CHAPTER 1

# Understanding the Small Business Environment



In today's many-faceted and multidisciplined economic environment, small privately owned business management must place greater emphasis on increasing results with fewer resources. Small businesses do this by evaluating the economy, efficiency, and effectiveness of organizational operations. In recent years, public business leaders from all sizes of organizations have discovered that by broadening their focus to include all operating activities, not just the sales function, they have an added valuable tool in achieving their business goals. However, many times, the small business owner sees these other activities as a cost center rather than a profit center. The small business owner needs to view operations in a new mindset—not as costly retardants that get in the way of efficient operations. If this is not possible due to the owner's resistance, then the possibility of success may diminish.

Keep in mind that before you can aid your nonregulated small business with the advice provided in this book, it is important to understand the landscape of the small business, and specifically the privately held small business being addressed here. Let us start by understanding the small businesses that can be best improved through implementing effective operating procedures.

## Understanding the Small Business

The typical privately held small business differs from a larger publicly held business in a number of ways that affect the use of best practice systems to enhance operations. These differences cover everything from government and regulatory compliance issues to the goals and motivations of the owners.

Closely held and/or family owned and operated businesses have different obligations to stakeholders than do publicly owned larger businesses, which are required to report to stockholders and the Securities and Exchange Commission (SEC). The owners of a privately owned small business have the right to operate their business in whatever (hopefully legal) manner they desire. However, the small business owner must guide and direct the small business to operate the business in a proper environment so that the business grows in the desired direction. Unfortunately, the desires of the owners (e.g., to maximize nontaxable cash in their pockets) may be in conflict with the exercise of proper business practices.

For instance, owners' desires may be to:

- Maximize sales, whether reported or not, at whatever price they can get.
- Spend whatever is necessary, with minimal regard to cost accounting, to operate the business.
- Maximize the amount of cash from the business.
- Charge off the greatest amount of expenses, business and personal, to the business as business expenses.
- Minimize the amount of net income reported as taxable (a loss, if possible).
- Minimize the amount of federal and state taxes paid.
- Recast the results of operations to add back questionable business expenses when the owners decide to sell the business.

I expect my business always to be here—and so far, so good.

Conversely, the quest for proper operations and controls may include:

- Proper recording of all sales, whether paid for in cash or billed
- Determination that each sale produces a contribution to the bottom line

- Control of necessary operating costs to manage the business properly
- Guidance and direction for the business to grow and prosper
- Internal accounting and operating controls that ensure proper operating and data recording controls
- Financial and operating reporting that reflect accurate information
- Preparation of tax returns that accurately reflect the results of operations

In a small business, the owner/operator's desires, plans, and monetary resources, and not corporate plans, provide guidance and direction for business decisions. The owners, regardless of their business acumen and expertise, reserve the right to operate their business any way they want. With all of the urgings of others, and because of their lack of obligation to public reporting, small business owners may ignore outside advice and guidance and continue to operate their business in an uncontrolled environment.

> The optimist is one who doubles the same efforts after failing—expecting different results.

The small business owner is typically focused on day-to-day operations in a crisis-management-type approach rather than on a big-picture, long-term-planning approach. Many times the small business owner assumes that if the business brings in sufficient sales, then the business is doing well and growing, even though increased sales often brings even greater costs and fewer real profits. It is the focus of this book to ensure that the small business operates most effectively in a controlled environment in the most economical, efficient, and effective manner. One can more clearly assist the small business owner in understanding that the business does not necessarily grow through additional sales but through profitable sales with realistic cost structures that provide real cash profits to the bottom line. Helping the small business to operate more profitably via the big picture of operating a growing business also helps to dispel the notion that the small business cannot afford to implement outside advice.

Moving fast is not necessarily the same as making progress.

Resources and capabilities within the small business are much more limited than in a large publicly held organization, particularly in the accounting/financial and information technology (IT) areas. In many small businesses the owners are involved in almost every aspect of operations as there may not be sufficient resources to hire the necessary competent non-value-added-type personnel such as in the accounting and IT areas. The owners may control those transactions to be entered into the accounting system, such as holding out certain cash sales, rather than having all business-related transactions flowing properly within a controlled environment. Almost all small businesses today use a microcomputer-based system or network with purchased packaged accounting software to process their accounting transactions. However, in most cases, neither the owners nor the computer operators have sufficient accounting and IT expertise to ensure that all accounting transactions are entered properly into the accounting system in a controlled environment and that no transactions are entered that should not be entered. Often, the computer operator may be anyone who is available, like a relative, a friend, a part-time person, or the owner's teenage child. It is the owner's responsibility to ensure that the computerized accounting system operates within a well-defined control environment that ensures the validity of all transactions entered and reports produced.

The sooner you are behind, the greater the time to catch up.

## Small Business Management

The complexities of operating a successful small business enterprise have grown considerably over the years. No longer can the individual responsible for the small business's accounting functions be merely a data entry clerk who enters transactions as provided by the owner or other managers into a computer system using purchased packaged software. As with larger organizations, the small business needs not only someone to post accounting transactions, but also someone who can be responsible for such diverse areas of the business as:

- Organizational planning
- Operational management and controls
- Budgeting, either formal or informal
- Basic financially related business decisions
- Computerization and its related controls
- Management, operations, and administration
- Personnel, hiring, orientation, training, evaluation, salary increases, promotions, firings, and the assignment of job responsibilities and expectations

Recent trends for the successful small business owner include a decision-making, internal operations, managerial, and problem-solving point of view. In a small business, where one individual possessing expertise in some of these areas but not in all assumes the role of owner or manager and may not have adequate expertise, the business is in itself operating in an ineffective operating environment. In some instances, an outsider is asked to perform the primary role of operations and/or financial manager. An effective small business manager must have a hand in every aspect of the business—financial and operational—and must know more about the company's operations than anyone else. The business manager becomes the internal business advisor to the small business owner.

## Small Business Computerization

Computerization has given even the smallest of businesses access to many new operational and financial management techniques. These techniques include:

- **Planning and budgeting systems**. Define the desired direction, develop plans as to how to get there, and monitor progress toward goals and objectives.

- **Capital investment analysis**. Determine whether the business needs to expand with additional investment, use present resources more effectively, or retrench certain operations by disposing of resources—or using them differently.
- **Operations research**. Apply mathematical models to solving business problems such as levels of inventory to maintain, how to distribute products, and cost-versus-benefit analysis.
- **Variance analysis**. Control plus-and-minus variances from expected results and take corrective action.
- **Breakeven analysis**. Determine the specific level of desired sales where all direct, indirect, and fixed costs are covered through the sale of an individual product, enabling management to improve their cost-to-pricing and related profit decisions.
- **Cost accounting systems**. These encompass collecting accurate data as to direct costs (material and labor), indirect costs (such as quality control, and machine maintenance), functional costs (such as purchasing, accounting, IT, and personnel), and customer costs (sales and marketing, servicing, complaints, phone calls, and after-delivery service).
- **Return on investment**. Ensure that management is using company resources effectively so that they provide a bottom-line real return that exceeds the cost of the investment and related operations.
- **Reporting systems**. Design them so that management can properly control all aspects of the business in a controlled environment ensuring that the business operates most economically, efficiently, and effectively.

All of these needs have combined to produce a more complex business environment and an increased set of responsibilities for small business owners—many of which far exceed their capabilities. The small business owner and manager of today must be involved in all aspects of the business's operations, and these days this includes IT electronic operations. The use of computers is how people do business today, even in the smallest of businesses. Computerization, while helping to manage businesses more effectively, has also introduced some operating problems such as poor integration, outdated databases, data security, and a general lack of IT knowledge by the business owner. Most small business owners are not the best people to be left to deal with IT issues. If the small business cannot afford its own IT staff, the external IT advisor can help advise or outside IT consultants can be used to help maintain the necessary strong IT arm of the business. For most small businesses, this can be accomplished only by working with outside experts.

> You do not have the experience until after you need it.

## Operational Management Function

Somebody, internal and/or external, connected to every small business—regardless of his or her title—must plan and pull together, review, analyze, interpret, and make decisions as to courses of action relative to the financial and operational requirements and consequences of company operations. In even the smallest of businesses, there is almost no aspect of its operations that does not have both financial and operational requirements and related consequences.

Depending on the nature of the small business and how it operates, the operational management function could include such activities as:

- Determining the financial resources necessary to meet desired plans and allocate resources to operating programs and activities
- Forecasting as to the extent that these requirements can be met through internal generation of funds, and how much needs to be obtained outside the company
- Developing the best plans for using internally generated funds and obtaining external funding that will provide a desired return on investment
- Establishing and maintaining a system of financial controls relative to the effective allocation and uses of funds
- Formulating programs to provide the most effective profit-volume-cost relationships, and to provide effective monitoring of such programs

- Analyzing financial results of all operations, reporting the facts to top management, and making recommendations concerning future operations

The operational manager must be familiar not only with financial and accounting concerns but also with activities and policies in such operational areas as manufacturing and/or service delivery, marketing, purchasing, sales, personnel relations, and general management. These functions encompass planning, directing, and measuring the results of the small business's monetary operations.

You can't fix the financial without fixing the operational.

## The Family Business

Many small businesses are closely held businesses owned and controlled by family members. A *family business* can be defined as a small business enterprise where two or more family members (e.g., husband and wife, parent and child, brothers and/or sisters) own and/or manage the business. These types of businesses are also known as *mom-and-pop* businesses. They can range in size from over $100 million in annual sales to less than $100,000 and from 500 employees to 2 employees, and by type such as manufacturing, service, professional practice, retail, and so on.

The family business, which is normally privately owned, has many advantages for its owners, which include:

- **Power and control**. Family owners make any decisions they desire and set the rules for nonfamily employees.
- **Different strokes**. Family owners/members take special privileges such as working hours, benefits, use of company assets, and access to inventory.
- **Accountability**. Different criteria from those of hired management: As part of the family, whatever you do is right.

- **Job security**. Family members do not normally get fired, but they may get promoted.
- **Company policies**. These do not apply to family members, as infractions will be forgiven.
- **Flextime**. Ownership has its privileges; family members come and go as they please. Family members can come in late, and even if they do, they can still leave early.
- **Compensation**. For family members, this is whatever the business will bear, regardless of their contribution (sometimes not even on-site—so-called phantom employees).
- **Business write-offs**. Charge whatever expenses you can to the business for the owners and other family members, including legitimate business expenses, questionable business expenses, and outright personal expenses.
- **Family inheritance**. The business may be the owner's principal asset that is seen as a living trust for the children.
- **Retirement-in-place**. Even after the time that owners can no longer contribute effectively to the business, they still may be compensated from the business as a form of early retirement or semiretirement.

Note that many of these advantages to the family business owner and family members may become major constraints to effective small business operations. However, you need to understand and take them into account, for many times the family business owner will balk at sound internal operating practice recommendations, even when they are in their own best interests, if they get in the way of one or more of the items listed above.

The case study in Exhibit 1.1 depicts the advantage of a family business to the father but the disadvantage to his sons.

Owning and operating a family business also has some potential drawbacks to which many a family business owner or manager has fallen victim, including:

- **Workaholism**. The business becomes your life. In the past, and presently, with many downsized or let-go employees deciding to operate their own business rather than go back into the employment

## EXHIBIT 1.1 Cashing In?

Joe Pep owns a small chain of three pizzerias, which his three sons operate. When Joe comes to visit, he always empties the cash register. His so-called cash disbursement is never recorded on the books. The sons have no idea as to the amount of cash that leaves the business through Joe's cash withdrawals. Joe sees this practice as an advantage to being a small business owner. The extent of the sons doing the same form of cash disbursement is not known, nor are the cash registers reconciled to daily sales. Each son, responsible for one of the stores, is paid a small salary plus half the profits of the store.

What changes to operating practices would you suggest implementing in this situation considering Joe and his sons' needs?

**Suggested Response**

As Joe is the owner of the business, it might be difficult to convince him that this practice of nonrecorded cash withdrawals is not best for him—it is a ready source of nontaxable cash that goes directly into his pocket. All of this cash is never recorded, so that these unrecorded sales never get on the books and reduce the amount of each store's sales and profits, resulting in reducing the sons' share of half the profits. Joe's practice may encourage the sons to do the same. There is no way to know what the real sales and profits are—only relying on those actually recorded on the books.

1. Convince Joe and his three sons that this practice is counter to building the business and that all sales must be recorded to properly control the business.
2. Establish daily cash register reconciliation and settlement procedures to ensure that all sales posted on the cash register reconcile to the cash-in in the register.
3. Establish a cost accounting and inventory control system to determine that material costs have a reasonable comparison to the amount of sales.
4. Develop effective reporting by store that shows the real volume of sales, actual material costs, and effective net profit margins by product and net profit per store—for one-half distribution to each son.
5. The reported data provided to the business and each son should assist them in effectively building the business on sound business principles.
6. Show Joe and his three sons that by conducting the business based on sound business practices, each of them will wind up with greater compensation even with paying more (but the right amount of) taxes.

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ranks, many small business owners have totally enmeshed themselves in the business. They are willing (and sometimes forced) to work long hours in their attempt to make the business successful, or they have no choice due to lack of success. In this situation, it becomes more difficult to convince such an owner to use more effective and proper business practices to operate the business in a more controlled environment.

- **Poor crisis management**. There may be an inability to properly manage and control (even though when one owns a small business one has the right to operate the business any way one desires). Normally this creates a crisis management situation. It could be the owner doing more than she should and getting into areas of the business she should not be in—reluctant to hire additional personnel, as it is money coming out of her pocket. Running from one crisis to another prevents the owner from focusing on proper management and control techniques. It also keeps the owner involved in all aspects of the business except proper management.
- **Lack of business acumen**. Think in terms of on-the-job training versus professional management skills. There are many people who have always wanted to operate their own small business or who have left a job to be on their own, but there is no guarantee that these individuals have adequate business acumen to effectively operate the business they have gone into. However, as the years go by and these owners remain in business, some even successfully, there is a tendency for them to convince themselves that they know all about operating their business. Who needs outside help—why pay for it?
- **Success in spite of yourself**. Maybe it is the business niche and/or good employees. Some small business owners get lucky and the business is successful in terms of net profit. However, such success must be analyzed as to the root cause. Many times it is not due the owner's magical management skills but rather that they fell into a niche market presently in demand (i.e., popular coffee shop, fast-food franchise, quick-oil-change garage) or that they somehow hired good employees who operate the business from an excellent customer service standpoint in spite of the owner. When such an owner says to me, "You can't argue with success," I respond by asking, "Would you like to be *more* successful?" Sometimes this translates into getting the owner less involved in the business so that the others can be more effective.
- **Minimal rewards**. There can be long hours with minimal compensation. The small business owner may have shoveled himself into a hole, with the business making him a slave to long hours and hard work but producing minimal monetary rewards. He is in a stuck position requiring some outside assistance to help him make the business more

successful. However, he is also in a position where he cannot afford to pay for it.

- **Inability to get out**. Too many resources tied up—what can they do? Many times small business owners have the bulk, if not all, of their resources tied up in the business. In addition, they may have been operating this business for many years. It might be extremely difficult for them personally to sell or get out of the business to enter the employment market. Their only solution seems to be to work to make the business more successful. However, they may be flogging a dead horse.
- **Family incompetence**. This relates to owners, spouse, children, relatives, and so on. With all best intentions, the owners and their relatives working in the business may be outright incompetent to run the business that they have decided to operate. For example, someone with a caustic personality might not be best suited to operate a retail store that requires close customer contact for success. In some instances, it may be that the owners have placed specific family members in positions in which they are ill qualified to perform adequately (for example, a playboy son assigned the role of plant manager over serious working machinists). How can one deal not only with business issues but also with family dynamics and personnel issues?
- **Business demands**. Business comes first, and family and friends second. The owners may be so immersed in the details and crises of their business that they have no time for family and friends, or to simply focus on managing the business rather than having the business managing them. This makes it extremely difficult for one to get their attention and convince them that there are better ways to manage their business with less stress and greater results.
- **Business consumes the owners' assets**. There could be an all-encompassing drain on financial assets. The owners may have been fortunate to have some capital (or borrowed some—usually from friends and relatives) to start up their business. However, now that the business is off the ground, the owners' wonderful and revolutionary idea has not been as successful as they had fantasized. Month after month, the owners have had to put additional capital into the business,

operating on a negative cash flow, while being unable to take much out of the business for themselves. They have become like the gambler who keeps hoping that the next poker hand will get all of their lost money back. It is probably not going to happen unless something unforeseen and fortunate occurs; it may be time for the owners to cut their losses and get out of the business.

Again, these issues need to be taken into account when assisting the small business to grow and prosper. Many times the small business (owners, family, and others) needs a family therapist and analyst as well as a business advisor. As you help to implement value-added effective operating practices and controls, you must also educate the family business owners as to the proper procedures for operating a business—making them more successful in spite of themselves. This is an ongoing process, of which one must be continually aware.

I am still looking for the functional family business.

## Family Dynamics

In providing consultative services for a closely held family business, it is often difficult to separate business issues from family concerns. In many cases, family dynamics from home tend to carry over into the family business, creating issues that may affect the business such as:

- Conflict resolution: sibling battles, parental favors, spousal-control battles, in-law issues, and so on
- Family-versus-business interests; sons'/daughters' marital status (e.g., single parent with preschool children); high-versus-low lifestyles (e.g., matching compensation to lifestyle), and so on
- Haloing and discounting family members; favorite/nonfavorite children; unwanted in-laws; likable son-/daughter-in-law
- Family role carryover: nurturing spouse, loved/unloved child, envied relative, over/underachiever, and so on

- Exploitation or taking advantage: child to parent, sibling to sibling (e.g., brother taking care of a sister), taking care of elderly founder, and so on
- Sibling rivalry or interfamily competition: older versus younger, brother/sister versus brother/sister, two sides of family (e.g., siblings of two different family founders)
- Compensation struggles: Who should get more money? Is it based on need or based on value of family member to the business?
- Contribution issues: Are family members being objectively evaluated based on contribution and compensated accordingly, or evaluated based on family position?
- Management concerns as to how to run the business: older owner versus younger, better-educated child; more than one family owner; expertise issues, and so on
- Succession issues: Who takes over or inherits the business—the family member who has contributed the most to the business, or a more logical inheritor who might not be part of the business or who might not even be a family member?

You must be prepared to deal with the business operational issues as well as some of the family dynamics issues as stated above. Many times you become more of a family counselor than a business counselor, as shown in the case study in Exhibit 1.2.

### EXHIBIT 1.2 **Case Study: Family Business**

Dad is an orthopedic surgeon, age 62, getting ready to retire in a few years. Mom has worked with him in the practice as Office Manager since he started on his own over 30 years ago. He is the principal shareholder in a group practice connected to the largest of 3 hospitals in a town of approximately 300,000 in population.

He has two nonfamily member associates who have been with the practice almost from the beginning. Each of them expects to take over the practice when Dad retires. One of these associates also has a daughter in the practice, whom he expects to succeed him.

Within the past ten years, Dad's two sons and a daughter have joined the practice. In addition, the daughter in-law married to the oldest son is employed as the laboratory supervisor. The oldest son is conservative like his father and is content to let his Dad run the practice the way he always has. The younger son, however, has recently joined the practice and is full of new ideas to increase the practice and each of their compensation—such as branch locations, increased laboratory services, advertising and marketing, and so on.

The older son's wife (the laboratory supervisor) and Mom agree with him. As a result, the two sons have stopped talking to each other. The daughter refuses to take sides, but is considering joining another practice.

Dad is beside himself as to what to do at this point and fears for his impending retirement. Mom just wants the family back—wants her sons and daughter and their families to all come to dinner at the same time.

From the scenario above, provide advice as to the major areas of concern and make recommendations as to what they should do:

1. What issues are involved in this situation?
2. What steps would you recommend to take to deal with these issues?

**Suggested Response**

***What issues are involved in this situation?***

- Strategic, long term, short term, and detailed planning
- What businesses the practice should be in; medical practice, laboratory services, surgery, branches and so on
- Operations; how to best run the practice.
- Organizational structure; how to manage and operate the practice
- Family versus nonfamily participation; management and operations
- Family dynamics; sibling rivalries, family role carryover, conflict resolution, management concerns, and so on
- Succession issues; who takes over the business from Dad, family versus nonfamily, continuity concerns, and so on.

***What steps would you recommend to deal with these issues in providing advice and/or consultation to this client?***

- Separate family issues from business issues.
- Develop plans—strategic, long term, short term, and detail—with all concerned that can be agreed to by all.
- Deal objectively with succession issues on a fair basis with both family and nonfamily members.
- Develop management and operating systems and procedures so that the business can continue successfully—whether Dad is there or not.
- Develop authority and responsibility relationships for all members of the practice with an objective relationship to the levels of compensation.
- Develop a system for valuing each practice principal's contribution to the business and an agreed-on objective basis for valuing their basis in the practice for future retirements or severances.

## Basic Operating Formula

Many small business owners have some measure of success or survival through their knowledge and skills in a technical area (such as sales, retailing, engineering, auto mechanics), but may possess minimal knowledge relative to basic good operating practices. I have found in working with certain small business clients that it is helpful to share some accounting basics that may have been studied back in Accounting 101 but that they have never learned or comprehended. The formula shown in Exhibit 1.3 exemplifies the basic relationship between sales or revenues, costs or expenditures, and the resultant profit (or loss).

**EXHIBIT 1.3 Small Business Success Formula 1**

$$R - E = P$$

*R* = Revenues (or sales)

*E* = Expenditures (or costs)

*P* = Profit (or the bottom line)

By including an additional dollar of sales to the business, the top line increases (gross sales), but unless expenditures are less than the amount of the sale, the contribution to the profit line will be zero or less (i.e., a negative or loss). However, by reducing expenditures by a dollar (all other things being equal), the reduction will fall directly to the bottom line and increase profits on a dollar-by-dollar basis. Accordingly, small business success is dependent on the small business owner acquiring only quality sales from quality customers (i.e., those sales that contribute a desired profit to the bottom line) and maintaining costs at a minimum. Of course, the small business owner must be aware of the costs and related pricing structure for each of the company's products and services and customers.

## Why the Small Business Is in Existence

Before one even thinks about implementing effective small business operating practices and controls, it is necessary to determine why the seriously operated small business is in existence. When small business owners are asked this question, invariably the answer is "to make money." Although this is true and certainly important to survival and growth, there are really only two reasons for a small business to exist:

1. **Customer service business**. To provide goods and services to satisfy desired customers so that they will continue to use the business's goods and services and refer it to others.
2. **Cash conversion business**. To create desired goods and services so that the investment in the small business is converted to cash as quickly as possible with the resultant cash-in exceeding the cash-out (net profits or positive return on investment).

This means that the small business is in business to stay for the long term—to serve its customers and grow and prosper. If it can operate under the above two concepts, the possibilities for success increase and the business is more likely to expand in the right directions. Typically, reporting controls emphasize sales, costs, and calculated profits. It is equally important to control the level of customer service to ensure ongoing growth, as well as properly controlling the cash conversion cycle. The small business operates on cash, not recorded profits. Proper operating practices encompassing these concepts help to ensure that the small business maintains its focus and operates in the most effective manner—doing the right thing, the right way, at the right time.

## Businesses the Small Business Is Not In

Once short-term thinking is eliminated, small business owners realize they are not in the following businesses and decision making becomes simpler:

- **Sales business**. Making sales that cannot be collected profitably (sales are not profits until the cash is received and the total cost of the sale is less than the amount collected) creates only numerical growth. Unless small business owners understand this concept, they may continue to believe that increased sales create positive growth for their business. The focus is to make quality sales to quality customers. Proper operating controls over each sale, as to its real profitability, looking at sales price less related costs such as direct product costs, functional costs (such as purchasing, billing, and collections), customer-related costs, and the cost of money, should enable the small business to recognize such opportunities.
- **Customer order backlog business**. Logging customer orders is a paperwork process to impress the owners and internal management.

Unless this backlog can be converted into a timely sale and profitable collection, there is only a future promise, which may never materialize. The small business owner cannot really afford the luxury of customer backlog where every customer and every order must be handled as the only one. Once a customer order is received, the small business must process and fill it (and collect) in the shortest time possible. Controls need to be implemented that ensure each customer order is entered into the production system upon receipt and handled in the desired times until completion.

- **Accounts receivable business**. Get the cash as quickly as possible, not the promise to pay. But, remember, customers are the company's business; keeping them in business is keeping the company in business. Normally, cash is already out to vendors and/or into inventory, complicating the cash conversion process. As many small businesses, such as retailers, are already in the cash business, accounts receivable are not their problem; control of cash is the problem. For those small businesses that offer billing terms, consideration should be given to establish a cash-only policy over small sales, where the amount of the sale is less than the cost of billing and collections, and for sales under a certain amount, say $500. For instance, the small business may establish controls to ensure cash collectibility either in advance or at the time of delivery. All sales resulting in accounts receivable would be reported as exceptions for follow-up.
- **Inventory business**. Inventory does not equal sales. Keep inventories to a minimum—zero, if possible—by procuring raw materials from vendors only as needed, producing for real customer orders based on agreed-on delivery dates, maximizing work-in-process throughput, and shipping directly from production when the customer needs the product. If inventory is the business, such as with a wholesaler, retailer, or distributor, then once again the small business wants to ensure that inventories are kept to a minimum within the constraints of fully serving customers. However, the owners must be in touch with costs and selling prices and knowing what items are in demand by the customer base. Making buying mistakes that result in selling off inventory at markdown prices is not the course to take for making the business successful. Such markdown practices usually only result in

absorbing losses, setting bad precedent for customer expectations, and ignoring the root of your problems—lack of knowledge of the business and/or its customers.

- **Employment business**. The trick here is to get by with the least number of employees possible. Never hire an additional employee unless absolutely necessary; rely on cross-training and transferring good employees. Not only do people cost ongoing salaries and fringe benefits, but they also need to be paid attention to—which results in organization building. This is extremely important to the small business, as it cannot afford to solve its problems (as large corporations do) by hiring or downsizing. The small business must solve similar problems with fewer employees, but be more flexible. Controls over the area of personnel include hiring statistics, effective use of personnel, productivity reporting, and results produced per employee.

The pessimistic small business owner is the one who winds up in the markdown business hoping to recover through volume.

If the small business does both of these successfully—that is, pay attention to its business, and stay out of the businesses it should not be in, it will more than likely (outside economic factors notwithstanding) grow and prosper through well-satisfied customers and keep itself in the positive cash conversion business—in spite of itself. The small business owner must decide which of the above factors (i.e., businesses to be in and not to be in) it wishes to embrace as its business criteria, which ones it does not wish to include as criteria, and which additional criteria to include. These criteria become the overriding conditions on which the business conducts its operations and against which it is measured. It is these agreed-on criteria that define the operating practices that need to be established.

Embracing the correct criteria is one issue; enforcing the application of the criteria is another issue. As previously mentioned, often small business family issues come to bear that create violations of good business principles, as shown in the case study in Exhibit 1.4.

## EXHIBIT 1.4 Slacking

Lou is the president of a small business that manufactures men's leisure slacks. Every Friday after work, Horace, the receiver/shipper, and also Lou's brother-in-law, loads his SUV with bundles of slacks. You happened to notice this routine. Upon investigation, you found no paperwork for the transaction, which was never posted to the books. Horace had a booth at the local in-door flea market, where he sold the slacks as irregulars at much less than retail. There was no indication of any returns. When you brought it to Lou's attention, Lou told you "What can I do. He's my wife's brother. Until I'm ready to divorce her, I've got Horace.

What operating deficiencies do you identify and how would you present them to the owner? What would you suggest to correct this situation from a control and business practices standpoint?

**Suggested Response**

***Control Deficiencies***

- *Inventory and production control*: Taking product out of stock without proper recording results in inaccurate inventory levels and records where there may be an expectation that such inventory is still on-hand. In addition, to make up for the lost items, assuming there is customer demand, requires additional unnecessary production orders placed into manufacturing.
- *Customer orders*: If these items were produced to fill customer orders, not only will the company be unable to fill such orders, but the company will have to enter additional manufacturing orders requiring the customer to wait—a violation of good customer service.
- *Cost accounting*: As these products are taken out of inventory without a corresponding sale, the result is an increase in cost for all other sales, making the overall cost data on which to base operating decisions inaccurate. While the owner does not know the extent of what is going out the door, the cost of such items, whether known or not, is passed on to his other customers or comes out of his pocket.

***Corrective Measures***

- *Inventory and production control*: If the owner insists that Horace continue running his side business out of inventory, handle such inventory issues as such and Horace's demands as part of customer production requirements. Also, record any returned merchandise by Horace. Such inventory issues should be billed out to Horace at a price that at least covers costs.
- *Customer orders*: Harold should be treated as another customer, even if sold at wholesale or preferred prices. He should be cautioned that no merchandise leaves the plant facility without proper recording. While it is all right to help a family member, proper business practices must be maintained to allow the owner to manage properly.
- *Cost accounting*: All costs need to be properly recorded into the business's records so that proper business decisions can be made, such as costing and pricing decisions by product line, product, and customer.

## Helpful Systems

In many small businesses today, the owners are grasping for ways to become competitive and maintain market position—or merely to survive. The owners and management have sensed that many of their systems are detrimental to growth and have held them back. These are the very systems that are supposed to be helpful; for example:

- Planning systems, long and short term, that resulted in formal or informal plans but not in actual results
- Budget systems that became costly in terms of allocating resources effectively and controlling costs in relation to results
- Organizational structures that created unwieldy hierarchies or gaps in responsibilities, which produced systems of unnecessary policing and control
- Cost accounting structures (usually lack thereof) that obscured true product costs and resulted in pricing that constrained competitiveness or ignored profitability
- Computerized accounting systems that produced elaborate reporting without enhancing the effectiveness of operations
- Sales functions and forecasts that resulted in selling those products that maximized sales commissions but may not have been the products to sell and produce for effective growth
- Operating practices that perpetuated outmoded systems ("we've always done it that way") rather than promoted best practices

Effective operating practices that ensure that these systems are operating most effectively, together with other techniques, are tools to make these systems helpful as intended and direct the organization toward its goals. With the passage of time, good intentions and initially helpful systems tend to deteriorate. Operational reviews are then necessary to help get the small business back on track by pinpointing operational deficiencies, developing practical recommendations, and implementing positive changes.

## Management Responsibility

Small business owners and managers at all levels should be held accountable for using the scarce resources entrusted to them to achieve maximum results at the least possible costs. Although management should embrace best practice operating concepts and apply them as they proceed, in the typical small business this is rarely the case.

More normally, small business owners and management need to be sold on the value of differential systems. In selling the benefits of implementing such operating practices, it is important to stress that unlike other techniques that cost time and money for uncertain results, best operating practices can pay for themselves. In effect, the operations and control environment becomes a profit center instead of a cost center.

With the success of best practice operating practices, management quickly realizes that the more effective the operating practices in place and the more recommended economies and efficiencies are implemented, the greater the savings and results. In addition, the residual capability for implementing and performing best practice operating procedures remains in each operating area, so that operations personnel can continue to apply these concepts on an ongoing basis.

Keep in mind that the intent of implementing best practice operating practices is not to be critical of present operations, but to review operations and develop a program of best practices and continuous positive operational improvements by working with management and staff personnel. The concept of best practices should be sold as an internal program of review directed toward improved economies and efficiencies that will produce increased operational results.

The successful small business owner is the one who listens and tries alternative approaches looking for the path to success.

## Operating Areas to Be Addressed

While typically the small business owner's major concern is daily operations, to be most effective one must include any and all organizational functions and activities that hinder or help the effort to maintain the business in the most economical, efficient, and effective manner possible. In this regard, you must be aware of basic business principles that help to enhance the organization's success as well as those that the company should avoid. With these principles in mind, you can analyze the small business's operations to identify areas for improvement in which best practices can be implemented that maximize the chances of success and minimize the risk of failure. Although the primary focus in identifying and establishing these operating practices is on the manner in which scarce resources are used, considering the sources and uses of resources and the policies and procedures used to deal with over- and underoperational conditions, there are specific areas that need to be addressed.

The first step in the successful identification and implementation of effective small business operating practices is to define the company's desired criteria for results as related to its reason for existence and basic business principles. These organizational criteria typically encompass the company as an entity as well as its major functions. Such criteria then become the basis for establishing controls to monitor progress toward these criteria. An example of such an organization-wide criteria structure is as follows:

- Operate all activities in the most economical, efficient, and effective manner as possible.
- Provide the highest-quality products to customers at the least possible cost.
- Satisfy customers so that they continue to use the company's products and refer the company to others.
- Convert the cash invested in the business as quickly as possible so that the resultant cash in exceeds the cash out to the greatest extent possible.
- Achieve desired results using the most efficient methods so that the company can optimize the use of limited resources.
- Maximize net profits without sacrificing quality of operations, customer service, or cash requirements.
- Based on established organization-wide criteria as stated earlier, you can then assist the small business in establishing related criteria for its major areas of operations such as:
  - Sales function
  - Direct cost
  - Functional activities

## Sales Function

In the best of circumstances, the criteria for the most effective and efficient sales operation involve making sales to the right customers who provide a profit source to the small business. A strong sales function creates realistic sales forecasts that result in a present or future real customer order. Sales orders and corresponding compensation systems should reinforce the goals of the company—that is, what items to sell, how much of each item to sell, at what price, and to whom. And finally, customer sales should be integrated with other functions of the company, such as manufacturing, engineering, accounting, purchasing, and so on.

- Are sales made to quality customers with the right products at the right time?
- Does each sale make a contribution to profits?
- Are all costs compared to the sale, such as product costs (direct material and labor), assignment of product-related activity costs (e.g., manufacturing processes, quality control, shipping, and receiving), functional costs (e.g., purchasing, accounts payable, billing, and accounts receivable), and customer costs (e.g., marketing, selling, support services, and customer service)?
- Do sales relate to an agreed-on sales forecast? Is the company selling the right products to the right customers?
- Do sales integrate with an effective production scheduling/control system?
- Are sales being made to the right customers—can they be collected profitably?
- Do realistic sales forecasts result in a present or future real customer order?
- Are sales for those products, as determined by management, to the right customers, at the right time, and in the right quantities?
- Do actual customer sales correlate directly with management's long- and short-term plans?
- Do sales efforts, and corresponding compensation systems, reinforce the goals of the company?

- Are customer sales integrated with other functions of the company, such as manufacturing, engineering, accounting, purchasing and buying, and so on?

## Direct Cost

The small business wants to operate in the most efficient manner with the most economical cost in the timeliest manner, considering processes such as customer order entry, production and service delivery throughput, and customer delivery. The small business should integrate manufacturing and service delivery processes with sales efforts and customer requirements, and increase productivity of manufacturing and service delivery operations on an ongoing basis. Direct cost control goals should include eliminating, reducing, or improving all facets of the business's operations including activities such as receiving, inventory control, production control, storeroom operations, quality control, supervision and management, packing and shipping, and maintenance. The small business owner should also be concerned with minimizing the amount of resources, such as personnel, facilities, and equipment, that are allocated to the manufacturing or service-delivery process.

- Are sales orders entered into an effective production control system, which ensures that all sales orders are entered into production in a timely manner to ensure on-time, quality deliveries?
- Is work-in-process kept to a minimum so that only real customer orders are being worked on rather than building up finished-goods inventory?
- Are the most efficient and economical production methods used to ensure that the cost of the product is kept to its realizable minimum?
- Are direct materials and labor used most efficiently so that waste, reworks, and rejects are kept to a minimum?
- Are non-direct labor (and material) costs such as quality control, supervision and management, repairs and maintenance, material handling, and so on kept to a minimum?
- Are all operations conducted in the most efficient manner with the most economical costs?

- Are manufacturing and service delivery processes integrated with sales efforts and customer requirements?
- Are manufacturing and service delivery operations conducted in the timeliest manner considering processes such as customer order entry, timely throughput, and customer delivery?
- Is there a system in effect to increase productivity in all operations on an ongoing basis?
- Are controls in effect to eliminate, reduce, or improve all facets of business operations?
- Do procedures exist to eliminate, reduce, or improve all facets of manufacturing and service-delivery operations?
- Are resources minimized, such as personnel, facilities, and equipment, that are allocated to the manufacturing or service-delivery process?
- Are raw material and finished-goods inventories kept to a minimum?
- Are raw materials delivered into production on a just-in-time basis?
- Are finished goods completed in production just in time for customer delivery?
- Is the business working toward getting out of the inventory business?

## Functional Activities

While the emphasis for many small business owners is to continually increase sales, it is the responsibility of the owner to obtain profitable sales from quality customers, convert a sale into cash as quickly as possible, and add real profits to the bottom line—more important components in operating a successful small business. Many times the small business cannot control the acquisition of customer sales when needed, sometimes resulting in making a sale for less than a desired profit margin (possibly at a loss). However, the small business can initiate efforts to control and reduce its internal functional costs, resulting in increasing its profit margins and creating greater flexibility in its pricing policies. Remember, a dollar of cost saved is a dollar that goes directly to the bottom line. Some of the areas of concern for typical functional costs are:

### *Accounting Functions—General*

- What is the purpose and necessity of each of the accounting functions and related activities, such as accounts receivable, accounts payable, payroll, budgeting, and general ledger?
- Is each of the accounting functions operated in the most economical and efficient manner?
- Are effective procedures in place that result in the accounting functions becoming more analytical than mechanical?
- Are computerized procedures developed that integrate accounting purposes with operating requirements?
- Do reporting systems exist that provide management with the necessary operating data and indicators that can be generated from accounting data?
- Is there a process that identifies, eliminates, or reduces all unnecessary accounting operations?

### *Billing, Accounts Receivable, and Collections*

- Are bills sent out in a timely manner—at the time of shipment or before?
- Are accounts receivable processing procedures the most efficient and economical?
- Is the cost of billing, accounts receivable processing, and collection efforts more than the amount of the receivable or the net profit on the sale?
- Is the number and amount of accounts receivable continually analyzed for minimization?
- Are any customers paying directly or through electronic funds transfer at the time of shipping or delivery?
- Are bills and accounts receivable in amounts exceeding the cost of processing excluded from the system?

### *Purchasing and Accounts Payable*

- Are all items that are less than the cost of purchasing excluded from the purchasing system—with an efficient system used for these items?

- Are all repetitive high-volume and -cost items (e.g., raw materials and manufacturing supplies) negotiated by purchasing with vendors as to price, quality, and timeliness?
- Does the production system automatically order repetitive items as an integrated part of the production control system?
- Has consideration been given to reduce these functions for low- and high-ticket items, leading toward the possible elimination of these functions?
- Does the company consider paying any vendors on a shipment or delivery basis as part of its vendor negotiation procedures?
- Does the purchasing function only purchase those items where economies can be gained through a system of central purchasing?
- Is there a direct purchase system for those items that the purchasing function does not need to process, such as low-dollar purchases and repetitive purchases?
- Are purchasing and accounts payable systems simplified so that costs are at the lowest possible levels?
- Do purchasing personnel effectively negotiate with vendors so that the company obtains the right materials at the right time at the right quality at the right price?
- Is there a vendor analysis system present that objectively evaluates vendor performance?

### *Other Costs and Expenses*

- Are all other costs and expenses kept to a minimum? Remember, a dollar not unnecessarily spent is a dollar directly to the bottom line.
- Are selling costs directed toward customer service and strategic plans rather than maximizing salespeople's compensation?
- Is there a system in effect that recognizes and rewards the reduction of expenses rather than rewarding budget increases or increased expenditures?
- Are all non-value-added functions (e.g., management and supervision, office processing, paperwork, etc.) evaluated as to reduction and elimination?

If you keep your eye only on the operations, you'll miss the results.

If you do not know where you are going and the results to be achieved, there is nothing to control against.

## Economy, Efficiency, and Effectiveness

In establishing effective operating practices for small business success, such practices must embrace the concept of conducting operations for economy, efficiency, and effectiveness. The following is a brief description of each of the *three E's* of effective operations:

1. **Economy (or the cost of operations)**. Is the small business carrying out its responsibilities in the most economical manner—that is, through due conservation of its resources? In appraising the economy of operations and related allocation and use of resources, you may consider whether the organization is:
   a. Following sound purchasing practices
   b. Overstaffed as related to performing necessary functions
   c. Allowing excess materials to be on hand
   d. Using equipment that is more expensive than necessary
   e. Avoiding the waste of resources
2. **Efficiency (or methods of operations)**. Is the organization carrying out its responsibilities with the minimum expenditure of effort? Examples of operational inefficiencies to be aware of include:
   a. Improper use of manual and computerized procedures
   b. Inefficient paperwork flow

   c. Inefficient operating systems and procedures
   d. Cumbersome organizational hierarchy and/or communication patterns
   e. Duplication of effort
   f. Unnecessary work steps

3. **Effectiveness (or results of operations)**. Is the organization achieving results or benefits based on stated goals and objectives or some other measurable criteria? The review of the results of operations includes:
   - Appraisal of the organizational planning system as to its development of realistic goals, objectives, and detail plans
   - Assessment of the adequacy of management's system for measuring effectiveness
   - Determination of the extent to which results are achieved
   - Identification of factors inhibiting satisfactory performance of results

A graphic way to look at the effect of economy, efficiency, and effectiveness on the small business's growth and profitability is shown in the formula below in Exhibit 1.5.

**EXHIBIT 1.5 Small Business Success Formula 2**

$$G + P = E1 + E2 + E3$$

*G* = Growth
*P* = Profitability
*E1* = Economy
*E2* = Efficiency
*E3* = Effectiveness

For the small business to be successful and grow and prosper in a profitable manner, the small business owner must operate the business using the least amount of scarce resources (economy), using sound business practices in its operations (efficiency) to achieve the optimum results of success (effectiveness).

## The Initial Survey

To develop effective operating practices for a small business that desires to operate properly using sound business practices and grow and prosper in a successful manner, an initial survey form can be used to identify present practices and effective controls over operations. A sample initial survey form is shown in Exhibit 1.6. The purpose of the initial survey is to identify areas of major importance in the total organization or specific operations to be improved.

**EXHIBIT 1.6 Initial Survey Example**

***Planning and Budgeting***

1. How does the company plan? Describe the system of planning.
2. Does a long-range plan exist? Attach a copy.
3. Do current short-term plans exist? Attach a copy.
4. What are plans for expansion or improvement?
5. What are plans for physical plant development?
6. What are plans for future financing?
7. What are personnel plans?
8. How does the organization budget? Describe the budgeting system.
9. Does a current budget exist? Obtain or prepare a copy.
10. Do budget-versus-actual statistics exist for the last five years of operations?

***Personnel and Staffing***

1. Does an organizational chart exist? Obtain or prepare a copy.
2. Do functional job descriptions exist for each block on the organization chart?
3. Do staffing statistics by functional area exist? Obtain or prepare a copy.
4. Is there a system of employee evaluations? Describe the procedures.
5. How are employees recruited, hired, evaluated, and fired? Describe.
6. How are new employees oriented and trained? Describe.
7. What are promotional policies? Describe.
8. How are raises and promotions determined? Describe.
9. Is there a grievance mechanism? Describe.
10. What type of personnel records are maintained? Obtain copies.

(*Continued*)

EXHIBIT 1.6 **(Continued)**

***Management***

1. Does a board of directors or other governing group exist? Attach a list of names and credentials.
2. Who is considered "top" management? Attach a list of names and credentials.
3. Who is considered "middle" management? Attach a list of names.
4. Who is considered "lower" management? Attach a list of names and credentials.
5. How adequate are existing reports in furnishing information for control purposes and making management decisions? Describe.
6. Are there tools for internal downward communication to the staff? Describe.
7. Is authority effectively delegated to management and lower levels? Describe.

***Policies and Procedures***

1. Do written policies exist? Obtain a copy.
2. Are written policies current?
3. Are systems and procedures documented? Obtain or provide a copy.

***Accounting System***

1. What is the chart of accounts used? Obtain or prepare a copy.
2. Is the accounting mechanized? Obtain documentation.
3. What financial and operational reports are produced? Obtain documentation.
4. Is there an internal audit function? By and to whom?
5. Are internal operating reports produced? Obtain copies and determine uses.

***Revenues***

1. What are the sources of revenue for the last five years? Obtain or prepare statistics.
2. Have there been any substantial changes during this period? Document them.
3. Is actual-versus-budgeted data available? Obtain or prepare a copy.

***Expenses***

1. What are the major expense accounts used? Obtain or prepare a copy.
2. What are actual expenses for these accounts for the last five years?
3. Have there been any substantial changes during this period? Document them.
4. Is actual-versus-budgeted data available? Obtain or prepare a copy.

***Information Technology***

1. Where is computer processing presently located in the organization? Obtain or prepare a copy of information technology organization.

2. What computer equipment is used? Obtain or prepare a copy of equipment list and locations.
3. What is total cost of equipment rental or purchase price?
4. What are the major applications computerized? Obtain or prepare a copy of the list of applications, with general systems descriptions.
5. Are management, operational, control, and exception reports provided?

***Purchasing***

1. What is purchasing authority? Obtain or prepare a copy of policy relative to purchasing authority.
2. Is purchasing centralized or decentralized? Describe operations.
3. How are purchase requisitions initiated? Describe general procedures.
4. Who determines quality and quantity desired?
5. Are purchase orders used? Describe the procedure.
6. Are competitive bidding procedures used? Describe the procedure.

***Manufacturing Systems***

1. Is a computerized manufacturing control system being used? Describe.
2. What types of manufacturing processes are being used? Describe processes.
3. How are jobs controlled in manufacturing? Describe procedures.
4. Is a manufacturing cost system used by job? Describe the system.
5. Are operational and management reports provided to control manufacturing operations? Obtain or prepare copies.

***Production Control***

1. Is a manufacturing control system being used? Is it computerized? Obtain or prepare a copy of general procedures.
2. What types of manufacturing processes are being used? Describe.
3. What is the location(s) of manufacturing facilities? Document.
4. Are production control cost centers used to control the routing of manufacturing orders? Obtain or prepare a copy of cost centers.
5. Is a manufacturing cost system used? Obtain or prepare a copy of cost accounting procedures.
6. Are operational and management reports provided to control manufacturing operations? Obtain copies.

***Inventory Control***

1. Is an inventory control system being used? Is it computerized? Obtain or prepare a copy of general procedures.
2. What types of inventory control procedures are being used? Describe.
3. Where are inventory storeroom locations? Obtain or prepare a copy of locations and describe storeroom procedures.

(*Continued*)

EXHIBIT 1.6 **(Continued)**

4. How are inventory records maintained? Describe procedures.
5. Are inventory statistics and data maintained? Obtain data as to items in inventory, dollar value, usage, on-hand balances, etc.
6. What is the basis for reordering inventory items, and how are reorder quantities determined? Describe procedures.

***Responsibility and Authority***

1. Are responsibilities clearly defined and understood by managers and staff personnel? Describe procedures.
2. Has authority been delegated effectively to managers and lower levels within the organization? Describe the process.

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*Adequate operating practices* are present if management has planned, designed, and organized in a manner that provides reasonable assurance that the organization's risks have been managed effectively and that the organization's goals and objectives will be achieved efficiently and economically, producing desired results.