, and retirement benefits cost an additional \$5,400 each for a total cost of \$23,400. Since there are ten repairmen, the yearly labor charge is \$234,000. DWA Repair Service has overhead expenses as shown below:

| Overhead Expense Per Year | |
|----------------------------------|----------|
| Salaries (including owner) | \$60,000 |
| Payroll taxes and costs | 3,700 |
| Insurance | 13,000 |
| Utilities | 2,600 |
| Rent | 10,000 |
| Telephone | 1,200 |
| Depreciation | 5,000 |
| Miscellaneous | 2,500 |
| | \$98,000 |
| Total overhead | |

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

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

Work days per year = 52 weeks x 5 days = 260 days. Subtract 15 vacation days, 7 sick days, and 8 holidays = 230 working days. Work hours = 230 work days x 8 hours = 1840 per year, for each repairman.

However, from experience the owner knows that he cannot keep his crew working 8 hours per day as there is lost time between jobs, and deducts 10% of the hours as non-billable,

leaving $1840 - 184 = 1656$ billable hours per repairman. Since there are ten repairmen the total billable hours $= 1656 \times 10 = 16,560$ per year.

To determine the hourly labor cost, divide the labor cost per year (\$234,000) by the billable hours (16,560), which is \$14.13 per hour. To get the total cost, overhead must be added. Total overhead per year is \$98,000. Overhead of \$98,000 divided by billable labor hours of 16,560 = \$5.92 per hour. The total hourly cost of labor plus overhead is $\$14.13 + \$5.92 = \$20.05$

The owner knows that if he charges the hourly rate based on actual cost he will only break even. The purpose of a business is to make a profit, which is needed to reduce debts, buy new equipment, provide working capital and provide a return on investment.

The cost of the business per year as calculated earlier was \$332,000. (Labor \$234,000 plus overhead \$98,000 = \$332,000)

$$\$20.05 \times 16,560 \text{ (billable hours)} = \$332,000 = \text{Breakeven Point.}$$

To make a profit, the owner decides to place a profit of 25% on his labor, and 30% on his overhead

| | |
|------------------------------|-------------|
| Labor cost per hour | \$14.13 |
| Profit on labor (25%) | 3.53 |
| Overhead cost per hour | 5.92 |
| <u>Overhead profit (30%)</u> | <u>1.78</u> |
| | \$25.36 |

The owner decides to charge \$25.50 per hour. A labor rate of \$25.50 per hour multiplied by the billable hours of 16,560 generates income of \$422,280.00 per year.

$$\$422,280 \text{ (income)} - \$332,000 \text{ (expenses)} = \$90,280 \text{ profit.}$$

Each year this calculation must be repeated to include any changes in labor rates or overhead. If any materials were used in the repairs, they would be figured into the cost per job. A profit is also added to the materials charge. Remember, the charge for a service = materials + labor + overhead, with a profit built into each component.

PRICING - PRODUCTS

In setting prices, the objective is to maximize profit. Profit has just three components: costs, selling price and sales volume. In this section we are concerned with selling price, which has essentially the same elements for all types of businesses.

In manufacturing, the elements of selling price are direct costs, manufacturing overhead, non-manufacturing overhead, and planned profit. In a service business, the elements are materials and supplies, labor and operating expense or fixed costs, planned profit, and competition. In a retail business the elements of price are costs of goods sold, overhead, sales volume, planned profit and, often, competition. In the retail business, there are two types of costs: the cost of acquiring the goods, called Variable Costs or Cost of Goods, and the cost of operating the business, called Fixed Costs or operating expense.

Variable Cost (Cost of Goods)

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

Fixed Cost (Operating Expense)

Operating Expense or cost is called Fixed Cost because it usually does not vary with the volume of business. Fixed Costs include wages, management salaries, rent, insurance, utilities, office supplies, and all other cost attributed to the operation of the business.

Planned Profit

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

COMPETITION

In addition to using Variable Costs, Fixed Costs and planned profit in setting prices, small businesses should consider prices charged by competitors for similar or comparable items.

A small business should not try to compete price-wise with large stores, discount houses, or supermarkets. This type of competitor can charge less because of buying power and sales volume. Pricing should be based on the quality of service, or on specialized services, as customers usually will pay higher prices for merchandise to obtain the services they want.

Pricing Below Competition

Beating the competitors' price is effective only if it greatly increases sales. This strategy reduces the profit margin. Consequently, Variable Costs and/or Fixed Cost must be correspondingly reduced and inventory must be closely controlled. The product line must be limited to fast moving items. Services must be limited or eliminated.

Pricing below competitors often backfires because every cost component must be monitored and adjusted constantly. Competitors can retaliate by matching the price-cutting, at which point all lose.

Pricing Above Competitors

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

Markdowns

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

Price Lining

This is a marketing strategy strictly based on price. A specific portion of the buying public is targeted by carrying products in a specific price range; for example, a retail store carrying an exclusive line of women's undergarments, or expensive designer perfume line. Price lining is only successful if there is little or no competition. It works to the benefit of the retailer because it limits the merchandise line, and makes inventory and buying easier. It is also easier for the customer to select merchandise, and often less sales people are needed.

Pricing

As stated above, the retail price of merchandise is based on the variable Cost of Goods sold plus fixed costs (overhead) plus profit.

Markup

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

One technique of establishing price is to mark up goods sold by adding some percentage onto the cost of goods. As an example a retailer purchases shoes at \$25.00 per pair and he marks them up 60% for resale. Cost of shoes per pair = \$25.00 x 0.60 = \$15.00 mark up.

$$\begin{aligned} \text{Cost of shoes} &= \$25.00 \\ \text{Markup} &= \$15.00 \\ \text{Selling price} &= \$40.00 \text{ per pair} \end{aligned}$$

The 60% mark up must cover all operating expenses, including the owners salary, and profit. A given mark up may be satisfactory if sales are high and unsatisfactory if sales are not as high as anticipated.

When beginning a business, it is very difficult to determine what percentage goods must be marked up because the mark up must be equated to the amount of unit sales over a period of time. An experienced retailer can use mark up particularly if he has historical information regarding the movement of merchandise. A better way to determine pricing is to do a Breakeven Analysis.

Breakeven Analysis

New, old, manufacturing and/or retail businesses can use a Breakeven Analysis. The Breakeven Point (BP) indicates the level of sales revenue at which neither a profit or loss occurs or the sales level at which both the Cost of Goods (Variable Costs) and the operating expenses (Fixed Costs) are paid. The formula expressed as dollars is:

$$\begin{aligned} \text{Sales} &= \text{Variable Costs} + \text{Fixed Costs} \\ \text{Or} \\ S &= VC + FC \end{aligned}$$

From a strict accounting standpoint, variable cost cannot be determined until an inventory has been taken because variable cost technically is determined as follows; inventory at beginning of a period plus purchases made during the period minus inventory at the end of the period equals variable cost. For purposes here, Variable Costs are taken to mean the purchase price the retailer pays for goods for resale.

The Breakeven Analysis involves a variation in the Breakeven Point formula given above since it is not known what the total Variable Costs will be. The gross profit, which will be referred to as Contribution Margin (CM), is the amount by which the sales price exceeds the variable cost, or the amount that the sale of one unit contributes toward fixed costs and profit. This Contribution Margin is determined as follows:

$$S - VC = CM$$

The Contribution Margin can also be expressed as a percentage of the sales price, and when expressed as percent of sales it is called the Contribution Rate (CR). The Contribution Rate is used to calculate the Breakeven Point in dollars, and the Contribution Margin is used to calculate the Breakeven Point in units to be sold. Again, the Breakeven Point is the level of sales in dollars or units at which neither a profit or loss occurs. Earlier, an example was used of a retailer purchasing shoes for \$25 a pair and selling them for \$40 a pair. Use the formula above to calculate the percent of VC and CM as percent of the sale price:

$$\begin{array}{r} S = \$40 \\ -VC = \$25 \\ \hline CM = \$15 \end{array}$$

$$\text{Contribution Rate} = CM \div S = \$15 \div \$40 = 37.5\% \text{ (or } 0.375\text{)}$$

The formula for determining the breakeven sales point is:

$$\text{BP in dollars} = \text{FC in dollars} \div \text{CR (as a decimal)}$$

Assume our retailer has fixed costs of \$75,000 per year. Inserting the numbers in the formula indicates that at a contribution rate of 37.5% (as determined above), the breakeven sales point is \$200,000 per year.

$$S = \text{FC} \div \text{CR} = \$75,000 \div 0.375 = \$200,000$$

Two hundred thousand dollars in sales means the retailer has to sell 5,000 pair of shoes at \$40 per pair to breakeven. Assume the retailer cannot sell 5,000 pairs of shoes each year. To breakeven he would have to raise his price, which will raise his Contribution Margin. The question is how much will the retailer have to raise his price to breakeven. Assume the retailer determines that he can sell the shoes for \$50 a pair instead of \$40.

$$\begin{array}{r} S = \$50.00 \text{ or } 100\% \\ - VC = \$25.00 \text{ or } 50\% \\ \hline CM = \$25.00 \text{ or } 50\% \end{array}$$

With fixed costs of \$75,000 the sales volume to breakeven is:

$$\frac{\text{FC}}{\text{CR}} = \frac{\$75,000}{0.50} = \$150,000 \text{ of sales}$$

At a price of \$50 per pair, the retailer now has to sell 3000 pairs of shoes to breakeven. The retailer is confident that he can sell this volume, but he will not make a profit selling at \$50 a

pair. He would like to realize a profit of 10% (\$7,500) on his fixed or operating cost (\$75,000 × 10% = \$7,500). To calculate the volume of sales required to earn this profit, add the profit to the fixed cost. If he holds the unit sale price at \$50 for a contribution rate of 50%, the sales needed to realize this profit are:

$$\frac{\text{FC} + \text{profit}}{\text{CR}} = \frac{\$75,000 + \$7,500}{0.50} = \$165,000 \text{ sales}$$

This level of sales will cover the variable expense (Cost of Goods), the fixed expense (operating expense), and make a profit of \$7,500. To generate this level of sales requires selling 3300 pair of shoes @ \$50 per pair (\$165,000 ÷ 50 = 3300). To make a profit of \$7,500 you need to sell an additional 300 pair of shoes. The owner is confident that he may be able sell this volume of merchandise but prefers to sell less and raise the unit price of the shoes. He decides to do a calculation using a contribution rate of 55%. The unit selling price or price per pair of shoes at 55% CR is determined by dividing the unit cost by the percent VC.

$$\text{VC} = 100\% - \text{CR} = 45\% \text{ (or } 0.45\text{)}$$

$$\frac{\text{Unit cost of shoes } \$25}{\text{VC (as decimal)} = 0.45} = \$55.555 \text{ Sales Price}$$

A retailer would round off the selling price. The decimals are used for purpose of calculation.

$$\begin{array}{r} \text{Sales} = \$55.555 \\ \text{VC} = \$25.000 \\ \hline \text{CM} = \$31,555 \end{array}$$

The breakeven sales point at a contribution rate of 55% is:

$$\frac{\text{FC} + \text{Profit}}{\text{CR}} = \frac{\$75,000 + \$7,500}{0.55} = \$150,000 \text{ Sales}$$

To achieve a sales level of \$150,000 per year at a unit price of \$55.55 means selling only 2700 pairs of shoes per year. For each pair sold in excess of 2700, a profit of \$30.55 would result (because once the fixed costs of a business are covered, the gross margin of all additional sales is profit). If he were able to sell 3000 pairs of shoes at the new unit price, this would result in a gross income or sales volume of \$166,665 yielding a much greater a profit of \$16,665, which is \$9,165 more than the \$7,500 profit originally desired. From these examples it should be noted that as the Contribution Margin and rate increase, the Breakeven

Point decreases, the amount of merchandise that must be sold decreases, and the profit increases.

Check to see if sales of \$150,000 at a CR of 55% will provide a profit of \$7,500.

$$\begin{array}{r}
 \text{Sales} = \$150,000 \quad \text{or } 100\% \\
 - \\
 \text{VC} = \$67,500 \quad \text{or } 45\% \\
 \text{CM} = \$82,500 \quad \text{or } 55\% \\
 - \\
 \text{FC} = \$75,000 \\
 \text{Profit} = \$7,500
 \end{array}$$

If a business manager calculates the Contribution Margin for all merchandise sold, a price structure can be determined which will generate the level of revenue necessary to purchase goods, pay operating expenses, and make a profit. The Contribution Margin percentage can be used as a monitor of the sales and purchasing area of the business.

If an item of merchandise has a low sales volume, it should have as high a Contribution Margin as possible, or else it will not be profitable. If a business does a high volume of sales, it may be possible to have a lower Contribution Margin, subject to calculation.

In review, the Breakeven Point is the level of sales that will just cover Fixed plus Variable Costs. By determining the Contribution Margin and contribution rate for each item of goods sold, the level of sales to breakeven can be determined as follows:

$$\frac{\text{Fixed Cost}}{\text{Contribution Rate}} = \text{Breakeven Point (Dollars)}$$

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

$$\frac{\text{VC (dollars)}}{100\% - \text{CM}\%} = \text{Unit Sales Price}$$

For example: Shoes cost \$25 per pair. What are the sales prices at 60% and 70% CR?

$$\frac{\$25}{1.00 - 0.60} = \$62.50 \qquad \frac{\$25}{1.00 - 0.70} = \$83.33$$

Many businesses have gone awry by ignoring the need for Breakeven Analysis. Remember: increased sales do not always mean increased profits. Goods must be priced properly. The guidelines are: goods that have low volume must have a high Contribution Margin, and goods that have a high volume may be profitable at a lower Contribution Margin. In all cases, the calculations must be made.

Again, *price products carefully!* Always know the Contribution Margin of the products being sold. Always know the Variable Cost (Cost of Goods). Control fixed costs. Constant vigilance in these areas is critical to operating at a profit.

MANUFACTURING COST ACCOUNTING

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

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

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

Cost accounting is used to:

- Control business operations by detailing the important costs of the business, permitting their analysis, and indicating where corrective action is required if costs are not meeting expectations (budgets, standards).
- Optimize business performance by using cost detail, along with sales revenue detail (sales price received by product, customer, territory, etc.) to identify the most profitable areas of the business for further development. Marginally profitable or unprofitable operations are ferreted out.
- Satisfy financial reporting requirements, particularly in the valuation of inventories in manufacturing businesses.

It should be pointed out that although the main use of cost accounting is in manufacturing businesses, it is equally effective in non-manufacturing businesses. The cost accounting

discipline of detailing costs by type and location, by indicating whether they are fixed or variable, and by comparing them with a reasonable expectation (budget, standard), provides a sound basis for controlling any activity along with the opportunity to perform that activity more efficiently.

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

- Whether the cost is direct or indirect, and
- Whether the cost is fixed or variable

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

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

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

Variable costs are those that vary directly with the quantity of product produced. Raw material costs are the primary example of variable costs. The labor required to process the raw materials might also be a variable cost if the amount of labor required is directly proportional to the quantity of production. Other costs such as fuel, steam, and power, if directly consumed into process operations and the amount of consumption is proportional to the quantity of production, can also be classified as variable.

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

Fixed costs are "fixed" only for a range of production levels. A significant change in production level can change the costs classified as fixed. Support activities such as purchasing, employee relations, plant administration, and insurance, along with direct costs

such as foremen and maintenance, can change with substantial changes in production levels. When a cost is considered "fixed", the range of production levels for which the cost is fixed should be understood. This is called the relevant range.

There are two other distinctions made concerning the application of cost accounting to manufacturing operations. Two types of manufacturing operations are recognized: job-order and continuous process. Job-order manufacturing is based on specific quantities of product being processed through the operations with all of the costs associated with that particular lot being collected and identified to that lot.

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

Typical manufacturing costs and classifications are shown below:

| Cost Element | Direct | Indirect | Variable | Fixed |
|---------------------------|---------------|-----------------|-----------------|--------------|
| Raw materials | X | | X | X |
| Labor | X | X | X | X |
| Salaries | X | X | | X |
| Supplies | X | X | X | X |
| Payroll taxes | X | X | X | X |
| Medical insurance | X | X | | X |
| Heat, light, power | X | X | X | X |
| Telephone/internet | | X | | X |
| Rent | X | X | | X |
| Insurance, Property taxes | | X | | X |
| Depreciation | | X | | X |

Manufacturing cost accounting is particularly effective when it includes a budgeting/standard cost system. A standard cost system develops a projected unit cost, achievable under controlled conditions, for each product. This unit cost is identified as the standard cost. The standard cost includes all the raw materials, labor, and other costs that are incurred to produce the product. This includes an allocation of the support costs.

A sample standard cost (summary) could be as follows:

| | |
|-----------------------|------------------------|
| Direct-Variable | \$2.00 per unit |
| Direct-Fixed | \$1.00 per unit |
| <u>Indirect-Fixed</u> | <u>\$1.25 per unit</u> |
| Total | \$4.25 per unit |

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

A sample budget, simplified for illustration purposes, follows on the next page:

ANNUAL BUDGET XYZ COMPANY

Production Requirements: 10,000 units (for the year)

Product Requirements:

Raw Materials @ \$6.00 per unit

Labor @ 5.0 hours per unit

Labor rate: @12.00 per hour

| Production Budget | Dollars | % Variable |
|--------------------------------------|----------------|-------------------|
| Labor (10,000 units x 5 hrs. x \$12) | 600,000 | 100 |
| Salaries (1 foreman) | 30,000 | 0 |
| Rent | 15,000 | 0 |
| Utilities | 40,000 | 50 |
| Maintenance | 50,000 | 0 |
| | <u>735,000</u> | |

| | |
|---------------|---------|
| Variable Cost | 620,000 |
| Fixed Cost | 115,000 |

Administration Budget

| | | |
|--------------|----------------|---|
| Salaries | 100,000 | 0 |
| Rent | 12,000 | 0 |
| Utilities | 3,000 | 0 |
| Depreciation | 50,000 | 0 |
| | <u>165,000</u> | |

TOTAL BUDGET

| | |
|------------------------------|----------------|
| Raw Materials (10,000 x \$6) | 60,000 |
| Production | 735,000 |
| Administration | 165,000 |
| | <u>960,000</u> |

Thus, standard cost per unit is:

| | |
|---------------------------------|--------------|
| Raw Materials | 6.00 |
| Direct Variable labor & expense | 62.00 |
| Direct Fixed | 11.50 |
| Indirect Fixed | 16.50 |
| | <u>96.00</u> |

Manufacturing cost budgets are calendarized (month, quarter, etc.) for business planning purposes as well as control purposes (compare actual costs with budget). The above annual budget for the XYZ Company could be calendarized quarterly as follows:

CALENDARIZED BUDGET, BY QUARTER

| ITEM | 1st Q | 2ndQ | 3rdQ | 4thQ | Year |
|-------------------------|------------------|------------------|------------------|------------------|------------------|
| Production Units | 3,000 | 4,000 | 2,000 | 1,000 | 10,000 |
| Raw Materials | \$18,000 | \$24,000 | \$12,000 | \$6,000 | \$60,000 |
| Prodn' Budget | | | | | |
| Labor | 180,000 | 240,000 | 120,000 | 60,000 | 600,000 |
| Salaries | 7,500 | 7,500 | 7,500 | 7,500 | 30,000 |
| Rent | 3,750 | 3,750 | 3,750 | 3,750 | 15,000 |
| Utilities | 11,000 | 10,000 | 10,000 | 9,000 | 40,000 |
| Maintenance | 12,500 | 12,500 | 12,500 | 12,500 | 50,000 |
| Total | \$214,750 | \$273,750 | \$153,750 | \$92,750 | \$735,000 |
| Admin Budget | | | | | |
| Salaries | 25,000 | 25,000 | 25,000 | 25,000 | 100,000 |
| Rent | 3,000 | 3,000 | 3,000 | 3,000 | 12,000 |
| Utilities | 750 | 750 | 750 | 750 | 3,000 |
| Deprec Insur. | 12,500 | 12,500 | 12,500 | 12,500 | 50,000 |
| Total | \$41,250 | \$41,250 | \$41,250 | \$41,250 | \$165,000 |
| Total Mfg. Cost | \$274,000 | \$339,000 | \$207,000 | \$140,000 | \$960,000 |

The calendarized budget is extremely important in planning raw material purchases, arranging to have labor available during seasonally busy periods, and most importantly, to be sure that cash is available to fund the manufacturing operations.

The calendarized manufacturing budget is also essential to control operations during the course of the year. As the year progresses, actual costs are compared to budget and differences from budget analyzed. The following is the manufacturing cost (or variance) report for the first quarter for the XYZ Company.

The report lists the actual costs and makes a comparison with budget. The manufacturing budget is adjusted for actual production volume. This permits a valid comparison of actual costs with allowable costs based on actual production volume

FIRST QUARTER COST VARIANCE REPORT

| ITEM | 1ST Q BUDGET | 1ST Q ALLOWABLE | 1ST Q ACTUAL | \$ VARIANCE |
|-----------------------|-----------------|--------------------|-----------------|-----------------|
| Production Units | 3,000 | | 4,000 | |
| Raw Materials Used | 18,000 | 24,000 | 25,000 | (1,000) |
| Prodn Dept | | | | |
| Labor | 180,000 | 240,000 | 260,000 | (20,000) |
| Salaries | 7,500 | 7,500 | 8,000 | (500) |
| Rent | 3,750 | 3,750 | 3,750 | 0 |
| Utilities | 11,000 | 13,000 | 12,000 | 1,000 |
| Maintenance | 12,500 | 12,500 | 12,500 | 0 |
| Total | 214,750 | 276,750 | 296,250 | (19,500) |
| Administration | | | | |
| Salaries | 25,000 | 25,000 | 25,500 | (500) |
| Rent | 3,000 | 3,000 | 3,000 | 0 |
| Utilities | 750 | 750 | 700 | 50 |
| Deprec Insur. | 12,500 | 12,500 | 12,500 | 0 |
| Total | 41,250 | 41,250 | 41,700 | (450) |
| Total Mfg Cost | | | | (20,950) |

The above first quarter report for the XYZ Company indicates that the plant exceeded allowable costs by \$20,950. Higher volumes than budget would result in higher actual costs compared to budget. However, it is important to compare actual costs to allowable costs (budget adjusted for actual volume) to make a meaningful comparison and analysis.

In this case, the analysis revealed that the unfavorable variance of \$20,950 was due mainly to a surge in orders requiring considerable overtime for direct labor. This resulted in a substantial unfavorable labor variance.

The unfavorable labor variance could have been avoided by moving more quickly to hire the additional labor to handle the increased orders. The variance report, with analysis, provides a much clearer understanding of costs so that actions can be taken when indicated.

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

INVENTORY CONTROL

In many businesses, the purchase of merchandise for resale (retailing) or the purchase and conversion of materials into finished product (manufacturing) represents the most significant cost of the business. The expenditures required to acquire merchandise in almost all retailing businesses are by far the greatest cost in conducting the business. Likewise, the manufacturing business incurs the major part of its costs in acquiring materials and applying labor with other costs to make the finished product.

Keeping track of merchandise and materials, which are called inventory, obviously is important because of the considerable costs involved. This is accomplished through a good inventory record keeping system. Various point-of-purchase systems and software packages tailored to your industry can be a big help.

INVENTORY RECORD KEEPING

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

Product Code: 1020

Product Description: 1 quart bottle, Hi Temp Oil

| Month: May | Begin | Sales | Production | End |
|------------------|-------|-------|------------|-----|
| Quantity (units) | 600 | 200 | 300 | 700 |
| Value (cost) \$ | 300 | 100 | 150 | 350 |

The value is the cost of the product. In the case of a retailer, this would be what the retailer paid for the product. For a manufacturer, this would be the cost of the materials purchased plus the cost of labor and other charges applied in converting the materials into the finished product. In this example, the cost of goods sold would be \$100 for this product for the period of May. There are two different methods used in inventory record keeping: (1) perpetual, and (2) periodic.

Perpetual Inventory

The Perpetual Inventory method starts with a physical inventory (actual count) and then adjusts this inventory for additions and withdrawals. The inventory at the end of the period is calculated. An example would be:

| | |
|-------------------------------|-----------|
| Beginning inventory | 100 units |
| Sales | 75 units |
| Production | 95 units |
| Ending inventory (calculated) | 120 units |

$$\text{Ending inventory} = \text{Beginning inventory} + \text{Production} - \text{Sales}$$

The Perpetual Inventory method is used where sales and production information is readily available and reliable, and the frequent taking of physical inventories would be burdensome. Physical inventories are taken after designated periods (such as quarterly or annually) to check the calculated inventories. The inventory records are adjusted to agree with the physical inventories. The financial effect of these adjustments is reflected in the balance sheet and the profit/loss statement of the business.

Periodic Inventory

The periodic inventory method also starts with a physical inventory. A physical inventory is taken at the end of each period and recorded. This method is used when reliable sales or production data is not readily available. In this case, the sales or production amounts are calculated based on the beginning and ending physical inventories. Consider the following examples:

Retailing example:

| | |
|----------------------------|----------|
| Beginning inventory | \$12,000 |
| Purchases | \$6,000 |
| Cost of Sales (calculated) | \$8,000 |
| Ending inventory | \$10,000 |

$$\text{Cost of Sales} = \text{Beginning inventory} + \text{Purchases} - \text{Ending inventory}$$

Manufacturing example:

| | |
|-------------------------|-------------|
| Beginning inventory | 1,500 units |
| Sales | 800 units |
| Production (calculated) | 900 units |
| Ending inventory | 1,600 units |

$$\text{Production} = \text{Ending inventory} + \text{Sales} - \text{Beginning inventory}$$

A major use of inventory record keeping is to determine the cost of goods sold as well as provide information for financial statements.

INVENTORY CONTROL

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

Inventory control consists of:

1. Setting objectives for inventory; what products/materials, quantities, costs, order/production points (what quantity will initiate action for re-supply),
2. Recording and reporting actual results (done by the inventory keeping system)
3. Comparing actual with the objectives and analyzing the differences,
4. Taking action to correct problems and/ or improve business performance.

The only reason for inventory is to have product to sell for profit. Inventory supports the sales activity. This means having what the customer is willing to buy, when needed at a price that provides an acceptable profit. Inventory control is integrated with systems that track sales, production, and purchasing activities. The following is a simple example:

The BAC Company plans to produce and sell three products, X, Y, and Z. Planned annual sales and production rates are:

| Product | Annual Sales | Production Rate |
|---------|--------------|-----------------|
| X | 26,000 | 200 |
| Y | 52,000 | 300 |
| Z | 13,000 | 100 |

The business operates 5 days per week, 52 weeks per year. The minimum economic production run is two weeks. It is planned to have a minimum inventory, equivalent to four weeks of the plan sales rate, to ensure having product available when the customer needs it. The maximum inventory is to be eight weeks of the plan sales rate to limit the investment.

The minimum and maximum inventories would be as follows based on the plan assumptions listed on the following page:

| Product | Daily Sales Rate (Units/Day) | Minimum Inventory (Units) | Maximum Inventory (Units) |
|---------|---------------------------------|------------------------------|------------------------------|
| X | 100 | 2,000 | 4,000 |
| Y | 200 | 4,000 | 8,000 |
| Z | 50 | 1,000 | 2,000 |

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

Various measures are used, for control purposes, to relate inventory amount to sales activity. Two commonly used measures are: (1) inventory days (used in manufacturing businesses), and (2) inventory turnover (used in retailing businesses).

Inventory Days

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

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

Inventory Turnover

Inventory turnover measures the number of times in a year that the inventory turns over. In the above example, if product X sales for the year is the planned rate of 100 units per working day, or 26,000 units for the year, and the inventory averages 3,000 units, the inventory turnover would be 8.67 ($26,000/3000 = 8.67$). Values (costs) could be used in calculating inventory turnover similar to that done above.

Although the time period of a year is used as the basis for calculating inventory turnover in most cases, a seasonal business (such as a store in a summer resort) would use the season as the basis. In this case, the business objective is to turn the inventory over as many times as possible and have little or no inventory by the end of the season. Actual sales activity (sales rate, product preferences, selling prices) must be closely monitored with inventory (products, quantities, costs, re-supply limits) to be sure that the inventory control system is properly supporting the sales activity.

Another important objective of inventory control is to keep the financial investment in inventories just sufficient to support the business. Inventory building converts cash into

products that may or may not sell and if sold, perhaps at a price less than cost. Inventories consume cash, increase the investment in the business, and can bankrupt the business if not properly controlled.

INVENTORY STRATEGIES

Every business competes within an industry. Each industry has a life cycle. The strategies employed by the business depend on where in the life cycle the industry is. The management of inventories is influenced by this life cycle. Generally, there are four stages in the life cycle of an industry. These are:

- *Development* – uniquely new products are being developed and market tested. Products must be available for market testing. There is little concern about inventory investment, other than to be sure products are available for market testing and development.
- *Growth* – The product has been demonstrated to have significant market potential and the business strives to gain a major market share. Investment in inventory is heavy to ensure product availability to gain significant market share.
- *Mature* – Growth has leveled off. Inventories are very closely controlled to keep investment in them just sufficient to maintain market share.
- *Aging* – A period of retrenchment, as competitive industries take away or eliminate markets. Inventories decline as unprofitable and marginally profitable segments of the business are weeded out.

The proper control of inventories is essential to the success of any business where investment in inventories is significant as is an awareness of the competition and the state of new product developments.

APPENDICES

COMPUTERS AND SMALL BUSINESS

Computers are a critical tool for small businesses. While the technology is changing all the time, practically speaking your choices are either a Windows or an Apple based system. Which one is best for your business depends on budget and your skillset on the systems. The next important choice is the software. Most small businesses will need a software package that has word processing, spreadsheets, a presentation module and increasingly, a database module.

Small businesses should also consider buying a small business accounting package to maintain financial information. QuickBooks is one well-known system but there may be others that fit your business needs. Even if you are using a bookkeeper, these systems help you stay on top of your financials and help you provide the data to your bookkeeper in a ready to use format.

If you are in a retail or food-service business you will need a POS system. There are many new systems being introduced. Look for one that not only processes payments but one that can also process invoices and track inventory. Make sure this system is compatible with any other systems that you are using.

Backing up your system is critical. It is something that many businesses do not do regularly. Whether you choose to backup to a physical device or use a cloud-based system, you must pay careful attention to developing a plan that you follow regularly. If you use a physical system make sure you make a copy and keep it in a location other than your business.

Small businesses also need to consider other cloud-based tools such as Constant Contact (www.constantcontact.com) that allows you to manage your customer database in an efficient manner. If you are building a customer database, educate yourself on current privacy regulations.

FRANCHISES

There are a number of features to franchising that are very appealing to prospective business owners. Because there is easy access to an established product and a proven method of marketing, many of the risks of opening a business are reduced.

Forms of franchising have been in use for over a century and, in recent years, enormous growth has occurred. Industries relying on franchised business to distribute their products and services touch every aspect of life from automobile sales and real estate to fast foods and tax preparation.

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

A franchise is a legal and commercial relationship between the owner of a trademark, service mark, trade name, or advertising symbol and an individual or group seeking the right to use that identification in a business. The franchise governs the method for conducting the business between the two parties. In its simplest form, a franchisor owns the right to a name or trademark and sells that right to a franchisee. This is known as "product/trade name franchising." In the more complex form, "business format franchising," a broader and on going relationship exists between the parties.

The latter provides a full range of services, including site selection, training, product supply, marketing plans, and sometimes financing. Generally, a franchisee sells goods or services supplied by the franchisor, or sells goods or services that meet the franchisor approval for quality.

Advantages:

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

Disadvantages:

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

DISCLOSURE DOCUMENT

The Federal Trade Commission requires that franchise sellers provide certain information to help a prospective buyer evaluate the franchise opportunity. This information is a Detailed Disclosure Document, which includes information such as:

- Names and addresses of other purchasers
- A fully audited financial statement of the franchise seller
- Background and experience of key executives of the franchisor's staff
- Cost required to start and maintain the business
- Responsibilities you and the franchisor will share

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

COMMENTS

An attorney should be engaged to assist the prospective franchisee evaluate the franchise package. An accountant may be needed to determine the full costs of purchasing, operation, and estimate the potential profit to the franchisee. Before purchasing a franchise you should think carefully about the level of independence you will maintain, how comprehensive are the operating controls, and be very clear as to the full costs of purchasing the franchise. Be sure to ask about the terms and conditions for reselling your franchise. While the success rate of franchises is high, very independent people with their own concepts of operating a business may not be the type to consider a franchise.

BUSINESS VALUATION

Prologue

The material presented in this chapter is meant to give the reader with no background in the intricacies of buying and selling a business a cursory introduction of the terms and mechanism of valuing a business for purchase or sale. Also it is intended to confer to the reader that the subject is complex and to become proficient at valuation requires considerable training and experience.

With this in mind, it is recommended that anyone who desires to buy or sell a business do the following:

- Retain a competent accountant, one with ABV or CVA credentials, to assist in establishing the price.*
- Retain an attorney experienced in buy and sell agreements.*
- Do not enter into any decision without complete knowledge and understanding of all the facts and aspects of the transaction.*

There are many complicated factors involved in the establishment of a price for the sale or purchase of a business. Establishment of a price is called valuation. The goal of business valuation is to arrive a market price that is the most probable in terms of money that a property should bring in a competitive open market under all conditions requisite to a fair sale, the buyer and seller acting prudently, and knowledgeably. It is assumed the price determined is not affected by undo stimulus.

An appraisal differs from valuation in that appraisal is limited to determining the value of a particular asset such as real estate, machinery, fixtures, equipment, inventory and other tangible assets while valuation takes into context the entire business. In the valuation process, the appraisal of tangible assets is necessary. Inherent in all small business buy and sell negotiations is the difference of opinions between buyer and seller. Usually the seller believes the business is worth more than the buyer does. Since emotion is often involved in negotiations, it is important that both buyer and seller understand the valuation process and both parties assume a non-adversarial posture.

In many evaluation methods, and there are several methods, the terms, *goodwill, normalized earnings, intangible assets, and capitalization* are used and often misunderstood. The Internal Revenue Service defines goodwill as follows: "goodwill is based on the earning capacity. The presence of goodwill's value rests upon excess of earnings over and above a fair return on net tangible assets. While the element of goodwill may be based primarily on earnings, such factors as prestige and renown of the business, the ownership of a patent,

trademark or brand name, and a record of successful operation over a prolonged time in a particular location also may furnish support for the inclusion of these intangible assets.”

Normalized earnings are a result of adjusting actual or average earnings to reflect the ensuing twelve months projected income. Adjustments are made to the actual or average earnings, as derived from income statement figures, by correcting for possible owner inflated salary, owner’s perks, inflation and rising prices of materials and labor, etc. Normalized earnings, also known as the income stream, reflect the future earning power of the business. For further discussion of earnings see Note 1.

Capitalize is to calculate the present value of future returns from a business. Capitalization is the conversion of income into value. Capitalization rate is any rate used, either as a divisor or multiplier, to convert a stream of income into an indicated value. The higher the capitalization rate, the lower the multiple. See Note 2.

Among the several factors that affect the valuation of a business are:

1. Risk
2. General condition of the company (facilities, book accuracy, etc.)
3. Market demand for the particular type of business or products
4. Competition
5. Economic conditions as they affect the business
6. Future profit potential and volatility of earnings
7. Ability to transfer goodwill to a new owner

Because a prospective buyer would place primary importance on the potential earnings of the business the most widely used method for evaluating a small, closely held, ongoing business is known as the capitalized earnings or excess earnings approach. An outline of this method is as follows:

1. Determine actual earnings by averaging the past 5 years of Income Statements.
2. Normalize these earnings by correcting for excessive owners salary and owners perks, recognition of bad debts, wage increases, removal of non-recurring expenses and the ensuing years potential sales.
3. Determine net tangible asset value.
4. Determine a percentage return on net tangible assts. Also known as cost of money.
5. Subtract step 4 from step 2. This amount is the “excess earnings,” i.e. earnings above a fair return on net tangible assets.
6. Determine proper capitalization rate to apply to excess earnings.
7. Add capitalized earnings to the net tangible asset value of Step 3. This is the value of the business.

A brief, quick, simplified example of this method is as follows:

Joanna owns an established, well-known hair salon that has a steady, year round business and it is profitable. She has a long term, transferable lease. After deducting a reasonable salary for Joanna, the shop earned \$10,000 per year.

The tangible assets of equipment, fixtures, furniture, inventory and décor is valued at \$15,000. For purpose of this example, a rate of return of 12% will be used for tangible assets, and a capitalization rate of 30% (3.33 multiplier) for excess earnings (see next page):

| | |
|---|---------------|
| Net tangible assets | \$15,000 |
| Normalized earnings | 10,000 |
| Earnings attributable to | |
| Tangible assets ($\$15,000 \times 0.12$) | <u>1,800</u> |
| Excess earnings | 8,200 |
| Value of excess earnings ($\$8,200 \times 3.3$) | <u>27,060</u> |
| Total value of business | \$42,060 |

A lot of work is required to arrive at an accurate figure for normalized earnings. From this example it can be seen that the capitalization rate is extremely important in valuing a business. Capitalization rates are based on goodwill that may also be interpreted as the difference between an established business and one that has not established itself and achieved success.

Joanna could point out that it took a lot of work, time, effort and know-how to establish her growing business, develop a customer list and wants the value of her business to reflect this. If the excess earnings were capitalized at 15-20% resulting in a multiplier of from 5 to 6.6, the value of her business would increase by \$13,000 to \$25,000. By the same token had not the business been profitable, the business value would probably only be equal to the assets.

In valuing a business for sale for either a buyer or seller, due diligence is called for to establish the condition of the business, quality and availability of employees, average and standardized earnings and the value of intangible and tangible assets. As indicated in the prologue, professional assistance is advisable

Note 1: There are three different variations of the earnings approach to valuation:

1. Current earnings. The most recent year earnings may or may not be representative of the actual earning power of the business.
2. Average earnings. If the current earnings are unusually high or low, then an average of the previous four or five years might be more appropriate.

3. Future earnings. If there has been a history of growth or earnings over the past few years, it may be appropriate to estimate future growth as follows:

$$\frac{\text{Earnings}}{\text{"Cap rate"} - \text{growth rate}} = \text{Value}$$

Note 2: Classification of Business Risk with Suggested Cap Rates

- **Class 1: Large sized business** (Over 10 million sales), sound financial condition, stable earnings, and experienced, capable management with depth.
 - Capitalization rate: 10-20%
- **Class 2: Medium to large business** (2-10 million sales), well established, with good management.
 - Capitalization rate: 15-20%.
- **Class 3. Small to medium business** (\$500,000 to 2 million sales) possible fast growth, but limited available capital. Less stable earnings pattern, management lacking experience and depth.
 - Capitalization rate: 20-30%.
- **Class 4. Small sized retail or service business** (restaurants, garages, marinas, etc), some capital required, limited growth potential, highly competitive environment, possible experienced management with little depth.
 - Capitalization rate: 30-50%.
- **Class 5. Personal service business** (Manufacturers rep., bookkeeping, personnel agency) very little capital required, highly dependent on skills of the owner or manager.
 - Capitalization rate: 40-50%. Value sometimes based on 1 year's revenue.
- **Class 6. Professional practice, highly technical.** Totally dependent on specialized knowledge of participants. Heavy capital requirements.
 - Value usually based on value of assets.

The above rates are designed to reflect a relatively normal period of economic activity and would be subject to variation were large changes in the economy to occur. Obviously, size is only one criterion for risk and other factors such as financial condition, the type of industry, and key employees should also be considered.

The multiple is the reciprocal of the capitalization rate. The higher the "cap" rate the lower the multiple, consequently the lower the business value.

USEFUL TAX PUBLICATIONS

| <u>NUMBER</u> | <u>TITLE</u> |
|----------------------|---|
| SS-4 | Application for Employee Identification Number |
| Sch C | Profit or Loss from Business—Sole Proprietor |
| 15 | Employer’s Tax Guide (Circular E) |
| 15A | Employer’s Supplemental Tax Guide * |
| 17 | Your Federal Income Tax |
| 334 | Tax Guide for Small Business |
| 463 | Travel, Entertainment, Gift and Car Expenses |
| 493 | Alternative Tax Withholding Methods & Tables |
| 505 | Tax Withholding and Estimated Tax |
| 533 | Self-Employment Tax |
| 534 | Depreciating Property Placed in Service Before 1997 |
| 535 | Business Expense |
| 538 | Accounting Periods and Methods |
| 541 | Tax Information on Partnerships |
| 542 | Tax Information on Corporations |
| 552 | Record Keeping for Individuals |
| 583 | Starting a Business and Keeping Records |
| 587 | Business Use of Your Home |
| 1996 | Independent Contractor or Employee |

Contact information for Federal tax information

1-800-829-1040 (Tax Assistance)

1-800-829-3676 (Publications)

Website for downloading Federal forms and publications

<http://www.irs.ustreas.gov>**Contact information for state of Massachusetts tax information**

Withholding Taxes 1-800-392-6089

Sales Tax 1-800-392-6089

Income Tax Assistance 508-775-0029

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