The following is a highlighted summary of the book, Self-Defense Finance for Small Businesses, *published by John Wiley & Sons Inc.. The statements below are key points of the book as determined by James Altfeld and have been made available at no charge to the user.*

Self-Defense

Finance for Small Businesses

By

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Guide to Planning your New Enterprise

Any company, regardless of its size, faces two common problems. First, it routinely functions with limited resources—just so much money and so many people available. Second, it has certain objectives, such as a desire to increase sales by 10%, to introduce new products or services, or to expand in other ways. Matching a company's objectives with its resources is an important task. Ensuring that the objectives are realistically achieved is an even greater undertaking. The purposes of the business plan are to guide the accomplishment of these tasks and, further, to serve as an instrument to secure financing where such is required.

1. The process forces the planner to think carefully, to be disciplined, and to focus.
2. The process helps identify which factors success depends upon and highlights critical elements that are essential to achieve a planned goal.
3. the plan provides a clear idea of what the organization or individual is attempting to do and how, when and why they plan to do it.
4. The plan can enable management to measure progress toward objectives.

The plan must be a living document.

The Business Plan

…the job of the private company manager more often becomes one of operating to minimize personal taxes.

…operating statements must often be reconstructed to reflect the true picture of the privately owned company's financial position.

National comparative information, by business type, can be obtained from the Annual Statement Studies, produced by Robert Morris Associates in Philadelphia, and from

financial Studies of the Small business, produced by financial Research Associates in Winter Haven, Florida.

The following list is an outline of elements and types of information common to all comprehensive business plans:

1. The loan request
2. Introductory material
3. Market research (Include both positive and negative factors about product, industry, potential customers, and competition).
4. The business or new idea
5.Organization
6. personal financials (on each principal)
7. sign the business plan report (provide for signature page toward end of report).

The Marketing Plan

A marketing plan should contain the following:

1. Statement of goals.
2. Background material
3.Description of the program
4. Statement on timing.
5. Statement describing who is responsible for what action.
6. Evaluation plan.

The Financial Plan

Financial planning falls into two broad areas of planning for liquidity and planning for profit:

1. Planning for liquidity. In essence this is simply planning the company's cash flow. A principal tool for short-term planning is the cash budget, which more often assists best as a written plan detailing the amount and timing of expected inflows and outflows of cash. It is commonly prepared on a month to month basis, for the period of one year at a time. Effectively applied, the cash budget will forecast the critical path of critical elements:

a. Identifies periods when cash inflows do not meet cash outflow requirements.
b. Identifies timing and magnitude of cumulative effect of "shortages" and/or cash excesses produced by the business.

Armed with this knowledge, the business owner knows how much financing will be needed, when it will be required, how long it will be used, and how it can be repaid.

2. Planning for profit. This usually involves a longer-range projection of the company's status, its future income, the assets required to generate this income, and the sources and amounts of funds that will be necessary to finance its growth. Planning for profit generally requires extending the one-year plan out into the future for three to five years of

expected performance. The principal means of accomplishing this task is to project the company's income statements and balance sheets into these future periods. In making these projections, it is necessary to make explicit, realistic assumptions, many of which are based on aspects of the marketing plan. These assumptions should be clearly stated within the context of the financial plan.

The single most important variable influencing future financing requirements is sales.

Planning allow management to view a wide range of possible outcomes with little or no cash impact on the current operation.

Summary

The business plan incorporates and exists through the features and benefits of both the marketing and the financial plans.

The plan becomes the word picture of the past, present, and future and the document for financing and for continuing management.

Ratio Analysis

The Annual Statement Studies, produced by Robert Morris Associates of Philadelphia, and Financial Studies of the small Business, published by Financial Research Associates of Winter haven, Florida, available at most libraries, were used as the basis for industry ranges.

Break-Even Analysis

Businesses with long delivery times, though constrained to fixed-quote sales, were stuck with one, two, or more supplier increases before they could finish sales.

Break-even analysis will allow time in planning for future increased costs of doing business.

At what price can a product or service be sold and still make a reasonable profit or maintain the existing profit margin?

When compared with company overall profit margins, break-even analysis can assist in "weeding" out marginal or less profitable items.

The following is an example of the more obvious relationship:

Sales	$500,000	100.0%
Costs of Sales	300,000	60.0%
Gross Profit	$200,000	40.0%

But this relationship tells only part of the story. First, it reflects only the historical picture in terms of absolutes. Second, it will not pointedly answer questions regarding the effect on gross profits with increases or decreases in future sales.

Third, it does not address changes taking place within fixed or variable expenses. For example, if costs go up 10%, 15% or more, how much of a sales increase is necessary to maintain the past level of profits? At what sales level does the company start losing money? What products contribute the most profit? Which contribute the least? What mix of product or services should the company strive for to gain maximum benefit from sales/profits?

A first step is to determine breakeven on a company-wide basis.

…controllable fixed costs would be salaries; advertising and promotion; donations and entertainment expenses; and in the case of ABC Company, show expenses.

…the number of shows attended and the expense of those shows are controllable by management. In this break-even analysis, they will be considered as fixed costs, because some level of trade show involvement is necessary for ABC to stay in business, but the level of involvement is defined by management.

Noncontrollable fixed cost examples are rent, interest, insurance, depreciation, and some utility expense. Variable costs are those that vary with or track with increasing or decreasing sales/production. Examples are commissions paid on sales, raw material costs, direct product or service labor, freight, and amounts of bad debt.

When fixed and variable costs are isolated, they can be related with each other or sales to create ratios, percentages, and break-even sales volume (BSV). The first step is to calculate the Variable Cost percentage (VCP).

$$\frac{\text{Variable Cost}}{\text{Sales}} = \text{VCP}$$

$$\frac{\$1{,}040{,}486}{\$1{,}752.729} = 59.4\% \text{ (VCP)}$$

The second step is to determine the Contribution Margin Ratio.
Sales – Variable Cost % = contribution Margin Ratio

Sales	100%
Variable Cost %	59.4%
Contribution Margin Ratio	40.6%

The third step is to determine **Break-even Sales Volume Break-even Sales Volume.**

$$\frac{\text{Controllable fixed + Noncontrollable fixed costs}}{\text{Contribution Margin Ratio}} = \text{BSV}$$

$$\frac{\$456{,}546 + \$80{,}345}{} = \frac{\$536{,}891}{} = \$1{,}322{,}392 \text{ (BSV)}$$

40.6% 40.6%

Targeting Profit Objectives

When break-even sales have been determined, it becomes relatively easy to estimate a level of sales necessary to meet a certain profit target. For example, we want to attain a 20% return on investment for the ABC Company. Investment in ABC is the net worth of $233,062, as noted in the 1993 balance sheet from Chapter 2. Thus, the profit objective would be $233,062 x .20, which equals $46,612. to calculate sales required to make a profit of 20%, the following formula will be used:

Fixed Cost + Profit Target
Contribution Margin Ratio = Sales Required

$536,891 + 46,612 = $583,503 = $1,437,200
40.6^ 40.6% (Sales Target for 20% ROI)

Commission sales persons are by nature an independent thinking lot, they are independent businesspeople. Break-even analysis can be used to evaluate the cost for a company in providing more and/or can show tangible evidence that more is not possible without added sales goals. Assume that a 5% greater commission payout has been requested.

Variable Cost %	59.4%
Add: Proposed commission Increase	5.0%
Adjusted Variable Cost %	64.4%

Recalculate Contributions Margin Ratio	
Stated at 100%	100.0%
Less: Adjusted Variable Cost %	64.4%
New Contribution Margin Ratio	35.6%

Fixed Costs
New contribution Margin Ratio = New Break-Even Sales

$536,891 = $1,508,121 New Break-Even
35.6% Sales with
5% Higher
Commissions Paid

For ABC to pay %% greater commissions, the breakeven has risen from $1,322,392 to $1,508,121. To maintain the 20% profit margin, the calculation would consider fixed costs at the 20% level, i.e., $5,83,503 ($536,891 = $46,612), versus the pre-commission level of $536,891.

$$\frac{\$583,503}{35.6\%} = \$1,639,053$$

All other considerations equal, ABC must reach $1,639,053 of sales to pay 5% more in commissions and main the 20% profit margin. The difference, $1,639,053 minus $1,437,200, i.e., $201,853, might then be established as a collective target for bonus commission or a condition under which 5% more commission might be considered.

Margin of Safety

The margin-of-safety sales volume is actual sales volume minus the break-even sales volume.

Actual Sales	$1,752,729
Break-Even Sales	-1,322,392
Margin-of-Safety Sales	$ 430,377

$$\frac{\text{Margin of Safety}}{\text{Actual Sales}} = \text{Margin-of-Safety Ratio}$$

$$\frac{\$430,337}{\$1,752,729} = 24.6\% \text{ (MSR)}$$

Product-By-Product Breakeven

If identified sales for product "A" represent 30% of total sales, then perhaps 30% of fixed, variable, and other expenses may be estimated to apply.

Product "A" may produce a 60% gross profit but only represent a small percentage of overall sales, while product "B" may provide only 30% toward gross profit but comprise the lion's share of total sales. The multiple-product-line small-business owner may want to minimally track key and high-volume sales items, particularly when overall margins may be dropping.

	Size A	Size B	Size C
Sales Price Per Unit	$2.40	$4.00	$7.20
Less: variable cost Per Unit	1.68	2.20	3.60
Contribution Margin Per Unit	$ .72	$1.80	$3.60
Contribution Margin Ratio	30.0%	45.0%	50.0%

The obvious would be to concentrate on selling size C, as breakeven requires 40% fewer sales than that of size A. One hundred units of size C equal $720 of sales, while 100 units of size A equal $240 of sales. Unfortunately, the obvious is not always the best case scenario. Size C may represent a bulk size that consumers purchase only occasionally, while size counts may have to be offered, and contribution margins may

drop to levels no greater than those of size A. Therefore, at what stocking levels do we maintain size C, if we choose to stock size C at all?

I quickly learned which lines sold well and which yielded the full retail price. Break-even analysis, combined with customer profile and market awareness, provided information that led to discontinuing all factory-standard colors and offering only custom-mixed colors. Within one year, waste was nearly eliminated, profit margins in the paint department rose by over 8%, and total paint sales volume was not materially affected.

Summary

Shifting from low-quality to high-quality sales, even with sales decreases, can materially increase a company's profit.

Making bold pricing decisions without the aid of break-even analysis can become a disaster waiting too occur.

Forecast Statements

When attempting to forecast remaining sales in any given year, consideration must be given to a number of potential influences.

1. Sales history and sales trends of the specific business. If, for example, the business in a preceding number of years has not achieved more than 5-10% growth per year, how can a forecast increase of 20% or 30% be realistic?

2. Existing business capacity and available work force. Reflect stages of progress toward goals.

3. Financial strength or weakness of the business. …two sets of projects: one that is achievable without financing and one that depicts the effect on performance when financing is added.

4. Product availability. Products and services must be obtainable in sufficient quantity, in a timely fashion, and at a middleman price where volume and profits can reasonably be assured.

5. Effect of competition—both existing and possibly developing. …most smaller businesses have only strategy to defend their position in any given market. The strategies are pricing, quality of product, or service offered. What is your business's edge?

6. Overall conditions of the economy in which the business operates.

7. Conditions of the industry in which specific business is a part.

8. Effect of population growth/restriction on the specific business.

9. Effect of changes in product or service pricing strategy. If products or services are priced too high by the perceived value system of a wide-scale public, and the business owner's perception of their value system is on the blink, they will not sell according to any plan he or she may have developed.

Forecasting Expenses

It is important to bear in mind that cost of goods sold contains only materials, labor, and freight directly associated with manufacturing that product.

Operating Expenses

…which of your expenses are fixed and which are variable in nature.

Variable expenses are those that track directly with or are caused by the movement of sales. Examples of variable expense could be direct manufacturing labor, raw materials purchased, cost of freight, direct sales labor, sales commissions paid, and the incurring of bad debts.

ABC Company Example

Changing the income statement to percentages both helps "flag" items needing attention and identifies items for which changes in practice might have the most impact on profits.

…it is important to understand the significance of what 1% may indicate. For each year in the statement, 1% of sales equals the following dollar amount:

	1991	1992	1993
One Percent Equals	$14,823	$14,955	$17,527

Although cost of sales appears to be returning to 1991 levels, bad debt is up by 1.1% over 1992. In forecasting future expenses, what, if anything, can be done about collection experiences? Is the business making sales that are too risky for collection? Revenue increased in 1993 over 1992 by 17.2%, but commissions decreased by .9%. what caused this to occur? What can be changed in operations to improve current expense.

Salaries and wages have increased at alarming rates. Is this a "luxury" choice or a real need in operations?

Salaries of owners in privately held companies frequently are the most significant variable found in the income statement. Regardless of how the income statement is constructed, whatever is left over after all expenses have been paid belongs to the owner in the form of salary, bonus, and working capital for the business. Viewing the income statement without owner perquisites can be more meaningful in developing forecast years. Owner salaries can be introduced to the statement after all other expense categories are forecast.

During the next 18 months, we will develop a long-range purchasing plan, based on expected sales, whereby we place a guaranteed advance order for one year of raw

materials involving staged, quarterly shipments, each carrying penalties to the supplier when not received by a certain date. This arrangement is acceptable to the various suppliers and has the effect of slightly reducing the cost of bulk-ordered material; it also provides "windows" for the suppliers to produce and ship at slack times and for suppliers to coordinate ABC orders with other manufacturers or vendors, thereby reducing freight expense through use of bulk container shipment.

ABC Company
Income and Loss Statement
As of December 31

Expenses
Salaries & Wages
Payroll Taxes
Advertising & Promotion
Auto & Travel
Bad Debt/collection
Commissions
Contribution/dues
Insurance
Office/Postage
Professional Fees
Rent-Equipment
Repairs/maintenance
Show Expense
Taxes-other
Telephone/Electric
Utilities
Rent Expense
Misc. Expense
    Owner salary
    Payroll Tax
    Depreciation
    Officer Life Ins.
    Director Fees
    Interest Expense
Total Expenses

Other Income
Income Taxes

Net Income

Balance sheet Statements

Increased sales cause the need for increased assets. Accounts receivables, cash, and inventory are good examples of variable assets, those that increase or decrease with sales.

Increased assets cause increased liabilities. For example, accounts receivable and inventory, as they rise, require funding through accumulated working capital, short-term loans, or accounts payables and, subsequently, become variable liabilities.

When the sales forecasts are completed, the next step is to determine what level of assets and liabilities will be required to support sales. This is accomplished through analysis of the percentage relationship that sales have to both variable assets and liabilities. Once again, we look to the past to predict the future need. The start-up company must look to industry and competitor standards as a reference guide in making actual cash outlays or incurring debt.

…it is highly unlikely that the owner of ABC Company would permit the corporation tax consequences suggested by significant net incomes in the previous income statements. Let’s assume that a bonus or salary increase to the owner will be paid in accordance with some degree of realism, similar to past practices of ABC.

Income and Loss Statement

Balance sheet

Applying each forecast year percentage to each forecast year sales, this statement can now be translated into a forecast balance sheet.

As it turns out, we will have to reduce note-bank and/or note-owner to reconcile the balance sheet.

Cash-short conditions can be estimated through application of the following formula.

…let’s use actual sales of $250,000 and a sales forecast of $400,000 in an example. Let’s assume variable assets of $124,000 and variable liabilities of $56,000 in the forecast balance sheet; $16,000 will represent net income.

Variable Assets / Sales	x	Sales Increase	-	Variable Liabilities / Sales	x	Sales Increase	-	Net Income	=	New Debt
$124,000 / $400,000	x	$15,0,000	-	$56,000 / $450,000	x	$150,000	-	$16,000	=	New Debt

[(31.0%) ($150,000)] – {14.0%) ($150,000)] - $16,000 = New Debt

$46,500 - $21,000 - $16,000 = $9,500 New Debt

The sales forecast of $400,000 is to be met, the company will need $46,000 of new assets, incur liabilities of $21,000, and require $9,500 of new debt. Forecasting debt requirements in advance of need reduces last minute or crisis borrowing situations. Carrying the forecast three to five years into the future helps determine whether short or long-term borrowing will be required.

Good financial management cannot be replaced with intuition and hope-I-can-do attitudes. Successful entrepreneurs must know where they stand in the present and in the future, or personal goals will certainly not be achieved with any regularity. The process of applying financial tools becomes easier with practice and time.

The Cash Budgeting Process

The monthly sales history exhibits the following pattern in occurrence:

	Historical Experience	Forecast 1994	Forecast 1995	Forecast 1996
Jan	4.01%			
Feb	9.08			
Mar	15.08			
Apr	19.058			
May	5.26			
Jun	4.41			
Jul	4.69			
Aug	6.83			
Sept	9.83			
Oct	12.08			
Nov	4.08			
Dec	4.35			
Totals	100.00%			

From the forecast balance, accounts receivables are $249,920. forecast sales for this same period are $1,760,000

Accounts Receivable Turnover = Sales = 1,760,000 = 7.04 Turns

A/R Collection Period = $\frac{365}{\text{A/R Turns}}$ $\frac{365}{7.04}$ = 51.8 days

We could dig into past sales, receivables, and payables accounts; determine precise individual receipt or payment history by month; and then develop more exacting percentages to be used in projected income statements.

A more practical approach, and one that may already be done, is to compile monthly profit and loss (P & L) statements.

Much less work is involved when sales are made with an immediate or 30 day cash payment plan and when materials are paid for within 30 days.

Monthly Income and Loss Statement—1994

	Jan	Feb	mar	Apr	May	June	Jul	Aug	Sep…
Net Sales									
Cost of Sales									
Gross Profit									
Expenses									
Salaries/Wages									
Payroll Taxes									
Aver/Promo									
Auto/Travel									
Bad Debt									
Commissions									
Contrib./dues									
Insurance									
Office/postage									
Prof. Fees									
Rent—Equip.									
Repairs/Main									
Show Expense									
Taxes—Other									
Tele/electric									
Utilities									
Rent Expense									
Misc Expense									
Office Life Ins.									
Interest Expense									
Total Expense									
Other Income									
Net Income before Tax									
Income Taxes									
Net Income									

Capital Budgeting

A cardinal rule of business is that to become and remain profitable, the business must pay for itself out of cash flow, within a reasonable amount of time. If used equipment fits the

overall bill, then purchase used equipment. Bells and whistles have no useful place in the business environment without capital investment justification.

Capital budgeting is simply the long-term planning for replacement of old inefficient equipment and/or additional or physical plant when growing business conditions warrant.

A decision to purchase a particular machine, or to purchase must be based in fact and provide satisfactory business-related answers to two fundamental questions. How much will be saved in terms of production costs, or what additional income can be generated through this purchase?

Equipment or facility purchase decisions require the balancing of a need for profit against cost to attain.

Repair costs during the past year amounted to $2,000. In downtime, four production days were lost, which idled $800 in labor. A replacement model will save one man-day of labor or $400 in each quarter of a year. Total annual savings of $3,200 through purchase could, theoretically, be attained. Cost of the replacement model is discovered to be $10,000, with a useful life expectancy of six years. Salvage value is estimated by the manufacturer to be 10%, or $1,000.

Does it make business sense to pay $10,000 to receive $3,200 for a period of six years?

…replacement can be planned in advance and timed with periods of increased business cash flow.

The successful entrepreneur overrides fears of the unknown and plans for the future so that he or she can appropriately handle future events through anticipation. It is simply better to be somewhat prepared than not prepared at all.

As individuals, we are filled with suspicious…

Often, a business without planning does not perceive the need for change until it is upon them and possibly too late for adequate response.

Rarely does anyone have enough time to do all that they want to do. Only when we schedule what we need to do will tasks get accomplished. When people get anything done effectively, it is because they have succeeded at planning, preparing, and implementing what they wanted to do. When they fair, it is usually because they have tripped over self-imposed obstacles of optimism, pessimism, procrastination, excuses for lack of time, job too big or too small, failure to prepare, and not being focused.

Perhaps the primary reason for not planning is inexperience with the concept.

It is through education and experience that we learn to plan actions that foster the achievement of some future event.

1. Yes, say the experts—if you know how to and do use them.
2. Studies show that companies that set goals, determine priorities, and develop plans to attain them consistently outperform companies that make decisions informally.
3. Most firms with a sales volume of five million dollars and above cannot now avoid establishing the direction of company growth for many years ahead.
4. studies further indicate that businesses are more apt to fail where there was the following:
    - A. Failure to provide sufficient time to thinking ahead on management problems.
    - B. Failure to plan adequately.
    - C. Failure to understand fundamental operating and financial relationships.

For example, if I presently earn $30,000 per year and want to earn $80,000 per year by the end of three years, what must I do with my company to meet this objective? A difference of $50,000 is what I must accomplish in just three years, which is a 267% increase! Stated another way, I must increase my personal earnings by $16,667 in each of the three years. Examination of my company's historical and future variables, when compared with my own capability, will confirm or negate the likelihood for achieving the personal goal with this specific company.

How to Deal with Banks

For significant loans to be granted by financial institutions, your business must show how these loans can be paid back out of business cash flow.

Bankers customarily seek three sources of repayment. They expect repayment of loans from cash flow of the business but usually require security for the unpaid principal in the form of pledged collateral.

Also they require personal guarantees from business owners., the personal endorsement represents a psychological commitment by the owner to make a success of his or her business. If a loan fails, the bank will seek to recover their money through disposal of pledged collateral.

Banks, in reviewing loan applications, make lending decisions based on the 5 Cs of credit: character, capacity, capital, collateral, and conditions. If an applicant's character and trust are in question, the bank will not work with them. Capacity relates to a business's financial strength and track record. How much of your own personal capital is invested in the business plays into the evaluation as well. Banks are more apt to welcome you as a customer when there is a 70% loan to appraised collateral ratio. How the local and national economy affects business conditions will also be considered. Securing a commercial or business loan requires salesmanship and educating the bank.

Think of their money as you would your product or service.

When you do accept business that seems a bit risky, what are the prevailing features and benefits that caused you to take that risk with a customer?

Financial institutions require logical, explainable, and tangible evidence that their product, money, can be returned at a profit, interest. It is the responsibility of the business owner or manager, not the bank, to prove within reason that such can be achieved. This proof is traditionally spelled out in a business plan.

Discovery

…the process of review is called DISCOVERY.

Discover what make your specific business worth lending sums of money. Do you serve a unique or niche marketplace? What products or services are most profitable and why? What are you doing to increase sales of these more profitable items? Is growth sustainable for these items, and why do you believe this is true? What influences will competition have on future sales? What influence has competition played in past sales or profit? What industry or legislative changes do you foresee? Which of these changes will affect you the most and/or least? Why and how will your business survive into the future? Where in your financial can you support this belief? Concentrate on your strengths while writing the business plan!

Improve upon weaknesses and capitalize on strengths.

A financial institution is at a disadvantage concerning information on your business. You are the chief supplier of information.

Discovery through research and documentation supported by fact substantially increase information believability. The English philosopher Thomas Hobbes wrote in his Leviathan: "The best prophet naturally is the best guesser, and the best guesser (is) he that is most versed and studied in the matters he guesses at, for (it) is he (that) has the most signs to guess by."

Dialogue in the business plan must be about you and your business.

Dialogue must include assessment of you, the business, its customers, it suppliers, its creditors, its competition or industry, and its future. Dialogue must be convincingly supported by fact and/or educated guesses into the future, called forecasts.

For the newly formed business or start-up, the task of discovery lies in research of what has been done by others.

Contrary to some negative belief, bankers are actually looking for reasons to grant a loan. Money is their inventory, and just as with your business, the bank cannot make a profit if this inventory is not sold in the form of loans. Good bankers are major assets to most businesses.

The obligation and responsibility of businesspeople is to prove the need and to prove the payback.

While the science form of mathematics is precise, the manipulative science form of statistics is not. Irrespective of the precision found in the science of mathematics to solve for unknowns, man created from a disciplined imperium a vaguer new science called statistics, to solve for variables and unknowns.

…we can safely conclude that there is vagueness in the artistic portion, preciseness in the math portion, and variableness in the statistics portion of business valuation.

"The determining of the value of anything, determined or estimated value."

In a free economy, estimated value, therefore, equals perceived value in the eyes of the beholder.

Smaller business is defined herein as any business where all principal decisions are made exclusively by owners who control all or the vast majority of the ownership. This definition also includes businesses where major decision making is essentially an individual process, and checks and balances rest also within that same individual.

When an owner of a smaller business wants to know what the market value of his or her business might be, the purpose or use of the ultimate answer must be determined first. If a sale to an unrelated party is contemplated, then the answer given might be twofold: asset/income value is estimated at A, and market value is estimated at Y. If a sale is contemplated to a related party, the ultimate answer might be somewhere between A and Y, recognizing some related involvement. If the purpose is for insurance, inheritance, or partnership reasons, the value may not resemble either A or Y but become A-/+ or Y-/+. Answers to the estimated value of any business are variable but can be refined by purpose and knowledge of the marketplace involving the specific business. Actual value can only be determined by completed arms-length transactions.

Dilemma Presented by Methods or Formulas

What is important is that estimated value itself be accurately reflected in and by the realism of purpose as well as the marketplace in which a particular business exists.

Recalling the statistical fact that 80% of all small businesses fail within their first ten years should be reason enough to question the product of any method that evaluates value in the context of earnings five, six, or ten years out.

People buy because they expect to earn from future value, but in the smaller business, that future value belongs to the future owner.

What Is Being Sold?

Buyers are rarely willing to pay more than 20-30% of the purchase in cash. Few buyers, if any, are willing to make up the entire spread between bank financing and purchase

price in cash. With this precept in mind, it appears likely that the seller may have to hold some part of the sale price in a second mortgage position.

Income Analysis

The financial management of the privately owned business is often to minimize the tax implications of the bottom line, whereas the financial management of public companies is to provide profit for stockholders.

Items for Reconstruction

1. An owner's personal consumption of business products or services offered can affect cost of goods sold, sales, and gross profits.
2. Auto and travel expense might be of trivial amounts or may contain significant expenditures for personal enjoyment.
3. Commission expense contained approximately 50% paid to a related party.
4. Insurance expense contained an item for $350 per month of health care insurance for the owner.
5. Professional fees, repairs, maintenance, telephone, utility, and miscellaneous expenses are notorious for containing personally used items.
6. Owner's salary and payroll tax are often the most significant variable to the bottom line in private companies.
7. Depreciation is a product of original prices paid by an owner.
8. Officer life insurance carried on an owner by a privately owned company can frequently be extraordinary in its face value amount.
9. Director fees paid are more apt to be found in the larger-sized company, but they are uncommonly paid in companies the size of ABC.
10. Interest expense is a product of the present company's debt structure.
11. Rent expense must thoroughly examined for conditions of business owner involvement.
12. Property taxes will occasionally include personal property taxes of owner's residences.
13. Retirement plan expenses of $19,324 during 1993 were found to be substantially available only to the owner and members of the family.

Intangible Business Value

The IRS roughly defines intangible value, or goodwill, as that amount paid for a business in excess of the market value of hard assets.

How much business value is directly attributable to a "person," and how much of that value will remain if he or she leaves?

A "business continuation" risk tends to decrease with increasing size of staff and, when the present owner is more separated from practice work, by the demands of administrative duty.

Service businesses in general, unless cash flow is quite substantial, tend rarely to command a net multiplier greater than 3.0. Many will fall below 2.5.

Most small businesses will fall in the net multiplier range between 2.0 and 5.0. These are the mainstay small operations in America—restaurants, grocery stores, retail operations, small wholesalers, small manufacturers, and also many service businesses.

…a low asset value might then bring a higher net multiplier range. Quite often this assumption turns out to be true. However, the element of cash flow, frequently a reason for purchase, would then be ignored. In choosing an intangible net multiplier, one must clearly decide what part of value is tangible (hard assets) and what part of value is intangible (goodwill, as defined by the IRS).

For the nearly 30 years I have wrestled with the question, What is business value?, and to this day, assignment of intangible value in small business remains the more perplexing task. There simply is no “pat” answer or formula.

If I have learned one common essential, it would be “exercise caution” in assigning intangible value and throughout the whole process.

The Valuation Exercise

Typical Business	Net Multiplier	One Or More Considerations
Professional services, i.e.,	1.0-1.9	* Earnings related flat
Physician, dentist, attorney		* Dependent upon skill of owner
Accountant, optometrist,		* Fierce competition
Architect, engineer, chiropractor,		* Labor versus capital intense
Veterinarian, real estate,		* Low hard assets
Insurance, etc.		* Start-up requires minimum
		Capital outlay
Other services, i.e., advertising	2.0-3.5	* Average growth of earnings
Funeral, entertainment, laundry,		* Skill of owner important but
Transportation hauling, printing		* replaceable with short-term
Restaurant, janitorial, beauty		training
Salon, travel employment		*Expected amount of competition
Agency, leasing services, etc.		
Contractors, i.e., general		*Labor/capital intenseness mixed
Electrical, plumbing and A/C,		
Painting, masonry, etc.		*Modest investment in hard
Retail, i.e, computer equipment		Assets in relationship to cash
fuel, oil, gift, video, stereo		Stream
Office supply, drug, general merchandise, food		*Start-up requires larger cash
Beverage, liquor, florists, jewelry, sporting		position and larger amounts of
Goods, floor covering, hardware, auto, etc.		working capital
Wholesale, i.e., building materials and supplies		*Significant growth of earnings
Food/beverage, auto supplies, electrical	3.6-5.0	*Skill factor more removed in
And plumbing supplies, etc.		administration versus “hands

		On high degree of transferability
Manufacturing, leased facilities and modest Equipment investment		*Virtually no competition * Asset base high, requiring large initial cash outlay
Services, i.e., motel, nursing home, parent bank Parent insurance, hospital, etc.		*Predictable growth or stability of earnings
Retail and manufacturing owned	5.1-8.0	*Operating skills transferable with educational and/or minimal training *Expected degree of competition *Real estate and capital equipment intense * Start-up almost cost prohibitive

Figure 2. Guide to selecting net multipliers.

Return on Equity = $168,825 = 84.4%
Down payment $200,000

Return on Total Investment:

Net Operating Income = $108,10 = 10.6%
Total Investment $1,021,299

Pretax Return on Total Investment:

NOI + Tax = $108,108 + $41,661 = $149,769 = 14.7%
Total Investment $1,021,299 $1,021,299

Prospective Buyer Cash Flow

Seller's Potential Cash Benefit

The myth that sellers can receive all of their deal in cash is, in fact, just a myth! In today's banking climate, as a seller, you can count on financing some portion of your sale. The net result of not doing so more or less translates into a reduced selling price.

…if a seller wants his or her price, then be prepared to offer financing. Buyers and their advisors want to see a portion of owner financing in the deal. Owner financing exhibits confidence that the owner's price is fair and reflects honesty by the owner that information is truthfully provided.

The secret to wealth building is to risk intelligently and to apply common sense.

Business Is Priced Fairly If:	Results of ABC Company:
1. Average reconstructed profits From several years is used to establish Value.	1. Three years used.
2. There is at least 10% sales growth per Year	2. Essentially flat until 1993.
3. Asking price is not greater than 150% of net worth (except where reconstructed profits are 40% of asking Price).	3. Asking price is 258% of net worth. Reconstructed profits are 25.6% of asking price.
4. Annual reconstructed profits are at least 25% of asking price	4. 25.6%
5. Down payment is approximately the amount of one year's reconstructed Profit.	5. Reconstructed profit equals $261,234, and and down payment, $200,000.
6. Terms of payment of balance of purchase price (including interest should not exceed 40% of annual reconstructed profit.	6. Reconstructed profit equals $261,234 and P&I payments equal $91,872, or 35.2%
7. Cash flow analysis provides for debt Coverage, comparable worth owner/ Manager salary, and return on investment	7. At average or slightly above.
8. Return on investment of at least 25%	8. 10.6%
9. Return on equity of at least 20%.	9. 84.4%

Summary

Henry M. Boettinger, author of Moving Mountains, wrote, "People seldom buy an idea without buying its author in the process. When they sense that they are treated as equals, all working together in the search for the right course of action, they eagerly join in discussion with good will, even if your idea is repellent.

Successful valuation lies somewhere between understanding the thought processes of humans, and in being mindful of an old saying, "When we get lost in numbers, things just don't always add up." Estimation of value, however, sets the stage and becomes a benchmark for negotiation.

Cost Accounting Systems

…cost accounting is actually no more than an extension of regular accounting. The profit and loss statement is actually cost accounting for a period of time involving the whole company. It is when consolidated statements fair to tell us all that we need to know about elements of the company that cost accounting performed on divisions, product lines, or single products can be particularly useful. Therefore, cost accounting objectives are to break down the summarized profit and loss activity into units to which cost can be assigned.

…it is nearly impossible to precisely measure the cost of anything.

"The search for fact is never lost, or never won—only fought for."

A Job Order Cost Process

Individual job order cost sheets should be developed to be used for each job or product. With a clear understanding of job costs, these data can be transferred into developing more accurate job estimating worksheets to create standards of price or cost.

Why Business Are For Sale—and Who Plays What Role

Often foremost in generic recommendations for selling a business is the owner who wishes to retire or has no succession of management in place.

…the average business for sale becomes available due to a current owner's inability to secure adequate returns.

…sellers generally fall into two categories:

1. Investment ownership: Ownership is purely financial in nature, i.e., individuals, venture capital, institutional, etc.
2. Management ownership: Ownership is both financial and operational.

Owners As Sellers

There are perhaps as many reasons for selling a business as there are owners waiting to sell…and money is not always the final consideration in selecting a buyer. Business necessity and psychological requirement, which are difficult but necessary to identify.

Business necessity is typically satisfied at the moment of sale, and regardless of the explanation, it almost always involves a need for cash to displace the problematic situation that is occurring.

1. Dissension among owners:

    a. Partners
    b. New partnerships

Dissension does not occur overnight; therefore a thorough understanding of the differences need to be explored.

2. Personal diversification:
3. Narrow product line:
4. Death in family:
5. Automation:

Some owners are unable or unwilling to make the transition.

6. complexity of business: The nature of doing business is increasingly more complex, and some owners are forced to engage costly outside professional help.
7. Vertical integration:
8. Squeeze on working capital:

Cash requirements to operate an expanding business become the leads, and cash from sales become the lags. The funding of expansion must come from profits, from borrowing, or from personal "tills," and the collection of receivables involving terms just never seems to be enough to cover all of the needs during significant growth.

9. **Lack of management succession: Owners of the smaller firm often do not plan for their eventual retirement. Habit often drives them to remain with their business beyond levels of enthusiastic support, and the business may experience serious contraction along with their own faltering desire. It is where the owner makes early identification of retirement that some of the most viable acquisition candidates are presented. Requirements for significant cash at closing are less evident, and an attractively financed purchase can often be negotiated. Some owners actually enjoy the status of maintaining an office and continued involvement in activities of the company. Trade-offs might be achieved in purchase price and terms, through some definitive role for the previous owner. Roles must be well defined and adhered to, or these arrangements can turn sour with time.**

1. Personal goals are often the reason for sale, not the least of which is money.
2. Perhaps a seller will have concerns he or she wishes to be respected after the sale is consummated.
3. There are times that a seller may want assurance that selected employees or customers are treated in certain ways.
4. A need for more security in terms of retirement, health, life, vacation, and various other employee group plans.
5. A need to stabilize earnings.
6. A desire to earn more than the smaller business provides.
7. 7. A regret for leaving the corporate environment and need for group acceptance.
8. A change in education or career direction.
9. A divorce or marriage.
10. Loss of family members, and wane in interest.

There will always be underlying psychological reasons for the sale, which tend to be unique with each individual seller.

No matter how valid are the business or personal considerations, the act of selling is a momentous decision for an owner. It is filled with agonizing uncertainties and personal stress. Success in the competitive buying arena demands that a purchaser be quick to grasp both financial and psychological motivations. A show of willingness and cooperation will go a long way toward convincing a seller that a buyer's eventual purchase will give him peace of mind.

In any event, some or all of the following should be a part of sound evaluation criteria:

About Value in Business

Any price paid for a business is fair as long as the business pays for itself in a reasonable period of time. Minimally, the business should provide for the following:

1. Interest on down payment equal to or greater than what is currently received or available from capital when placed in other, perhaps safer investments.
2. Salary for operating the business that is at least equal to the cost of hiring an outside manager to do the specific job required.
3. Business must pay for itself out of earnings over a reasonable period of time. Depending upon the circumstance, reasonable can be as short as three to five years or as much as ten or more years. Terms of purchase dictate much in the establishment of time required.
4. Prospect for growth.
5. Prospect for continued and growing profit.

What is being Purchased

Elements of sale can include some or all of the following:

1. Facilities:

   a. Real estate to be purchased will often require appraisal if it is to be pledged as collateral. Regardless of how taxes are allocated, the fair market value should be completely understood.
   b. Leased facilities can present a series of problems through their immediate transferability and in their long-term use. Seeking legal advice prior to contract is always advisable for any type of buyer. The purchased lease must minimally provide 5-7 years or more of uninterrupted use.

2. Furniture, fixture, and equipment: These items present various degrees of difficulty in establishing their value, particularly due to the “stand-alone” value versus the theoretical “in-service” value sometimes applied. Institutional banking will seldom recognize more than a part of their stand-alone value. Qualified appraisers can often shed light on condition and remaining useful life. Occasionally, they can provide insight to available parts and service as well. There are instruments for a fairly wide array of production equipment that can predict wear-related failure, and these tests may be worthwhile consideration for evaluation of critical assets.
3. Vehicles: Blue book values can easily be obtained. It is advisable to consider buying a mechanical assessment, especially where this asset is sizable in the purchase price or where vehicles are significant to operating the business.
4. Inventory: Special care needs to be exercised when evaluating the condition and value of inventory. Rare is the business that maintains only saleable stock. Human errors in orders or misjudgments in markets do occur. Inappropriate inventory at high levels not only can indicate opportunities for improving profits

but also may signal that the business is out of control. It is inadvisable to purchase the mistakes of another and compound those we may make of our own.

5. Work in Process: An item combining inventory, labor, manufacturing, and administrative overhead costs. Without their purchase, a business might fail to meet promised delivery schedules. Their value is found in examining an accounting process and where a buyer may find it extremely useful to engage professional assistance to review.
6. Customer deposits: Tied to some stage of work-in-progress, these need to be transferred along with new ownership. Inventory work-in-progress, and customer deposits require integrated analysis that often is best performed in conjunction with the buyer's financial advisor.
7. Customer lists: These are a necessary item to the continuing success of a business. However, their value is difficult to establish with any degree of certainty. Institutional financing can rarely be obtained.
8. Covenant not to compete: This element is an important feature in all sales. While a retiring owner may indicate no continuing interest in the business of the company, he or she nevertheless possess proprietary information that could ultimately put the newly acquired company at risk. Ask for and expect noncompetitive agreements, but recognize that they must be reasonable in order to be enforced. An attorney can provide the appropriately structured agreement.
9. Patents, copyrights, and trademarks: These might represent the essence of business continuity and, where existing, should be examined by appropriate legal professionals.
10. Office and shop supplies: Rarely more than a small part of the overall deal, they can represent annoyance and distraction when concentration on more important matters is required.
11. Transferable franchise agreements or territorial licenses: When existing, these form an integral part of authority to conduct business. Appropriate legal advice is always indicated.
12. Service contracts: Examine closely for expected costs to maintain these contractual agreements. In certain companies, these can represent significant "future" obligations that may not have been factored into the purchase price. When service contract obligations are significant, their estimated cost to uphold must be considered in pricing a business.
13. Employment contracts: Examine the cost and consequences of these agreements. Check for "golden parachute" clauses that a previous owner may have included to reward past service of an employee or to gain a cooperation during the sale process. Unless you can find future benefit for these promises, then you may be buying a pig in a poke.
14. Accounts receivables: The best for last is advised to be first on the list. Accounts receivables often represent a major element of working capital. Strongly consider purchasing the " deemed collectible" portion of this liquid asset. Negotiate the remainder with a seller, including his warranty of those that may be in question. Although institutional financing is available for at least some part of receivables, it is usually beneficial long term to keep this out of pledged collateral for the basic loan. Receivables can sometimes be "factored" for quicker returns of operating

cash. The penalty for this action can include significant discounts from amounts due, thereby impacting the quantity of profit.

History in Prologue

The here and now is how to buy, but the future for the business must hold appropriate promise for a steadily increasing value.

Troublesome Mistakes Buyers Often Make In Purchasing Businesses

1. Fails to establish "personal need criteria." Establish a list of personal and family requirements.
2. Becomes overanxious…Do not overestimate your own skills.
3. Fails to allocate time for "discovery" and information verification.
4. Inadequate assessment of business needs.
5. Fails to view cash flow in pessimistic and optimistic light.
6. Fails to assess and deal with key personnel and customers. Remove this person and a tendency to remove the business occurs. Decide which skills you lack, and develop a plan… There is the risk that employees and customers will not react adequately to the new owner.
7. Fails to evaluate the effect of competition on the marketplace.
8. Fails to consider purchasing receivables. Receivables frequently represent a major part of a company's working capital. Sellers will often expect to remove receivables and other liquid assets at the time of sale.

Purchasing business receivables can be an important source of secondary financing and should not be casually overlooked.

9. Fails to negotiate "achievable" payout. Rather blunt but to the point, acceptance of unrealistic payout schedules almost certainly will force the buyer into bankruptcy proceedings.

Bear in mind that any price ultimately paid for a business is fair, but only as long as existing cash flow will pay for the purchase over a reasonable length of time. (This is the golden rule of business purchase). Only giants such as Fortune 500 companies have reasonable assurance of continuity of business. Smaller companies, including those with sales as high as $50 million, are at risk and have little or no guiding control of the market economy outside their enterprises. Pricing and buying a business, other than giants, on future earnings is an incredibly risky and adventuresome purchase decision.

10. Fails to consider alternatives for financing.
11. Fails to make proper use of professionals.
12. Depends too heavily on others in forming a business plan.
    a. The buyer is forced into thinking, really thinking, about the planned purchase.
    b. The buyer is compelled to look hard at what needs to be accomplished, considering his personal skills in the process.
    c. The act of working and reworking the numbers can be very revealing.

Preparation for Sale of a Going Concern

…management the business as if it is always for sale. …decide to always maintain "paper trails" for each and every financial transaction.

A cardinal rule that nearly always confronts sellers is that you "can't sell what can't be proven beyond a reasonable doubt." "If those numbers he claims existed, did exist, then the seller has already received a large part of the sale. I'm not going to pay for it again."

If I took my profits out through not reporting revenue or through inflating expenses, then I have enjoyed a large portion of yield already. I may have "crippled" my financial statements to the extent that both value and financing capability for a new buyer are no longer there to support a high sale.

Think about what has just been reflected. Think about the likelihood that a ready, willing, and able buyer may approach your business today or at any time. Do financial statements reflect an accurate picture of business health at all times? Can a legitimate paper trail for actions taken to reduce taxes on business activity be provided?

Whether one plans for sale at the time of purchase or later during ownership, the plan for a sale must be well in advance of actual marketing activity.

Impulsive decisions to sell one's business will cost hard earned dollars, unless the plan to sell was initiated well in the past.

The Process of Selling a Business

1. Start with attitude. Assume that the business will never sale, and keep operating as if that fact is true.
2. Allow plenty of time. It takes an inordinate amount of time to sell a company.
    a. Gather together at least the past three years' tax filing. Anticipate the questions by prospective buyers. Put on the buyer's hat. Be prepared to inundate the prospective buyer with explainable financial information.
    b. Establish a fair market price for the business.
    c. **Write a job description of owner duties being performed. Highlight the top one or two skills most required. Outline which skills might be desired to carry the business to a next level. Describe elements that you as the owner might wish had been handled differently.**
    d. **Write a brief but thorough history of the company. Include information about previous owner operation and changes currently accomplished.**
    e. Decide how marketing the business will be accomplished.
3. Prepare the "plan" for selling the business. View the sale as an investment. Your sale is an investment in your own future. Identify those attributes about yourself that you feel will be necessary for a new owner to win in your business. Put these characteristics down on paper, bearing in mind that you will most likely be expected to finance a portion of your sale. With this picture of your ideal purchase candidate, you will be amply prepared to screen prospects for the

business. Be sure that you understand what you are selling before you offer the business for sale. Establish a price for the business that is in line with the market.

…is merit in viewing your business as if it were merchandise on a shelf.

4. Enlist professional help where required. Be sure that each element is understood before contract and sale. Inform the accountant and lawyer as early as possible of your pending decision. Ask them to join you in selecting a finder or broker, if you choose to go this route.

Trust not your ultimate decisions to anyone else but yourself. An old saying states, "The only person that you will never lose is yourself."

5. Prepare a "confidential" offering document on the company. Include such items as company history, industry trends, survey of competition, survey of production facilities, list of furniture, fixture and equipment by age and condition, marketing strengths and weaknesses along with ideas for improvement, past financial statements (reconstructed for extraordinary and personal expense items), a possible forecast statement for a new owner, attribution of purchase price (all with supporting rationale), and a disclaimer statement that cautions the prospective buyer to conduct further discovery. Add photos of various elements of the business.

8. "Fairness" reduces risk. Out-of-balance transactions tend to put all parties at risk. "Bulls and bears make money, but the hogs don't."
9. Be open, and listen to alternative methods of purchase. Try to stay open-minded, until the proposal fully unfolds.
10. Seek compromise. Successful sales of companies involve a fair amount of give and take during negotiations.

Troublesome Mistakes Owners Can Make in Selling

1. Overpriced.
2. Poor timing of sale. The best time to maximize the selling price is when business is good and when the operation is growing.
3. Unrealistic down payment demand.
4. Wants two dollars for one dollar of collateral.
5. Payout period to amortize debt. Could the seller make forecast monthly payments out of the cash flow of his or her business? Would the seller be able to "survive" on his or her own cash flow and still have enough reserve for emergencies? An intelligent buyer will require the purchase to be self-sustaining, on its own financial merits.
6. Wants to have their cake and eat it too.
7. Auction to the highest bidder.
8. Inadequate records.
9. Targets a "dream" market.
10. Understates business requirements for a new owner.

11. Each proposed deal must be viewed on individual merit and not on deals will be right for both parties.
12. Unmanaged use of professionals
13. Bilked by a "smoothie." Look beyond the individual to see if there are both ability and security behind the buyer. Evaluate your investment in the buyer.
14. The best way to avoid surprises is to make all appropriate information available to a qualified buyer in advance.

"If you rely just on 'thinking big', all you'll ever be is a big thinker." David J. Schwartz, "The Magic of Thinking Big"

"Every bit of human progress…our inventions big and little, our medical discoveries, our engineering triumphs, our business successes…were first visualized before they became realities." David J. Schwartz

"People don't care how much you know about them once they realize how much you care about them."

"Show the way to others and you'll discover the way yourself."

22 "Jump-Start" Thoughts about Buying or Selling a Business

1. Purchasing a job.
2. Increase personal wealth.
3. Independence.
4. Family employment.
5. Boredom.
6. Lost cause.
7. Vertical integration.
8. Diversification.
9. Eliminate duplication in a shrinking market.
10. Reduce marketing and distribution expense.
11. **Market penetration**
12. Retirement
13. Tax reasons.
14. Leverage.
15. Improved capital position.
16. Investment
17. Optimistic adventure.
18. Competitive advantage and growth.
19. Ease and cost of entry.
20. Consolidating R&D facilities
21. Technology.
22. The American dream

Even the Blazing sun can't burn a hole through paper, unless its rays are concentrated on one spot."

…if your sights are set far above the merely secure and mediocre."

"People seldom buy an idea without buying its author in the process. When they sense that they are treated as equals, all working together in the search for the right course of actions, they eagerly join in discussion with good will, even if your idea is repellent." Henry M. Boettinger

The meeting of two personalities is like the contact of two chemical substances: If there is any reaction, both are transformed." C.G. Jung

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