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Handbook of small business Finance (1961)

Ralph B. Tower

United States. Small Business Administration

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SMALL BUSINESS MANAGEMENT SERIES NO. 15 (Fifth Edition)

A Handbook of
Small Business
FINANCE

By Ralph B. Tower
Professor of Economics and Finance
West Virginia University

Revised by staff members of
the Small Business Administration

SMALL BUSINESS ADMINISTRATION
WASHINGTON, D.C., 1961



SMALL BUSINESS ADMINISTRATION

JOHN E. HORNE, *Administrator*

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Foreword to the Fifth Edition

The subject-matter of this fifth edition of *A Handbook of Small Business Finance* is basic to the economic well-being of small as well as large business. Undoubtedly, this fact is one of the reasons for the continuing popularity of this booklet which, in this respect, has thus far outdistanced all others in the series.

The need for good financial management begins with the birth of a small business and continues forever with increasing complexity. The present text makes no pretense at complete coverage of the complexities. All it sets out to do is to inform its readers concerning some of the basic concepts and, in this way, help them to avoid some of the pitfalls which may be encountered in handling their business finances. In so doing, this fifth edition has been revised to reflect recent changes in Federal legislation in the field of small business and to update some of the material which appeared in previous editions. This new edition is offered to small business owners and managers with the expectation that its future usefulness and popularity will match its past record.

For balanced perspective, it is worth keeping in mind the fact that financing is only one of many aspects of management. And financing is often complicated by problems arising from poor judgment or inexperience in controlling inventories, extending credit, buying raw materials, estimating markets, and other aspects of management.

The objective of *A Handbook of Small Business Finance* is not to cover all phases of the subject. Nor is it to provide an exhaustive treatment of any one topic. Rather, it is to furnish new owners and inexperienced managers with basic information to help them understand better the financial operations of their businesses. As such, this booklet should aid small business owners and managers in making better use of the financial assistance available to them—particularly from local banks—and guide them in measuring the progress of their operations.

No business can be conducted successfully just from books. They are seldom adequate substitutes for experience, or for firsthand advice and guidance from specialists. Nevertheless, handbooks like this do contain useful ideas through which small firm owners and managers can enlarge their knowledge of the best methods and practices in business finance. For that reason, it has been gratifying to see this volume used not only by small concerns themselves, but also by banks, educators, and advisory organizations. It is to be regretted that the author, Dr. Ralph B. Tower did not live to see this continuing success of his work.

Statistical records of small business failures show that inexperienced management is often much more fundamental than lack of financial resources. This is not true in all cases, of course, or under all circumstances. But it is precisely for this reason that, in the legislation creating the Small Business Administration, the Congress provided that technical and management assistance be furnished for small business concerns. As a partial result of that Congressional intent, this booklet and 26 others in this Series have been prepared.

JOHN E. HORNE,
Administrator, Small Business Administration.

OCTOBER 1961

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CHAPTER I

Financial Statements

Contents of the balance sheet—Assets—Liabilities and net worth—Description of asset accounts—Description of liability accounts—Form of balance sheet—Simple balance sheet—Valuation accounts—The 100 percent size statement—The income statement—The comparative income statement

Your financial statements may be used in a number of ways. They are the basis for financial analysis, but financial analysis in turn is a means toward the attainment of definite business objectives. Statements are useful in helping your banker in arriving at his loan decisions. Well-drawn statements that can be given a favorable interpretation will improve your borrowing prospects. If you are prepared to explain or defend items that appear in the statements, the banker will have a better opinion of your managerial ability than otherwise.

State and Federal laws in such areas as financing and taxation frequently make it necessary for the small businessman to submit financial statements in support of requests or claims. And, of course, the small-business man should be able to read his financial statements as a part of his management program. Only through effective financial analysis can you detect elements of weakness in your financial policies and take necessary measures to correct them.

Most small business executives are not accountants, but it is unnecessary to possess the skills of an accountant to learn the meaning of the items that are found in the statements of small concerns or to interpret such statements.

There are two principal statements: The balance sheet; the income statement.

Contents of the balance sheet

The balance sheet shows the condition of the business at any given time. It indicates the results of management, good or bad. For this reason, it is very important to the small business manager.

The balance sheet consists of the assets, the liabilities and the net worth of the firm. These groups of accounts may be listed with the assets at the left and the liabilities and net worth at the right, or with the assets at the top of the statement and the liabilities and net worth below.

Assets

Assets are items owned by the Company. For a small manufacturer they commonly include: Cash; notes receivable; accounts receivable; inventories—materials and supplies, finished product, land, buildings, machinery, equipment, investments.

Liabilities and net worth

Liabilities are amounts owed by the company to creditors. Among the more common liabilities are: Notes payable, accounts payable, accrued liabilities, reserve for Federal taxes.

Net worth represents the equity of the owners. The usual net worth accounts for a small corporation are: Capital stock, surplus.

Description of asset accounts

Cash.—This is the total of cash in banks, plus petty cash in the office. If the cash account is overdrawn, the overdraft should be treated as a current liability.

Accounts receivable.—The balance sheet figure should represent the amount of unpaid sales billed to customers after proper allowance has been made for uncollectible accounts.

Inventories.—The small manufacturer usually carries inventories of materials and supplies and finished goods. The materials and supplies inventory consists of materials to be placed in production at a later date, together with supplies used in connection with their processing. Finished goods are merchandise ready for sale. This inventory is often warehoused as a basis for bank lending.

All inventories should be valued according to some accepted method, the one in most general use being "cost or market, whichever is lower." Care should be taken to see that pricings, extensions, and footings are accurate. In lending, on the basis of the balance sheet, banks are likely to place particular emphasis on finished goods inventories.

Land.—This is the plant site and should be valued at cost of acquisition.

Buildings.—Any buildings owned should be shown on the balance sheet at cost less suitable valuation accounts (i. e., reserves for depreciation).

Equipment.—Equipment should be valued at cost less an allowance for depreciation and/or obsolescence.

Machinery.—Machinery should be handled on the same basis as equipment.

Investments.—Investments should appear in the balance sheet at current market values.

Descriptions of liability accounts

Notes payable.—Notes payable represent the amount of notes signed for borrowing purposes.

Accounts payable.—This is the total amount owed to trade creditors for merchandise, materials, and supplies.

Accrued liabilities.—Accruals include unpaid wages, rent, interest, and other items of a similar nature.

Reserve for Federal taxes.—Federal income taxes should be estimated on the basis of monthly profits and included among current liabilities as a liability reserve.

Capital stock.—Capital stock is the total value of the shares issued to the owners of the business. If the business is unincorporated, there will be no capital stock account. Instead, capital accounts will appear under the name or names of the owner or owners.

Surplus.—Earned surplus is the balance of undistributed profits left in the business after the payment of dividends. If the business is unincorporated, there will be no surplus account.

Form of the balance sheet

In its most rudimentary form, the balance sheet consists of a list of the assets with their total and a list of the liabilities with their total. If the accounts are arranged in the order followed in setting forth the explanation of the accounts, it will be logical and it will show two simple facts. First, it is a list of what the company owns and what it owes; second, the two totals are equal. That is another way of saying that the total value of what the company owns is claimed by those firms or individuals included among the list of liabilities. Unfortunately, this set of figures alone will not go far toward offering an explanation of the financial relationships that are found in the balance sheet.

To illustrate how much more effective a classified balance sheet is as a tool of financial analysis, compare it with one showing only general groupings of accounts. The balance sheet presented below is of that type.

Simple balance sheet

The Blank Manufacturing Company Balance Sheet

Assets:	
Cash.....	\$20,000
Accounts receivable.....	40,000
Inventories:	
Finished product.....	\$35,000
Raw materials and supplies.....	10,000
	45,000
Land.....	12,000
Buildings.....	28,000
Machinery.....	20,000
	\$165,000
Liabilities:	
Notes payable.....	30,000
Accounts payable.....	20,000
Accrued liabilities.....	6,000
Reserve for taxes.....	4,000
Capital stock.....	50,000
Surplus.....	55,000
	\$165,000

Now consider the simple balance sheet using a slightly more detailed statement that follows:

**The Blank Manufacturing Company
Balance Sheet**

	ASSETS	
Current assets:		
Cash.....		\$20,000
Accounts receivable.....		40,000
Inventories:		
Raw materials and supplies.....	\$10,000	
Finished product.....	35,000	
	45,000	
Total current assets.....		105,000
Land.....		12,000
Buildings.....		28,000
Machinery.....		20,000
Total assets.....		\$165,000
LIABILITIES		
Current liabilities:		
Notes payable.....		\$30,000
Accounts payable.....		20,000
Accrued liabilities.....		6,000
Reserve for taxes.....		4,000
Total current liabilities.....		60,000
Capital stock.....		50,000
Surplus.....		55,000
Total liabilities.....		\$165,000

The second balance sheet shows an important improvement over the first in that it groups current assets and current liabilities under their respective heads. This enables you to tell at a glance whether the concern is solvent, i.e., whether its current assets are greater than its current liabilities and by how much.

In this case the current assets amount to \$105,000, while the current liabilities are \$60,000. This means that the current assets exceed the current liabilities by \$45,000, provided that the current assets have been correctly valued and that all the current liabilities have been included. If some of the current assets have been overvalued, or if the amount of the current liabilities has been understated, the current position of the firm will be overstated. This is another way of saying that the management shows greater ability to pay its current debts on the books than it in fact has.

Suppose that in the present example accounts receivable are actually worth only \$30,000, that inventories had been overvalued by \$10,000, and that \$10,000 of notes payable has been inadvertently, or purposely, omitted from the books. If these errors are corrected, the net effect will be to reduce total current assets to \$85,000 and to increase total current liabilities to

\$70,000. While the concern is still solvent, its net working capital has been reduced to \$15,000, an amount \$20,000 less than total inventory.

Valuation accounts

Because of the importance of stating balance sheet values correctly, it is customary to set up a balance sheet in such form as to show that proper provision has been made for losses in asset values arising from depreciation and other factors. This involves the use of depreciation or valuation accounts. Some of the more common of these accounts are:

Reserve for doubtful accounts.—Accounts receivable should be “aged” (that is, analyzed according to the length of time the money has been owed), and an estimate made of their collectibility. The reserve for any accounting period is usually calculated as either (1) a percentage of the average balance of receivables, or (2) a percentage of net sales.

Reserve for inventory valuation.—An estimate of possible shrinkages in the value of inventories should be made if there is a distinct possibility that there will be losses as the result of price changes, style changes, physical deterioration, pilferage, or other causes.

Reserves for depreciation of fixed assets.—Fixed assets, other than land, decline in value as the consequence of use, technical obsolescence, the action of the elements, and other factors. A periodic charge for depreciation should be made to account for such losses.

If now we make changes in our classified balance sheet to give recognition to the problem of valuation, we may come up with something like this:

**The Blank Manufacturing Company
Balance Sheet**

Current assets:	ASSETS	
Cash.....		\$20,000
Accounts receivable.....	\$40,000	
Less reserve for doubtful accounts.....	3,000	
	37,000	
Inventories:		
Raw materials and supplies.....	10,000	
Finished product.....	\$35,000	
Less reserve for inventory losses.....	5,000	
	30,000	
	40,000	
Total current assets.....		\$97,000
Land.....		12,000
Buildings.....	\$28,000	
Less reserve for depreciation.....	6,000	
	22,000	
Machinery.....	20,000	
Less reserve for depreciation.....	4,000	
	16,000	
Total assets.....		\$147,000

LIABILITIES

Current liabilities:

Notes payable.....	\$30,000
Accounts payable.....	20,000
Accrued liabilities.....	6,000
Reserve for taxes.....	4,000
Total current liabilities.....	60,000
Capital stock.....	50,000
Surplus.....	37,000
Total liabilities.....	\$147,000

Note the changes that have occurred:

- Accounts receivable have been reduced to an estimated \$37,000, all collectible.
- Inventory values have been reduced to \$40,000.
- Current assets show a reduction of \$8,000.
- The value of buildings has been reduced to \$22,000.
- Machinery is now valued at \$4,000 less than previously.
- Total assets have declined \$18,000.
- The excess of current assets over current liabilities is now \$37,000, a reduction of \$8,000.
- Surplus is now \$37,000, a decline of \$18,000.

Apart from improving the accuracy of the statement figures, there has been one other important gain. Most of the writedown of current assets has been in the inventory account, a move that has improved the relation of excess working capital to total inventory.

Further expansion of the balance sheet will improve its readability. The version that follows shows the result of evolution from a simple listing of accounts to the relatively detailed statement of a typical small manufacturer.

The Blank Manufacturing Company

Balance Sheet

ASSETS

Current assets:

Cash.....	\$40,000
Accounts receivable.....	\$90,000
Less reserve for doubtful accounts.....	10,000
	80,000

Inventories:

Finished product.....	150,000
Raw materials.....	20,000
Supplies.....	10,000
	180,000

Prepaid expenses.....	10,000
	180,000

Total current assets.....	\$310,000
----------------------------------	------------------

Fixed assets:	
Land	\$20,000
Buildings	40,000
Machinery and equipment	30,000
Furniture and fixtures	10,000
	100,000
Less reserve for depreciation	30,000
	\$70,000
Investments	20,000
Total assets	\$400,000

LIABILITIES AND NET WORTH

Current liabilities:	
Notes payable	\$80,000
Accounts payable	40,000
Accrued liabilities:	
Wages and salaries	\$4,000
Interest	1,000
	5,000
Reserve for taxes:	
Income tax	16,000
State taxes	4,000
	20,000
Total current liabilities	\$145,000
Capital stock	200,000
Surplus:	
Balance, beginning of year	\$80,000
Profit for year	50,000
	130,000
Less dividends	75,000
	55,000
Total liabilities and net worth	\$400,000

The 100 percent size statement

The small manufacturer may find it to his advantage to reduce the values in his balance sheet to percentage figures. This may be accomplished simply by counting total assets as 100 percent and then determining the percentage that each asset and each asset group is of the total. The same line of procedure may be followed with the liabilities. Such analysis is of limited value unless the computed percentages can be compared with figures for other businesses in the same line of activity, or with past balance sheets of your own firm.

The income statement

The income statement does two things:

- It sets off the income against the expenses of doing business. The difference between the two is the net profit or loss.
- It measures the quality of business management.

In its rudimentary form the income statement of a small manufacturer looks about like this:

The Blank Manufacturing Company	
<i>Statement of Profit and Loss for the Year Ending</i> _____.	
Sales	\$120,000
Manufacturing cost.....	70,000
	<hr/>
Gross margin.....	\$50,000
Selling expenses:	
Salaries.....	\$15,000
Commission	5,000
Advertising.....	5,000
	<hr/>
	25,000
Selling margin.....	\$25,000
Administrative expenses.....	10,000
	<hr/>
Net profit.....	\$15,000
	<hr/> <hr/>

Sales.—Sales include all sales of merchandise or services. Net sales as listed in the simple profit and loss statement are determined by subtracting sales returns and allowances and sales discounts from gross sales. Out-freight is also a deduction if goods are sold f. o. b. destination. Warehousing expense may also be included among the deductions.

Manufacturing cost.—Manufacturing cost consists of (1) direct variable expenses made up of direct materials and labor; (2) variable indirect expenses which fluctuate according to administrative policy, and include such items as indirect labor, machinery repairs, light, heat, and power, casualty insurance, and fire insurance on materials and supplies; and (3) fixed indirect expenses consisting of such items as plant insurance, taxes, rent, depreciation, and plant superintendent's salary.

Selling expenses.—These consist of expenses incurred directly or indirectly in producing sales. In addition to the accounts listed in the simple profit and loss statement form on this page, shares of rent, heat, light and power may be allocated, as well as supplies and other expenses that contribute to the sales activities of the enterprise.

Administrative expenses.—General salaries and wages, supplies, and other operating costs that can be ascribed to the overall administration of the firm fall in this group.

Financial management income.—Some small manufacturers may derive supplemental income from interest and dividends, miscellaneous sales, rents, and royalties, gains on sale of capital assets, and so on. In such an event these amounts should be added to the net profit shown in the illustrative profit and loss statement. This is really a net operating profit under such circumstances. From this amount should be subtracted any interest paid. The resulting figure is the net profit before State and Federal income taxes.

The comparative income statement

It is desirable that some type of income statement be made available to the management of a small manufacturing concern at least once monthly. Monthly figures should be combined to furnish quarterly totals as well as year-end results. Usually a condensed reporting of income and expenses will be sufficient. The statement should provide for both actual performance and budget estimates. With such information available, the management can exercise much more effective control over expenses than otherwise. This means that unfavorable trends can be detected early enough to correct them before they result in serious damage to the business.

A simple form that will serve as the basis for such an analysis follows:

Form 1

	Comparative income statements							
	Jan.	Feb.	Mar.	3 months	Apr.	May	June	6 months
Sales.....								
Manufacturing cost.....								
Gross margin.....								
Selling expenses.....								
Selling margin.....								
Administrative expenses..								
Net profit.....								
Gross margin percent.....								
Net profit percent.....								
Budgeted net profit.....								
Variance.....								
Comments:								

CHAPTER II

Financial Management

Creditors in the balance sheet—Owners in the balance sheet—Advantages from the use of borrowed funds—Disadvantages of borrowing—Basic financial principles

As a small business operator you will constantly be confronted by financial problems. These fall roughly into the following groups:

Planning capital requirements.—You will need capital to start your business. You will need extra capital during those periods of the year when your operations are above normal. You will need more capital if you plan to expand your business on a permanent basis.

The problems of capital requirements involve answers to the following questions:

Why do I need this capital?

When do I need it?

How long will I use it?

How much do I need?

Where can I obtain it?

How can I repay it (if borrowed)?

Raising funds or credits.—This involves the steps necessary to establish proper contacts with capital sources culminating in the actual loan or investment.

Controlling capital.—The basic purpose of financial control is to protect the financial health of the business so that it may operate with maximum profitability. Sound financial control should help to preserve the solvency of your business. And it should make it easier for you to earn an adequate return on your investment, provided that other management factors are favorable.

The owner of a small business can have the best of financial records; they may be presented to him in proper form at the correct time. But if he has no financial background or has not learned how to interpret even the simplest information, they will be of small value. Financial management, however, like shop practice, selling, or any other business responsibility, comes from experience based upon a knowledge of the fundamental ideas. Sound financial judgment can be acquired by learning some of the principles and putting them into practice.

Creditors in the balance sheet

The contributions of creditors to the business are temporary. As the term *creditors* implies, they extend credit to the firm in the form of either

money, merchandise credits, or services. Creditors expect to be repaid for the advances that they have made to the business according to the terms of the agreements upon which such advances are based. Credits extended to small manufacturers are generally repayable in less than 1 year, although term loans, bonds, and mortgages represent more extended maturities.

If you are unfamiliar with the sources of creditor funds and other advances, an examination of the *liability section* of a small manufacturer's balance sheet will show the more common ones. They include:

Notes payable.—These generally represent loans of funds to the business by commercial banks, finance companies, officers, employees, stockholders, and others. If they are listed under *current liabilities* they have a maturity of less than 1 year from the date of the balance sheet. Funds supplied in this manner are represented by promissory notes. Promissory notes are credit instruments signed by one or more of the owners or their authorized agent.

Accounts payable.—Accounts payable represent extensions of trade credit growing out of the sale of goods or services to the business by creditors on open account. No note or credit instrument is used in connection with these transactions. Goods are shipped to the firm and billed to it by the seller. They are paid for according to agreed terms. Prompt payment usually entitles the purchaser to a cash discount.

Accrued expenses.—Accrued expenses are amounts owed by the firm for expenses that have accumulated. In this group are unpaid wages, rents, and interest, as well as State and local taxes, other than taxes on net income. Unpaid Federal and State income taxes are usually shown in a *reserve for taxes* under a separate heading. All types of expense or tax accruals represent credits that the firm is able to use. To the extent that you are able to utilize the services of your employees before paying them, you are actually using credit extended by them. Likewise, you are using credit extended by others when you pay interest, rents, or taxes in arrears. In the case of income taxes, you are able to utilize profits that must ultimately be paid to the Government.

Mortgages.—The mortgage is evidence of long-term debt. It indicates that the firm has been obliged to put up some kind of collateral such as land, buildings, or equipment as security for the loan. Small corporations, partnerships, and single-proprietorships are usually obliged to resort to this type of financing arrangement when in need of long-term funds.

Bonds.—Relatively few small manufacturers are able to sell bonds. Apart from the fact that the majority of such firms are unincorporated, the cost of issue is prohibitive. When bonds are marketed they are usually offered in denominations of \$1,000. The mortgage is made out to a trustee in favor of the bondholders.

Owners in the balance sheet

In addition to the contributions of creditors, the right-hand side of the balance sheet lists the investment of the owners. Such investments are reported in various ways according to the form of business organization and the ownership pattern within a given company. The interests of the owners are permanent and represent claims against the assets subordinate to those of creditors. The showing of ownership is substantially as follows:

Single proprietorship.—The owner's interest in a single-proprietorship business is represented by a single capital account. This account consists of sums invested by the owner, additions in the form of profits, and deductions resulting from withdrawals or losses. The account is commonly designated by some such title as "John Doe, Capital."

Partnership.—In the partnership the owners' interests are represented in a manner similar to that employed by the proprietorship. However, there are separate capital accounts for the several partners. If the partnership is of the limited variety, the partners are divided into two classes: those with full liability, and those whose liability is limited to the amount of their investment. Those in the first group are known as *general partners*. The others are *limited partners* or *special partners*.

Corporation.—The funds supplied by the owners of a small manufacturing corporation are generally represented by two accounts—capital stock and surplus. If there is more than one class of stock, additional capital stock accounts will be shown to represent these ownership interests. Since surplus may arise from other sources than earnings, there may be more than one surplus account in recognition of this fact.

Advantages from the use of borrowed funds

Many small businesses never borrow. Some borrow intermittently. Those whose financial resources are inadequate may borrow almost continuously. As a small business executive, it should be your goal to avoid excessive borrowing. At the same time you should be aware of the possible benefits that may result from borrowing if such action becomes desirable or necessary. Among them are:

There is no sharing of control between owners and creditors.—Since this is true, owners may expand their operations by borrowing and still maintain secure control over the enterprise. On the other hand, to bring new stockholders or partners into the business might lead to a dilution of control, or even to its loss.

The cost of credit can be low.—Because creditors have a prior claim to income and to assets in the event of dissolution, they will generally accept

a relatively low return in comparison with what is expected by owners. This leads to the practice known as *trading on the equity*. Trading on the equity means to obtain the use of capital upon which a fixed rate of return must be paid. This rate of return is lower than the expected return on total investment. The effect of such a policy, if successful, is to increase the return to the owners beyond what it would have been if no borrowing had taken place.

Here is a simple example of trading on the equity. In this case, equity capital is assumed to be \$50,000 with a mortgage of \$30,000. Total investment is \$80,000. The interest rate on borrowed money is assumed to be 5 percent.

Item	1st year		2d year		3d year	
	Amount	Percent	Amount	Percent	Amount	Percent
Earned on total investment	\$4,000	5	\$12,000	15	\$2,000	2½
Interest on mortgage (5 percent) . . .	1,500	5	1,500	5	1,500	5
Return on equity capital	2,500	5	10,500	21	500	1

In the first year, earnings on total investment were at the same rate as that paid on borrowings. There was no net advantage from trading on the equity. In the second year, however, the company was able to realize 21 percent on the investment of the owners. This resulted from the fact that the rate of 5 percent paid on borrowed capital was substantially less than the rate of return earned on total investment. Actually, \$4,500 was earned on borrowed capital but only \$1,500 of this amount had to be paid out as interest. The balance of \$3,000 added to the earnings on their own investment gave the owners a return of \$10,500. In the third year the company was forced to pay out most of its earnings as interest. In this case the return on total investment was less than the 5 percent required to meet interest charges. Had the firm been only slightly less successful a deficit would have resulted.

What you must remember when you trade on the equity is that unless your business can maintain relatively stable earnings it may be dangerous to borrow in substantial amounts for more than short periods at a time. If you manufacture or sell merchandise that is not in regular demand, such as luxury goods, novelties, high-priced commodities or services or items that are particularly susceptible to business changes, you will do well to weigh carefully the risks of borrowing against the possible disadvantages of being underfinanced.

Borrowed funds may be the only funds available.—It is often difficult to get someone else to invest in your business. The risks appear large, and

the prospects of profits are often too remote for the potential owner-investor to be willing to invest his capital. If he does invest, he may expect more from you in the way of sharing control or in protection for his investment than you are willing to offer him. Loan funds are usually more plentiful than equity capital anyway.

Borrowing is generally more flexible than ownership.—An owner expects a return on his investment over the life of the business. Yet when he supplies the entire investment he may find that part of his capital is idle during off-seasons or depressions. As a result, he may obtain a smaller average return than he would have received had he invested less money and borrowed during peak periods.

Unless borrowed money is held for an extended length of time, as in the case of a mortgage loan or a bond issue, the small manufacturer can increase or decrease the amount of capital utilized through borrowing to coincide fairly well with his business capital requirements. This is particularly true of accounts receivable and inventory financing where the amounts borrowed can be adjusted to day-to-day needs.

Example: A small manufacturer supplies the entire amount of capital invested in his business—\$100,000. During 6 months of the year he is unable to utilize \$20,000 of his investment. As a result, he loses any return on that portion of his equity capital during this period. If he is able to withdraw the amount in question and to borrow \$20,000 for 6 months each year, he stands to gain a considerable advantage. In the first place, he can invest his \$20,000 elsewhere on a permanent basis. In the second place, he should be able to use short-term borrowed funds to meet his temporary needs and to employ the principle of trading on the equity.

Tax savings may be realized when part of the funds used is obtained from creditors.—When the total investment is supplied by the owners, the entire net income is taxable. The share of business revenues paid to creditors as interest is a business expense and is tax deductible. If borrowed funds are employed, a substantial tax saving may be realized. Before deciding upon a borrowing policy, the management will need to weigh the gains from such tax savings against the added risks resulting from borrowing operations.

Some dealings with creditors are a matter of convenience.—The practice of buying merchandise on open account and the purchase of services on an accrual basis are examples of the convenient use of credit. Long-established trade terms in many lines of manufacturing make it easier to arrange to pay merchandise obligations on a time basis rather than to make a cash settlement. This is partly the result of the time flow of funds and partly a consequence of accounting practices affecting such items as purchases returns and allowances. Wage accruals are an example of the advantage of paying on other than a day-to-day basis. Even a very small manufacturer would find it difficult, if not impossible, to make daily wage settlements.

Disadvantages of borrowing

Responsible businessmen do not borrow money or credits unless they expect to be able to repay their borrowings. This obligation is both legal and moral. Failure to settle your debts in a manner acceptable to the lender or the seller can destroy both your business and your business reputation.

Small manufacturers who are established should plan to borrow infrequently and only when the use of borrowed funds will result in clear-cut business gains. Exceptions to the rule against regular borrowing may, of course, be noted in fields where the use of such arrangements as warehouse financing and accounts receivable financing are well established. But even here, it must be borne in mind that the financing institution will not advance funds unless such an operation is mutually advantageous.

Basic financial principles

Sound financial policies rest upon the application of the basic principles of financial management. If these principles are adhered to, 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. Stated in simple terms, these principles of sound financial management are:

- Avoid an excessive investment in fixed assets.
- Maintain net working capital in proper proportion to sales.
- Avoid excessive inventories.

Each of these problems is dealt with to some extent under the subject of "Ratio Analysis," but because of their special importance they also are given considerable space at this point.

Principle I.—Avoid Excessive Investment in Fixed Assets

Whether the investment in fixed assets is *excessive* depends upon its relationship to *tangible net worth*. Net worth represents the excess of the assets as reported in the balance sheet over the liabilities as listed in the same statement. Tangible net worth is determined by subtracting from the total value of the *tangible assets* all debts and reserves. Tangible assets are such items as cash, receivables, inventories, prepaid expenses, plant and equipment, furniture and fixtures, investments, and deferred charges. They do not include trade-marks, patents, copyrights, franchises, leaseholds, goodwill and other intangible assets. Debts include all liabilities, a term that embraces such items as notes and accounts payable, accrued expenses, reserves for taxes and contingencies, term loans, mortgages, and bonds.

Example.—A concern with tangible assets of \$100,000 and liabilities and reserves of \$30,000 has a tangible net worth of \$70,000.

Fixed assets, as used in the comparison between fixed assets and tangible net worth, mean *net fixed assets*. Net fixed assets represent the amount of fixed assets after deducting accumulated depreciation. Fixed assets for a small manufacturer typically include: Land (not depreciated), buildings, furniture and fixtures, machinery, equipment, tools (if life exceeds 1 year), trucks, leasehold improvements (but not leaseholds which are intangible).

Such assets are usually carried in the balance sheet at cost or appraisal value less depreciation reserves when sound accounting practices are observed. Depreciation is charged off each year against fixed assets in recognition of the fact that their value has declined as the result of wear or technical obsolescence. This decline in value is part of the cost of production and reduces the book value of the fixed assets. The amounts charged off are commonly shown in the balance sheet under depreciation reserves.

Usually they appear in some such form as:

Buildings.....	\$35,000
Less reserve for depreciation.....	7,000
	28,000

Sometimes the reserves for depreciation are included among the liabilities and on such occasions the fixed assets appear at cost or appraised value. The effect is the same in either case, since the net fixed assets are, by definition, fixed assets minus depreciation reserves.

Interpretation of Principle I

This principle states that you should avoid excessive investment in fixed assets. In other words, the amount invested in fixed assets must be in proper proportion to the tangible net worth. It suggests that there is less danger in underinvesting in plant, equipment, and other fixed assets than there is in tying up too much of the firm's capital in these items.

What constitutes a satisfactory relationship between net fixed assets and tangible net worth depends very much upon the practice followed in your industry. Among established firms the ratio varies widely. In the garment trades, for example, the proportion of net fixed assets to tangible net worth is commonly less than 10 percent. In lines of production requiring heavy equipment, the ratio may be 40 to 50 percent. Specific industry relationships are published by Dun & Bradstreet, Inc., Robert Morris Associates, trade associations, various Government agencies, and others.

As a rule, the small manufacturer should attempt to keep his investment in fixed assets as small as he can in line with his production requirements. The reasons for such an objective include:

- Too large an investment in fixed assets may leave too small a one in net working capital. Unless you expect your creditors to assume the entire burden of financing current operations, it will be necessary to limit your

investment in net fixed assets to somewhat less than your total tangible net worth.

- Fixed charges resulting from an excessive investment in net fixed assets may become burdensome during periods of declining sales volume or falling prices. Such items include insurance on plant and equipment, interest on fixed indebtedness, taxes of many types, and maintenance charges.
- High fixed costs growing out of an excessive investment in net fixed assets will tend to make the *break-even point* too high. This is another way of saying that the larger your fixed costs of doing business, the longer it will take you to reach a profitable level of sales.

Example: Assume that you and your competitor each do \$100,000 worth of business annually, and that your fixed costs are \$15,000, while his are only \$8,000. Also assume that each of you must meet variable production costs of \$8 per unit with sales of 10,000 units annually. Apart from the rather obvious fact that under these conditions his net earnings will be \$12,000 for the year, while yours will amount to only \$5,000, he will be able to balance his sales against his costs before you do. This may be demonstrated by the following figures:

(1) *Your competitor:*

$$\text{Break-even sales} = \text{Fixed costs} \div \frac{\text{sales} - \text{variable costs}}{\text{sales}}$$

$$\text{Break-even sales} = \$8,000 \div \frac{\$100,000 - \$80,000}{\$100,000}$$

$$\text{Break-even sales} = \$8,000 \div 0.20$$

$$\text{Break-even sales} = \$40,000$$

(2) *You:*

$$\text{Break-even sales} = \$15,000 \div \frac{\$100,000 - \$80,000}{\$100,000}$$

$$\text{Break-even sales} = \$15,000 \div 0.20$$

$$\text{Break-even sales} = \$75,000$$

A simple explanation of the break-even formula follows:

Sales at break-even point (unknown = x) = Total fixed charges in dollars \div percentage of variable costs to sales

Total fixed charges in dollars are budgeted either for total sales, or departmental sales if the firm is departmentalized. The percentage of variable costs to sales is determined by dividing the budgeted variable costs, either departmental totals or the grand total by sales estimates, also departmental or total.

In the example, variable costs are 0.80 of sales. Hence, at the break-even point fixed costs must be 0.20 of sales. In the first case, \$8,000 = 0.20 of break-even sales, which amount to \$40,000. In the second, fixed expenses are also 0.20 of break-even sales, so break-even sales amount to \$75,000. When your competitor has sold \$40,000 worth of merchandise, he will begin

to make a profit. Your firm is going to gain a profit, if any, on its last \$25,000 worth of sales for the year.

The small manufacturer who is entering business should make every effort to keep his investment in plant and equipment at a minimum. He will find such financing and managerial devices as the following helpful in accomplishing this objective:

Mortgaging fixed assets.—This will enable him to obtain the use of buildings and equipment with a minimum cash investment. For most types of new machines, the down payment is usually 20 percent of the purchase price with 30–36 months in which to pay the balance. Loans on buildings are not always as easy to obtain as equipment financing, but it may be possible to borrow a substantial fraction of the purchase price, provided the building is modern and of standard design. Some industrial foundations and State and municipal financing agencies occasionally sell new buildings on a no-down-payment basis, the purchase price to be paid over a period of time ranging from 10 to 25 years.

Leasing of fixed assets such as land, buildings, machinery, equipment and trucks.—Care must be exercised in entering into lease agreements, especially if the prospects of the business are uncertain. But a firm may be able to raise working capital by selling its plant facilities and leasing them back from the purchaser.

- *Subcontracting production, thus avoiding outright responsibility for the care and maintenance of fixed assets.*

All the foregoing suggestions may be helpful in limiting the required investment in fixed assets. To the extent that this is possible, the working capital position of the firm may be improved.

Principle II.—Maintain Net Working Capital in Proper Proportion to Sales

Net working capital may be defined as the *current assets* minus the *current liabilities*. Current assets are those assets that in the normal course of business will be converted into cash within 1 year. They consist principally of cash, notes and accounts receivable of customers, and inventories. For the small manufacturer inventories usually include materials and supplies and finished product. Readily marketable securities and prepaid expenses are frequently found among the current assets. Slow assets or items such as permanent investments in other companies should not be included.

Current liabilities are debts that mature within 1 year. They consist principally of notes and accounts payable and accrued expenses, such as wages, interest, and taxes. They also include any portions of the long-term or intermediate-term debt falling due within a year.

Net working capital represents your investment in the current assets. Sometimes a small manufacturer may be able to improve his net working capital position by mortgaging his fixed assets. If, for example, a small manufacturer with net working capital of \$10,000 mortgages his plant for \$5,000, he will be able to increase his net working capital to \$15,000. This presumes that the funds are not required for other purposes. Assuming no previous borrowing on term loans or mortgages, he, himself, supplies the original excess working capital; the increase has been furnished by creditors. The improvement in his working capital position may be illustrated by two simple balance sheets.

Balance Sheet No. 1 (fixed assets unmortgaged)

<i>Assets</i>		<i>Liabilities</i>	
Current assets.....	\$20,000	Current liabilities.....	\$10,000
Fixed assets.....	10,000	Net worth.....	20,000
	30,000		30,000
Total assets.....	30,000	Total liabilities.....	30,000
Net working capital.....	10,000	Current ratio.....	2.0

Balance Sheet No. 2 (fixed assets mortgaged)

<i>Assets</i>		<i>Liabilities</i>	
Current assets.....	\$25,000	Current liabilities.....	\$10,000
Fixed assets.....	10,000	Mortgage debt.....	5,000
	35,000	Net worth.....	20,000
Total assets.....	35,000		35,000
Net working capital.....	15,000	Total liabilities.....	35,000
		Current ratio.....	2.5

It should be borne in mind that net working capital has no relation to specific current assets. It is neither cash, receivables, inventories, nor any combination of these or other current assets. It is the difference between the current assets and the current liabilities. As a matter of fact, it may be possible for any of the current assets to exceed the net working capital if its amount is small. This is the case in the following example:

<i>Current assets</i>		<i>Current liabilities</i>	
Cash.....	\$6,000	Notes payable.....	\$12,000
Notes receivable.....	8,000	Accounts payable.....	14,000
Accounts receivable.....	9,000	Accrued expenses.....	6,000
Inventories.....	12,000		32,000
	35,000	Total.....	32,000
Total.....	35,000		
Net working capital.....	3,000		

Here each of the current asset items is larger than the amount of the net working capital.

How much net working capital?—Every small manufacturer requires working capital to finance his current operations. How much depends upon the industry, the size of the firm, length of the production process, credit terms, seasonal conditions, general business conditions, and a number of

other factors. While a small firm does not need as much working capital as a larger one does, if operating in the same field, it must increase its investment in current assets as its sales volume increases. This is particularly true if the growth of sales is substantial, as may be the case when a sizable contract is signed with the Federal Government.

The first step to be taken in testing the adequacy of net working capital is to measure its turnover. This may be done by dividing annual net sales by the average net working capital.

$$\frac{\text{Annual net sales}}{\text{Average net working capital}} = \text{Net working capital turnover}$$

The resulting turnover figure indicates how many dollars' worth of business has been done during the course of the year for each dollar of working capital used in excess of the claims of short-term lenders, trade creditors, and other short-term creditors against the current assets. If net sales are \$100,000 and excess working capital is \$20,000, you are getting a net working capital turnover of 5.0. This is another way of saying that it takes \$1 of excess working capital for every \$5 of net sales. In established lines of manufacturing, typical turnover rates range from 4 to 6 times yearly.

Offhand, it would appear that an increase in the ratio of net sales to net working capital would be desirable. However, to expand the volume of net sales usually requires a larger investment in both accounts receivable and inventories. Moreover, a larger working force may be needed. Forward commitments (for merchandise or materials, advertising, and other items) grow. Unless additional working capital is obtained to help in the financing of expanded operations, the business may be subjected to various strains that can cause insolvency. This may easily be illustrated by a simple example. In this case, the current sections of two balance sheets are shown. In each instance the amount of excess working capital is the same, but in the second statement the company has increased its current indebtedness to finance additional current asset requirements resulting from expanded sales.

Current assets:	I	II
Cash	\$5,000	\$4,000
Accounts receivable	20,000	30,000
Inventories	20,000	40,000
	<hr/>	<hr/>
Totals	45,000	74,000
	<hr/> <hr/>	<hr/> <hr/>
Current liabilities:		
Notes payable	10,000	20,000
Accounts payable	20,000	35,000
Accrued expenses	2,000	6,000
	<hr/>	<hr/>
Totals	32,000	61,000
	<hr/> <hr/>	<hr/> <hr/>
Excess working capital	13,000	13,000
	<hr/> <hr/>	<hr/> <hr/>

In Balance Sheet 1 the firm has \$25,000 of cash and accounts receivable with which to meet \$32,000 of maturing notes and accounts payable, and accrued expenses. Presuming that at least some portion of the inventories will be liquidated before all these items fall due, the concern should be in a fairly sound financial condition and in no real danger of becoming insolvent. Even if inventory and accounts receivable values decline \$13,000, the company will still have \$1 in current assets for every \$1 in current liabilities. Such a decline would be equivalent to a drop of 28.9 percent. If an equivalent percentage decline were to take place in the value of the current assets listed in Balance Sheet 2 it would represent a loss of \$17,629. This would not only wipe out the entire amount of the excess working capital but would leave the firm with a current ratio of less than 1.0. While a ratio of this size does not of itself spell financial disaster, it often points the way to insolvency.

Principle III.—*Avoid excessive investment in inventories*

Principle III can be explained in terms of simple arithmetic. The moment a firm's inventories exceed the amount of net working capital, cash and receivables are insufficient to cover current liabilities. This situation may lead to insolvency if additional funds are not forthcoming to meet maturing current obligations. What may happen can be demonstrated through the following example:

<i>Current assets</i>	<i>Current liabilities</i>
Cash ----- \$10,000	Accounts payable ----- \$22,000
Accounts receivable ----- 12,000	Accrued expenses ----- 3,000
Inventories ----- 20,000	
Total ----- 42,000	Total ----- 25,000

In this case the firm has net working capital of \$17,000. This is less than the merchandise inventory of \$20,000. Since the current assets are substantially greater than the current liabilities, there is little cause for concern. After all, a shrinkage of \$17,000 in the value of the current assets could occur before a current ratio of 1.0 would be reached. However, it is to be noted that much of such a decline would be represented by inventory shrinkages, since inventories make up almost half of current asset values.

Let it be supposed that the management acquires an additional \$20,000 in inventory on account. Immediately total inventory becomes \$40,000, total current assets \$62,000, accounts payable \$42,000, and total current liabilities \$45,000. In this situation inventory comprises almost two-thirds of the total value of the current assets. While the amount of excess working capital remains unchanged, its importance is less than it was when the inventory was smaller. A decline of \$17,000 earlier was equivalent to a

shrinkage in current assets of 40.5 percent. If such a percentage change occurs after the purchase of the additional inventory, it will mean a loss of more than \$25,000. As in the previous situation, a shrinkage in current asset values will fall largely upon inventories. In this instance, however, the effects of such a shrinkage are likely to be more serious.

Small manufacturers are prone to assume that an investment in inventory values will furnish an adequate basis for short-term bank borrowing or for loans from other financial institutions. This may be true when inventory values are stable, but lenders are extremely hesitant to make advances on collateral that is currently declining in value. Great care must be exercised in controlling inventories to avoid overinvestment and subsequent crippling losses.

Ratios and Turnover Rates

Ratios—The current ratio—The operating ratio—Turnover rates—Accounts receivable turnover—Turnover of net fixed assets—Turnover of business capital employed

Ratios are devices for measuring financial conditions or financial changes. A ratio shows the relationship between two items—usually between a whole and one or more of its parts, or between two or more of the parts themselves. In financial analysis, ratios may be classified either as those that compare items that are parts of the same statement or those that compare items that are drawn from more than one statement of the same firm. Comparisons can also be made between ratios of one firm and those of another firm or of an entire industry.

Ratios

Accountants and credit men use many different financial ratios. Some of those that are of particular value to the small manufacturer are:

- *Current ratio.*—This is the ratio between current assets and current liabilities. It is sometimes known as the working capital ratio.

$$\frac{\text{Current assets}}{\text{Current liabilities}} = \text{Current ratio.}$$

- *Operating ratio.*—This ratio relates net profits to total net sales.

$$\frac{\text{Net profits}}{\text{Total net sales}} = \text{Operating ratio.}$$

- *Earning ratio.*—This shows the relation of the gross margin to total net sales.

$$\frac{\text{Gross earnings}}{\text{Total net sales}} = \text{Earnings ratio.}$$

- *Unit cost ratio.*—The relation of unit costs to the physical volume is indicated by this ratio.

$$\frac{\text{Production costs}}{\text{Physical volume}} = \text{Unit cost ratio.}$$

- *Capital employed ratio.*—This is the ratio between net profits and total capital employed.

$$\frac{\text{Net profits}}{\text{Total capital employed}} = \text{Capital employed ratio.}$$

- *Fixed property ratio.*—This is the ratio between total net sales and fixed assets.

$$\frac{\text{Total net sales}}{\text{Tangible fixed assets}} = \text{Fixed property ratio.}$$

- *Inventory to net working capital ratio.*—This ratio shows the percentage of inventory included in net working capital.

$$\frac{\text{Inventory}}{\text{Net working capital}} = \text{Inventory to net working capital ratio.}$$

The current ratio

One of the most important ratios in financial management is the *current ratio*. This shows the relationship of the current assets to the current liabilities.

There is no such thing as an ideal current ratio, but the small manufacturer can compare his own current ratio with standard ratios for the same line of business. Even these may not be entirely helpful, since they generally show considerable variation between the highest reported ratios and the lowest. As an example, Dun & Bradstreet, Inc., presents sample data for 5-year periods showing first quartile ratios, median ratios, and third quartile ratios. Such averages may be interpreted as follows:

25 percent of the firms included in the sample have current ratios below the first quartile.

25 percent of these firms show current ratios with values that fall between the first quartile and the median.

25 percent of the sample firms in this industry show current ratios that fall between the median and the third quartile.

25 percent of the group have current ratios that are above the third quartile.

Example:

First quartile, 1.8: 25 percent below this ratio.

Median, 2.7: 50 percent below this ratio, and 25 percent between 1.8 and 2.7.

Third quartile, 3.3: 75 percent below this ratio, 25 percent between 2.7 and 3.3, 50 percent between 1.8 and 3.3, 25 percent above 3.3.

Probably the wisest course of action is to compare your own current ratio with the *average* for the industry. The median is generally the best average for your purposes. This is found by arranging current ratio figures in order of their size; the median is the middle item.

In determining the current ratio, the small businessman should value current assets conservatively, and include all liabilities payable within the next year.

Many small businessmen are able to get along on a current ratio in which current assets are approximately equal to current liabilities, but such a ratio may prove dangerous if the concern is doing a substantial credit business and anything happens to retard the collectibility of accounts receivable or to reduce the salability of merchandise stocks. Generally speaking, it is a sound policy to maintain a current ratio of at least 2.0.

The small manufacturer should note that the current ratio may be improved by:

Payment of debts.

Additions to current assets resulting from term loans or other borrowing with a maturity of more than 1 year.

Additional investment in current assets.

Tax refunds.

Conversion of noncurrent assets into current assets.

Profits.

The current ratio will suffer as a result of:

Borrowing on short-term notes or other obligations.

Purchase of goods, materials, and supplies on account.

Withdrawal of investment in current assets as dividend payments or reduction in fixed investment as a result of withdrawals.

The accrual of expenses, Federal taxes, etc., if such items are set up to show both the expense and the offsetting liability or liability reserve.

Conversions of current assets into noncurrent assets.

Losses.

Some simple examples will show the effects of several types of financial transactions on the current ratio. Assume that a small manufacturer has the following current assets and current liabilities:

Current assets:	
Cash.....	\$10,000
Accounts receivable.....	20,000
Inventory.....	20,000
Total.....	50,000
Current liabilities:	
Accounts payable.....	20,000
Other.....	5,000
Total.....	25,000
Net working capital.....	25,000
Current ratio.....	2.0

If this manufacturer purchases \$15,000 worth of merchandise on account, inventory will be increased to \$35,000, and current assets to \$65,000. At the

same time, accounts payable will be increased to \$35,000, and current liabilities to \$40,000. The current ratio will fall to 1.62.

Assuming that \$7,000 of accounts payable are liquidated, the current ratio will increase to 2.39. In neither this case nor the preceding one, however, will there be a change in net working capital.

If, on the other hand, the manufacturer invests an additional \$10,000 cash in his business, current assets will be increased to \$60,000, the current ratio will increase from 2.0 to 2.4, and net working capital will increase from \$25,000 to \$35,000.

The operating ratio

The operating ratio is the relationship between net income and total net sales. (Net income \div Total net sales = Operating ratio.) Operating ratios vary widely between manufacturers, even those in the same line of business. For this reason it is impossible to generalize as to the ideal ratio. What is important to remember is that variations in operating ratios between companies are largely the results of varying degrees of efficiency in business management. One company may be able to show a net return of 2 percent on a sales volume of \$500,000. Another in the same field of operations may be forced to do twice as much business to produce the same net income.

Turnover rates

Turnover rates, like ratios, reflect relationships between two elements of the business. The most common of these is:

The inventory turnover.—This is the number of times that stocks are sold out and replenished during a given period such as a month, quarter, or year.

$$\frac{\text{Cost of goods sold}}{\text{Average inventory}} = \text{Inventory turnover}$$

In measuring inventory turnover, it is common practice to divide net sales for the year by average annual inventory. This practice is unsound in most cases, because:

(1) Net sales are reported at selling price, while inventory figures are kept at cost. Sales should be reduced to a cost basis before the comparison is made; otherwise the rate of turnover on an annual basis will be overstated.

(2) Year-end inventory figures commonly are used in determining yearly average inventory, and these are generally misleading. Most companies carry inventories of varying size during different months of the year. The year-end inventory is frequently the smallest of the entire period. If used to measure turnover, it may result in an exaggerated turnover rate.

As a hypothetical illustration, assume the following monthly inventory figures:

<i>Month</i>	<i>Monthly inventory</i>	<i>Quarterly totals</i>
January	\$20,000
February	30,000
March	40,000	\$90,000
April	50,000
May	25,000
June	30,000	105,000
July	30,000
August	40,000
September	30,000	100,000
October	35,000
November	65,000
December	25,000	125,000
Total	420,000	420,000

Monthly average inventory, \$35,000.

If the cost of sales for the year is \$140,000, the merchandise turnover will be four times ($\$140,000 \div \$35,000$). This means that the businessman has purchased (or manufactured) and resold his total stock four times during the year.

A merchandise turnover of 4.0 may be good or bad depending upon the line of business involved, the level of business activity and various other factors. An examination of standard turnover rates will help to answer that question. Past experience will also serve as a guide.

The profit return is also important, since a satisfactory merchandise turnover may often be achieved at the expense of profits.

Since monthly sales are usually affected by seasonal influences, it is desirable to set up inventory turnover figures by months. In this way variations in turnover may be more clearly ascertained and weaknesses in buying and stocking policies may be noted. Such a statement should be cumulative and may follow the form indicated below:

Form 2.—Turnover of Total Inventory by Months

<i>Month</i>	<i>Inventory</i>	<i>Cost of sales</i>	<i>Monthly turnover</i>	<i>Annual rate</i>
January				
February				
2 months				
March				
3 months				
April				
December				
12 months				

The small manufacturer will find it to his advantage to set up his production and sales by units and to compute his inventory turnovers on this basis. Such calculations involve additional expense, but they will disclose which items are being produced and sold at a satisfactory rate and those that are slow moving. Where such computations are made, they may be developed on a monthly basis using units produced and sold instead of dollar inventories and dollar cost of sales figures. A form similar to the one used to measure dollar turnovers may be set up for each item manufactured. These may then be combined into a form showing unit turnovers for separate months, cumulative, and annual turnovers. Such a form may resemble the one below:

Form 3.—Monthly inventory turnover by items

Month	Product A	Product B	Product C	Product D	Product E, etc.
January					
February					
2 months					
March					
3 months					
April					
4 months					
May					
5 months					
June					
December					
12 months					

This type of analysis will frequently show that item turnovers vary considerably with a result that those items that are slow-moving tie up excessive amounts of working capital. This situation may be corrected for slow-moving items by:

Increasing sales by finding additional outlets.

Reducing the number of units manufactured.

If the firm manufactures price lines within the main product lines, an analysis of inventory turnover should be made in the same manner as for the products themselves. Frequently such a breakdown will show that higher priced items in the line tie up so much capital and are so relatively unprofitable that they ought to be discontinued. *The important thing is to make the analysis.* After that it is up to you.

Accounts receivable turnover

Accounts receivable turnover is the relationship between outstanding accounts receivable and net sales (Net sales \div Accounts receivable = Accounts receivable turnover). This indicates the number of times merchandise stocks are turned into sales during a given period of time.

Accounts receivable turnover should be calculated at least once a month. This information should be placed in the hands of the manager by the accountant and should include a report of:

Monthly sales on account.

Balance of receivables at end of month.

Number of day's sales unpaid.

The number of day's sales unpaid may be computed by the following simple formula:

$$\frac{\text{Balance of receivables at end of month}}{\text{Monthly sales on account}} \times 30.$$

Whether the number of day's sales unpaid indicates a satisfactory rate of collections depends in part upon the credit terms that prevail. If customary trade terms are 30 days and 15 days' receivables are outstanding, collections are in good condition, but if terms are 10 days and 15 days' accounts receivables are still on the books, slow collections are indicated and prompt action should be taken to speed up the rate of receivables' turnover. The proportion of cash sales should also be considered in measuring the effectiveness of the firm's collection policy.

Slow collections will not present as serious a problem to the firm doing most of its business in cash as they will for a concern doing the greater part of its volume on a credit basis. It is important in any case to analyze outstanding accounts receivable at the end of each month. Those that are past due should be followed up for collection. Slow collections tie up capital and may result in bankruptcy if the situation is not corrected. If accounts receivable analysis shows customers who are chronically slow pay, it is usually the best policy for the small manufacturer to get rid of them. They eat up the firm's profits and should be replaced by new customers who can and will pay their accounts promptly.

Turnover of net fixed assets

This represents the amount of net fixed assets required for each dollar of sales. For example, if net fixed assets (cost less depreciation) amount to \$200,000 and the total annual volume of sales is \$1,600,000, the turnover of fixed asset investment is 8 times (Total net sales \div Net fixed assets = Turnover of net fixed assets). This indicates that \$8 of sales were produced for each \$1 invested in fixed assets.

Generally speaking, the small manufacturer who is able to realize a high rate of turnover of fixed property investment is fortunate indeed. If he can continue to operate in this manner he will fare better than competitors who possess more costly facilities, for they must meet various costs that for him are small or negligible. This can best be illustrated by a simple example. Firm A has a net fixed asset investment of \$10,000 and sells \$200,000 worth of goods a year. Firm B does the same volume of business but has an investment in net fixed assets of \$40,000. Because B has the larger plant investment, the owner is likely to find that such costs as depreciation, property taxes, and property insurance are greater than A's expenses for the same purposes. Under the circumstances A has a definite competitive advantage.

Turnover of business capital employed

If inventory turnover, accounts receivable turnover, and fixed property turnover are satisfactory, capital turnover must also be satisfactory. These items—inventory, accounts receivable, and fixed assets—constitute the bulk of all the assets and there is little likelihood that the turnover of the total will be unsatisfactory as long as the turnovers of its major parts are adequate. It may be defined as the relationship of total net sales to the total assets of the business ($\text{Total net sales} \div \text{Total assets} = \text{Capital turnover}$).

Example:

Total net sales, \$500,000.

Business capital employed, \$50,000.

Turnover, 10 times.

This may also be expressed as the percentage of capital employed to net sales, or 10 percent.

What this means is that \$1 of assets has been required to produce \$10 of sales. It also signifies that each dollar of assets has been used or turned over 10 times during the year.

As with other turnovers, the effectiveness of this one as a tool of financial management is increased by placing it on a monthly basis. A simple table showing monthly sales, assets used each month, monthly turnover, and yearly turnover based on the monthly rate can be used to compare turnovers from month to month.

Monthly turnover rates are important as a financial yardstick to bankers and credit men in evaluating the financial efficiency of various businesses.

[A more extensive treatment of the subject of ratio analysis is available in *Ratio Analysis for Small Business*, by Richard Sanzo, Small Business Administration, 1957. For sale by the Superintendent of Documents, Washington 25, D.C. The price is 25 cents.—Ed.]

Banking Relationships

Concerns using bank credit—Using bank funds profitably—Choosing a bank—The loan request—The “C’s” of credit—Form of loan application—Financial statements—Common type of bank loans

Although a small-business manager may not have need to borrow from a commercial bank, he should still make use of other services that the bank commonly offers. Among such services are:

1. *Deposits.*—The commercial bank accepts deposits of coin, currency, checks, and other items received over the counter or by mail.

2. *Cashing and certification of checks.*—*Check cashing* is a great convenience to the small-business man who is thus relieved of the necessity and the risk of making up payroll envelopes in currency and coin. *Check certification* means that the bank earmarks a specific portion of the depositor’s account to meet the certified item. Certified checks are frequently needed as evidence of good faith in contract bidding or for remittances to out-of-town creditors who are unwilling to ship merchandise to buyers of unknown credit standing.

3. *Collections.*—Banks collect checks, notes, bills of exchange and other negotiable items for business patrons. This is one of the greatest conveniences offered by such institutions, in that direct collections are slow and costly. Banks also collect money due on contracts, mortgages, warrants, and other obligations.

4. *Cashier’s checks and bank drafts.*—The businessman wishing to transmit funds to another section of the country may purchase such items from his local bank and thus make the transfer cheaply, safely, and speedily.

5. *Coin and currency supply.*—If a businessman is in need of coin or currency, or if he has coin and currency that he wishes to dispose of, the bank will serve him.

6. *Credit information and financial advice.*—The bank maintains comprehensive credit and financial information and thus can be of much assistance to customers seeking such information.

7. *Investments.*—The bank buys and sells for customers, securities of the United States Government and its instrumentalities, and securities of States, counties, cities, and other municipal bodies. It also purchases commercial paper for customers, and it will place customers’ orders with brokers for the purchase and sale of securities.

8. *Transfer of funds.*—The bank will transfer funds by mail or by telegraph anywhere in the United States.

9. *Securities’ services.*—The bank arranges for the shipment, transfer of ownership, and exchange of denomination of securities, and a variety of other such services.

10. *Safe deposit service.*—Most banks maintain vaults containing safe deposit boxes and safes for securities, documents, and other articles. The larger ones lease storage space for bulkier items of value.

11. *Foreign finance relations.*—Although smaller banks are not equipped to render foreign exchange and related services, they maintain correspondent relations with metropolitan banks that are fully prepared to undertake such activities. These include granting credits for financing imports and exports, issuing commercial letters of credit, discounting foreign bills of exchange, buying and selling foreign exchange, issuing drafts payable in foreign countries, transferring funds to foreign countries by mail or cable, maintaining current information on financial and economic conditions in foreign countries, and a wide range of other services. If you are engaged in any aspect of the export or import trade, your banker will be able to serve you.

12. *Trust functions.*—The bank will act as a corporate trustee under agreements entered into by individuals for specific purposes, such as the managing or distribution of assets under trust agreements. It will also perform the duties of an insurance trustee. It will relieve individuals of the care of their securities. It will serve as an escrow agent for individuals. It will act as a corporate trustee performing the various functions of such trustees under indenture agreements, as transfer agent, as registrar, as dividend disbursing agent and in various other particulars. Consultation with your bank and your attorney will give you a better understanding of how the bank can help you in trust matters affecting your business.

Concerns using bank credit

Many bank borrowers are repeaters. They are usually small concerns with limited financial needs. More business loans by banks are made to borrowers in the \$1,000–\$5,000 bracket than to borrowers in any other business loans grouping. Firms borrowing on this limited scale, with some exceptions, find it necessary to obtain funds to finance both long-term and short-term needs from banks and other traditional suppliers of short-term capital. Concerns in this group are usually quite young, although normally they are not beginners. Generally, they are well enough established to survive, but in most cases they have been unable to accumulate a sufficient amount of working capital to meet peak business requirements. Usually they are growing concerns, for banks are not anxious to lend to unprofitable firms whose operations are declining.

Using bank funds profitably

Business borrowers obtain money or credit from banks and other outside sources because they expect to derive some advantage from such action. Generally speaking, they plan to use such funds or credits for one of two

major objectives. Either they hope to increase the net return on their investments, or else they are trying to protect themselves from insolvency. Business activities that may lead to greater profits include:

- Building up inventory.
- Adding new lines or enlarging existing ones.
- Expanding production.
- Buying an interest in another business.
- Buying out a partner (this may also be an act of survival).
- Effecting operating economies.
- Financing new buildings and equipment.
- Making repairs and modernizing existing facilities.
- Financing accounts receivable.
- Financing advertising and sales promotion programs.

Choosing a bank

As a rule, a small business owner can gain little by shopping around for banking connections. The volume of loan business that he can give the banker is too small to justify an interest rate much below the legal maximum, and the types of banking services that he needs can usually be supplied by his hometown bank. To deal with a banking institution located at some distance presents serious disadvantages that are not always offset by possible superiority in the quality of services rendered. On the whole, your local bank should be able to meet your banking needs in a thoroughly satisfactory manner.

It is a good plan to discuss your financial problems with your banker. He is a man of wide business experience and his knowledge of prevailing business conditions and trends may be of considerable help to you in formulating your own business judgments. Moreover, his institution performs many banking services that may be useful to you, even if you do not intend to borrow. You can learn about these services from him.

The loan request

The banker will need certain information upon which to base his loan decision. Part of it will be furnished by the borrower. The rest will come from the banker's own credit files or from outside sources. This information relates to what the credit man calls the "C's" of credit. They are *Character, Capacity, Capital, Collateral, Circumstances, and Coverage* (insurance). Any statements made by the customer will be verified by the banker. For this reason the borrower should make every effort to present his case as truthfully and correctly as he can.

The "C's" of credit

In the order listed above, the "C's" of credit are:

- *Character*.—Moral character is the most valuable asset a small-business owner can possess. To the banker it means two things in particular:

(1) *That the borrower will do everything in his power to conserve his business assets and thus assure the repayment of his indebtedness*.—He will not squander his own or other funds in such activities as betting, other forms of gambling, and related activities, or by attempting to maintain living standards for himself or his family that necessitate excessive withdrawals of funds or merchandise from the business. He will manage his business to the best of his ability.

(2) *That the borrower is a man of his word*.—If he says that he will repay his borrowings promptly, he means just that. If he fails to redeem his promise, it will only be after he has made every effort to do so.

- *Capital*.—The investment of the small manufacturer in his own business is evidence of his faith in its future. If he is so weak financially or so lacking in a sense of business responsibility that he expects others to carry his financial burdens on a permanent basis, he should stay out of business. A manufacturer is an enterpriser whose function is to *manage* the other factors of production—capital, labor, and land.

Only large manufacturers can expect that others will supply a substantial part of the capital necessary for permanent operations. The small manufacturer must furnish management and most of the capital until the time comes when others have confidence in his business to the extent of being willing to invest in it. When that day arrives, he will usually have accumulated enough permanent capital of his own to do without outside help, unless he plans a substantial program of expansion.

- *Capacity*.—The managerial skill demonstrated by the small manufacturer in utilizing his investment and in enlarging it is another important business asset. For those embarking upon a business career or entering a new field of endeavor, past experience may be of limited value. A successful record as a machinist, salesman, or bookkeeper does not qualify an individual to direct the operations, for example, of a machine shop.
- *Collateral*.—Manufacturers whose credit standing as borrowers is high do much of their borrowing on an unsecured basis. Those who are weaker are obliged, in many instances, to reinforce their general credit standing with specific collateral. This is likely to be true of the new small manufacturer. If he owns a home or other improved real estate, life insurance policies with a cash surrender value, or marketable securities, he may be able to use such assets as a basis for business borrowing.

Before borrowing on such terms, however, he should seriously consider the consequences to his family and to himself in the event that he is forced to

withdraw from business before he becomes established. A small manufacturer who retires from business prematurely usually does so at a loss. If he is a younger person, he may easily be able to find employment or to reestablish himself in another business venture. An older man or woman may be less fortunate.

● *Circumstances.*—Many factors have a bearing upon the making of a bank loan and its repayment. Some of them are mentioned under the headings of character, capacity, capital, collateral, and coverage. Others include:

- (1) Seasonal character of business.
- (2) Long-run business changes.
- (3) Level of community business activity.
- (4) Competitive position of the firm.
- (5) Nature of product.

● *Coverage.*—The matter of proper insurance coverage is of great importance. Small manufacturers are subject to many kinds of business losses, such as those resulting from:

- (1) Death of owner, partner, or principal stockholder.
- (2) Cessation of operations as the result of fire, explosion, flood, tornado, or other violent causes.
- (3) Losses from theft, embezzlement, or other acts of dishonesty by owners, officers, employees, or others.
- (4) Public liability not covered by workmen's compensation insurance.

While the beginner is less able to insure fully against loss than the established firm, he should recognize the need for adequate coverage. For the going concern, there is little excuse for neglecting to establish and maintain adequate insurance protection against basic risks. See your insurance broker, agent, or company representative. The Small Business Administration has prepared a series of four Management Aids for Small Business covering aspects of business insurance. They are in order of publication:

Business Insurance—I. Fidelity, Forgery, and Surety Bonds; Burglary Insurance.

Business Insurance—II. Workmen's Compensation Insurance; Accident and Health Insurance.

Business Insurance—III. General Liability Insurance; Automobile Insurance.

Business Insurance—IV. Boiler and Machinery Insurance; Glass Insurance; Credit Insurance.

(These four publications may be found reprinted in *Management Aids for Small Business: Annual No. 1*, for sale by the Superintendent of Documents, U. S. Government Printing Office, Washington 25, D. C.—price 65 cents.)

Form of loan application

You may find it to your advantage to obtain bank loan application forms and financial statement forms before you start negotiations. This will give

you a better idea of the types of information that the banker wishes to have you furnish. If you do not understand how to prepare these forms, you may obtain help from the banker or from a public accountant or others familiar with them.

The application forms that follow are those of a medium-sized national bank operating in a city of 30,000 population. While the details of application forms vary, those of smaller banks are generally much like the ones appearing in this study. They all include substantially the same basic information.

Form 4.—Application for Loan

Individual

Borrower:

Date: _____

Business or Profession:

Amount of loan \$

Endorsers or collateral offered:

Amounts already owing this bank by borrower { On collateral \$
Unsecured \$
As endorser \$

Purpose of loan:

Will loan be handled on demand, thirty-, sixty-, or ninety-day basis?

If loan is not to be paid in full at first maturity, state what arrangements are agreed upon as to reductions at first and successive maturities. (Care should be exercised to see that the borrower understands fully the arrangements as to liquidation of loan.)

Borrower's principal source of income and approximate amount of same per annum:

From what source does the borrower expect to obtain the necessary funds to meet the liquidation as outlined above?

This _____ day of _____ 19__

Signature of applicant

Form 5.—Application for Loan

Corporation-Partnership

Borrower:

Date: _____

Business:

Amount of loan \$

Banking account?

Endorsers or collateral offered:

Amounts already owing this bank by borrower	{	Unsecured	\$
		On collateral	\$
		As endorser	\$

List of officers if corporation:

List of Partners if partnership: (Show how ownership is divided)

List individual borrowings from bank by Officers (if corporation) or by partners (if partnership). Showing in each case whether the borrowings are on Collateral or Unsecured:

Purpose of loan:

Will loan be handled on demand, thirty-, sixty-, or ninety-day basis?

If loan is not to be paid in full at first maturity, state what arrangements are agreed upon as to reductions at first and successive maturities. (Care should be exercised to see that the borrower understands fully the arrangements as to liquidation of loan).

This _____ day of _____ 19____.

Signature of applicant

Financial statements

Besides the loan application, the borrower must file recent copies of his financial statements with the bank. These consist of the balance sheet and the income statement. Manufacturers applying for bank loans should be able to present cost figures and other additional business data upon request.

While the bank does not, as a general rule, require that you use its statement forms, you will find them helpful as a guide in preparing your own financial statements. They indicate what the banker needs to know about your finances in order to make a sound estimate of your credit worthiness.

An increasing number of businessmen are submitting financial statements prepared by professional public accountants. Since a competent accountant is thoroughly familiar with bank loan requirements, he can furnish statements in a form that the banker is accustomed to reading. This is often not the case when the customer prepares his own statements.

Financial statements submitted to a bank in support of a loan application must be signed by the applicant and by a representative of the public accounting firm if they are based upon a audit. Such statements are relied upon as a guide to loan policy, and the banker may take legal action against a borrower who uses them to commit an act of fraud. Moreover, the transportation of such statements through the mails is a criminal offense when they become the basis for a fraudulent attempt to obtain money or credit.

Examples of statement forms follow. You will find it worth while to study them carefully.

TO
THE FIRST NATIONAL BANK

Name _____ 19____
 Business _____
 Location _____

The undersigned, for the purpose of procuring and maintaining credit with your bank on negotiable paper or otherwise, hereby furnish and warrant the following facts to you, which fully and truly represent the financial condition of the undersigned on _____ day of _____ 19____, (should the day be left blank, the date of the statement will be taken for the day), which facts and representations you can consider as continuing and remaining full, true and accurate unless notice of change is given you, and agreement is hereby made, to notify you promptly of any change in financial condition that materially reduces the pecuniary responsibility of the undersigned.

In consideration of the granting of credit the undersigned agree that in the event of failure, insolvency or committing an act of bankruptcy; if any of the representations below are untrue; if the undersigned fail to notify you in writing of any change as before agreed, then, or in either case, all obligations of the undersigned held by you shall immediately become due and payable without demand or notice and the same may be charged against the balance of any account to the credit of the undersigned with you. A continuing lien is hereby given on any balance on deposit to the credit of the undersigned, also choses in action, from time to time existing, to secure all obligations of the undersigned held by you.

It is hereby expressly agreed and understood that in the event I make application for further credit or for the renewal or extension of any existing indebtedness, this statement shall be as valid and binding as if delivered as a true and correct statement of my financial condition on the date such further credit, extension or renewal is requested and granted.

FILL ALL BLANKS. WHERE NO ANSWER IS GIVEN, "NO" OR "NONE" WILL BE TAKEN FOR YOUR ANSWER.

ASSETS		LIABILITIES	
Cash on hand and in bank _____		Notes owed by me—without security _____	
Accounts due me—Good _____		Notes owed by me— with security other than real estate _____	
Unsecured loans due me—Good _____		Notes or mortgages owed by me— with real estate as security _____	
Secured loans due me _____		Notes owed by me— with Chattel Mortgage as security _____	
Mortgaged loans due me _____		Accounts owed by me _____	
Stocks and Bonds _____		Any other indebtedness—itemize _____	
United States Securities _____			
Land _____			
Buildings _____			
Any other property or investments—itemize _____			
		TOTAL LIABILITIES	
		NET WORTH	
TOTAL		TOTAL	

CONTINGENT LIABILITY OF ANY KIND	
On Notes of others endorsed by me _____	
As Guarantor for accounts and notes of others _____	
On Notes exchanged with others _____	
As Bondsman or Surety for others _____	
For Leases _____	
Other than above specified _____	
TOTAL	

LAND AND BUILDINGS—DETAILS RELATIVE TO ASSETS AND LIABILITIES						
DESCRIPTION AND LOCATION	TITLE IN WHOSE NAME	ASSESSED VALUE	APPRAISED VALUE	MORTGAGES	INSURANCE	RENTALS RECEIVED LAST FISCAL YEAR
		\$ _____	\$ _____	\$ _____	\$ _____	\$ _____

By whom appraised? _____ When? _____
 Taxes paid to what date? _____

(See Reverse Side)

Form 6—Single Proprietorship

Is there any other person interested in your business either as special or limited partner? _____

Are you a partner in any firm? _____

Are there any judgments unsatisfied, or suits pending against you, and for what amount? _____

Is your life insured? _____ Amount? _____

Who is the beneficiary? _____

Have you any leaseholds not mentioned in your assets? _____

Give details _____

What in your opinion is the net worth of each endorser on your notes? _____

Are any of your assets, other than real estate, pledged or hypothecated in any way? _____

NOTES OWED BY ME:—

TO WHOM GIVEN	AMOUNT	DATE	WHEN DUE	INTEREST RATE	DESCRIPTION OF SECURITIES PLEDGED
	\$				

ACCOUNTS OWED BY ME:—

TO WHOM	AMOUNT	WHEN DUE	FOR WHAT
	\$		

OTHER PROPERTY

DESCRIPTION	LOCATION	VALUE
		\$

I hereby solemnly declare and certify this to be a true and correct statement of my financial condition at the close of business

_____ 19__

(Sign Here) _____

Date _____ 19__

Form 6—Continued

TO
THE FIRST NATIONAL BANK

Name..... 19.....

Business.....

Location.....

The undersigned, for the purpose of procuring and maintaining credit with your bank on negotiable paper or otherwise, hereby furnish and warrant the following facts to you, which fully and truly represent the financial condition of the undersigned on..... day of

..... 19....., (should the day be left blank, the date of the statement will be taken for the day), which facts and representations you can consider as continuing and remaining full, true and accurate unless notice of change is given you, and agreement is hereby made, to notify you promptly of any change in financial condition that materially reduces the pecuniary responsibility of the undersigned.

In consideration of the granting of credit the undersigned agree that in the event of failure, insolvency or committing an act of bankruptcy; if any of the representations below are untrue; if the undersigned fail to notify you in writing of any change as before agreed; then, or in either case, all obligations of the undersigned held by you shall immediately become due and payable without demand or notice and the same may be charged against the balance of any account to the credit of the undersigned with you. A continuing lien is hereby given on any balance on deposit to the credit of the undersigned; also choses in action, from time to time existing, to secure all obligations of the undersigned held by you.

It is hereby expressly agreed and understood that in the event we make application for further credit or for the renewal or extension of any existing indebtedness, this statement shall be as valid and binding as if delivered as a true and correct statement of our financial condition on the date such further credit, extension or renewal is requested and granted.

FILL ALL BLANKS. WHERE NO ANSWER IS GIVEN, "NO" OR "NONE" WILL BE TAKEN FOR YOUR ANSWER.

ASSETS					LIABILITIES				
Cash on hand and in Bank					Notes Payable for Merchandise.....				
Notes Receivable of Customers:					Acceptances Issued.....				
Current.....					Notes Payable to Banks.....				
Past Due, Cash Value.....					Notes Payable for Paper Sold.....				
Accounts Receivable of Customers:					Notes Payable to Officers				
Current.....					Directors and Stockholders.....				
Past Due, Less than 6 months.....					Notes Payable to Others.....				
Past Due, over 6 months.....					Accounts Payable—Not Due.....				
Acceptances of Customers.....					Accounts Payable—Past Due.....				
Merchandise:					Accounts Payable to Officers				
Finished.....					Directors and Stockholders.....				
In Process, Unfinished.....					Accounts Payable to Officers				
Raw Material.....					Deposits of Money with this Co.				
Collateral Pledged to Loans:					By Officers and Others.....				
Notes Receivable.....					Secured Liabilities by				
Accounts Receivable.....					Notes Receivable.....				
Trade Acceptances.....					Accounts Receivable.....				
Merchandise.....					Trade Acceptances.....				
Securities.....					Merchandise.....				
Other Active Assets.....					Securities.....				
					Any Other Current Liabilities.....				
Total Active Assets.....									
Due from Controlled or Allied					Total Current Liabilities.....				
Concerns: For Merchandise.....					Mortgages or Liens on				
For Advances.....					Real Estate.....				
Stocks, Bonds and Investments					Bonded Debt.....				
Land.....					Chattel Mortgages.....				
Buildings.....					Any Other Liabilities—Itemize.....				
Machinery, Equipment and Fixtures									
Horses, Wagons and Automobiles.....									
Notes Receivable—Due from Officers,									
Stockholders and Employees.....					Total Liabilities.....				
Accounts Receivable—Due from					Reserve—Itemize.....				
Officers, Stockholders and Employees									
Good Will, Patents and Trade Marks									
Other Assets—Itemize.....					Capital Stock—Prof. Outstanding.....				
					Capital Stock—Com. Outstanding.....				
Deferred Assets.....					Capital Stock—No Par Value.....				
					Surplus and Undivided Profits.....				
TOTAL.....					TOTAL.....				

(Use Reverse Side.)

Form 8—Corporation

Contingent Liability of Any Kind

Upon Receivables Discounted or Pledged.....				
Upon Accommodation Paper or Endorsements.....				
Customers' Account Sold and Assigned.....				
As Guarantee for Others on Notes, Contracts, etc.....				
For Bonds or Unfinished Contracts.....				
For Leases.....				
Other Contingent Liabilities.....				

Commitment Liability

Contract Price of Goods Purchased, Delivery to be made During 19				
Present Market Value of Goods Purchased, Delivery to be made During 19				
Insurance. Fire, on Buildings \$.....			Machinery, Fixtures and Equipment \$.....	
Merchandise \$.....			Life in favor of Company \$.....	

CONDENSED PROFIT AND LOSS STATEMENT FOR FISCAL YEAR ENDING 19

EXPENSE				INCOME			
Cost of Material or							
Merchandise Consumed.....				Net Sales.....			
Actual Expense of Conducting				From Investments.....			
Business, Including Rent,				From Discount in Purchase.....			
Taxes, Insurance, etc.....				From Other Sources—Itemize.....			
Salaries Paid to Officers.....							
Int. on Borrowed Money, Bonds.....							
Bad Debts Charged Off.....							
Depreciation Charged Off.....							
Net Profits.....							
Total.....				Total.....			

Surplus and Undivided Profits

At Close of Previous Year \$.....							
Less Charges Not Applicable to Current Year.....	\$			\$			
Add Net Profits as Above—Itemize.....	\$			\$			
Less Dividends (Preferred (Per Cent).....	\$						
(Common (Per Cent).....	\$						
(No Par (Per Cent).....	\$						
Undivided Profits.....						\$	

We hereby certify that the foregoing figures are taken from the books of this Company and that they and the statements contained on both sides of this sheet are true and give a correct showing of the financial condition of the Company.

Signed this..... day of..... 19....
 Name.....
 By.....
 (State official title)

I—We have audited the accounts of..... for the period from..... to..... and certify that in my opinion the above Balance Sheet and Statement of Profit and Loss set forth the financial condition of the firm or company at..... and the results of its operations for the period.

Public Accountants

WORTH OF ENDORSERS EXCLUSIVE OF THEIR INTERESTS IN THE BUSINESS

.....	\$.....	\$.....
.....	\$.....	\$.....
.....	\$.....	\$.....

Common types of bank loans

The principal types of bank loans are: Straight commercial loans, installment loans, character loans, term loans, accounts receivable loans, warehouse receipts loans, equipment loans, and collateral loans.

Straight commercial loans.—These loans are usually made for a period ranging from 30 to 90 days. Often they are single-name paper without endorsement and are based upon financial statements. They are self-liquidating in that the expectation is that they will be paid from the proceeds of the transactions which gave rise to them. This type of paper is used particularly for seasonal financing and for building up inventories.

Installment loans.—Loans of this type are commonly made by larger banks. Such loans are made for almost any productive purposes and may be extended for almost any period that the bank sees fit to offer. Payments must be made, usually on a monthly basis, but as the obligation is reduced it may be possible to obtain refinancing at more advantageous rates. These loans may be tailored to the seasonal requirements of the business, with heavier repayments in peak months and smaller repayments during off-season periods.

Character loans.—Such loans are usually of the consumer credit variety, although they are sometimes used for business purposes.

Term loans.—Such loans have maturities of from 1 to 10 years and may be either secured or unsecured. Loan repayments may be made on almost any agreed basis—monthly, quarterly, semiannually or annually. Early payments are often relatively small, with a large final payment. Such loans are usually covered by a comprehensive agreement calculated to protect the lender against drastic changes in the value of collateral security or in business income available for repayment of principal and payment of interest. Because of the extended maturities of such loans, borrowers will find it necessary to submit periodic statements during the life of the loan. Term loans are described in considerable detail in chapter V.

Accounts receivable loans.—You may use your accounts and notes receivable as a basis for bank borrowing. The bank will take over these items on a notification or a nonnotification plan. If the former method is used, the bank notifies the debtor that the receivables have been assigned to it and that it will collect them as they fall due. The bank credits collections to the account of the borrower after deducting its service charges. Under the nonnotification plan, the borrower collects his accounts as usual and then pays off his indebtedness at the bank. Small banks are not well equipped to service this type of loan, and the majority of their business customers are too small to take advantage of it.

Warehouse receipt loans.—Under this form of financing, goods are stored in warehouses and the warehouse receipt given to the bank as security for a loan to pay off the supplier. As fast as the purchaser is able to sell his

merchandise, or to use it in manufacturing operations, he buys back portions of the inventory. This type of borrowing enables him to get along with a smaller investment in working capital. Loans of this type apply only to nonperishable items that are readily marketable. (Warehouse receipt financing and accounts receivable loans are discussed at greater length in the following chapter.)

Equipment loans.—Loans are made to finance the purchase of machinery and equipment under either of two plans depending upon the applicable State law. The buyer has possession and use of the equipment in either case while he is paying for it.

Using one approach, the equipment involved is sold under a "conditional sales agreement," with the bank (or other financing institution) retaining title until installment payments have been completed. In a number of States, however, an alternative approach is used when advances on machinery and equipment are made under an arrangement by which the bank takes a chattel mortgage as security for payment.

Collateral loans.—Business borrowers may be able to obtain bank loans on the basis of such collateral as chattel mortgages on personal property, real estate mortgages, life insurance up to the cash surrender value of the policy, or stocks and bonds. Insurance loans have been popular in the past, although they seem to be on the decline at present.

Term Loans, Accounts Receivable and Inventory Financing

The term loan—The loan agreement—Limitations on the borrower—Credit standards for term loans—The cost of term loans—Advantages of term loans—Accounts receivable financing—Method of financing receivables—Notification and nonnotification plans—Charges for accounts receivable financing—Factoring of accounts receivable—An example of accounts receivable financing—Advantages and disadvantages of accounts receivable financing—Loans secured by warehouse receipts—The basis for inventory loans—The warehouse receipt—Field warehousing—Financing purchases with warehouse receipts as security—Financing a loan on field warehoused merchandise—Borrowers on inventory security

This chapter describes term loans, and loans based upon accounts receivable or inventories. All of these financing arrangements have been developed to meet special situations not adequately provided for by the typical unsecured short-term bank loan.

The term loan

A term loan is a business loan with a maturity of not less than 1 year, and usually not more than 10 years.—Term loans are usually amortized. Long-term credit on real estate does not fall under this heading.

The term loan has been developed to fill a gap in the financial requirements of the small and moderate-sized firm. It makes available capital for other than temporary needs without forcing the owner to surrender business control. This type of loan gives to the manufacturer who cannot fully pay for plant and equipment in cash the opportunity to build up his equity over a period of years. As a simple example: A small manufacturer needs new equipment that will substantially increase his output but lacks the cash to pay for it. With a term loan he will be able to acquire title to the machines immediately. During the life of the loan, the equipment will be helping to produce income from which to meet installments and interest. If the undertaking is successful, it will be producing extra profit for the manufacturer, too.

Other common uses of term loans are:

- To provide funds for the purchase of existing businesses or to help to establish new ones.
- To provide additional working capital.
- To provide funds for the retirement of outstanding bond issues at call dates or at maturity.
- To permit the retirement of outstanding preferred stock.

The loan agreement

In granting term credit, banks and other lenders often impose conditions on the borrower telling him what he must do and what he cannot do during the life of the loan. These terms are embodied in the *loan agreement*.

The loan agreement may provide for a single note to be retired by payments on a monthly, quarterly, semiannual, or annual basis, or it may consist of a series of notes, one coming due at each payment date. In some instances payments are equal. In others, there may be a series of smaller payments, with a large final payment. This is sometimes called a *balloon* payment.

Limitations on the borrower

A typical loan agreement may require that the borrower:

- Maintain excess working capital at a specified minimum.
- Furnish certified financial statements at the close of each fiscal year or on other dates at the request of the lender.
- Provide assurance with each statement that he is not in default and will not be within a specified period.
- Refrain from certain acts during the life of the loan, except by consent of the lender. These may include agreements not to:
 - (1) Pay dividends or purchase or redeem the capital stock of the firm.
 - (2) Enter into any merger or consolidation or lease or sell substantially all of the firm assets.
 - (3) Create or permit to exist any pledge, mortgage, lien or other encumbrance against any firm assets, except liens in the ordinary course of business.
 - (4) Create or assume any obligation, direct or contingent, for money borrowed by the firm or otherwise, except as provided in the agreement.
 - (5) Guarantee, endorse, or otherwise become surety for or upon the obligation of others.
 - (6) Make capital expenditures in excess of a specified amount.
 - (7) Sell receivables with or without recourse.
 - (8) Make loans or advances to others in excess of a specified amount at any one time.
 - (9) Purchase securities other than United States Government securities.

The agreement commonly contains a statement covering the obligations of the borrower in the event of default. One feature of this agreement is an *acceleration clause* under which any breach of agreement by the borrower will cause the entire amount of the debt to become due immediately.

Under many term loan agreements, loans may be repaid without penalty before they become due. Such action is usually possible, however, only if repayment is made from earnings or from the sale of business assets.

If other credit sources are used to repay the loan, a prepayment penalty is generally imposed. Prepayments are usually credited in reverse order; that is, installments with the most advanced maturities are paid off first.

The interest rate is generally specified in the agreement. It may appear under the description of the notes that are used in making the actual loans. The interest rate may be a flat rate on the balance of the loan, or it may be a series of rates which increase with longer maturities.

Credit standards for term loans

Although many term loans are backed by collateral security, such as plant and equipment, the lender must rely primarily upon the ability of the borrower to repay his indebtedness out of earnings over the life of the loan. This means that the ability of the small manufacturer to operate his business on a profitable basis is more important to the lending institution than the liquidation value of the security. Fixed assets disposed of at forced sale seldom realize more than a small fraction of their book value. The additional security merely strengthens the possibility that the banker or other lender will be able to recover his loan with interest during its life.

In many respects, lending requirements imposed by term lenders resemble those that apply to short-term loans. The term lender is particularly concerned with the moral responsibility of the borrower, as well as with his managerial ability. These credit factors usually show up more strongly over a period of several years than they do when the loan has a short maturity.

The current position of the borrower is very important. Ordinarily, the lender will require that current assets exceed current liabilities in at least the traditional 2-to-1 ratio. If your business shows considerable fluctuation in earnings over a period of several years, the required ratio may be much higher.

Bankers commonly require that the ratio of equity capital to debt shall be more than 1 to 1. If the owners have a substantial investment in the business, they are likely to manage it more carefully than would be the case if they were relying heavily upon outsiders for financing.

The freeing-up of cash is also important, since the ability of the firm to pay off its borrowings depends upon having cash that can be applied to the reduction and ultimate elimination of the term loan. You should be able to estimate how much cash you will have available for these purposes. If you are unable to do so, your banker can make the necessary calculations.

The cost of term loans

The term loan is tailored to meet a specific situation, and for that reason no indication of standard loan rates can be given. In general, the small borrower will pay a total charge about equal to the legal interest rate. Larger

borrowers receive better terms, although recent advances in interest rates have reduced their advantage somewhat. If you borrow in the \$1,000 to \$5,000 range, you may well have to pay from about 6 to 8 percent. On loans in excess of \$5,000, you may be able to get a lower rate if your credit rating is very high.

Advantages of term loans

Although the borrower is subject to certain restrictions as to how he may manage his business during the life of a term loan, such a loan has several advantages. Some of them are:

- The loan is carefully negotiated between lender and borrower. Its provisions must be satisfactory to both parties before it becomes effective.
- It is based upon the ability of the borrower to make repayment out of earnings, generally with the intention of having the loan fully paid up by the time of maturity.
- The borrower has assurance that no portion of his loan must be paid before its due date, as long as he lives up to the terms and conditions of the loan agreement.
- In case it becomes necessary to revise the loan agreement, such a revision can be accomplished much more easily than in the case of a bond indenture or a preferred stock agreement.
- There is no registration expense or any expense in connection with the issuance and transfer of securities. The borrower is expected, however, to absorb the lender's legal fees and other expenses connected with the loan.
- Term lenders have long experience with borrowers and can give them the benefit of expert advice on business matters affecting the loan.

Accounts receivable financing

Small manufacturers in many lines of business raise funds needed for current operations by borrowing on the security of pledged accounts receivable or by selling their accounts receivable. Firms with a limited amount of working capital, or those subject to fluctuations in sales volume, find accounts receivable financing of particular value. Such financing can be arranged through your own bank, or through a finance company or a factor.

Method of financing accounts receivable

If you engage in accounts receivable financing, you will enter into an *underlying agreement* or *working plan* with your bank or a finance company or factor. This agreement will specify what percentage of your receivables

assigned or sold will be available to you. In the case of a bank loan, the amount will usually be from 75 percent to 80 percent of good receivables. Factors' advances are larger. The agreement will also set forth your rights and liabilities as well as those of the lender, together with the overall conditions under which each assignment is to operate. Assignments will be made as you need funds. On such occasions, you will prepare a schedule of assigned accounts, and, if a loan is made, will execute a demand note for its amount. Usually the lender will stamp the assigned accounts in your accounts receivable ledger, indicating that such accounts have been assigned. In some States this book-marking is required to validate the assignment. Be sure that you have conformed with this requirement, if your State is among those which have it.

Notification and nonnotification plans

Banks and most finance companies use the nonnotification type of assignment. Under this plan your customers are not informed that their accounts have been assigned. You will collect the accounts and (1) remit the proceeds to the lender in their original form, or (2) deposit them in a special agency account, which is subject to withdrawal by the lender only. Both you and your customers will probably prefer the nonnotification plan of payment.

Factors and some finance companies use the notification plan. Under this arrangement, the original bill or invoice is sent to the customer with a stamped notation indicating that the account has been assigned. Your customer pays the factor or finance company directly.

Charges for accounts receivable financing

There are no standard charges for this type of financing. The charges are stated in the agreement. In some cases the loan may be made at interest, calculated on the average daily balance computed over a specified period of time. Sometimes the loan is discounted. On other occasions the lender may levy a service charge based upon the total number of accounts and the face amount of the receivables. Finance companies often have both interest and service charges.

Factoring of accounts receivable

In an increasing number of lines of business, factoring companies are being used to convert accounts receivable into cash. Under a continuing agreement made between the seller of merchandise and the factoring company, the factor contracts to buy all the accounts receivable of the seller as they arise. The factor assumes all the risk and has no recourse if the accounts receivable prove uncollectible. This means that if you factor

your accounts receivable, the factor will pass upon the credit standing of your customers.

The factor typically charges a fee of 1 percent or 2 percent per month on the face amount of all accounts bought during the previous month. This is his charge for assuming the credit risk. In addition, he will charge you 6 percent a year interest. This charge is deducted from the payment for your accounts. Factoring is an expensive method of raising funds, but it eliminates the need for maintaining a credit and collection department.

An example of accounts receivable financing

A small manufacturer with maturing notes and accounts payable finds himself short of cash. One possible way of raising funds is to pledge or sell his accounts receivable. Assume that he has \$30,000 of accounts and notes payable, of which 50 percent are due immediately, and that he has \$20,000 of accounts receivable on his books. After analyzing the collectibility of these accounts, the bank agrees to advance \$16,000, or 80 percent of the face value of the receivables.

The manufacturer can now pay off \$16,000 of his short-term indebtedness. This will relieve the pressure on his cash balance. It will also improve his current ratio. With the balance of payables reduced to \$14,000, the manufacturer is now in a better position to obtain additional trade credits or bank loans. Of course, he has disposed of his best receivables to accomplish these objectives, but it may be worth it.

Advantages and disadvantages of accounts receivable financing

The principal advantages of accounts receivable financing are:

- The credit of the business may be too weak to finance in any other way.
- Concerns selling on the installment plan or those that find that they must give relatively long credit terms will find this a logical method of financing, particularly if accounts receivable constitute a large part of their assets.
- Interest is paid only upon funds actually received and used. This differs from traditional bank practice where the borrower must pay interest on the full amount of his loan, irrespective of whether the borrowed money is active or idle.

Disadvantages of accounts receivable financing are:

- Interest rates are higher than those on bank loans, when the latter are obtainable.
- Where the notification plan is used, customers may resent the pledge or sale of their accounts.

Loans secured by warehouse receipts—the basis for inventory loans

If a small manufacturer wishes to buy nonperishable commodities such as grain, cotton, wool, tobacco, lumber, or other staple inventory items that can be stored in a warehouse, he can borrow from a bank or a finance company to pay for such purchases by using the proceeds of a loan obtained on the security of a warehouse receipt. If the manufacturer already owns such goods in storage, he may be able to obtain loans by using the warehouse receipts as collateral. This practice enables the small manufacturer:

- To build up inventories when it is most advantageous to do so.
- To take advantage of cash or quantity discounts.
- To obtain additional working capital at a time when production and operating costs are high and working capital is low.

The warehouse receipt

The basis for the inventory loan is the warehouse receipt. When goods are properly warehoused, it signifies to the banker:

- Sound security for his loan.
- A warehouse in charge of a dependable warehouse company.
- Legal possession of the inventory for the life of the loan.

The warehouse receipt is a receipt for goods placed in a warehouse. Warehouses are of two types—public and field warehouses. Public warehouses are buildings operated by persons who are lawfully engaged in the business of storing goods for a profit. Public warehousing is impracticable when the merchandise is bulky or the cost of moving it is excessive. Consequently, the field warehouse, which is a part of the manufacturer's premises, has come to be widely used.

Field warehousing

Under this plan, a warehousing company takes a lease on a part of the borrower's premises on which it places signs to indicate that it is the occupant. The borrower applies in writing for space in the warehouse area. As goods are deposited therein, the custodian, who is in the employ of the warehouse company, issues warehouse receipts to cover the merchandise. The custodian and other employees of the warehousing company are under bond, so that there is little danger of loss to the lender.

Financing purchases with warehouse receipts as security

The steps generally taken in financing purchases with warehouse receipts as security are:

- Buyer advises his bank that he is ordering goods from the seller.

- Buyer arranges to have bank pay draft to be forwarded to bank with bill of lading covering shipment.
- Seller ships goods and sends draft with bill of lading to bank.
- Bank pays draft upon arrival of goods and obtains note from purchaser to cover cost of goods.
- Buyer gives bank trust receipt in exchange for bill of lading.
- Buyer gets goods and stores them in warehouse.
- Buyer receives warehouse receipt which he gives to bank in exchange for trust receipt which is canceled.
- Warehouseman releases goods upon surrender of warehouse receipt or notification from bank ordering partial release.

Before the bank will give up a warehouse receipt or order a partial release of goods, the borrower must either reduce his loan in proportion to the value of the goods released, or give the bank a trust receipt for the goods withdrawn. If the goods covered by the trust receipt are sold, the proceeds must be used to pay the bank. Then the trust receipt will be canceled.

Financing a loan on field warehoused merchandise

When small manufacturers accumulate inventories in anticipation of seasonal or other peak demand requirements, they are frequently in need of extra cash. This need may be met by offering warehouse receipts to the bank as collateral for a loan. When orders are received, the borrower will be able to buy back his warehouse receipts from the bank and thus be in a position to fill such orders. As additional sales are made he will be able to buy back all his warehouse receipts and thus complete the repayment of his loan.

Borrowers on inventory security

Borrowers on inventory security are usually medium-sized firms. Credits obtained commonly range from \$15,000 to \$60,000, although in some instances the amounts borrowed may exceed \$100,000. Financing costs vary widely depending upon the range of bank charges and the field warehouseman's bill. This is based on (1) the value of the inventory, (2) the work involved in checking the inventory in and out, and (3) the duration of the agreement. Charges generally run as follows: Bank charges, 6 percent or more; combined charges, 6 to 12 percent.

From the schedule of charges it is clear that inventory financing is relatively expensive. However, it may be the only type open to a borrower who has exhausted his unsecured credit.

CHAPTER VI

Some Other Sources of Financial Assistance for Small Businesses

Venture capital organizations—Establishing contact—Financing operations—Project analysis—Management assistance—Financing methods—An example of financing by a venture capital organization—State development credit corporations—Industrial foundations—General services—Specific advantages—Financial policies of industrial foundations—Suggestions to the small manufacturer—Jobs, Incorporated

Venture capital organizations

Some firms in need of equity capital may find it worth while to consider the possibilities offered by venture capital organizations. Chapter VIII of this booklet describes the Small Business Administration's investment program and the venture capital organizations which are developed through it. Other venture capital groups are often financed by wealthy individuals who are willing to invest their funds in new or relatively undeveloped industries showing growth prospects. As a rule, they supply risk capital to manufacturers in such fields as aviation, chemicals, electronics, and applied nuclear physics, although they are often interested in technical developments in other areas of business.

Some of the principal venture capital enterprises are:

American Research & Development Corp., Boston, Mass.
Wm. A. M. Burden & Co., New York.
Fox, Wells and Rogers, Stamford, Conn.
Industrial Capital Corp., San Francisco, Calif.
New Enterprises, Inc., Boston, Mass.
Payson & Trask, New York.
Rockefeller Bros., Inc., New York.
Henry Sears & Co., New York.
J. H. Whitney & Co., New York.

Establishing contact

Venture capital organizations often seek out their own prospects, although they also depend to a considerable extent upon investment banking houses, patent lawyers, corporation research directors, and others who are in contact with inventors and promoters. *Either your commercial bank or your public accountant may be able to establish a contact for you.* In all probability, they can present your case better than you can. Venture capital organizations generally center their attention on firms operating in the United States. Also, note that they are usually looking for new products or processes, rather than services.

Financing operations

Venture capitalists prefer to finance projects that have advanced beyond the stage of invention or experimentation. In most instances they are particularly interested in ideas that have successfully passed the pilot plant stage to a point where the product can be commercialized by a substantial capital investment and nothing more. Some venture capital organizations are beginning to finance established companies, provided they show possibilities for growth through new capital investment or management. Some, but not all, investment capital firms place a lower limit on the size of their investments—\$100,000 is a fairly common minimum.

Project analysis

Each year many new projects are submitted to the venture capital organizations for their consideration. Most of them are rejected immediately, or after a brief review by a staff member. The analysis of a product beyond the pilot stage of development includes:

- A careful revaluation of the stage of product development.
- A check on the accuracy of experimental work.
- Demonstration of the quality of the product.
- Verification of operating cost estimates.
- Estimate of potential market opportunities.
- Estimate of competitive position of product or process.
- Capital requirements and profit potential.
- Preparation of budgets.
- Decision as to method of financing long-term growth of venture.

Unless profit prospects are exceedingly good, further consideration of the enterprise is out of the question. Venture capitalists have found that such a policy is necessary to offset the high mortality rate on projects undertaken. *The greatest single problem of the venture capital concerns has been to find or to train qualified business managers.* For this reason, venture capitalists place great emphasis on the quality of management. In their opinion, even a good product that can be produced under exceedingly favorable competitive conditions with excellent earning prospects is of little merit if the quality of management is inferior.

Management assistance

Venture capital enterprises are in a position to give management assistance as well as financial help. Even though they do not, as a rule, control firms under their financial sponsorship, venture capitalists usually insist on having

a strong voice in the management of such companies. Commonly they place representatives upon the boards of directors of financed companies, but they do not attempt to interfere with the normal operations of such concerns as long as their managements display a proper degree of competence. Risk capital groups expect to leave their investments with financed companies for a number of years. Unless it is possible for them to withdraw funds without impairing the operations of a growing concern, it is unlikely that they will attempt to recover capital advances until a more propitious time.

Financing methods

Risk capital enterprises finance their projects through issuance of securities of all kinds. Debentures are used to give the venture capital firm an income from the beginning of operations, as well as a tax-deductible interest item. Preferred stock of all types is employed. In every case the company insists on holding common stock in a financed company or upon receiving a stock option to buy at a predetermined price. In most instances, the venture capital firm does not insist upon holding a controlling stock interest, and the question of control is seldom a factor in negotiations preceding the actual financing. Once the company has made its initial investment, it tries to encourage outsiders to take a financial interest in the project.

An example of financing by a venture capital organization

An example of the activities of a venture capital organization is the financial assistance rendered by the American Research & Development Corp. to Tracerlab, Inc., a pioneer in the field of the commercial development of radioactivity products and applications. The American Research & Development Corp. invested \$236,830 in the company in 1946 and 1948, making possible its establishment and early expansion. By 1949, the company had progressed to the point where it was able to raise additional capital through a public offering of \$1,300,000. In 1951, an additional public offering of \$2,581,250 made possible the acquisition of the Kelly-Koett Manufacturing Co., Inc., the oldest and one of the largest X-ray equipment manufacturing companies in the United States. It also provided additional working capital. By 1957, Tracerlab, Inc., reported consolidated sales of over \$12,000,000. In 1959, the company employed some 670 people, including a sales office in the Netherlands. Also during 1959, Tracerlab offered 100,000 shares of common stock at \$11.00 a share.

Some of the projects sponsored by the American Research & Development Corp. have involved larger contributions than that invested in Tracerlab, Inc., but a number of them have received substantially smaller amounts of financial assistance.

State development credit corporations

Business interests in the six New England States have established development credit corporations to help relieve the venture capital shortage in their areas. Such organizations confine their operations largely to lending, although they are authorized to buy capital stock. They supply funds in a time range falling between short-term bank lending and equity capital financing.

Industrial foundations

Small manufacturers in need of financial assistance or advice will often find the services of the industrial foundation exceedingly helpful. Many such organizations have been established in various parts of the country to perform functions related to the development and expansion of community business activities. The main objective of these groups is to bring new industrial enterprises to the community, although they frequently assist local manufacturing firms. They are usually identified in some way with local boards of trade or chambers of commerce.

General services

Buying, developing, and selling industrial sites.—Small manufacturers sometimes need to find new industrial sites at reasonable prices. However, if a manufacturer makes it known that he is interested in locating in a given community, the asking price of desirable land is likely to go up as soon as the landowner has learned that some company is considering the purchase of his land. The foundation that owns good industrial land can quote attractive sales prices immediately to a prospect. As a result there usually need be no delay in negotiations because of a lack of land at a satisfactory price.

Buying and building plants for lease or sale.—Many concerns cannot obtain capital for plants or do not wish to tie up their money in real estate. Industrial foundations often will erect buildings for lease or for sale. Contracts are not standard but vary according to negotiations with each manufacturer. Some industrial foundations lease with option to purchase. These agreements are similar to the sale-and-lease-back arrangements made by insurance companies. In some cases, industrial foundations help businesses by accepting a lower rate of return on their real estate investments than would be paid if the transactions were negotiated through regular business channels. In a few instances, industrial foundations offer free use of buildings to business concerns moving into the area.

By obtaining your plant on a lease basis, you will have more money available for working capital purposes. In addition, you will be able to charge off your rental payments as operating expenses, and may, thereby, reduce your income taxes.

Providing funds for loans to or investment in industries.—Industrial foundations may supply funds to new business enterprises or established local companies. This is accomplished either by making direct loans or by purchasing shares of stock in the firm. New companies obtaining funds from industrial foundations usually invest them in land and/or buildings. Established companies generally utilize such funds for refinancing, supplementary working capital, or new plant equipment.

Giving managerial, engineering, and other counseling services to small businesses.—These services are of particular value to small firms. Few excel in all phases of management which are essential for efficient and profitable operations. An industrial foundation is often in a position to provide expert advice and make profitable suggestions to small companies by pooling the knowledge of the businessmen of the community.

Specific advantages

Business executives seeking plant locations will find that there are specific advantages in choosing a community in which there is a functioning industrial foundation. For example, consider the following points:

- The presence of an industrial foundation in the community means to the executive that if his firm locates there, it will be assured of strong community backing even though he does not call upon the foundation for help. The existence of the foundation indicates that the community is seeking new enterprise.
- Developed plant sites are available. Paving, grading, utilities, and railroad sidings can be provided. Thus, the industrialist is able to avoid delays in establishing his plant, as well as the necessity for substantial cash outlays for site improvements.
- Lease arrangements may be made by the executive who wishes to avoid heavy outlays for plant facilities. In many cases, he can lease new buildings especially constructed for his use for long periods of time at reasonable rentals, provided they are of fairly standard design.
- Industrial foundations will provide loans to firms by accepting risks that are greater than those acceptable to banks. In some instances they will lend larger amounts in ratio to the value of security and for longer periods than is customary with banks.

Financial policies of industrial foundations

The financial policies of industrial foundations may be summarized briefly.

- *Security.*—The industrial foundation takes a mortgage on land, buildings, or machinery sold. Such mortgages commonly have a maturity of 10 years or longer and carry relatively low interest rates.

- *Representation.*—The industrial foundation will elect a representative to the board of directors of the financed company. He will be able to determine whether the funds invested or loaned by the foundation are being used wisely, and he will be able to give sound managerial advice to the company.
- *Amount of investment.*—The charter of an industrial foundation usually limits the amount of funds that can be invested in any one firm. The objective of the foundation is to assist as many sound business enterprises as possible, but not to become a major stockholder in any one of them.
- *Size of loan.*—Loans from industrial foundations to business enterprises are limited to a maximum percentage of the paid-in capital of the assisted firm. Such a policy tends to encourage the borrower to rely upon his own resources as much as possible and not to become heavily dependent upon the industrial foundation. Industrial foundations encourage those whom they finance to obtain funds from regular financial institutions as soon as the credit standing of such firms is strong enough to permit such a course of action.

Suggestions to the small manufacturer

Industrial foundations are becoming very popular and they render many useful services to the small manufacturer and to the business community. Remember, however, that:

- Well-managed industrial foundations cannot afford to be interested in poorly managed companies.
- If you cannot furnish a substantial part of the required investment, no soundly managed industrial foundation will be interested in you.
- Industrial foundations prefer to finance established products or, in the case of products which have not been distributed previously, those for which the market outlook is favorable.
- The industrial foundation expects to have a voice in business policymaking. This is part of the price you must pay for the risks taken by the foundation.
- Industrial foundations are primarily interested in attracting payrolls to the community that they serve. They may be more interested in trying to sell you on the industrial possibilities of the area than they are in your financial needs.
- There are many cities where businessmen take the attitude that a firm that has to “be bought” does not deserve the support of the community.
- Unless you are successful within a reasonable time after having located in the community, the industrial foundation may be unable or unwilling to give you further assistance.

Jobs, Inc.

Many manufacturers, both large and small, have received invaluable assistance from industrial foundations or community development corporations. One interesting example of their operations is found in the case of Albert Lea, Minn. During World War II, Albert Lea was chosen as a trial city for the development of a postwar planning program that was used by the Committee for Economic Development and the Chamber of Commerce of the United States. This program was conducted through an industrial development corporation known as Jobs, Inc.

As the result of efforts by the sponsors of Jobs, Inc., employment in the area nearly doubled between 1940 and 1951. Among the manufacturing projects aided in the past are several small woodworking plants, an electroplating firm, and branches of several nationally known manufacturing companies.

Jobs, Inc., has made direct business loans and has assisted in arranging outside financing for several concerns. In one instance it has purchased stock in a small firm. Its program has recently been enlarged to include plant facilities for sale or rent to interested manufacturers. This phase of its activities is conducted by a separate corporation, Jobs Building, Inc.

If you are interested in the possibility of obtaining financial assistance from industrial foundations, the Chamber of Commerce of the United States, 1615 H Street NW., Washington 6, D.C., may be able to help you make contact with an appropriate organization.

The Cash Budget

Budgeting cash by the cash receipts and disbursements method—Forecasting collections from sales—Forecasting disbursements—Form for estimating cash receipts and disbursements—Estimating cash requirements

The cash budget is the most valuable financial tool at your disposal. With it, you can plan your cash requirements and your cash resources. It can help you in various ways, such as:

- Developing the efficient use of cash.
- Financing seasonal business needs.
- Developing a sound borrowing program.
- Developing a workable program of debt repayment.
- Providing funds for expansion purposes.
- Planning for the investment of surplus cash.
- Realizing cash savings.

Budgeting cash by the cash receipts and disbursements method

Among the various methods for budgeting cash, the *cash receipts and disbursements method* is the most commonly used. This method of cash planning is flexible and permits budgeting for short periods at a time. With it you can prepare a cash budget based on weekly, 10-day, or monthly periods. Small manufacturers whose sales are uneven, whose earnings are irregular, or whose cash balances are inadequate will find this method of budgeting well suited to their needs.

The cash receipts and disbursements method of budgeting permits the effective control of cash, since it provides for a comparison between actual cash receipts and disbursements and budget estimates. Cash disbursements can be timed to cash receipts. This makes possible a close control over payments. By coordinating cash disbursements with cash receipts it is possible to keep your cash balances at a desirable level.

Forecasting collections from sales

Your cash receipts will come mainly from sales. There are several methods of estimating collections from sales. Here is one of them. You will note that it is based on the number of calendar days in the month:

Sales for March 1959.....	\$200,000
Accounts receivable, Mar. 31, 1959.....	50,000
Percent of sales outstanding (200,000÷50,000).....	25 percent
Times number of days in month of March.....	31
Days' sales uncollected.....	7.8

It is now possible to estimate collections for the month of April.

Accounts receivable, Mar. 31, 1959.....	\$50,000
Sales for April.....	250,000

Total.....	300,000
Deduct:	
Estimated accounts receivable, Apr. 30, 1959:	
7.5/30 × \$250,000.....	\$62,500
Bad debts (estimated).....	2,500
	<hr/>
	65,000
Estimated collections, before discounts.....	235,000
Less probable cash discounts, 1 percent.....	2,350
	<hr/>
	232,650

Here it is assumed that the percentage of each month's sales remaining uncollected at the end of the month is always the same. This is, of course, only a rough approximation that takes no account of variations in such factors as trade terms, types of merchandise sold, seasonal business conditions, and general business conditions.

This type of forecast of collections from sales is based upon the number of days' sales that are outstanding at the end of each month.

If collections tend to be distributed over several months, you should develop experience figures from which to estimate the percentage of any month's sales that is likely to be collected in a succeeding month. Here such factors as terms of sale, business trends, seasonal influences, discount policies, and credit and collection policies must be taken into account.

Forecasting disbursements

Anticipated cash disbursements can be estimated from budgets of costs and expenses. Capital outlays are listed in the capital expenditures budget. Purchases may be estimated from the purchases budget. Normally, the materials consumed in production are not equivalent to the purchases that must be paid for during the budget period. Monthly outlays for purchases may be estimated as follows:

[Purchases (gross) + In-Freight + Accounts Payable (beginning of month)] - [Purchases Discounts + Returns and Allowances + Accounts Payable (end of month)] = Cash outlays for merchandise. This assumes that there are no cash purchases.

If you pay salaries or wages by the week, remember that some months have five paydays and budget your payroll expenditures accordingly.

Form for estimating cash receipts and cash disbursements

A form that can be used in estimating cash receipts and cash disbursements follows:

Form 6.—Estimated cash receipts and cash disbursements—January to March, 196—

	January		February		March	
	Budget	Actual	Budget	Actual	Budget	Actual
Estimated receipts:						
Cash sales						
Accounts receivable						
Other income						
Total receipts						
Estimated disbursements:						
Accounts payable						
Payroll						
Expenses						
Advertising						
Interest expense						
Plant and equipment						
Repayment of bank loan						
Total disbursements						
Estimated excess of cash receipts over cash disbursements						
Estimated balance at beginning of month						
Estimated bank borrowings during month						
Estimated loan repayments during month						
Estimated balance at end of month						

Estimating cash requirements

The cash balance at the end of any month can be related to cash on hand at the beginning of the period by the following simple statement:

(Cash on hand at the beginning of the month + cash receipts during the month) – cash disbursements during the month = cash on hand at the end of the month.

If the cash balance at the end of the month is small, it may be necessary for you to plan a borrowing program to extend over a period of time ranging from 30 to 90 days or longer. The maturity of your loan will depend upon the nature of your cash needs and your ability to make repayment.

The Small Business Administration's Lending Program

SBA's program of financial assistance—Financial counseling—SBA loans—Seek private credit before applying to SBA—Bank-SBA participation loans—Direct SBA loans—Credit requirements for SBA loans—How to apply for a loan—Loan processing—Types of loans not approved by SBA—A brief statement of SBA loan policy

The Small Business Administration was established by Congress by the Small Business Act of 1953 (Public Law 163, 83d Congress) as the first independent agency created to serve and represent all small business both in peacetime and in periods of national emergency. The agency is now permanent and operating under the Small Business Act of 1958 (Public Law 536, 85th Congress), as amended. In this capacity, SBA is prepared to help small business in four major areas:

- Obtaining a fair share of Government procurement.
- Gaining access to adequate capital and credit.
- Obtaining competent management, technical, and production counsel.
- Licensing of small business investment companies.

SBA's program of financial assistance

SBA's program of financial assistance is designed to stimulate and preserve the initiative, independence and enterprise of the small firm. Such concerns are generally at a competitive disadvantage compared with large businesses because:

- They are frequently unable to afford specialized financial management.
- They are often unable to obtain from private sources the intermediate and long-term credit required for their general purposes and normal growth.

As an essential part of its financial assistance program, SBA gives counseling assistance to small firms, directing them whenever possible to available private sources of credit and thus minimizing the need for Government credit. SBA makes direct business loans only after all other possibilities for assistance have been exhausted.

Financial counseling

If you are a small-business owner and are in need of financial counseling help, you may obtain such help from financial specialists assigned to SBA's regional and branch offices. These experts are qualified to offer financial advice on a wide range of problems, such as:

- Possible means of obtaining private credit on reasonable terms.
- Possible assistance available from local development coordinators.
- Various alternative plans of financing production.
- Adequacy of accounting and auditing methods and other aspects of financial management.
- Means of increasing equity capital.
- Eligibility for V-loan financing of defense contracts.
- Feasibility of obtaining advance or partial payments on contracts.

SBA loans

Under Section 7 of the Small Business Act of 1958, as amended, SBA is empowered—

“to make loans to enable small-business concerns to finance plant construction, conversion, or expansion, including the acquisition of land; or to finance the acquisition of equipment, facilities, machinery, supplies, or materials; or to supply such concerns with working capital to be used in the manufacture of articles, equipment, supplies, or materials for war, defense, or civilian production or as may be necessary to insure a well-balanced national economy;”

However, under the Act, SBA cannot consider an application for financial assistance unless there is evidence that the desired credit is not otherwise available on reasonable terms.

Seek private credit before applying to SBA

A businessman operating a small firm needing credit should first make application at his bank. If the banker is unable to meet his loan request, the applicant should consider other possibilities, such as the following, before making direct application to SBA for financial assistance.

Other banks.—The loan may be of a size or type that the local bank cannot or will not handle. Either a correspondent bank or another local bank may be able to accommodate you. It may be possible to arrange a participation in which your bank will share, either with one or more other banks.

Other sources of business funds in the community.—In many towns and cities there are individuals, local credit pools, or lending agencies that are willing to make business loans on terms that may fit the needs of the borrower.

New securities issues.—If your firm is incorporated, it may be feasible to sell stocks or bonds, either publicly or by private placement, or to sell convertible debentures to small business investment companies licensed by SBA under Public Law 85-699.

Sale of assets.—You may have assets that are not essential to the present or future financial health of your business and that you can sell to obtain needed financing. Security holdings are a good example.

Your own private funds or those of your business associates.—It may be possible for you or others associated with you in business, such as partners, managers, or principal shareholders, to furnish additional funds without undue hardship.

V-loans, or other applicable Government financing.—You should consult your banker or SBA to determine whether such types of financing are available to you.

Bank-SBA participation loans

It is the policy of SBA to encourage loans by banks and other private lending institutions. However, if the entire amount of a loan cannot be obtained from such sources, SBA will consider participating in the loan with the bank or other lending institution. Under the Small Business Act, SBA may participate up to 90 percent of the amount of a loan, but the SBA portion to any one borrower cannot exceed \$350,000. The SBA participation may be immediate or may be deferred until some future date as the bank may determine. Under the law, SBA cannot enter into an immediate participation agreement if a deferred participation is available.

The maturity of a loan in which SBA participates may not exceed 10 years except that a loan for construction of facilities may have a maturity of 10 years plus such additional time as is needed to complete construction. The maximum interest rate on SBA's share of a participation loan, is 5½ percent. A private lending institution may set a higher rate than 5½ percent on its share of a participation loan, provided the rate is legal and reasonable; it may also set a higher rate than 5½ percent on SBA's share of a deferred participation loan, the higher rate on SBA's share to apply until SBA is called upon to purchase its share of the loan. If a private institution sets a rate lower than 5½ percent per annum on its share of a loan, the interest rate on SBA's share shall be the same as that of the private institution. SBA's interest rate may not be less than 5 percent, except in cases where loans are approved to small business concerns located in areas which have been classified by the Department of Labor as being areas of substantial unemployment or areas of substantial and persistent unemployment or where more than 50 percent of the loan proceeds will be used in such classified areas, in which case, SBA's portion of the loan will be 4 percent.

Direct SBA loans

If the businessman's bank is unable to extend needed credit as a bank loan, or to make the loan in participation with SBA, the businessman may then apply for the loan directly to an SBA field office.

SBA's direct loans also are limited by law to a maximum of \$350,000 to any one borrower. As in the case of a participation loan, the maturity of a direct SBA loan may not exceed 10 years, except that a loan to construct plant facilities may have a maturity of 10 years, plus such additional time as is needed to complete construction.

The interest rate on a direct SBA loan is 5½ percent per annum except in cases where loans are approved to small business concerns located in areas which have been classified by the Department of Labor as being areas of substantial unemployment or areas of substantial and persistent unemployment, or where more than 50 percent of the loan proceeds will be used in such classified areas, in which case, SBA's portion of the loan will be 4 percent.

- The applicant must be of good character.
- There must be evidence the applicant has the ability to operate his business successfully.
- On a term loan—one repayable in installments over a period of several years—the past record and future prospects of the business must show sufficient probable income so it can be logically assumed the applicant will be able to repay the loan out of future income from the business.
- The applicant must have enough capital in the business so that with loan assistance from SBA it will be possible to operate on a sound financial basis.
- As required by the Small Business Act of 1958, as amended, the loan shall be of such sound value or so secured as reasonably to assure repayment.

How to apply for a loan

A bank or other financial institution may agree to make a loan conditioned on SBA taking a *deferred* or *immediate* participation. In such a case, the applicant must file an application at the SBA office serving the territory in which the applicant's home office is situated. Application must be made on SBA's Form 4, properly signed by a representative of the participating bank in the space provided on the last page.

The same form is used—but without needing the signature of the bank representative—if the bank is unable to make a loan on any basis, and a direct loan is desired from SBA. In either case, while it is not required that the applicant be present in person, it is always desirable for the applicant to discuss his situation personally, when possible, with an SBA financial expert.

SBA regional and branch offices are situated throughout the United States. Information and appropriate application forms may be obtained by writing or calling on the nearest office. No charge is made for information and counsel furnished by SBA in connection with the preparation and filing of an application, or in connection with its general financial counseling.

The SBA has established a program known as the Limited Loan Participation Plan. Under this plan, private banks and the Small Business Adminis-

tration cooperate in extending financing to small retail, wholesale, service, and other business which have only limited tangible collateral to pledge for loans, but which are soundly managed and have good earnings and credit records. The SBA's share of a loan of this type can be no more than \$25,000 or 75 percent of the total amount of the loan, whichever is the lesser. The participating bank's share in the loan must be not less than 25 percent of the total amount of the loan and ordinarily must be "new money," that is, money which is not already owed to the bank and which would be repaid out of the loan.

However, short-term loans which have been outstanding no more than 6 months, or loans made for a longer term on which repayments have been made promptly as originally scheduled, are considered qualified and may be substituted by the bank for this "new money" requirement or included in computing its participation in the loan. In either case, the bank's share in the loan must at least equal the outstanding loan to be refunded with a part of the new loan or be 25 percent of the full loan, whichever is the larger.

The small firm seeking a loan under this plan should apply directly to a bank which proposes to join with the SBA in making the loan. The firm's application should be submitted on SBA Form 6, which may be obtained from any SBA office. The original and two copies of the application, and of any supporting documents, should be filed with the bank. The bank then sends two copies of the form and any supporting documents to the nearest SBA office, together with a completed SBA Form 6a in duplicate or a letter stating the proposed amount of the bank's participation and the bank's opinion of the character and ability of the applicant's management, the firm's future business prospects and repayment ability, and the recommended loan terms and conditions, including collateral required.

Loan processing

Loan applications are received and processed in SBA's field offices by a staff of skilled credit men. In certain circumstances involving participation loans in amounts up to \$150,000, and direct loans up to \$50,000, a loan can be made by the SBA field office without submitting the application to the Washington headquarters.

Types of loans not approved by the SBA

Since it is a public agency, using taxpayers' funds, the Small Business Administration has an unusual responsibility as a lender. The Agency's loans must meet the requirements established by Congress, SBA and the Loan Policy Board. Accordingly, the SBA will not make certain types of loans under certain circumstances.

Loans will *not* be granted by SBA:

1. If the funds are otherwise available on reasonable terms (*a*) from a private financial institution, (*b*) from the disposal at a fair price of assets not required by the applicant in the conduct of its business or not reasonably necessary to its potential growth, (*c*) through the use of personal credit and/or resources of the owner, partners, management, or principal stockholders of the applicant, (*d*) from other Government agencies which provide credit specifically for the applicant's type of business, or (*e*) from other known sources of credit;

2. If the loan would be for the purpose of (*a*) paying off a creditor or creditors of the applicant who are inadequately secured or are in a position to sustain a loss, (*b*) providing funds for distribution or payment to the owner, partners, or shareholders of the applicant, or (*c*) replenishing working capital funds previously used for either of such purposes;

3. If the purpose of the applicant in applying for such assistance is to effect a change in ownership of the business, unless such change will promote the sound development or preserve the existence of a small business concern;

4. If the loan will provide or free funds for speculation in any kind of property, real or personal, tangible or intangible;

5. If the applicant is an eleemosynary institution or non-profit enterprise, except for cooperatives which carry on a business activity for the purpose of obtaining pecuniary benefit for their members and whose members are themselves otherwise eligible small business concerns;

6. If the purpose of the loan is to finance the construction, acquisition, conversion or operation of recreational or amusement facilities, unless such facilities contribute to the health or general well-being of the public;

7. If the applicant is a newspaper, magazine, radio broadcasting company, or similar enterprise;

8. If a substantial portion (50 percent or more) of the net sales of the applicant is derived from the sale of alcoholic beverages;

9. If any of the gross income of the applicant (or any of its principal owners) is derived from gambling activities;

10. If the loan is to provide funds to an enterprise primarily engaged in the business of lending or investments or to any otherwise eligible enterprise for the purpose of financing investments not related or essential to the enterprise.

11. If the purpose of the loan is to finance the acquisition, construction, improvement or operation of real property which is, or is to be, held for sale or investment; provided, however, that this prohibition shall not apply to loans for the remodeling or improvement of existing commercial and industrial structures held for rental where the applicant is performing substantial maintenance and operational services in connection with such structures; and provided further that no loan may be made to build or acquire buildings for investments;

12. If the effect of the granting of the financial assistance will be to encourage monopoly or will be inconsistent with the accepted standards of the American system of free competitive enterprise;

13. If the proceeds of the loan will be used for moving an eligible business when the move is for other than a sound business purpose.

A brief summary of SBA loan policy

It is the policy of the Small Business Administration to make loans that will actually help the borrower operate his business successfully. However, the businessman should bear in mind that no lending program by itself can make small business concerns successful. A certain minimum amount of the owner's funds is essential in every business. Moreover, the businessman must have essential experience and business know-how if he expects to operate successfully under the highly competitive conditions that prevail today in most areas of small business.

CHAPTER IX

The Small Business Administration's Investment Program

Policy of Congress—Essentials of the program—Small Business Investment Companies—Building your case—Making contact with an SBIC—Working with an SBIC—Types of financing from SBICs—Limitations on financing—Miscellaneous facts about SBICs.

Under the Small Business Investment Act of 1958 (Public Law 85-699, as amended) a Small Business Investment Division was established within the Small Business Administration. The Act authorized the establishment of a new type of institution devoted to the financial needs of small businesses—the Small Business Investment Company. Responsibility for licensing, regulating, and helping finance these new organizations was vested in the Agency. A unique feature of this new medium of small business financing is that it brings together local capital and management talent. The organizers of investment companies know their own communities and industries. They are familiar with the needs of small businesses in their own areas. They are, therefore, in a good position to render effective financial and management assistance.

Policy of Congress

Section 102 of the Small Business Investment Act of 1958 states: "It is declared to be the policy of the Congress and the purpose of this Act to improve and stimulate the national economy in general and the small-business segment thereof in particular by establishing a program to stimulate the flow of private equity capital and long-term loan funds which small-business concerns need for the sound financing of their business operations and for their growth, expansion, and modernization, and which are not available in adequate supply . . ."

Essentials of the program

Under the Small Business Investment Act, the Agency is authorized to license Small Business Investment Companies, lend funds to such investment companies, and regulate and examine such companies. The Small Business Administration does not deal directly with small businesses under the SBIC program. Nevertheless, it achieves the purposes of the Act by encouraging the establishment of Small Business Investment Companies, by providing financial assistance to help them meet the initial capital requirements of the Act, and by making loans to them for the expansion of their operations.

Small business investment companies

To get a well-rounded understanding of this program, a good way to start is to take a quick look at the nature of the investment companies themselves.

Small Business Investment Companies (SBICs) are privately owned (that is, non-Governmental) and privately operated corporations. These companies are established to return a profit to their shareholders. But they are restricted in their activities to the provision of equity financing, long-term loans, and consulting and advisory services to small concerns. Other activities may be engaged in *only* if they are incidental and appropriate to those named.

The Small Business Administration grants licenses to companies chartered under applicable State laws. The criteria for granting licenses include the following:

1. The need for financing of small concerns in the area in which the proposed company is to do business (an actual, rather than a theoretical, need must be demonstrated);

2. The number of SBICs previously organized in the United States, and the volume of their operations;

3. The experience of management, and its ability to carry out its plan of operation; and

4. The stated plans of operation of the company (these should be in such detail as to permit consideration by SBA in the light of their completeness, general feasibility, and soundness).

Public interest.—The public interest and the general objectives of the Small Business Investment Act are paramount in the application of the criteria. SBIC incorporators and management must be of good reputation—particularly in all their financial dealings. Managers should be experienced in the investing, banking, credit, or similar fields. However, the experience requirements may vary with the size of the proposed organization, its area of operations, and its ability to secure advice and counsel from its stockholders and from others interested in the success of the company's operations.

Licensing by the Small Business Administration depends on the Agency's determination of the applicant's ability to carry out the purposes of the Act. And SBA may, at its absolute discretion, decline to issue a license.

Formation and qualification.—The Agency encourages financial institutions—to the extent permitted under applicable laws—to participate in the ownership of Small Business Investment Companies. Organization and capital structure must, of course, conform to applicable laws. In all cases, the approval of SBA's Administrator is required before a license is issued.

Any organizing group must submit for consideration the following: (1) Articles of incorporation and bylaws, whether proposed or actually adopted; (2) amount and classes of its capital stock; (3) purposes for which the company is formed; (4) name assumed by the company; (5) area in which

operations are to be conducted; (6) location of the principal office; (7) names and background of its directors, officers, and counsel; (8) certain other items called for in the prescribed application form.

Building your case

In exploring the possibilities of working with this potential new source of funds for your business, you should start by becoming familiar with the Small Business Investment Act of 1958, as amended, and the SBA Regulations. Also, you should be informed on the procedures to be followed in obtaining financing from a small business investment company. You need to consider the costs that will be involved in obtaining financing. And you would do well to weigh the advantages that expansion of your operations and access to management skills may bring to you.

Most of all: *know your own company*. Consult carefully with your technical and professional staff; for example, engineers, accountant, legal counsel, and your banker. In short, before starting negotiations with an investment company, have a complete knowledge of your particular organization—condition, needs, and future development—and a detailed justification (including specific purposes) for the desired financing.

Making contact with an SBIC

After you have analyzed your own requirements, the next step is to get in touch with a Small Business Investment Company in or near your community and explain your needs for financing to its representative.

The names and addresses of the SBICs are published as they are licensed by the Small Business Administration. This information may also be obtained at any one of the Agency's regional or branch offices (cities in which offices are located are listed on page 3 of the cover of this booklet); or you may write directly to the Small Business Administration, Washington 25, D.C. Your bank, too, should be able to put you in touch with one or more SBICs in your area.

Working with an SBIC

When you have made contact with an investment company, its managers will discuss with you the size standards and other criteria which determine whether your firm qualifies as a "small business" for financing under the Small Business Investment Act. If you are eligible, they will consider your financing requirements, and the prospect of your meeting obligations which they may propose as a plan for financing your needs.

A business is "small" if it does not have assets exceeding \$5 million, does not have net worth in excess of \$2½ million, and does not have

an average net income after Federal income taxes for the preceding two years in excess of \$250,000.

The Small Business Administration will not supervise any negotiations between you and the investment company. And moreover, any agreement you subsequently reach will be strictly between you and the SBIC.

Like your own firm, it is a *private* enterprise, organized for profit, and serves much the same function for small business concerns as an investment banking house does for large corporations. Consequently, any transaction undertaken will be purely a private business arrangement between you and the company. It will have no direct connection with the Small Business Administration or any other agency of the Government.

The Small Business Administration's functions in this program are:

1. To license the private investment companies to operate in accordance with the Small Business Investment Act of 1958;
2. To furnish them with funds which they may request under the Act; and
3. To regulate their activities.

Types of financing from SBICs

In approaching a Small Business Investment Company for financing, you should be aware of what types of financing it is permitted to offer, and what other services it is permitted to render.

Under the Small Business Investment Act of 1958 and SBA's regulations, a Small Business Investment Company may finance your small business in two ways (including combinations of them);

1. By the purchase of any types of equity securities, or
2. Through long-term loans.

If you need more funds than one Small Business Investment Company can extend, it may be possible for the SBIC to have other SBICs participate in a loan or in the purchase of your debentures. In this way, you may be able to meet your requirements.

Equity type financing.—Capital may be provided to an incorporated small business through any type of equity securities, including certificates of stock of any class, or securities evidencing a debt if they are convertible to stock of the company or carry stock purchase rights or warrants. Any such rights or warrants issued in connection with equity securities shall expire after 10 years from the date of issuance or not more than 2 years after the maturity date of the equity securities involved, whichever is the earlier.

Convertible debenture financing is in many ways the ideal method of providing risk capital to small businesses under this program. Such debentures, purchased from the small business by the licensee, must be convertible (up to the face value of the debenture and at the SBIC's option) into stock of your company at a price per share determined by you and the SBIC

when the debentures are issued. This conversion figure is described in the Small Business Investment Act as the "sound book value" of the stock, and may take into consideration a comparison of net assets to earnings, and other relative criteria.

The proportion of your capital stock, representing part ownership and voting control, which the SBIC can obtain through conversion must be negotiated at the time the deal is made for financing. This is a matter of special concern to you. As a rule, SBICs do not pursue a policy of acquiring control of small businesses they finance, except in unusual circumstances. But it is an element in the terms to be negotiated to which the small business management should pay particular attention.

Convertible debentures or other types of financing must state a minimum maturity of 5 years but must also contain a clause which permits you to prepay them on any interest date, provided you give 3 months' notice of your intention. Also other terms of the convertible debenture plan, such as interest rate, plan of repayment and related details must be agreed upon through negotiation between you and the SBIC.

The SBIC is authorized to require, as a condition of convertible debenture financing, that you do not enter into any "outside" debt financing during the term of the obligation without giving the SBIC the first opportunity to provide such financing. However, the SBIC must permit you to purchase on "open account," and establish similar short-term credit subject to agreement between you and the company. Other standard terms and conditions as to your operations and management may be required by the SBIC to protect its investment.

In considering convertible debenture financing, you should have your lawyer inform you fully about State and other laws concerned. Bear in mind, too, that to issue convertible debentures, your firm must be a corporation. If it is a proprietorship or a partnership and you do not wish to incorporate, a long-term loan is the *only* means of financing available from SBICs.

Long-term loans.—If your firm is incorporated and an SBIC makes a loan to it (instead of convertible debenture financing), the SBIC may not acquire stock or other proprietary interest in your corporation except through foreclosure on equity securities that are pledged as collateral.

If your firm is *not* incorporated, only long-term loans (5 to 20 years) are available to you. In this situation you will, no doubt, be asked to arrange reasonable security and a mutually satisfactory schedule of repayment. The Small Business Administration's regulations provide that you must be permitted to prepay all or any part of such loans on any interest payment date, if you wish to do so.

Maturities of loans may not exceed 20 years—except the maturity may be extended or the loan renewed for additional periods, not exceeding 10 years, if the investment company finds that such extension or renewal will aid

in the orderly liquidation of the loan. Loans may be made directly or in cooperation with other lending institutions through agreements to participate on an immediate or deferred basis. In loans made on a deferred participation basis, the participation by the SBIC may not be in excess of 90 percent of the balance of the loan outstanding at the time of disbursement.

Other services.—Regardless of whether your business is or is not incorporated, and irrespective of the type of financing you arrange, your relationship with the investment company may provide you the advantage of access to supplementary management skills. These skills may be highly important to your concern as it grows, enters new markets and areas, and encounters new competitors. For this reason, you would do well to inquire into the management consulting and advisory services which the Small Business Investment Company is prepared to offer (for which a fee may be charged). The investment company may also wish to put a representative on your board of directors both to help you and to keep the SBIC management informed of your progress.

Limitations on financing

If a concern which applies to a Small Business Investment Company for financing is substantially owned by shareholders of the SBIC, then the SBIC must obtain Small Business Administration approval before it can extend such financing.

For any single firm, the total amount of obligations and securities acquired and for which commitments may be issued by a Small Business Investment Company, may not exceed 20 percent of the SBIC's combined capital and surplus (including subordinated debentures SBA holds)—unless prior consent is obtained from SBA. However, two or more investment companies may jointly provide financial assistance to a single small business. Also, at its discretion, SBA may authorize commitments in excess of the 20 percent limit.

A small business may not re-lend funds obtained from a Small Business Investment Company. Nor may it re-lend funds released in its accounts as a result of SBIC financing. Therefore, if your concern is a loan or mortgage company, it is not eligible for financing from an SBIC.

Inasmuch as all types of financing furnished by SBICs must be for not less than five years, you will be asked as a condition to such financing to certify that you intend to operate your small business continuously for five years or longer.

Miscellaneous facts about SBICs

A few additional facts may be useful to you in understanding how SBICs function. Here are some final highlights.

The operation of a Small Business Investment Company, including the generation of business, may be undertaken in cooperation with banks or other financial institutions. Any servicing or initial investigation required for loans or acquisitions of securities by an SBIC may be handled through banks or other financial institutions on a fee basis. And an investment company may receive fees for services rendered to banks or other financial institutions.

In addition, SBICs may use the advisory services of the Federal Reserve System and of the Department of Commerce which are available and helpful to industrial and commercial businesses. They may provide consulting and advisory services on a fee basis. Any Federal Reserve Bank may act as a depository or fiscal agent for any investment company.

Funds of investment companies not reasonably needed for their current operations may be invested only in direct obligations of, or obligations guaranteed as to principal and interest by, the United States.

Should a Small Business Company violate or fail to comply with any provisions of the Small Business Investment Act of 1958, or regulations prescribed under it, all its related rights, privileges, and franchises may be forfeited. Whenever in the judgment of the Small Business Administration any person has engaged in, or is about to engage in, practices which constitute, or will constitute, a violation of the Act or regulations, the Agency may apply to a District Court of the United States for an order enjoining such acts, or enforcing provisions of the Act or the regulations.

CHAPTER X

For Further Information

While the subject-matter of this booklet is directed for the use of the owner-managers of small business, the amount of literature in the field of business finance is vast. Some of the information contained in the books, periodicals, and other printed media is applicable to the finance problems of small business. Anything approaching complete coverage would lead to a publication beyond the scope of this Series. The following list may be used as an introduction for small business owner-managers who wish to pursue the subject of business finance further. No slight is intended toward authors and other sources whose names and/or works are not included.

Small Business Administration Publications

Small Business Management Series (available from the Superintendent of Documents, Washington 25, D.C., at prices indicated)

Public Accounting Services for Small Manufacturers (SBMS No. 5), 15 cents.

Cost Accounting for Small Manufacturers (SBMS No. 9), 35 cents.

Ratio Analysis for Small Business (SBMS No. 20), 25 cents.

Equity Capital and Small Business (SBMS No. 24), 35 cents.

Guides for Profit Planning (SBMS No. 25), 25 cents.

Annual Series (available from the Superintendent of Documents, Washington 25, D.C., at prices indicated)

Management Aids for Small Business: Annual No. 1, 65 cents. (Budgeting in the Small Plant)

Management Aids for Small Business: Annual No. 2, 55 cents. (Borrowing Money From Your Bank; How to Choose Your Banker Wisely; Loan Sources in the Federal Government)

Management Aids for Small Business: Annual No. 3, 45 cents. (How Field Warehousing Concerns Help Small Business; How Good Records Aids Income Tax Reporting)

Management Aid for Small Manufacturers: Annual No. 4, 45 cents. (How the Securities Act of 1933 Affects Small Business; Using Your Banker's Advisory Services; Planning Your Working Capital Requirements)

Small Business Research Series (available from the Superintendent of Documents, Washington 25, D.C., at prices indicated)

Cash Planning in Small Manufacturing Companies (SBRS No. 1), \$1.25.

Management Aids for Small Manufacturers Series (available free on request to the Small Business Administration, Washington 25, D.C., or at SBA field offices)

"Watch Your Cash" (No. 105)

"Providing Capital For Your Firm" (No. 115)

"Helping The Banker Help You" (No. 116)

"Cash Management in Small Plants" (No. 124)

Small Marketers Aids Series (available free on request to the Small Business Administration, Washington 25, D.C., or at SBA field offices)

"Break-Even Point Studies for Small Marketers" (No. 50)

"Depreciation Costs—Don't Overlook Them" (No. 68)

Small Business Bulletins Series (available free on request to the Small Business Administration, Washington 25, D.C., or at SBA field offices)

“Operating Costs and Ratios—Retail” (No. 8)

“Operating Costs and Ratios—Wholesale” (No. 11)

Management Research Summaries Series (available free on request to the Small Business Administration, Washington 25, D.C., or at SBA field offices)

“Cost Control Problems of Small Manufacturers” (No. 3)

“Facts About Small Business Financing” (No. 10)

“Financial Analysis and Small Business” (No. 33)

Miscellaneous

Small Business Investment Companies—A Bibliography. 1961 (available free on request to the Investment Division, Small Business Administration, Washington 25, D.C.)

Other Federal Government Agencies

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