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Money Management in Small Business

ONE BUGBEAR of the manager of a small business is to maintain productivity. Machines cost money whether they are used or not, because they depreciate and become obsolete. Idle time of a machine is like idle time of a workman, paid for but returning nothing in earnings. Proper work organization is imperative, plus a sound knowledge of the facts of production.

As small-business managers quickly come to realize, general-purpose machinery reaches economical value at a relatively low level of output, while special-purpose machines cost so much and are designed to produce so prolifically that their purchase is justified only by the need for great output.

Professor W.M. Hoad, of the University of Michigan, put this in parable form in his book *One Hundred and Fifty Questions for a Prospective Manufacturer*. A small plant, he says, may have a number of different types of general-purpose machines. If it wants to expand by, say, 25 per cent, it simply needs to install one additional machine for each four already in use. A plant using special-purpose machinery to capacity will probably have to replace substantially all of it with a larger size in order to expand by 25 per cent.

There are no disadvantages involved in the use of machines if they are carefully selected for their contribution to production in the way of efficiency and cost-savings. The great sin that lands a small-business manager in a hot place economically is when he gives in to the temptation of indiscriminate enthusiasm for modernization.

Discretion is needed to make your choice on the basis of what has to be done. Determine your needs, call in equipment salesmen, listen to their advice, correlate their opinions with your own knowledge of what you want the machines to do, and work out the cost in terms of how long it will take increased production to pay for the machine.

Financing

The necessity for capital and saving is usually underestimated by sanguine young people. The whole of their financing problem is not solved when they have raised enough money to go into business : the important point is how much it takes to stay there.

Proper financing requires two kinds of capital: equity capital and loan capital. Equity capital is composed of the funds invested in your business by yourself and your partners and stockholders in the hope of deriving profit from the venture. These take the greater risk, because they are entitled to a return on their investment only after the claims of creditors have been settled. The bondholders and other creditors, who supply the borrowed capital, enjoy greater safety, but are generally limited to a fixed rate of return.

A survey showed that a shortage of equity capital persistently faces the small enterpriser, and consequently he must make use of short-term costly credit at a critical stage of his operation. It is in this period that credit is most difficult to get, because the business has not yet proved itself in such a way as to show certainty of being able to repay the obligation. A depression in general economic conditions would add still further to the uncertainty.

The small-business manager will use credit as a money-making tool. One general rule should be to use credit only when its use will increase your net sales by an amount greater than the total cost of accepting such credit. Says the *Small Business Manual* of the Department of Trade and Commerce, Ottawa: "The only time you should break this rule is when your firm runs into a serious but temporary financial reverse. Then you may have to borrow merely to pull yourself out of the difficulty. You should make sure, however, that the reverse is a purely temporary one."

Authorities urge repeatedly the need for care in accepting credit, and the desirability of raising capital funds in other ways. Long term trade credit is a legitimate source of capital for the small new business, but a risky one. It is not comfortable, or conducive to his best effort, for the small-business man to be in a state of financial dependence on wholesalers or manufacturers who extend him credit. He would be much better to start small and work up carefully, even parsimoniously, until he can afford the bigger plant, the better office and the smarter machines he desires.

Mistakes cost money

Some things must be learned by the new enterpriser through trial and error, but the error part costs money. Mistakes may be avoided to some extent by following sound financial policies undeviatingly. If certain basic principles of financial management are followed, says R. B. Tower in *A Handbook of Small Business Finance* (Superintendent of Documents, Washington), "there is no possibility of financial failure. The greater the difficulty a small manufacturer has in following them, however, the more certainly his finances will ultimately drag him down the road to insolvency." Mr. Tower states the three principles in simple terms: avoid an excessive investment in fixed assets; maintain net working capital in proper proportion to sales; avoid excessive inventories.

In this advice the operative word is "excessive". It is poor economy to skimp on money for the necessary or desirable development of your business. No one should hesitate to borrow so long as he can put the money to efficient and profitable use and pay it back when it is due.

The careful operator of a business will take certain safeguards. He will, for example, look ahead for five or more years and draw up alternative sets of plans to meet varying business conditions. He will prepare memoranda of his anticipated cash requirements for shorter periods, perhaps for months as well as for six-month periods. These will show now what will be needed when, and give the manager a chance to plan where he may hope to get the money.

The manager will shift some risks from his shoulders by insurance. He will take competent advice about preparing his tax returns, so as to secure advantage of all legitimate deductions. He will take all necessary steps to keep up his equipment.

Credit through banks

Most of the short-term credit to business in Canada is supplied by the chartered banks.

In order to make loans with a high degree of safety and protection for the depositors who supply the funds that are loaned, bankers need clear and dependable facts concerning the businesses that ask for loans.

Banks are, naturally, careful about advancing credit to business men who have placed little or no capital of their own in the venture and have not yet demonstrated the probable success of the business.

Credit standards and requirements of banks vary with the type, condition and size of borrowers. One principal requisite of credit to small business is the personal and moral character of the borrower. This means that the borrower will do everything in his power to conserve his business assets and thus assure repayment of his indebtedness, and that he is a man of his word. "A bank," says the *Small Business Manual*, "does not want to have to police a loan, or seize and sell a firm's assets in order to secure repayment. Therefore the bank lends only to those in whose integrity it has confidence."

While the banks want to lend money, because that is part of their business, they require certain basic information on which to base their decision to do so. Some of this will be given by the borrower and the rest will come from the bank's credit files. It will relate, roughly, to what is covered by the six "C's" of credit: character, capacity, capital, collateral, circumstances and coverage (insurance).

In considering whether or not to advance credit, the bank performs a double service: it facilitates business and it guards against indiscretion. All financial experience shows that too much credit may be fully as dangerous as too little, and that unsound credit is as harmful to the borrower as to the lender and is bad for the community.

The banker, weighing projects with the care and judgment that come from experience and knowledge, and having behind him all the information sources of his great institution, is in a position to encourage a sound proposition or to raise a warning signal when the would-be borrower is too optimistic to be supported by the facts.

Money management

Financing is only one of the many aspects of management, and financing is often complicated by problems deriving from inept or inexperienced management in handling inventories, extending credit, purchasing, predicting sales, and so forth.

Money management — the old-fashioned, every-day, common sense handling of money matters — is an absolute essential to the health of a business. Its absence is a weighty factor in many of the commercial failures that take place every year. There were 2,278 failures recorded under the Bankruptcy and Winding Up Acts in 1954, an increase of 37 per cent over 1953, with $53 million in defaulted liabilities.

Making a budget

The only generally available way to manage money efficiently is by the budget system. Few, if any, techniques are more vital to the sound management of an enterprise than budgeting, yet it is a tool unwisely neglected by many small companies.

When one builds a budget, reducing to dollars and cents one's best estimate of sales, expenses, capital expenditures, credit and all other income and outgo, that is an inoculation against disaster. It uses both hindsight and foresight, because it draws on the experience of past years to judge the expected performance of future years. It shows the break-even point, below which all the dollars we earn by selling at a price higher than the actual out-of-pocket expenses of producing the product must go to pay for services, equipment, taxes and so forth. Above that point we have a chance to start contributing to our own pockets.

The use of departmental budgets for cost control is a most effective way of making workers cost-conscious, because they know they either have to live within the budget or explain the reason why. This is important in a small business, where workers can lose more with shovels than the manager can bring in with a bulldozer.

Cost accounting is not an end in itself. Its purpose is to provide management with information that is useful in directing operations, in choosing between alternative processes, and in guarding against adverse developments.

Business records

Many small-business people have not kept their records up to the standard of other phases of operation, yet maintenance of proper records and accounts is an essential factor in the success of a small business. In fact, surveys made in an attempt to find out why so many small businesses in Canada have failed show that a large percentage of those which have become bankrupt either kept inadequate records or none at all. In making this statement the Department of Trade and Commerce handbook previously referred to adds: "While record keeping will not insure your success, it will keep you informed as to progress of your business and disclose faults in operation which might be disastrous if not detected in time."

There are other reasons than the economical running of the business for the keeping of records. Suppliers and banks require financial statements before advancing credit; income tax regulations require supporting evidence of all transactions undertaken during the year; some industries are required to report certain information to the customs and other government departments; and well-kept records play a big part in persuading someone to invest in the business or to buy it.

Marketing

Last act in the daily drama of business is marketing. Invention, financing, production, management, and all the rest would be futile if the goods were not sold. Proficiency in marketing can go a long way toward overcoming incompetency in one of the others.

The principle of effective marketing is to know what people want and then convince them that you can supply it in good quality at a reasonable price. Although many other things influence profits, a producer cannot long survive the fault of having an inferior product, or the handicap of charging higher prices than his competitors.

Here is another use for records. They can be made to tell the story of past sales: what the level and trend is of sales by commodity groups, where sales have originated and in what volume from each territory, what is the relative importance of each channel of distribution being used. The answer to many other questions, like cost of selling, expense of storage and losses incurred through carrying dead stock, will turn up almost incidentally in process of analyzing sales data.

Upon the base of such information the manager may plan an enlarged, more economical sales programme, filling in gaps and expanding into new territory where that seems to hold out promise of profit, and withdrawing where experience indicates that sales activity is uneconomical.

Another fact that records will reveal is the soundness or unsoundness of the firm's credit policy. The result of too-generous credit, a weakness common to small companies, is excessive losses in accounts that become worthless, and tied-up capital that may be badly needed.

Sound credit sales policies begin with a thorough knowledge of your customers' financial position. If a small business sells on credit it should have a firm understanding in every transaction about the length of the credit period, and a definite undertaking to pay by a set date. Then its records should be of such a sort that the transaction is kept in sight and the necessary steps taken to secure fulfilment of the promise.

As for the future . . .

Every person of normal sensibility wishes to see the business he has built continue to thrive, whether he is present in it or not, and yet many a man puts off planning for the time when he will not be there until, alas! it is too late. There are some who postpone retirement or estate planning because, in the delightful way Dorothy Sayers puts it in one of her Lord Peter Wimsey stories: "it upsets them to think of such things."

Small businesses are mostly of the individual or family type. Many of them will be continued by sons and daughters, or managed by partners for the benefit of the family. Who is to run the business, with what resources, are questions urgently demanding the attention of every small-business owner.

To start with, he should give earnest attention to succession duties, a liability made pressing by today's high rates. From each bequest under a will the proportion of succession duties payable on it is deducted before the bequest is paid. Federal duties and provincial duties are ordinarily payable within six months, and the necessary cash must be raised from the business or from other sources.

Some saving may be effected. For example, a trust may be created giving a life estate to the primary beneficiary, with an ultimate division of the capital among other beneficiaries. Otherwise an estate may shrink considerably, as for example by the payment of succession duties twice, once on the testator's death and again on the death of his beneficiary.

What we are principally interested in, however, is to see that an estate is so set up that the business may continue in operation, and shall not have to be liquidated in order to pay succession duties. There must be liquid assets available. One way of insuring this is by having a specially earmarked life insurance policy.

A family business

Montreal Trust Co. puts it this way in a booklet entitled *How to Keep Your Business in the Family:* "The problem of leaving the estate in a form liquid enough to meet the succession duty liability and other debts can only be solved by intelligent and early estate planning. It is impossible to stress strongly enough the importance to the owner of a family business of placing his affairs in order early in life while he is in good health and there is time to do a proper job by using the services of a qualified estate planner."

The booklet, which is available on request at any office of Montreal Trust Co. and at branches of The Royal Bank, goes on to tell some of the advantages of estate planning. The owner of the business is, of course, the one best qualified to discuss the problems facing it. With his intimate knowledge made available to estate planners, they may be successful in establishing principles that will continue the business on a firm base.

The owner who wishes to keep his business in the family, or to have it continue after his retirement or death so as to provide a continuing income, must have four objectives in mind. He must reduce the tax liability as much as possible ; he must establish with as much certainty as possible the actual value of his estate; he must leave his estate in a form liquid enough to provide funds to pay the succession duty liability and other debts; and he must make suitable arrangements for the continued management of his business. Failure to arrange these things may leave his family in very insecure position, or force the sale of the business.

Some owners make the mistake of keeping in their own hands sole control over all phases of operation, so that when they pass from the scene there is a drastic state of confusion. When a son is relied upon to continue the business, he needs to be trained, and responsibility must be given him over the years so that when the time comes he will take the reins with confidence and ability. The owner of a business who has no family member to take over faces an even greater problem. He must not only train those who are to succeed him, but he must also secure their continuing loyalty to the business after his death.

Is the business successful?

Many things may be taken into account when assessing whether or not a man has been successful in his business, but there are four questions that cover the matter rather well.

1. Has he done what he set out to do? His may not have been the biggest establishment in its line, but perhaps it was what he wanted. There are other measuring tools than the yardstick of size.

2. Has the volume of his business been as big as was warranted by its nature, its environment, its opportunities, and his desires?

3. Has he managed his business in a money-wise way, so that profits were as big as could reasonably be expected, used in such a way as to contribute to the growth of his business and his family's welfare?

4. Has he planned efficiently, so that he can rest assured the business he has reared will continue in a healthy way after his departure, well managed by people he has trained, yielding the sort of income he desires for his family?

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