DOCUMENT RESUME

ED 059 456 AC 012 328

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TITLE Records and Credit in Profitable Management.
INSTITUTION Small Business Administration, Washington, D.C.
REPORT NO Topic-2
PUB DATE 64
NOTE 78p.
AVAILABLE FROM Superintendent of Documents, U.S. Government Printing Office, Washington, D.C. 20402 ($1.25); Small Business Administration, Washington, D. C. 20416 (on loan basis)

EDRS PRICE MF-$0.65 HC-$3.29
DESCRIPTORS *Administrative Personnel; Audiovisual Aids; Bibliographies; *Business Administration; Case Studies (Education); Course Content; *Credit (Finance); Distributive Education; *Educational Programs; Industry; Instructional Materials; Lesson Plans; Management Education; Participant Characteristics; Professional Continuing Education; *Recordkeeping; Stimuli; Teaching Guides; University Extension

ABSTRACT

The second in a series of subject presentation in the field of administrative management for use by educators and businessmen who teach management courses is offered. The point is made that the concept of an educational program in small-business administrative management involves the investigation of a series of topics stemming from basic management functions as opposed to purely operational features of the business represented. The Lesson Plan is an outline of the material covered which may be used as a teaching guide, or as a framework for developing an individualized presentation. The Presentation is a carefully prepared subject presentation which may be used as written or modified to meet local needs and conditions. The Visual Aids are photographic copies of the set of visual aids which are available for this topic. These visuals are 8- by 10-inch colored transparencies prepared for use on overhead projectors. The Supply Department consists of materials which may be reproduced locally for distribution to course participants. Cases in Point list short actual small-business management cases which may be used to augment the presentation and to develop discussion. The Incubator provides ideas for stimulating further thought and discussion by the participants. A bibliography is provided, and field offices of the Small Business Administration are listed. (CK)

RECORDS AND CREDIT

IN PROFITABLE MANAGEMENT

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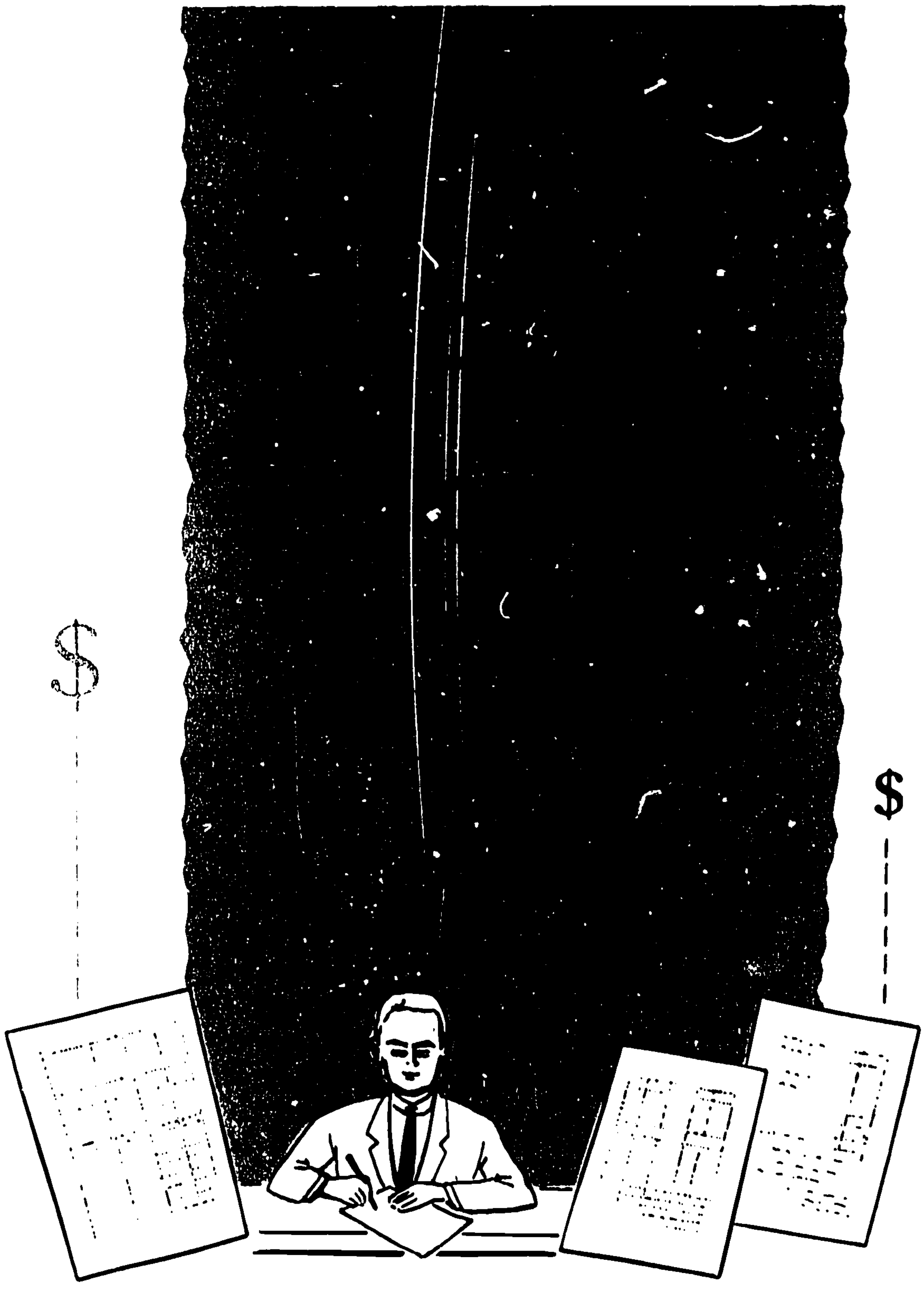

ADMINISTRATIVE MANAGEMENT COURSE PROGRAM

2

Small Business Administration

Washington, D. C. 20416 •1964

SMALL BUSINESS ADMINISTRATION

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FOREWORD

The Administrative Management Course Program was developed by the Small Business Administration in cooperation with educational institutions in 1954 to bring modern management knowledge and techniques to the owners and managers of small businesses. Since then, more than 700 American universities, colleges, and local school systems have cosponsored 2,800 courses with this Agency. Over 88,000 owners and managers of small businesses have attended these courses.

This is an outstanding demonstration of public spirit and service on the part of these hundreds of educational institutions. Yet, there remain many thousands of communities, particularly those under 25,000 in population and whose business establishments are all small, which have never had an administrative management course.

A committee on management education was recently formed consisting of representatives of the Distributive Education division of the American Vocational Association, and the Small Business Administration to study ways of meeting the small-business management needs of these small communities. The committee recommended that a series of subject presentations, including lesson plans, lectures, visual aids, case studies, and handout material, be developed to assist in the establishment of administrative management course programs in new locations. Further, it was felt that this material could materially assist existing management programs, particularly by emphasizing the importance of continuing education for small-business owners and managers, and by assisting the busy instructor with his preparation.

SBA accepted the responsibility for developing a series of subject presentations in the field of administrative management for use by educators and businessmen who teach these management courses. This booklet is the first in the series. We believe that these presentations will be particularly useful to Distributive Education in the smaller community where library research facilities are limited and equipment for the production of visual aids is not readily available.

I wish to express appreciation to the Richmond Public Schools System for granting a leave of absence to Mr. John O. Perreault. Mr. Perreault did the research and preliminary draft of the booklet under the supervision of Mr. Grant C. Moon, Chief, Management Courses and Conferences Division. Mr. George C. Willman, Jr. and Mr. John W. Clark, Educational Specialists in the Division, have edited and prepared the booklet for publication with the assistance of Mr. Thomas O. Barnes and Miss Margaret Torpey. Artwork and visuals were prepared by Mr. Michael J. Fontana and Mr. Milton H. Weber of the Graphics Branch, Office of Administrative Services.

Eugene P. Foley
Administrator

July 1964

TABLE OF CONTENTS

A WORD ABOUT THIS SESSION

The concept of an educational program in small-business administrative management involves the investigation of a series of topics stemming from basic management functions as opposed to purely operational features of the business represented. The operational factors vary widely, but the principles of sound management have quite universal application.

It is anticipated that, through the medium of administrative management courses or institutes, educational institutions will cooperate with the Small Business Administration and other community agencies in bringing the specialized knowledge and experience of a series of management specialists to small-business owners and managers participating in the program.

Typically, the "faculty" of a cosponsored management course might include:

- A lawyer,
- A banker or financial executive,
- An advertising executive,
- A Dun & Bradstreet, Inc. executive or a management consultant,
- A trade association executive,
- An accountant,
- A Distributive Education coordinator,
- A school or college faculty member, in specialized business administration or merchandising fields,
- An SBA Management or Financial Specialist, and/or
- Other businessmen.

This topic, Records and Credit in Profitable Management, may be handled by an accountant or management consultant. The U. S. Office of Education publication, Guide for Part-Time Instructors, Distributive Education for Adults, may prove useful to local instructors.

This is one of a series of subject presentations which are available to the local educator. The complete set may be obtained from the Small Business Administration.

The system of colored divider sheets is used in all booklets in the series. The color code is:

Grey -- The Lesson Plan. An outline of the material covered which may be used as a teaching guide, or as a framework for developing an individualized presentation. The lesson plan contains two columns: the left-hand column is an outline of the presentation; the right is a step-by-step indication of procedure, including chalk-board suggestions, quotations, discussion points, and a keyed guide to the visual aids supplied.

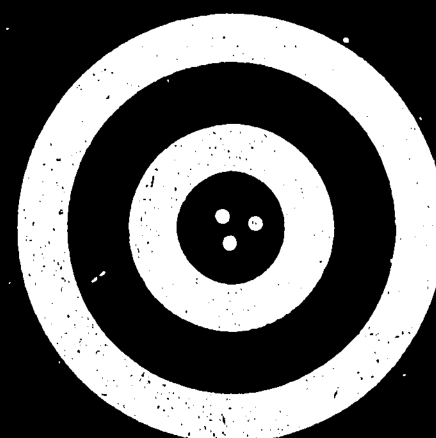
Rust -- The Presentation. A carefully prepared subject presentation which may be used as written or modified to meet local needs and conditions. It may also be used as a source of information by a person preparing his own lecture.

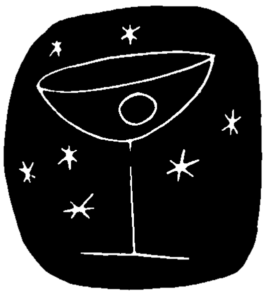
Buff -- The Visual Aids. Photographic copies of the set of visual aids which are available for this topic. These visuals are 8- by 10-inch colored transparencies prepared for use on overhead projectors. The subject presentation and lesson plan are keyed to the visuals. A set of visuals for each subject in this series may be borrowed from the nearest SBA regional office.

Green -- The Supply Department. Materials which may be reproduced locally for distribution to course participants. Your nearest SBA office can furnish information on current availability of SBA free publications, including titles published subsequent to this volume.

Yellow -- Cases in Point. Short actual small-business management cases which may be used to augment the presentation and to develop discussion, or as the basis for a second session on the same topic.

Blue -- The Incubator. Ideas for stimulating further thought and discussion by the participants. This material may be reproduced locally for distribution to course participants. "Assignments" are designed to aid in retention of the subject matter of the session.





STIMULATE GROUP BY SERVING AN INSTRUCTIONAL COCKTAIL

RECIPE

Use The Three B's (Bubbles)

- O ***Base*** instruction on problems at learners level.
- O ***Blend*** instruction with job experience.
- O ***Brighten*** instructions with variety of ***illustrations, investigations*** and grouo ***participation.***

FOUR BASIC STEPS OF INSTRUCTION

Instructing is like selling - -

Selling	Instructing
1. Approach customer Promptness Put at ease Awaken ***interest***	1. Prepare the group Start on schedule Put group at ease ***Awaken*** interest
2. Present merchandise or service Select merchandise to fit need Show one item at a time Demonstrate ***selling points***	2. Present information Gauge material to needs Present one point at a time ***Show, illustrate, question***
3. Have customer take part Get merchandise into customer's hands Let customer "try on" merchandise Answer questions and meet objections	3. Have group participate Get group to ***discuss*** Have members ***demonstrate*** or ***use*** ideas Answer questions and correct errors
4. Bring sale to close Help customers decide; ask: "which" "for whom" "when" Be sure merchandise fits need Summarize points of care and use Handle mechanics of sale Pave way for return visit	4. Bring meeting to a close Check on understanding; ask: "why" "how" "when" "what" "where" "who" Be sure group now can use information Summarize "take away" ideas Make a definite conclusion Pave way for next session

How To Deal With "Difficult Customers"

What To Do

THE "MOUTH"—wants to do all the talking.

Take the play away from him by asking others to comment on his remarks.

Deliberately turn to others and ask for their opinions. Avoid looking at him.

Tactfully ask him to give someone else a chance, or talk to him in private.

THE "ARGUER"—constantly tries to catch you up.

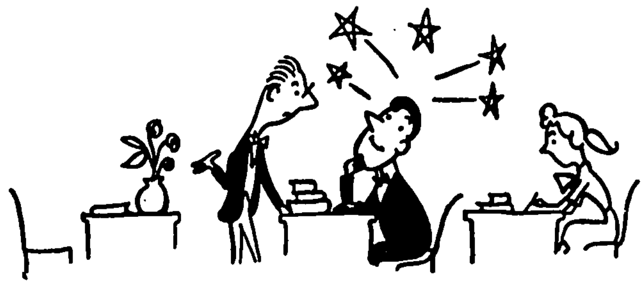
Keep cool. You can never "win" an argument. Always make him back it up. Ask for evidence.

Avoid getting personal.

Refer the question to the group and then to him.

THE "MOUSE"—is in every group.

Call him by name and ask him for an opinion. Ask him an easy question he is sure to answer well, then praise him. This person is worthy of your attention.



THE "SO-WHATER"—is disinterested.

Point up something he has done as a good example of the point being stressed. Ask direct questions affecting his work.

LESSON PLAN

TOPIC: RECORDS AND CREDIT IN PROFITABLE MANAGEMENT

OBJECTIVES: To establish the concept of records as a management tool.
To point out the typical problems evolving from poor records.
To determine the types of records needed.
To emphasize the importance of control in credit management.
To outline means of handling slow or overdue accounts.

SESSION CONTENT	TIPS AND APPROACHES
I. YOUR RECORDS AS GUIDELINES TO PROFITABLE MANAGEMENT	
A. Importance of records	
1. Record keeping is the "language of business"	Nile story -- or other appropriate introductions
2. Without records business transactions become hazy and unintelligible	
3. SBA publication "Are You Kidding Yourself About Your Profits?" poses three record-related management problems: a. The existence of a profit b. The sufficiency of profit c. The relative profitability of the product mix	
4. The Pitt study	

a. Parallel (controlled) case studies revealed the one overwhelming difference between <u>successful</u> and <u>unsuccessful</u> firms lies in approach to management information	Describe study controls
b. 90% of failures kept poor records	
B. Record systems -- simple or complex	
1. Simplest form of records consists of some form of income record and some form (checks, stubs, cash slips, etc.) of record of money that goes out	Quote Dr. Woodruff, this manual, page 15
2. Accurately kept, these <u>expense</u> and <u>income</u> records provide the brick and mortar for more complex or elaborate systems	
3. Overly elaborate records can also be a hinderance rather than a help	Quote "can't see forest for the trees" example
4. Records that immerse management in unimportant trivia are to be avoided	Quote Dr. Woodruff, this manual, page 15

C. Typical problems evolving from inadequate or unintelligible records	
1. Tax problems	(Visual No. 1)
2. Excessive fixed costs	(Visual No. 2)
3. Financial over-reaching	(Visual No. 3)
4. Misinformation about the nature, location and source of true market	(Visual No. 4) Cite Richmond Bakery experience and Visual No. 5
5. Poor product or service diversification	(Visual No. 6)
6. Obsolescence of product or equipment	(Visual No. 7)
7. Inventory troubles	(Visual No. 8)
8. Expansion problems	(Visual No. 9)
9. Combination of above problems	
D. Basic records needed	
1. Records that are required are affected by the business functions involved:	
a. Financing	List on chalkboard
b. Equipping	
c. Personnel utilization and control	
d. Purchasing	
e. Storing	
f. Production	
g. Marketing or selling	
h. Financial reporting and control	
2. Size, type of organization, kind of business, etc. indicate to some extent the type and variety of records needed, but all businesses require certain basic records	

R ecords of Cash Receipt with provisions for segregating receipts from sources other than income (such as bank loans)

E xpenditure Records with provisions for designating the nature of the expenditure and the method of payment

C ontrol of Payroll Expenditures - showing names, social security numbers, time of payment, gross pay, payroll deductions, and taxes

O n Account - or accounts receivable records showing customers' accounts and your experience with them

R esources and Accounts Payable - showing your experience with suppliers

D ocumentation File - for the orderly accumulation of documentary evidence (invoices, stubs, etc.) supporting your other records

S ummarization - general ledger and periodic statements (P & L, balance sheet, etc.)

Visual No. 10 or write on chalkboard outline of anagram

R ____________

E ____________

C ____________

O ____________

R ____________

D ____________

S ____________

Then fill in as each record is discussed

E. Data to be provided by records

Records should provide management with information to:

Point out records represent events -- records exist because things happen, not the reverse

1. Facilitate dealings with banks and other credit or lending agencies

Hand out and discuss Hand Out Sheet No. II-1

2. Facilitate management plans regarding new lines, changes in operations, diversification, elimination of profit drains, expansion, etc.

3. Establish accountability of employees (or departments) for assets and functions entrusted to their charge

4. Give information as to past experience with merchandise lines, customers, and suppliers

5. Provide information and data to assist professional resource people such as your accountant, your attorney, your trade association executive to help you in your business

6. Provide a tangible basis for State, district and local licenses or permit fees

7. Provide basis for assessment for personal and real property

8. Provide for the determination of taxable wages under social security and unemployment regulations

9. Keep systematized records of operation cost, obsolescence, depreciation, etc.

10. And finally, to support the figures that go into tax calculations

F. Sources of help in establishing records

1. The sooner you start the better — Discuss

2. As a minimum let your banker be your record keeper

   a. Deposit all money received with a notation as to its source

   b. Make all expenditures by check with a notation as to purpose

c. Keep memoranda of details not immediately reflected by receipt or disbursement

d. Preserve all documentary evidence (bills, contracts, tax returns, etc.) and file them in a safe orderly fashion

3. Best to enlist the help of professionals in most cases

Enumerate available sources of aid

II. CREDIT & COLLECTION TECHNIQUES

Visual No. 11

A. Credit is a broad topic in itself

Here we content ourselves with a brief look at credit from a management viewpoint -- i.e., the things to watch for in establishing policy and in controlling practices

Cite Dr. Clyde W. Phelps' report, The Ten Hidden Losses In Slow Charge Accounts

1. The hidden losses in charge accounts:

a. American retailers lose more from slow payers than from bad debts

b. The cost associated with slow accounts constitutes the most important item in the total cost of doing a credit business	
c. The cost can be eliminated by individual care or collective action	
2. Losses from slow accounts	Write on chalkboard or show in Poster Form (Use progressive disclosure techniques) <u>Discuss each</u>
a. Bad debt losses b. Bookkeeping & collection cost c. Added interest cost d. Tied-up capital e. Reduced capital turnover f. Lost customers g. Borrowing difficult for you h. Fruitless competition caused	
3. The law of "diminishing returns" in collections	
4. The older an account gets the tougher it becomes to collect	Show Visual No. 12 - Discuss
5. Steps to prevent and cure "slow accounts"	
a. <u>Investigate</u> thoroughly b. <u>Explain terms clearly</u> and unmistakably c. <u>Suspend</u> further credit	

d. Help delinquent by suggesting ways and means

e. Act decisively

B. Building a credit business

1. The need for a policy -- what to include in a credit policy

2. The three "C's"

3. Investigate

a. Location and permanency
b. Occupation and earnings
c. References -- personal & bank
d. Marital status
e. Property and credit status
f. Ability to repay

Stress need to look for answers to these questions:

1. Does he have enough income?
2. Does he change residence often?
3. Frequent job changes?
4. Is he a slow payer?
5. How does he stand in the community?

C. Rules of collecting

Questions to cover in rules

1. When is account payable?
2. How soon after due date for first reminder?
3. Credit suspension - how soon?
4. How many steps; at what intervals?
5. Which of the tools of collection to use when?
6. When to turn account over to professionals?

Call attention to SBA-SMA No. 49 Improving Collections From Credit Sales

D. Collection procedures and methods 1. Remind customers 2. Request response 3. Insist on payment 4. Final action	Visual No. 13
E. Summarize	Use focal points No. 2

RECORDS AND CREDIT IN PROFITABLE MANAGEMENT

YOUR RECORDS AS GUIDELINES TO PROFITABLE MANAGEMENT

The River Nile and its meandering tributaries have a prominent place in the affairs of all of mankind. Men in all ages have navigated its serpentine channel. Wars have been fought over its possession--and nations have come to birth and death in the verdant plains that have developed on its deltas. Today only a few half-demolished ruins tell us of the forgotten cities which once grew strong and opulent on the commerce it produced.

Because we cannot find, or cannot understand, the records of these ancient civilizations, we have limited knowledge of their history, their achievements, their hopes, or aspirations.

Each age speaks a distinct language. If an age or an institution is to go forward and endure, it must speak a language that itself endures. In order to develop in strength, small business, too, must be able to analyze and record the variety and complexity of its transactions. This recording must be in terms and in a form that will not be misunderstood, --weeks, months, or even years afterward.

Modern business must be operated on the basis of adequate records. Records are necessary to determine profit or loss, return on investment, owner equity, assets, liabilities, and other pertinent facts. In addition, good records constitute a basic tool of good management. Information obtained from records furnishes the basis for managerial decisions ranging in scope and importance from policy formation or revision down to day-to-day decisions regarding routine operational activity.

Several years ago SBA published a leaflet entitled, <u>Are You Kidding Yourself About Your Profits?</u> This article pointed out what business educators, consultants, and trade association people have been trying to say for a long time--that many small-business men do not know from day to day whether they are making money or losing it. It is only at the end of what might be a critical period that they have a profit and loss statement drawn up to find out just where they are going.

Statistical studies have shown that the great majority of failing businesses have inadequate records. Department of Commerce figures, bank analyses, and Small Business Administration surveys abundantly substantiate these findings. Good records can help the confused owner or manager answer the following important questions:

Am I making a profit?

Am I making enough profit?

Am I selling (or manufacturing) the most profitable product mix?

A few years ago the Bureau of Business Research of the University of Pittsburgh made the first of a series of modern bankruptcy studies. Parallel case studies were set up in which (for study purposes) unsuccessful firms were matched with successful ones. Firms selected were of about the same size, in the same lines of business, and in the same city or locality to insure that the compared firms would be subject to the same business conditions and geographical peculiarities. The "Pitt" study was designed to isolate significant management differences between the successful and unsuccessful firms.

The one overwhelming difference that came out of these studies was in the approach to management information. Over 90 percent of the unsuccessful firms failed to keep adequate records or failed to use the records kept. In other words, management could not at any given moment determine:

1. The existence of profit,

2. The adequacy of profit, or

3. The relative profitability of their product mix.

Nor could they make intelligent decisions in a variety of management or operational matters that must be based on adequate sources of intelligence or information. The unsuccessful managements were just existing. Without records they didn't know which way they were going until too late. On the other hand, in over 90 percent of the cases studied, the successful firms had well-established systems of records which kept management constantly informed. The successful managers knew just how and where they were going because they used their records as guidelines to profitable management.

SIMPLE OR COMPLEX

Recordkeeping systems vary from the most simple to the most elaborate. The simplest consist of some kind of a record of income and some measure of money (such as check stubs and cash slips) going out. Dean A. M. Woodruff of George Washington University may be quoted directly in this regard:

> "I have been called in as a consultant in small firms where these (check stubs, etc.) were the only records kept and where even these records were kept so sloppily that the man who kept them couldn't read his own handwriting, and neither the income nor the check stubs could be reconciled with the bank statements."

If the expense and income records are kept accurately, they provide the brick and mortar that go into more complicated systems of accounting. They rarely provide all the answers a manager eventually comes to need, but on the other hand, where these basic records are not well kept, most later decisions will be made on the basis of wild guesses.

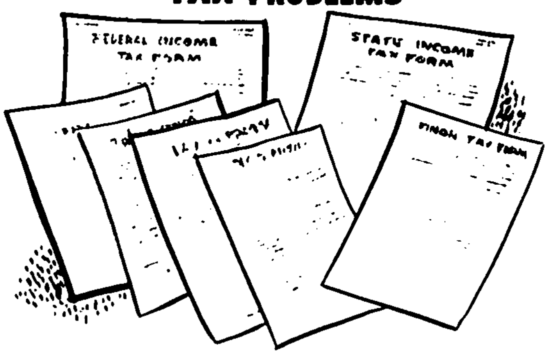
At the other end of the pole is the manager whose records are an obsession rather than a tool. He is weighed down with ledgers, journals, and inventory records to the point where he can't turn around. Records that reach this point no longer serve a useful purpose. The boss can't separate details important to management decisions from the utter mass of unimportant trivia in which they are immersed.

Again quoting Dr. Woodruff:

> "I was once called in by a firm that was losing money. (They) kept records on each machine in operation (that were) so detailed that every month the boss received a stack of papers about an inch thick. His operation was based around three large machines, each slightly different, but each producing the same item. After a week of hard reading, I realized that his cost on the first and second was about 6 cents per unit, but his cost on the third machine was nearly 21 cents. Not only did the boss not know this, he actually scheduled the third machine full and often left the first and second machines idle. All the necessary information was on his own desk, but not in a form that was worth anything to a busy man. (This) boss was just as ignorant as the man who kept no records at all."

We would like at this point to emphasize some of the faulty decisions in critical situations that can come about by way of inadequate or unintellibible records. Here are some of the typical problems which evolve from inadequate records.

Tax Problems



Almost 40 percent of the unsuccessful firms in the Pitt study were in trouble with the Internal Revenue Service. This did not come about because these small operators were consciously trying to defraud the government. On the contrary, some weren't even taking the legal depreciation and other allowable deductions. A Dun and Bradstreet survey indicated that over 75 percent of the small firms contacted were actually overpaying their taxes. Unless your records are complete and intelligible, you cannot possibly know where you stand--and you can't prove anything. Moreover, you should remember this: in the matter of such things as tax deductions, the burden of proof is on you.

Excessive Fixed Costs

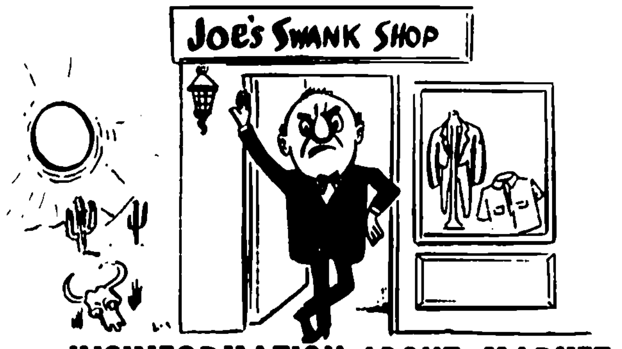
EXCESSIVE FIXED COSTS

About 33 percent of the Pitt study firms were suffering from "hardening of the business arteries." Their financial circulatory system had, so to speak, slowed down to a dribble or come to a complete stop. This was because their capital was all tied up in heavy overhead and excessively high "fixed costs." One of the fundamental concepts of business is the rotation of capital. Merchandise or supplies are wisely purchased, a fair mark-up to cover operational and promotional cost is affixed; and then the merchandise, product, or service is sold, it is hoped, at a figure that will cover expenses and bring in an adequate profit. When this formula is interfered with, you might be in business, but you certainly aren't doing business. When your money gets so tied up in fixed operational costs and overhead that you have no cash to buy the supplies necessary or take cash discounts, you are no longer in a profitable business.

Financial Over-Reaching

Another 33 percent of the firms got into expansion programs that were beyond their financial depth. Lack of records caused these managers to "bite off more than they could chew."

Misinformation About the Nature, Location, and Source of True Markets



Nearly 50 percent of the unsuccessful firms had only the haziest knowledge of their own market. They didn't know who was buying their product, nor why, so they couldn't foresee changes in demand.

A type of small business that has been slowly passing from the American scene is the old neighborhood "baked goods" shop. These savory-smelling, colorful havens of sweetness and delight once dotted American cities like bright flowers in a midwinter garden. Today it almost takes a detective agency to search one out in some communities. Part of the reason for this, of course, is the change in business climate which makes this kind of operation unfeasible in many localities. Part of it may be traced to the fact that many independent bakers who failed to survive did so because they did not know their markets.

Sometime ago a retail bakery management conference was held in Richmond, Virginia, under the direction of a progressive Distributive Education Department and with the support and encouragement of the local trade association (Virginia Bakers Council).

The assembled bakers complained of their difficulties:

> There were too many bakers in the city and too much competition within their own industry.

A large map of the city was hung in the conference room and each of the dozen or so managers was asked to go to the map and pinpoint his location and then draw a circle around it embracing what he considered to be his "trade radius."

The resultant picture is shown in Visual No. 5 (page 19). This picture revealed two important management factors:

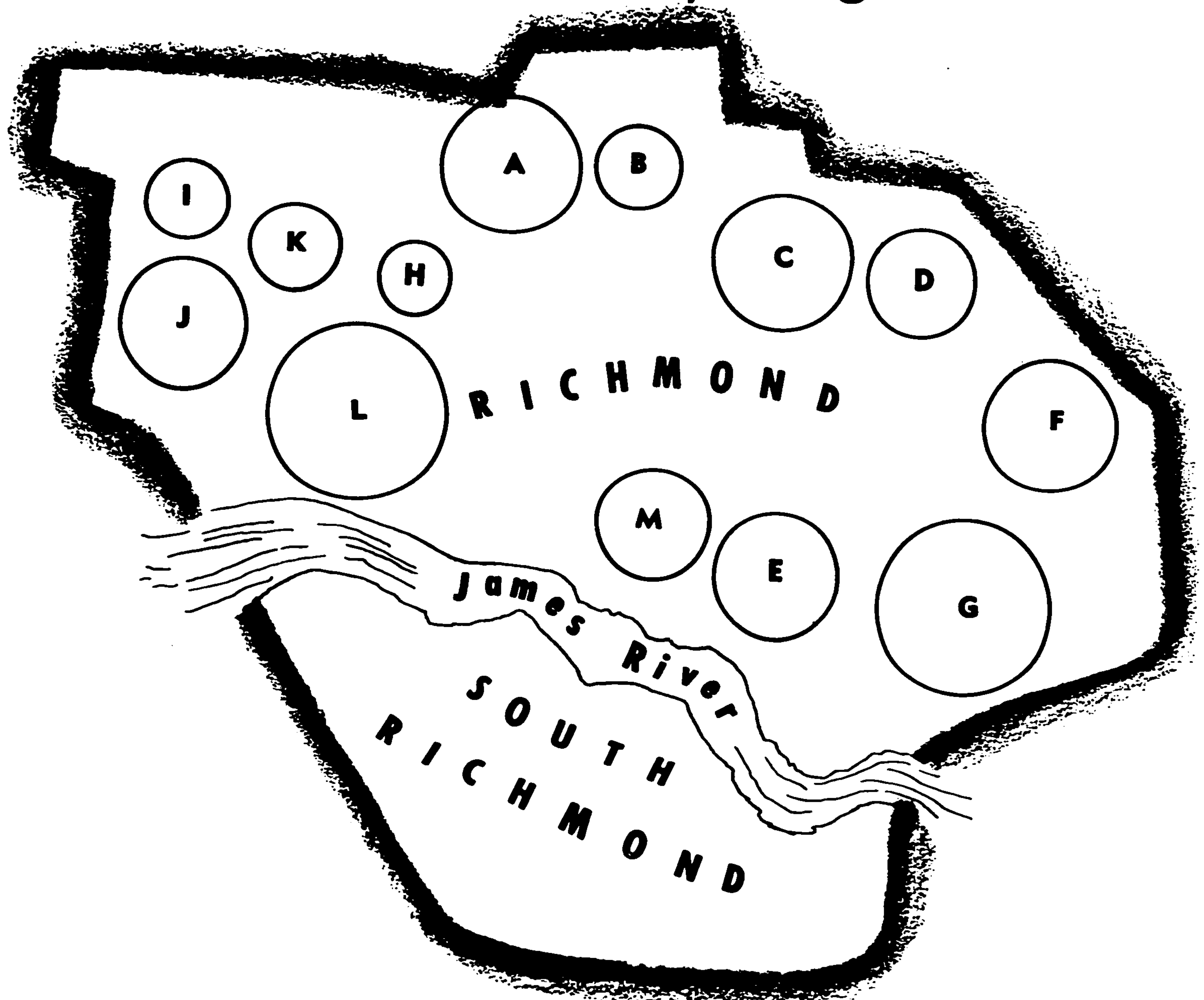
1. In no case did their self-selected "trade areas" overlap. (The bakers were not really in competition with each other. They were actually in competition with products that were replacing bakery goods on the tables of Richmond householders. Some of these products were: ice cream, fresh and canned fruits, packaged cereals, breakfast foods, etc.)

2. There were wide gaps between the circles revealing portions of the city that were in nobody's trade area. With one-third of the total city population living on the south side of the James River, there was not at that time a single retail baked goods store in this entire area. In other words, South Richmond was a "no-man's land" as far as the bakers were concerned.

Any of these managers with adequate market information and records could probably have reached these conclusions by himself. It was the old story of lack of information and not being able to see the forest for the trees.

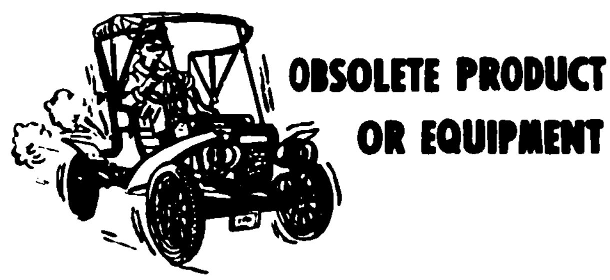
Happily, many of those in attendance at this conference were alert businessmen, who, with the guidance of their trade association executive, began to remedy this oversight and to do something about meeting their real competition. In other words, they determined who was buying their products and why, and then collectively met their competition. Today these businesses continue to thrive and grow because their records help them analyze and then meet their true market.

BAKERY MARKET AREAS
Richmond, Virginia



Poor Diversification or Product Obsolescence

About 50 percent of the firms in the Pitt study lacked diversification of products or services to a crippling degree. In other words, they had "all their eggs in one basket." One of the firms was set up many years ago and was continuing to produce obsolete wooden ice chests, although the market for this product was rapidly disappearing. They could have diversified their production, with a little thought, to include a wide range of wooden cabinets and products that were in the growth stage, such as TV, radio, and trophy chests. Instead, they continued to make ice chests and progressively increased their deficit because they could not, or would not, diversify. Adequate records would have shown a decreasing market for ice chests and the need for diversification.



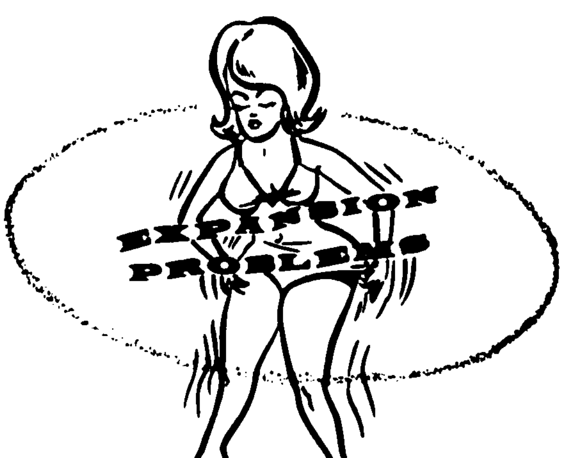
Inventory Troubles

How many firms have gotten into some kind of inventory trouble through a lack of good records, or a lack of knowledge of recordkeeping procedures, is almost impossible to estimate. Here is an example involving inventory problems which resulted in the failure of the business. If the operator of the business cited had been an experienced merchandiser with a knowledge of management recordkeeping, he would either not have gone into the operation, or would have known his way out.

Our case is taken from a recent research report of the Small Business Administration, "The First Two Years":

"Mr. Byrd, an unemployed, unskilled laborer, 34 years old and single, was talked into buying a failing pet shop by a friend; he paid $500 for a stock which was worth no more than $200. He put an additional $300 into stock purchases but bought the wrong kind of merchandise. For a pet shop, the business contained remarkably few pets. His stock consisted of about a dozen small turtles, one tank with a few goldfish, and eight or nine canaries and parakeets. In addition to a small array of dog and cat collars, the bulk of his stock consisted of large amounts of pet food. As the interviewer observed: 'He would never be able to make the business worth while selling dog biscuits and birdseed, particularly since every item in the shop can be found in any reasonably large supermarket or 5-and-10-cent store, generally at lower prices.' His lack of business know-how was further substantiated by the fact that after one month in business, he still had no idea what sort of mark-up he was working on. He lasted altogether 2 1/2 months and lost $500 in his venture."[1]

Expansion Problems



The national growth of American business increases moderately from year to year. The rate at which the corporate giants expand might look high in a local situation, but when viewed nationally, is quite modest. U. S. Steel can add a hundred employees, nationally, and hardly change their employee-management ratio. On the other hand, if a firm with two employees adds two more, it has grown by an increment of 100 percent. This type of growth is not only common, it is a characteristic of successful small business.

[1]Kurt B. Mayer and Sidney Goldstein, The First Two Years: Problems Of Small Firm Growth And Survival, p. 127.

Imagine for a moment the problem which would result if U. S. Steel doubled in size in a year's time. This would not mean a hundred, but a hundred thousand more employees, billions of additional investment dollars, legal involvements, and other problems that would tax the greatest resources and best brains of American industry.

Now this problem, except for scale, happens every day in the small-business field. The two-man firm jumps to four, the four to six or eight, and so on. Where this happens, inadequate records and management information quickly come home to roost.

A man who was able to carry in his head easily and accurately the information which he needed when he had four employees suddenly discovers that his "system" doesn't work with eight. Among the worst tragedies of American business are the firms that fail because they succeed--firms which develop sufficient business and have the incentive to expand, but are unable to operate on the expanded basis for want of an established system of records that keeps the boss informed on what is going on.

Very often the expansion of a small firm involves launching some new line of endeavor. At this point, it becomes important to the operator of the firm to know whether or not he is making money on each of the separate lines and how much. If his books are not being kept in a way that tells him all the facts, he may carry on an unprofitable line of business for some time at the expense of a more profitable line; and he ends up losing money or barely breaking even.

BASIC RECORDS NEEDED

We may identify broad functions of your business to better define the areas of managerial problems and decision-making--and, at the same time, specify the nature and variety of records upon which these decisions can be intelligently based.

These business functions involve:

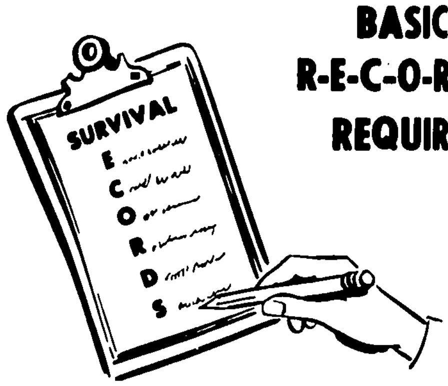
1. Financing
2. Equipping
3. Personnel utilization and control
4. Purchasing
5. Storing
6. Production
7. Marketing or selling
8. Financial reporting and control

Factors such as the size, type of organization, and kind of business indicate to some extent the type and variety of records needed to accomplish and transcribe the activities of each of these functions. What we want to do at this point is to broadly outline a normal pattern of records needed by almost all businesses to intelligently carry out the listed functions. Much more could be added, and much more is frequently desirable or even demanded. The question is not, "Do you need records?" but "What records, within the limits of resources, are needed to do the job?" Thus the problem of records is first a manager's problem (administration) before it becomes a bookkeeping problem (operations).

In this presentation, we have to make certain assumptions. Because firms vary in size and complexity, we must start from scratch, so to speak. Accordingly, this approach to recordkeeping assumes that you have no formal internal accounting force, or at most, you only have a bookkeeper. To the extent you employ full-time accounting personnel and you are not included in the above assumptions as to size, you may easily adapt and expand on these observations. My fondest hope is that each of you will be motivated to start or enhance your business self-improvement program by keeping adequate and appropriate records, and by using these records to guide you in your management.

Looking back on the business functions we just outlined, you will see that they all have certain common characteristics.

1. They represent things you do in conducting your business. They are events that happen. They are inescapable in your daily chores. Records do not cause their existence--rather records exist because these functions happen--and will continue to happen.
2. Each function generates pieces of paper which describe what each activity is all about. These records are your communications network. Accurate records must be made. Given the functions, the need for information, and the pieces of paper, accounting can systemize and improve the collecting and interpreting of information and report the results.
3. One must distinguish between the event that is recorded and the meaning of these records to management. A document or record can accurately describe a physical condition or event without indicating the relative quality of the condition reported. For example, a document can report that ten pounds of material or twenty hours of labor were used on a particular job, but only management can determine whether or not they should have been used. Records exist because things happen, not the reverse.



BASIC R-E-C-O-R-D-S REQUIRED

The size, type of organization, kind of business, and other factors govern to a large extent the records needed and the complexity of the record system to be used. Every business, large or small, simple or complex, needs seven basic kinds of records. In order to help you remember just what these foundation records are, we have arranged their listing in the form of an anagram which spells R E C O R D S.

Records of Cash Receipt with provisions for segregating receipts from sources other than income (such as bank loans).

Expenditure Records with provisions for designating the nature of the expenditure (for example, materials and labor expense) and the method of payment (check or cash).

Control of Payroll Expenditures - showing names, social security numbers, time of payment, gross pay, payroll deductions, and taxes.

On Account - or accounts receivable records showing customers' accounts and your experience with them.

Resources and Accounts Payable - showing your experience with suppliers (such as cash discounts and dates).

Documentation File - for the orderly accumulation of documentary evidence (invoices, stubs, etc.) supporting your other records.

Summarization - in order to summarize the variety of transactions already basically recorded, and to provide a permanent, intelligible history of the business, you need a general ledger. This record shows the beginning values of assets, liabilities and capital. It summarizes the results of operations for any given period (week, month, quarter, year). It provides a "running" record of assets, liabilities, and capital at any given moment. It establishes accountability to employees or departments for funds or other assets entrusted to their care.

DATA TO BE PROVIDED BY RECORDS

It should be noted that, while we have listed a lot of troubles that some firms have gotten into because they failed to keep records, we have also emphasized that records are kept for specific purposes and should be designed for these purposes. The whole essence of this topic, therefore, is informed management. There is no excuse for keeping records simply for the purpose of keeping records, but some firms get into situations where they do just that.

In all too many cases, records are kept primarily for the annual ritual of preparing an income tax return. We are not saying that records should not facilitate and substantiate this activity; recordkeeping for tax management decisions is extremely important. But this should not become the sole purpose of recordkeeping, nor should other considerations be eliminated from the recordkeeping design merely because they don't fit into the taxation scheme.

Other types of data that should be quickly available from records include information to:

Facilitate dealings with banks and other credit or lending agencies.

Facilitate management plans regarding such factors as new lines, changes in operations, diversification, elimination of profit drains, and expansion.

Establish accountability of employees (or departments) for assets and functions entrusted to their charge.

Give information as to past experience with merchandise lines, customers, and suppliers.

Provide information and data to assist professional resource people such as your accountant, your attorney, and your trade association executive to help you in your business.

Provide a tangible basis for State, district, and local licenses or permit fees.

Provide basis for assessments for personal and real property.

Provide for the determination of taxable wages under social security and unemployment regulations.

Help you keep systematized records of operation costs, obsolesence, and depreciation.

And finally, to support the figures that go into tax calculations.

SOURCES OF HELP IN ESTABLISHING RECORDS

To be sure, the best time to establish your record system is at the same time you start into business. However, even if you've been in business for some time without one, you can't start sooner than now to set up an effective recordkeeping system.

But what sources of recordkeeping aid are available to the small businessman? There are several.

As a very minimal approach, a small businessman can let his bank serve as his bookkeeping department. This can be accomplished with little expense by observing the following guide:

1. Deposit all money received from any source (with a notation of the source).

2. Make all expenditure payments by check (with a notation as to the purpose of the expenditure).

3. Keep written memoranda giving necessary details of all transactions not immediately reflected by the receipt or disbursement of cash (such as sales or purchases on account).

4. Preserve all documentary evidence supporting any transaction (such as bills, contracts, and tax files).

This system will suffice for only the simplest of operations. A more complex business, even a small firm, can profit by a more detailed recordkeeping system.

If you need a more sophisticated plan, you may well consider retaining the services of a bookkeeper or an accountant. You can obtain such service on a part or full-time basis depending on your needs. There are also available franchised bookkeeping service organizations such as "Mail-Me-Monday" and "A-1 System," which can offer package recordkeeping systems which they will set up and administer for you. Of course, most management consulting firms also offer the service of setting up your system of records. In some lines of business, trade associations and suppliers will furnish recordkeeping aids at a minimal cost, or in some cases, free.

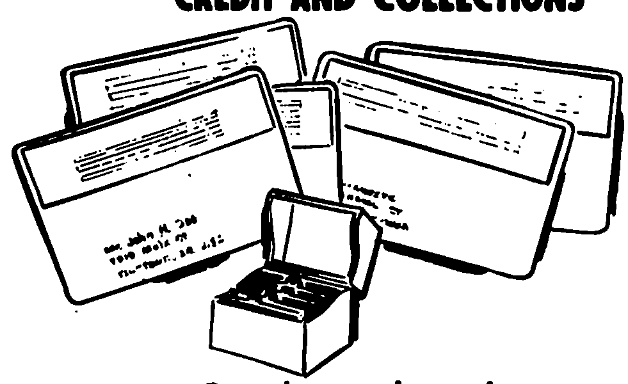
In developing your recordkeeping systems, your choice of advisors will depend on answers to the following questions: which sources are most readily available to you? which ones are best qualified to advise your kind of business? and which ones offer services within your ability to pay. You may find answers to these questions by asking your present accountant or bookkeeper. Or you may inquire of fellow businessmen around you as to what sources they may be using.

The need for adequate recordkeeping should be apparent. The tools for setting up such systems are available. Be sure you are keeping the proper records and making the best use of them.

CREDIT AND COLLECTION TECHNIQUES

Credit and collection is a broad topic. It could be discussed in a session by itself or even a whole series of sessions. Here we must content ourselves with a brief look at credit from a management viewpoint--that is, the things to watch in establishing policy and in controlling procedure. As we discuss credit control, you should notice how important good records are to effective credit and collections.

CREDIT AND COLLECTIONS



Depend on good records

If we may again make reference to the SBA publication, The First Two Years, we see documented evidence of typical problems that can descend upon the retailer or service firm manager who gets involved in the over-extension or unwise extension of credit.

Case I: Stella's Restaurant.

For example, in the case of Stella's Restaurant, the extension of credit hastened the demise. Located in an area in which a large part of the population was receiving public assistance, she did not hesitate to give out credit freely. Within a few weeks of operation, she had $90 outstanding--more than a fourth of her total capital. Recognizing her predicament too late, she told the interviewer: "I haven't been able to make enough money to pay my bills. People haven't been paying me for the credit I gave them, and I can't pay my bills if they don't pay me. I've stopped giving credit now, but I'm afraid it's too late; and if I don't start getting some money back soon, I will have to close down before I get deeper in debt."[2] Stella's Restaurant closed less than ten months after it first opened.

Case II: Richards' Service.

A much larger amount of credit was involved in the case of Richards' Service. Unlike many owners, Richards had planned his venture quite carefully. He and his wife had saved almost $6,000, and he had waited until he found what he considered an almost ideal location for a filling station. With eight years' experience as a mechanic behind him, Richards bought all new equipment for which he paid $4,000 in cash. With $1,700 left over for working capital, he was very confident that he would succeed.

From all objective accounts, the business should indeed have succeeded quite well. As the representative of the oil company stated, sales had been increasing every month of the 13 months that Richards was in business, his bills were all paid, and he was getting the business into a position where he could have made "some good money real soon." However, Richards' actual financial situation was far worse than the sales record indicated because much of his capital was actually tied up in accounts receivable which he could not collect. Despite good intentions and a big "No Credit" sign put up at the opening, Richards was soft-hearted. As he put it: "See that sign? I mean what it says. You can't afford to get started in a credit business because you can never pinpoint the deadbeats. I don't want to extend credit to anyone, but the problem is to say so in a nice way. You know what I mean--so I won't lose their business." Apparently, he never acquired that knack, for he lost over $2,000 in bad debts in less than a year. In desperation, he stopped giving credit altogether, but the result was that his gross dropped almost in half. This so discouraged him that he sold the station for $2,500.[3]

[2]Ibid., p. 128.

[3]Ibid., pp. 128-129.

An excellent little booklet on this topic of extending credit was written by Dr. Clyde William Phelps, Professor of Economics, University of Southern California, retired. It is called The Ten Hidden Losses In Slow Charge Accounts.[4]

This publication is actually addressed to management and starts out with a bit of warning.

> "Failure to make a fair profit is bad enough. But making a profit and then losing it is worse."
>
> Dr. Phelps concludes:
>
> That the American retailer loses far more from slow accounts than from bad debts.
>
> That the costs associated with slow accounts constitute the most important item in the total cost of doing a credit business.
>
> That these costs caused by slow accounts can be practically eliminated by retailers acting either independently or collectively with a resultant increase in business volume and profits.[5]

What are the ways in which your slow charge accounts eat into your profits? Here's what happens when you let customers take more than 30 days to pay.

1. You run up bad debt losses.
2. You increase your bookkeeping and collection expense.
3. You add to your expense for interest because you tie up more capital in slow accounts.
4. You accumulate frozen assets which hinder your taking full advantage of cash discounts and profit-making opportunities.
5. You reduce your capital turnover and your rate of profit.

[4] Dr. Clyde W. Phelps, The Ten Hidden Losses In Slow Charge Accounts.

[5] Ibid., p. 3.

6. You lose some good business because customers who are allowed to become slow payers tend to transfer their patronage elsewhere.

7. You are often forced to borrow, and slow accounts make it difficult for you to borrow.

8. You get into useless and unprofitable competition with other retailers.[6]

Dr. Phelps' thesis is further supported by a quote from Credit World:

> "For years the National Retail Credit Association has pointed out that selfish and misguided retailers--who used terms as a competition feature in their businesses with the idea that it would attract to them more business--who extended credit to those owing long past-due accounts to other merchants--were causing the loss of millions of dollars to merchants and encouraging disrespect for the sacredness of a credit obligation, promoting bankruptcies and undesirable and unstable citizenship."[7]

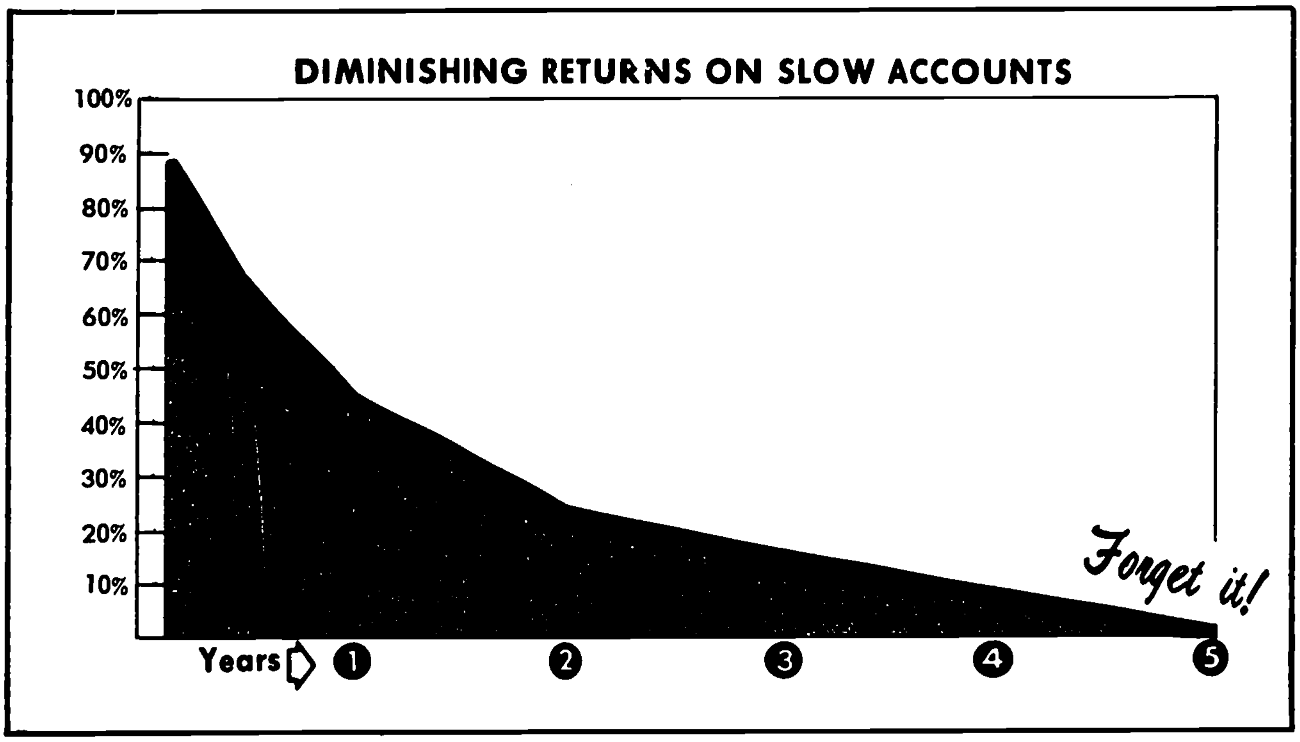
The following is an interesting chart which graphically presents what might be called "the law of diminishing returns" or what happens to the slow or old accounts.[8]

The older it gets, the tougher it becomes to collect

[6]Ibid., p. 2.
[7]Ibid., p. 23, as cited by Dr. Clyde W. Phelps.
[8]Ibid., p. 5.

The older a charge account becomes, the tougher it gets to collect.

Age of Account	Proportion Collectable
Over 60 days	89%
Over 6 months	67%
Over 12 months	45%
Over 24 months	23%
Over 36 months	15%
Over 5 years	Forget it!



POSITIVE SUGGESTIONS FOR PREVENTION

Dr. Phelps goes on to make the following positive suggestions to prevent and cure chronic credit procrastinators.

1. Investigate thoroughly - Use your professional credit agency.
2. Explain terms clearly and unmistakably.
3. Follow up promptly.
4. Suspend further credit to slow payers until past-due accounts are paid.

5. Help delinquents - When a customer becomes delinquent, call him in for a personal interview. Help him to pay you by suggesting ways and means.

6. Act decisively.

To these we might add one more fundamental point. Establish an appropriate credit and collection policy based on the recommendations of a retail credit bureau--and then stick to it.

BUILDING A CREDIT BUSINESS

Establish a definite credit policy covering the following credit factors:

1. Credit or no credit.
2. Down payment or no down payment.
3. Typical down payment and time allowance on installment sales.

Select your credit customers with care using the Three C's of Credit as standards of selection:

Character - What is his reputation in business and the community?
Capacity - What is his ability to repay?
Capital - How much of his own money does he have invested in his business?

Investigate the credit applicant thoroughly to get the following information:

1. Address and length of residence in your locality.
2. Occupation and earnings.
3. References.
4. Bank references.
5. Marital status and number of dependents.
6. Property ownership.
7. Other credit accounts.
8. Extent of debts or payments.

Look for the answers to these questions:

1. Does he have income to meet all present and projected obligations?
2. Does he change residence often?

3. Does he change jobs frequently?
4. Is he a slow payer?
5. Does he have substantial community references?

Use your retail credit bureau to secure confidential reports.

Limit credit.

1. Set definite limits as to the amount a customer can charge. Keep his credit within bounds.
2. Keep accurate and complete records.
3. Send statements at regular intervals.
4. Watch past-due accounts.
5. Take legal steps when necessary.

Dr. Phelps, writing later in a SBA Small Marketers Aid entitled Improving Collections From Credit Sales, makes the following additional observations:

RULES FOR COLLECTING

Your collection policy should set up specific rules on such matters as the following:

1. When accounts are to be payable;
2. How soon after the due date the first reminder shall be sent out;
3. How soon after the due date the credit privileges on a past-due account shall be suspended;
4. How many steps shall be in the standard follow-up, and how much time shall elapse between the several steps;
5. Which of the available tools and methods shall be used in the various stages of the follow-up; and
6. When past-due accounts shall be turned over to a collection agency or an attorney. [9]

The prior development of such collection procedures is a matter of policy determination. Where a policy has been well-planned, management is relieved of many subsequent headaches that result from having no specific procedure.

[9] Dr. Clyde W. Phelps, Improving Collections From Credit Sales, p.2.

COLLECTION SYSTEMS

Dr. Phelps ties credit and collections back into the framework of good management and good recordkeeping with his recommendations for collection systems.

You may improve your collections by improving your collection system: the setup of records, filing devices, forms, and office machines and equipment which you utilize in applying various collection methods according to a definite collection procedure. . . . These requisites are:

1. It (the system) should provide an accurate record of each step in the collection process . . . .;
2. It should bring accounts to notice automatically at the proper time;
3. It should avoid unnecessary duplication of records and efforts;
4. It should provide for classifying or segregating the accounts into three categories: current, past due, and suspense or attorney . . . .;
5. It should be arranged so that cash received is posted daily to the collection records before it goes to the general bookkeepers in order that these records will be kept up to date daily . . . .[10]

COLLECTION PROCEDURE AND METHODS

Your collection procedure should be deliberately planned so that it will move, in a regular and orderly way, through a series of steps. The collection effort gradually becomes more insistent until final decisive action is taken. The procedure can be organized into four logical steps: (1) remind the customer, (2) request response, (3) insist on payment, and (4) take final action.

[10] Ibid.

Remind the Customer

The customer should be reminded shortly after his account has become past due. The tone of this first reminder should be mild. It is only reasonable to assume, at this point, that the customer has merely overlooked the matter.

Good methods for giving past-due customers a reminder are printed or mimeographed form notices and duplicate statements with or without a reminder message. Reminder messages may make an appeal in the form of a sticker, insert, rubber-stamped or handwritten message. This is an impersonal form that indicates to the customer that he is not being singled out for discriminatory action, but is receiving the same treatment given all others in similar circumstances.

Request Response

Those customers who do not react to the reminder should be automatically subjected to the second step of collection follow-up after a predetermined number of days. This message not only reminds the customer of his debt, but also asks for a response. There is rarely justification for waiting more than 15 days after the reminder before requesting a response.

You still use a mild and courteous tone. You can no longer assume that this slow account represents an oversight (since the debt has already been brought to the customer's attention by the first reminder). However, the only logical attitude to take is that there is some valid reason why payment has not been made. And there are plenty of good reasons possible--there may have been a mistake in billing, the customer may have been dissatisfied with the goods or the treatment received, or he may be temporarily financially embarrassed.

The purpose of this step is to get a rise out of the customer--to find out why the customer is slow in paying so that you can figure out what can be done to remedy the difficulty. The approach is still an impersonal one. The methods employed in the first step are equally valid here.

Insist on Payment

Those customers who have not responded to the foregoing follow-up require a third step in which still a different procedure is applied. At this point, it is reasonable for you to begin to suspect that the customer may prove unwilling and perhaps does not intend to pay his bill. Therefore, you are now justified in bearing down and applying increasing pressure.

In this step a number of efforts, increasing in severity, are often called for. A variety of methods may be employed:

1. Collection letters utilizing appeals to fairness, pride, self-interest, and fear.
2. Humorous or stunt letters.
3. Telephone calls.
4. Telegrams.
5. Registered letters.
6. Personal calls.

Various pressures may be used and included in the message sent to the customer—temporary suspension of credit privileges; threats to report the account to the credit bureau, a collection agency, or an attorney; and, in the case of installment sales, threats to repossess the merchandise or to sue. Although it depends on the circumstances in each case, this stage may extend over several weeks or months while successive efforts, increasing in severity, are made to collect the account.

Final Action

If the first three steps prove unfruitful, final and decisive action must be taken. Customers who have failed to respond satisfactorily after the preceding three steps fall into two main classes.

The first class consists of those who are willing but unable to pay in full within a reasonable time. You can often help such customers pay you by assisting them to pool their obligations and set up a firm, realistic plan or schedule for repayment.

The second class consists of those who are able to pay, but who must be forced to do so. With people in this category, you should make good on any threats used. You can turn the account over to a collection agency or an attorney or, if an installment contract is involved, you may prefer to sue or repossess.

No general rule can be laid down for all cases and all lines of business, but certainly if you have been wrestling with a past-due account for six months and have gotten nowhere, it would seem undesirable to delay longer in turning it over to an agency or an attorney specializing in collections.

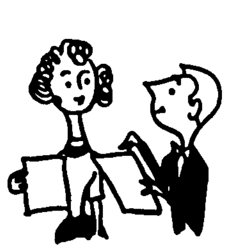
Plans, policies, and definite procedures are needed to carry on a successful credit business. Controlling the issuing of credit, as well as controlling the accounts which are currently payable, is required. Credit can be a useful tool for increasing sales, but it must be applied judiciously to insure that the increased sales result in increased profits.

USE OF VISUAL AIDS

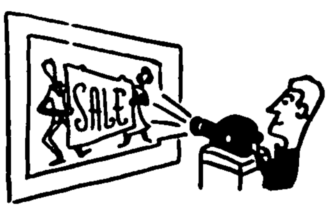
WHAT TO USE	WHEN AND HOW TO USE
Chalkboard	Study and plan before a meeting what to put on the board and where to put it. Use it to present sketches, diagrams, outlines, definitions, key words, directions, record of class contributions, and summaries. Suit material to board space. Write plainly and quickly. Keep wording simple. Stand at one side of board while referring to material. Talk to the group, not to the board. Erase material no longer needed.

WHAT TO USE	WHEN AND HOW TO USE
Posters, Charts, and Diagrams	To arouse interest and attract attention; to show relationships and trends; to inspire group. Use device large enough to be seen. Post where everyone can see. Present at right time. Discuss information illustrated.

WHAT TO USE	WHEN AND HOW TO USE
Hand-Out Materials	To present information uniform in character and as a guide to material covered; emphasize key points; arouse interest and discussion; review or summarize discussions; and serve as permanent reference. Select to serve a definite purpose. Introduce at right time. Distribute in manner to convey its importance. Direct members how to use.



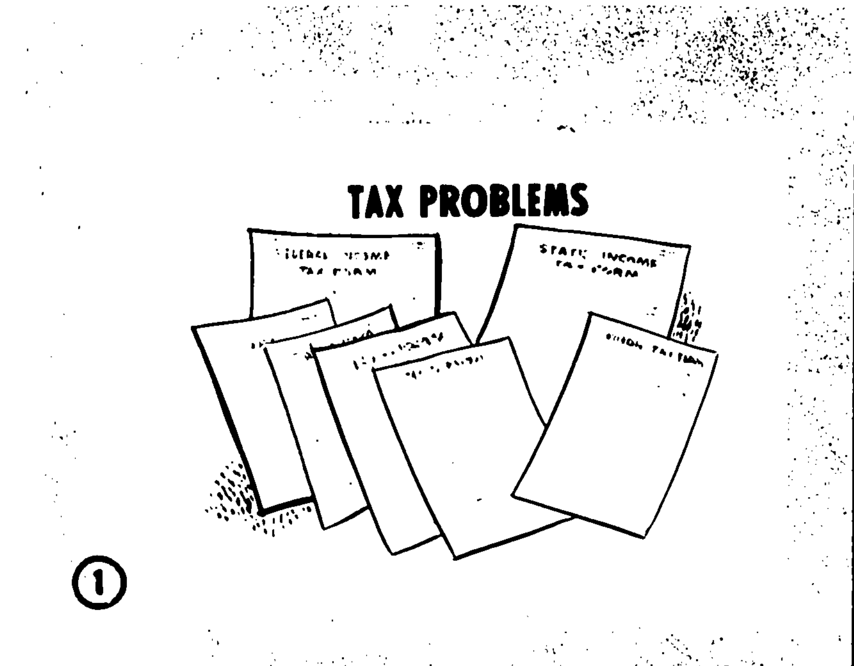
WHAT TO USE	WHEN AND HOW TO USE
Films and Film Strips	Present an overall view; introduce a new subject; emphasize specific aspects of a subject; arouse interest; summarize. Select carefully to relate to the discussion and plan presentation. Arrange room and equipment for showing. Alert the audience for the showing or what will be seen. Run the film. Discuss the subject matter and summarize.

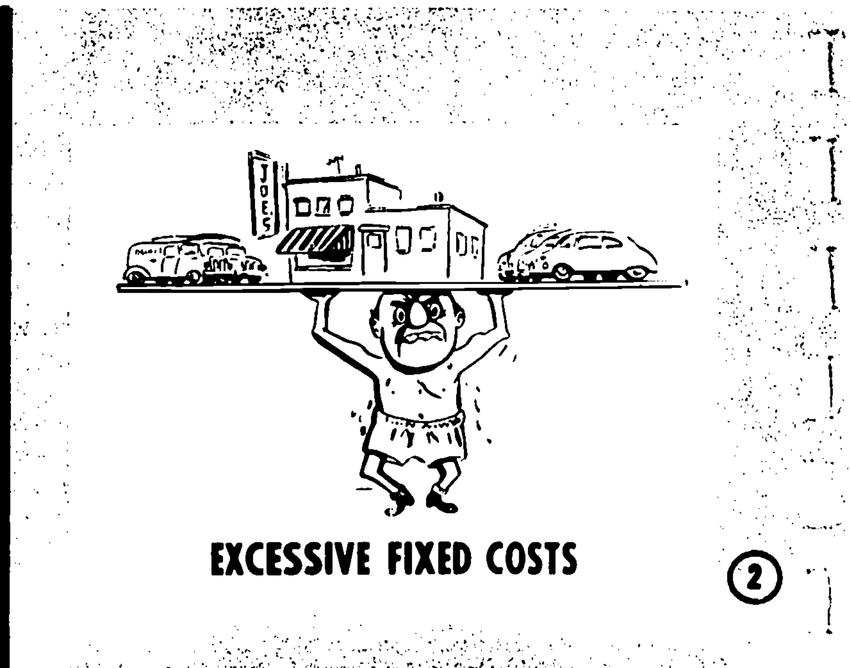


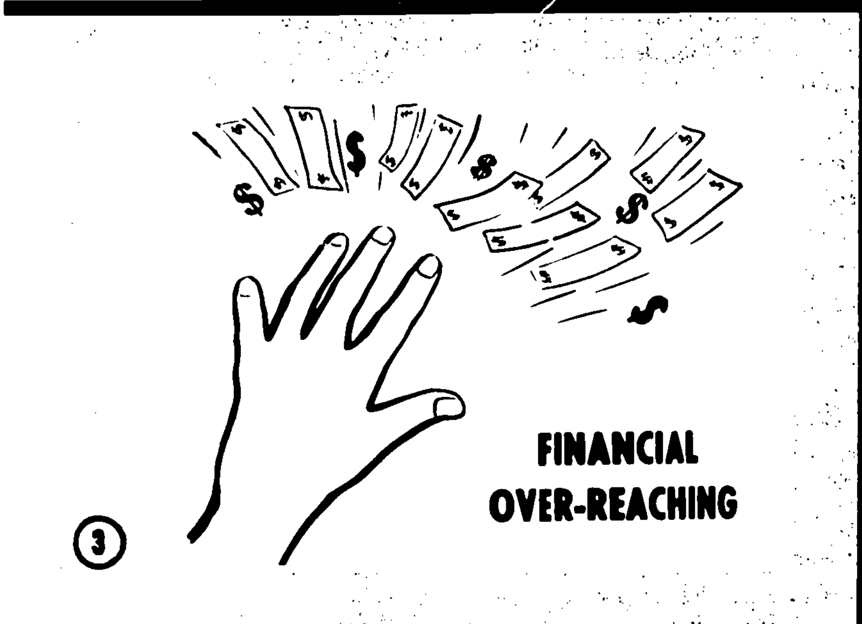
WHAT TO USE	WHEN AND HOW TO USE
Samples, Forms, and Exhibits	Keep subject matter practical; show development of a process; increase understanding. Select only enough to illustrate, not confuse. Pass around if necessary. Take time to present clearly. Comment when presenting.

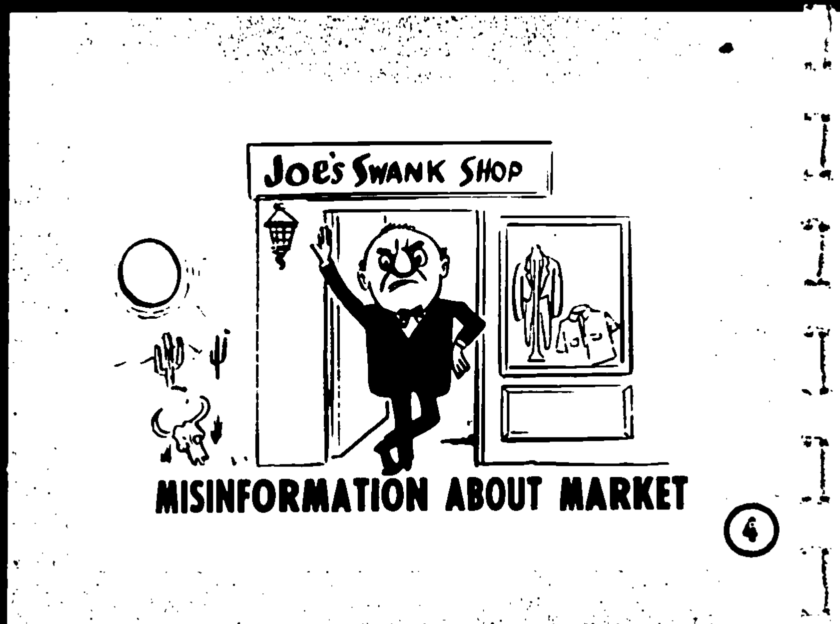
WHAT TO USE	WHEN AND HOW TO USE
Pedestal Chart	A pad of newsprint sheets or similar paper may be used for the same purposes as the chalkboard. Material recorded with chalk or crayon may be saved for future reference by the group or by the instructor.

OVERHEAD PROJECTUALS



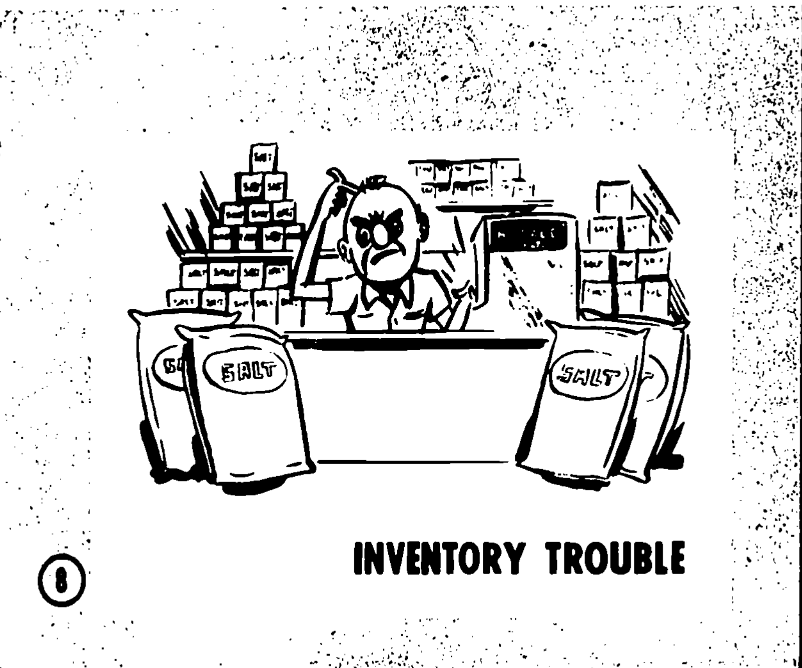


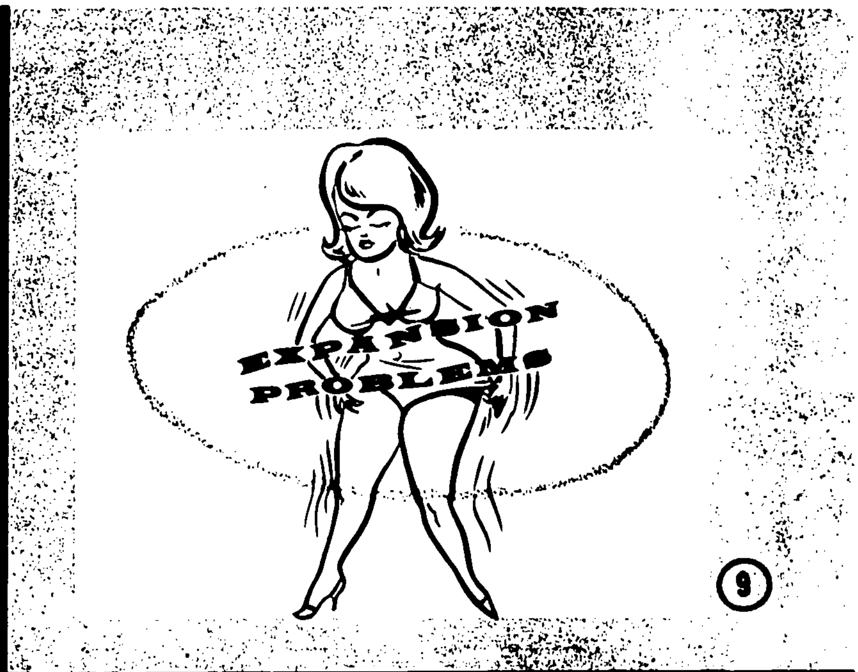


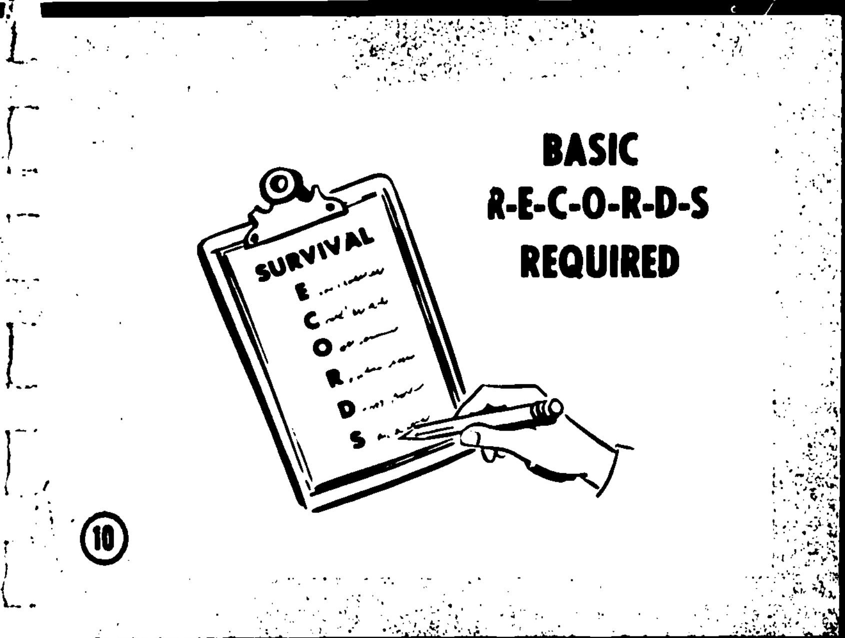


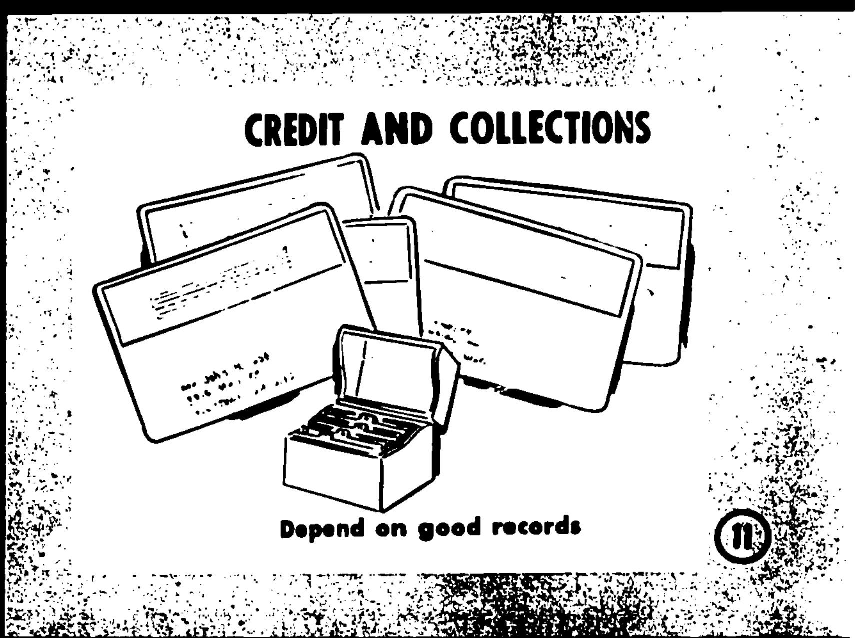
Note: For projectual No. 5 see page 19

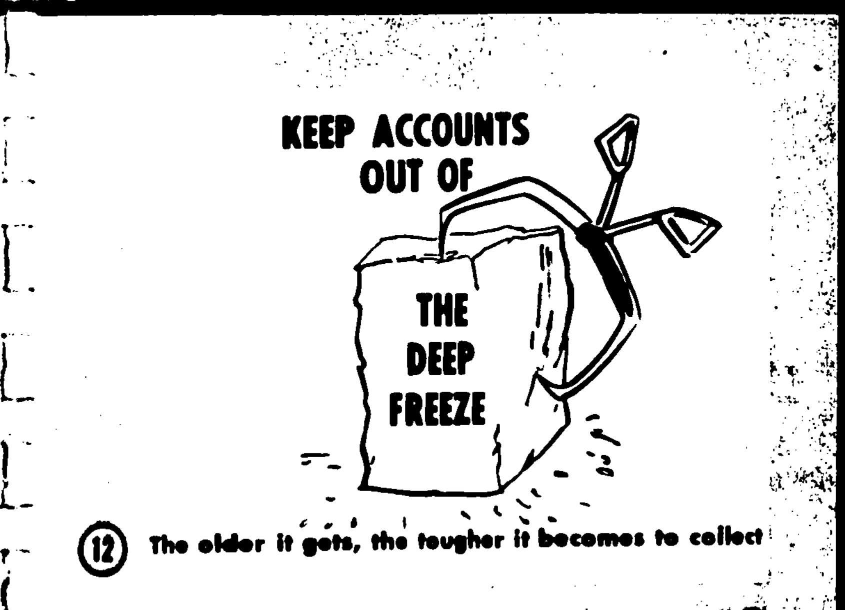
OVERHEAD PROJECTUALS

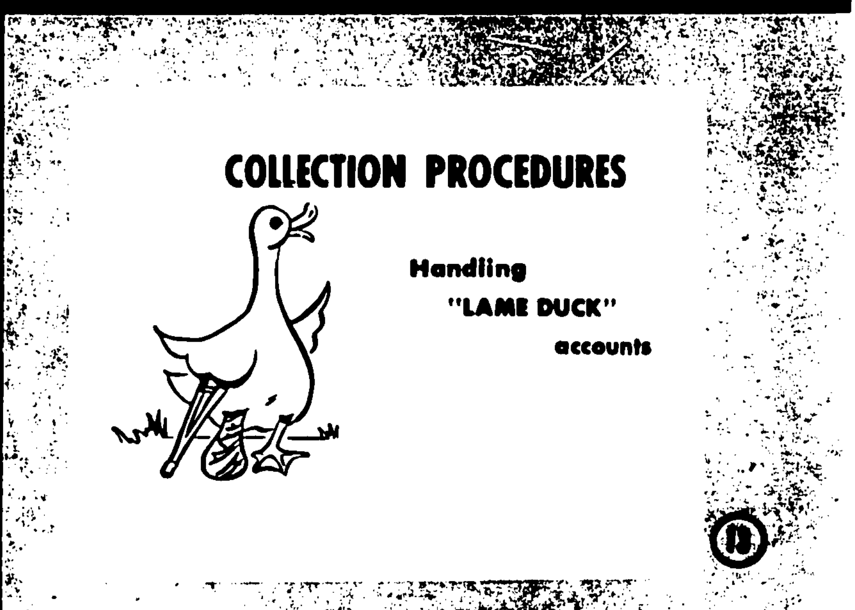












USE OF RECORDS

Types of data that should be quickly available from adequate records include information to:

Facilitate dealings with banks and other credit or lending agencies.

Facilitate management plans regarding such factors as new lines, changes in operations, diversification, elimination of profit drains and expansion.

Establish accountability of employees (or departments) for assets and functions entrusted to their charge.

Give information as to past experience with merchandise lines, customers, and suppliers.

Provide information and data to assist professional resource people such as your accountant, your attorney, and your trade association executive to help you in your business.

Provide a tangible basis for State, district, and local licenses or permit fees.

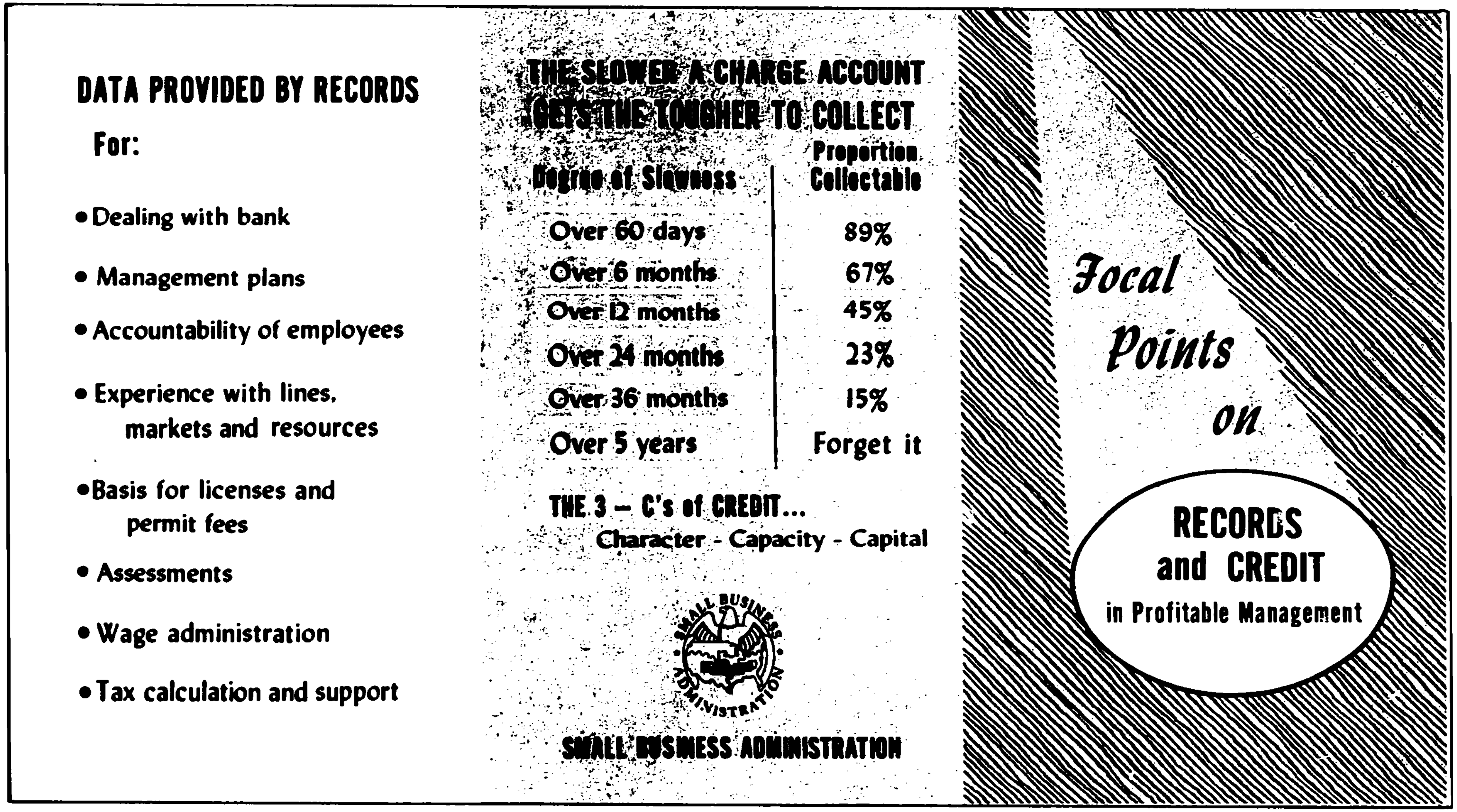
Provide basis for assessments for personal and real property.

Provide for the determination of taxable wages under social security and unemployment regulations.

Help you keep systematized records of operation costs, obsolesence, and depreciation.

And finally, to support the figures that go into tax calculations.

Hand Out Sheet # II-I



DATA PROVIDED BY RECORDS

For:

- Dealing with bank
- Management plans
- Accountability of employees
- Experience with lines, markets and resources
- Basis for licenses and permit fees
- Assessments
- Wage administration
- Tax calculation and support

THE SLOWER A CHARGE ACCOUNT GETS THE TOUGHER TO COLLECT

Degree of Slowness	Proportion Collectable
Over 60 days	89%
Over 6 months	67%
Over 12 months	45%
Over 24 months	23%
Over 36 months	15%
Over 5 years	Forget it

THE 3 – C's of CREDIT...
Character - Capacity - Capital

SMALL BUSINESS ADMINISTRATION

Focal Points on

RECORDS and CREDIT in Profitable Management

The three-fold leaflet, illustrated above and on the next page, may be ordered in quantity from the nearest SBA office for free distribution to course participants.

Tax troubles
Excessive costs
Financial over-reaching
Market problems
Poor diversification
Obsolesence
Inventory trouble
Expansion problems
Uncompetitive position

90%

HIDDEN LOSSES in SLOW CHARGE ACCOUNTS

1. Bad debt losses
2. Bookkeeping & collection expenses
3. Added interest expense
4. Tied-up capital
5. Reduced capital turnover
6. Lost customers
7. Borrowing difficulty for you
8. Fruitless competition caused

FUNDAMENTAL R—E—C—O—R—D—S

R ecord of Cash Receipt
E xpenditure Record
C ontrol of Payroll Expense
O n Account - Receivables
R esources & Accounts Payable
D ocumentation File
S ummarization - General Ledger

Accounting

SMALL BUSINESS ADMINISTRATION

SMALL MARKETERS AIDS No. 25

Washington 25, D. C.

Revised August 1962

ARE YOU KIDDING YOURSELF ABOUT YOUR PROFITS?

By *Fredrick G. Disney*, Management Consultant, Fort Worth, Texas

SUMMARY

Net profit is probably the most important indicator of the success of a business operation. Hence you should be concerned about the reliability of that figure. You can be surer of its accuracy by understanding the principal ways in which profits can be erroneously stated. Basically, there are four areas in which you can kid yourself about your profits.

1. The Existence of a Profit. Key question: Are such items as depreciation and inventory handled realistically in the accounting system?

2. The Sufficiency of the Profit. Key question: Although you may be making a profit, can it be considered sufficent for your size and type of operation?

3. The Profit Mix. Key question: Although you may be showing a good profit from your total operation, are there lines or departments in the company which are actually losing money?

4. The Profit Trend. Key question: Does the trend of profit show healthy progress, or is the tendency towards less and less profit?

To judge your own position in these areas, get appropriate help and guidance from your accountant or auditor. If your present information is not adequate for such an analysis, you should develop suitable records as soon as you can.

Basic to accurate profit determination is a system of accurate and meaningful accounting. The words *accurate* and *meaningful* are very significant because not all accounting systems convey a realistic picture of the results of operations. Although the proper mechanics of accounting may assure a balancing of debits and credits, this procedure will not of itself tell the whole profit story. Such information must be interpreted to provide the manager with a sound basis on which to direct future operations.

To be sure, consideration of the accounting procedures is necessary, since a figure of net profit has to be derived from some system. However, to managers, the detailed procedures of bookeeping are of little interest as compared to the ways these techniques can be applied to policy decisions.

There are four major areas in which you can kid yourself about your profits. They are: (1) The existence of a profit, (2) the sufficiency of the profit, (3) the profit mix, and (4) the profit trend.

THE EXISTENCE OF A PROFIT

A good first question to ask is: "Do I actually have a real profit?" You must realize that a final answer to this question is not necessarily indicated by the figure of "Net Profit" shown on the profit-and-loss (P and L) statement. To make sure that you are not being misled by this figure, you must analyze the basis of it.

● ***Analyzing the Basis of Net Profit.*** An orderly procedure is to start at the top of the P and L statement and compare every item with its counterpart in several other operating periods. A questioning attitude about each figure on the statement will help you to evaluate the true situation. You should not accept figures at their face value, but rather look behind the scene of each one to ferret out any hidden meanings.

● ***A Word About Profit and Loss Statements.*** There are two principal methods of reporting income and expenses on the P and L statement -- *the Cash Method* and *the Accrual Method.* The cash method shows only the actual receipt of cash (income), and the actual expenditures of cash (expenses). The accrual method reflects business transactions which took place during the reporting period whether or not any money, as such, changed hands. These two methods can convey totally different pictures of profit.

The cash method is usually not a reliable picture of income and expenses for the period covered by the P and L. The reason is that credit business comprises over 90 percent of all commercial transactions. Thus, a P and L reflecting only cash transactions will not account for much of the business applicable to the period. The accrual method, however, *can* account for all activities, cash or credit, completed during the period.

● ***Sales.*** Some accounting procedures do not go to the extent of determining *net* sales (generally the gross sales less returns and allowances). Try to make sure, therefore, that "sales" figures reflect the actual, final sales which took place in the period covered by the P and L.

● ***Cost of Goods Sold and Inventory Valuation.*** Cost of goods sold, the next item after Net Sales on the P and L, is determined by subtracting the inventory at the end of the period from the total obtained by adding the inventory at the beginning of the period to purchases made during the period. (Note: Beginning inventory and purchases are often referred to as "merchandise available for sale.") Sometimes this method of inventory valuation can be the cause of significant distortion in the profit picture. If, for instance, the closing inventory were valued high, the cost of goods sold would be lower and profits would be higher. Thus, the cost-of-goods-sold figure easily can be distorted by any change in the method of inventory valuation, or by failure to observe sound valuation methods.

Each manager should review his own inventory procedures to determine, first, what basis is used, and second, if this basis reflects the most realistic value of the stock on hand.

● ***Depreciation.*** One of the most critical areas in the over - or understatement of profits is that of depreciation. Here is a specific area wherein you can be misled by what appears to be a sound and accurate accounting procedure. For one thing, the depreciation account can show a record of depreciation down to the exact penny. These entries in this account give the impression of absolute accuracy. Because of this you can easily lose sight of the fact that the human judgment which established the original depreciation rate could have been in error - - sometimes in gross error.

By way of illustration, the decision to depreciate some store fixtures over a period of 10 years by one company proved to be unrealistic since it was found that these items had actually reached the limits of their usefulness and needed to be replaced at the end of 6½ years. Hence for 6½ years the owners of that company had been kidding themselves about the amount of their profit.

You should carefully review depreciation policies in terms of your past experience, good judgment, and the experiences of the trade. The tax rules of the Internal Revenue Service inform you of legal limitations and serve as a basis for the determination of a realistic depreciation policy. They can be a useful guide. However, in new situations it is often desirable to work out depreciation schedules through detailed discussions with Internal Revenue authorities as to what is reasonable.

In addition to making certain that your depreciation policies are realistic, you also shold determine whether all depreciable items are included in your depreciation schedules.

● ***Failure to Prorate Annual and Quarterly Expenses Each Month.*** Companies kid themselves about their monthly profits when they do not take into account charges and expenses which arise only annually. In many smaller businesses these items are not considered until they arise at the end of the year, often to the disillusionment of the manager. Such omissions are particularly noticeable in job estimations and pricing in job-shop operations. The manager thinks he is figuring jobs on the basis of a good profit but finds that his total operating expenses should have included a number of items he actually failed to consider in the day-to-day job estimations.

Some examples of these expenses are:

(1) Income taxes
(2) Insurance premiums
(3) Rent (if paid quarterly or annually)

● ***Maintenance and Upkeep Expenses.*** Another expense allied to the annual and quarterly expenses discussed above is that for facilities and equipment maintenance. The monthly P and L statement may fail to carry an allowance for this expense for some months. In that case the profits for those months will have to be readjusted when large repair bills fall due. Sometimes these bills can be large enough to wipe out profits for several months.

● ***Low Salary for the Owner-Manager.*** Many small businesses which appear to be making a fairly good profit would find a changed situation if they allowed a comfortable salary for the owner-operator. Often the proprietor draws money out of the business on an irregular basis, as he needs it. Many times this does not amount to reasonable compensation when compared with the pay of other similar managers working on a regular salary basis.

For example, total withdrawals for a year by one owner-operator amounted to $8,000, but the going pay for comparable work was actually $15,000 a year. Consequently $7,000 of the profit figure was the result of the fact that the owner was underpaid by that amount. If he had had to withdraw from the business and hire someone to perform his job, he would have had to pay at least $15,000.

Often a manager will not recognize that fact until he approaches his bank for a loan. In examining the company's financial statements, the banker will recognize that the profit figure is not so much a result of profitable business operation as it is of working for an unrealistic salary. Of course, when thus done intelligently and deliberately, as a means of building up capital funds in a new enterprise, most bankers would not criticize.

● ***Lack of Sufficient Insurance Coverage.*** The profit figure can also contain amounts which are brought about as the result of unjustifiable risk-taking by the business. Serious fires or other accidents, if not covered by adequate insurance protection, can cause a drain on resources that may wipe out much or all of the profits for the past year or so. When a company has been carrying insufficient insurance coverage to guard against such disastrous experiences, somewhat more profit will be shown from month to month. In such cases the profit figure can be said to be a combination of the results of profitable operation, plus false savings brought about by undue risk taking. Just how much protection is "adequate" is, of course, a matter of judgment. For advice on this point consult your insurance agent, broker, or company representative, and your accountant or banker.

● ***Minimum Wage Laws.*** With the current emphasis on compliance with the minimum wage law it is increasingly important for you to clarify the status of your company in this connection. Therefore, make sure you are not kidding yourself with inflated profits resulting from paying your employees a lower rate than is required.

THE SUFFICIENCY OF THE PROFIT

Although you may have determined that you actually have a profit, you may be kidding yourself as to the sufficiency of that profit. You may fancy yourself as a fairly efficient operator since you are showing what you consider a very respectable total dollar profit. However, you may actually be operating below par as compared to others performing the same or similar types of marketing operations. The point on which you may be kidding yourself is judging your profits against too low a standard. This will naturally make them look good.

In order to get a reliable perspective in this regard, you must reexamine your standard and establish a sound basis for comparison. If you establish a standard that represents real accomplishment, your comparisons will be valid.

A good procedure in this connection is to gather some statistics on the trade you are in as well as data on some of the most successful companies in that trade. Trade associations and publications are helpful sources of this information. One well-prepared set of figures is "The 14 Important Ratios" of Roy A. Foulke. These are published by Dun and Bradstreet, Inc., 99 Church Street, New York 8, N. Y., in a small volume revised each year. In addition to showing "Net Profits on Net Sales" for a number of businesses, this publication shows 13 other bases for measuring operations. Another good source is the continuing series of *Statement Studies* published annually by Robert Morris Associates, Philadelphia National Bank Bldg., Philadelphia 7, Pa.

THE PROFIT MIX

Although you find that you are making a real profit and that your profit is sufficient as compared to a good cross section of other similar concerns, there is another area in which you may be kidding yourself. It is in assuming that the total profit figure depicts the true situation for all the various lines or services of the company. Upon careful examination you may find that some activities are doing exceedingly well and even carrying other losing activities.

If your company is engaged in selling a number of products, providing a number of services, or engaged in a combination of these activities, you should develop a system for constantly determining the actual contribution of each of these goods, services, or activities to the total profit. There are, of course, cases where you may have to continue to handle certain losing items because they must be provided to complete your line of merchandise or service. If possible it is desirable to avoid this situation. But regardless of whether you can avoid them or not, you certainly should know specifically *what* activities are losing, *how much* they are losing, and *why* they are losing.

This information can be determined by a careful breakdown of income and expenses by individual line. The objective of this kind of "costing" is to allocate to each activity the costs required to carry it on. Typically, the costs will fall into three main categories:

(1) Wages
(2) Merchandise
(3) Overhead

Systems of costing need not be elaborate nor complicated, nor is it always necessary to carry on the procedures constantly. Periodic checks will often suffice.

THE TREND OF PROFIT

You may be satisfied with your analysis of the existence of a profit, the sufficiency of the profit, and the profit mix, and even then kid yourself in still another area. That is in the trend of your profit. The examination of your profit picture at any one point in time, such as a monthly or a yearly P and L statement might prove satisfactory. But when viewed in relation to a number of months or years it might instead show an unsatisfactory trend.

This comparative analysis might reveal such things as an increase in volume, but a decrease in the ratio of net profit to sales. Or expenses might be increasing at a faster rate than sales or net profit. Comparisons of this sort usually become more meaningful when all items are reduced to a percentage basis. Typically, all items are expressed as a percentage of net sales.

Many small marketers find return on investment to be a useful yardstick for measuring the trend of their profits. It is not difficult to develop and apply. Essentially it tells you two things: How well your firm did in one reporting period in contrast with others, and how much the money invested in your business earns in comparison with other investment alternatives.

For example, suppose you had a small service business in which capital of $38,000 had been invested. And suppose you felt that, all things considered, the yield on that capital should be about 9 percent a year before taxes. This would total $3,420.

That figure might work out to, say, 3 percent of annual net sales of $114,000. Therefore, to keep track during the year of how things were going--the trend, in other words--you might keep score, on a quarterly basis, of sales and profits. Any quarter ending with sales of less than $28,500 and profits below $855 would indicate that things were moving in the wrong direction.

Knowing that, you could try either to increase sales volume to produce more profit dollars, or to obtain better margins on existing volume. If neither was possible, you might want to consider reinvesting your capital in a more profitable way.

ANALYZE YOUR OWN OPERATION

The considerations discussed above are not intended to be all inclusive. Other factors may also be worth analyzing to determine their influence on the accuracy of the profit figure. Using this Aid as a guide, each manager should endeavor to develop his own checklist of potential trouble spots in his particular business. This checklist should certainly be discussed with your accountant so he will understand your purpose in questioning these areas. Frequently, he will be able to offer valuable suggestions.

FOR FURTHER INFORMATION

Readers wishing to explore further the subject of statements and analyses of profitability may refer to the following publications. Consistent with the objectives of these Aids, this listing is intended only as a starting point. It should not be considered as an all-inclusive index. No slight is intended towards authors whose works are not mentioned.

(1) *Profit Management*, by F. V. Gardner et al. McGraw-Hill Book Company, Inc., 330 West 42d Street, New York 36, N. Y. 1955. $6.

(2) *Practical Distribution Cost Analysis*, by D. R. Longman and Michael Schiff. Richard D. Irwin, Inc., 1818 Ridge Road, Homewood, Ill. 1955. $7.80.

(3) *Financial Statements: Form, Analysis, and Interpretation*, by R. D. Kennedy and S. Y. McMullen. Richard D. Irwin, Inc., 1818 Ridge Road, Homewood, Ill. 1952. $7.80.

(4) *Guides for Profit Planning*, by B. La Salle Woelfel. Small Business Administration, 1960. Available from Superintendent of Documents, Washington 25, D. C. 25 cents.

(5) *Ratio Analysis for Small Business*, by Richard Sanzo. Small Business Administration. 2nd Ed. 1960. Available from Superintendent of Documents, Washington 25, D. C. 25 cents.

GPO 938335

SMALL BUSINESS ADMINISTRATION

No. 75

Management Aids for Small Manufacturers

Washington 25, D. C. July 1956

PROTECTING YOUR RECORDS AGAINST DISASTER

By *Edward J. Stewart*, Regional Director
Small Business Administration, Region I, Boston, Massachusetts

SUMMARY

Disaster is no respecter of small business. Recently, a typical small concern in a disaster area lost everything—including all records. It was a striking example of what lack of important documents and information can mean to a business establishment in time of disaster. An appeal was made to the American Red Cross and Small Business Administration for funds with which to restore the business. Both agencies were badly hampered by the lack of proper records of earnings. If the businessman had taken proper advance precautions to protect his valuable records, there would have been less delay and little chance of his not obtaining the funds he needed.

During the past 2 years, various U. S. regions have been the scenes of major disasters. These have ranged from tornadoes and hurricanes to salt-water floods and high winds with torrential rainfall. In addition, while business buildings are often located above the flood line, many of them do not have adequate protection from cyclones and tornadoes.

In situations like these, one of the gravest management problems derives from the loss of business records. The problem is grave because any evaluation of the extent of damage, to be acceptable, must be supported by accurate figures and descriptive information. Virtually every organization providing financial assistance covering losses due to a disaster—a bank, an insurance company, the Red Cross, or the Small Business Administration—must have dependable proof as to the size of the loss and the fact that relief is justified. To provide this proof, correct and current records should be maintained and should be protected against destruction.

Where business records are concerned, carelessness and lack of foresight by owners and managers is all too common. Often, important ledgers and irreplaceable legal documents are lost forever. As a result, there have been many cases where disaster-struck concerns, seeking financial assistance for rehabilitation, have met serious obstacles. Such difficulties could have been avoided had essential information been protected systematically in advance. Moreover, the fact remains that in large companies, as well as in small concerns and among individual proprietors, most regular records are vulnerable to loss or destruction.

Here is the experience of one firm. This concern was operated in a one-story, wooden-frame building located in a low area at the foot of two hills. A flood swept through the building damaging the flooring, electric motors, and inventory. The operator stated that he "kept the books under the counter, and they were so badly damaged that they were thrown out with all of the other debris." When the owner applied for a loan, he could not give any figures to substantiate his loss, nor could he submit any figures which would enable an investigator to determine what the past business experience of the concern had been. The inability of the applicant to substantiate any claims resulted in his loan application being declined. In fact, he could not be helped in any tangible way.

Floods, winds, and fire can strike anywhere and cause key documents to be destroyed or rendered completely useless. How would your concern make out if your office were demolished? Do you have an alternative, immediate source of information as to inventory, receivables, finances, and similar items? Could you prove how much a disaster cost you? Could you back up your tax returns?

TAX CONSIDERATIONS

Continuity of records—and hence the safeguarding of them—is important from the tax standpoint. Some records (like employee withholding statements) are required by law, others (like unusual business expenses) are dictated by commonsense. All of them help to document earnings statements and avoid mistakes on tax returns. What you need, of course, is sufficient evidence to support the figures you claim. The burden of proof lies with you. If appropriate records are not available, due to a disaster, expensive confusion and even tax penalties may result. Here again, carefully protected duplicate information is usually the best answer.

If your return is questioned and the Treasury agent finds upon inspection that you haven't appropriate records to justify what you claim, you are told both orally and by letter to keep permanent books of account plus the following original records: invoices, bills, vouchers, tapes (such as for cash register), and receipts. These items, therefore, should be added to your list of records which should be protected against disaster.

In fact, if a follow-up investigation shows that a businessman has consistently failed to maintain proper records, the Internal Revenue Service may hale him into court on the charge of willful negligence. The penalty for this misdemeanor is a fine of $10,000 or one year's imprisonment, or both, plus the court costs.

Four specialized types of records which are important to safeguard for tax purposes are depreciation, tax withholding statements, unusual business expenses, and business losses.

- **Depreciation.**—To substantiate depreciation figures on capital assets (like machinery and equipment), you should safeguard records on date of purchase, cost, estimated useful life, estimated salvage value; and depreciation already taken in past years.
- **Tax Withholding Statements.**—As an employer, you are required by law to maintain records on (1) income taxes withheld from employees' wages, (2) taxes withheld from employees' wages under the Federal Insurance Contributions Act for old age and survivors insurance, and (3) taxes on employers under the Federal Unemployment Tax Act for unemployment insurance. Hence, these documents, too, should be protected.
- **Unusual Business Expenses.**—If you want to take the full deduction for unusual expenses such as entertainment and travel which are incurred on behalf of your firm, they should be fully documented to show that they are both accurate and allowable. These records, therefore, have lasting value.
- **Business Losses.**—There may also be legitimate deductions for losses sustained in the course of regular operations. For example, a marketing innovation may not work out, a manufacturing experiment may fail—or a disaster may strike. Such situations may produce sizable losses which are quite properly deductible—if suitably recorded.

Here is a case in point. One businessman, engaged in the manufacture of automotive devices, was the victim of a severe flood. A substantial part of his loss was destroyed or damaged inventory ($35,000) and records. An outside financial specialist had to be brought in to make estimates and analyses of the company's sales and normal inventories—with the usual ratios in effect in the automotive trade. If the owner had been able to produce proper inventory records, he would have been able easily to substantiate his inventory losses. Failure to maintain these records and store them in a safe place required that the financial specialist devote much high-priced time to his estimated verifications of the flood loss.

GOVERNMENT CONTRACT RECORDS

If you have a supply contract with the Federal Government you have still another series of documents to protect. They can range from invitations to bid and requests for proposals, through your actual bids or proposals, to the contract itself with the specifications, drawings, reports, correspondence, invoices and payments relating to it.

Essentially, you want to be able to reconstruct the terms, history and status of your contract. Details about what you agreed to do, how far you have progressed, and what remains to be accomplished can be of cardinal significance in working out with your contracting officer arrangements for completing work and avoiding deliquency.

For example, an aircraft company sustained heavy loss as a result of floods. Unfortunately, master blueprints and specifications for plane production were lost and serious interruption of operations resulted. The cost of reproducing the necessary thousands of drawings and specification records was very high. Moreover, only a rough estimate of their replaced value could be made. The loss on account of production problems, and delays in delivery of finished units was extremely heavy. However, if a second set of prints and specifications had been deposited in a safe, dry vault located on high ground out of reach of floods, the company could have been back in production almost immediately—and could have saved much goodwill and thousands of dollars.

In the same way, you also need to take care of records relating to any Government work you may be doing under subcontract to a larger prime contractor. Remember that the prime has schedules and prices to meet, which, in part, depend upon you. If disaster strikes you, the prime will want to know as soon as possible what the effect will be upon him and how soon he can expect you "back on the team" productionwise.

You may also need detailed records on costs and pricing in connection with the renegotiation procedure. If your Government-contract work during a fiscal year totaled $250,000 or more, and involved renegotiable contracts, you can be renegotiated. If you are, and can offer proof of having priced closely and of having accepted risks, you stand a better chance for a favorable settlement than if your operating statements show apparently excessive profits with no background facts to justify them. Such background facts can come only from good records.

CONSTRUCTIVE ACTION POSSIBLE

The cases of lost records mentioned in this Aid point to a serious situation. Nevertheless, it is one in which constructive action is possible—even for the small enterprise.

A good place for a firm to start is to collect all its valuable papers which are not frequently used for reference. They should be placed in a safe-deposit vault (for example, a bank or other safekeeping institution) where they will be adequately protected from fire, wind and from water damage in case of flood. Such vaults are available for rent in most cities; the cost is low when compared to the potential loss.

Current records of accounts payable and receivable should be reproduced regularly and preserved in a safe place. Similar precautions should be taken for sets of tracings, blueprints, drawings, and important specifications, as well as for models and prototype mechanisms. Special care should be taken of items for which it is not feasible to make and store a duplicate. Insurance policies and related data also deserve special care. The settling of claims can be greatly accelerated when adequate information is available. Then, too, if a dispute arises between the businessman and the insurance company, proof of loss through accurate documentary evidence may save thousands of dollars for the insured.

Remember, however, that such safety measures are worth very little if the material you store and safeguard is out of date. Unless all documents are maintained on a reasonably current basis or have a long-term value, you are missing the point of the whole procedure.

FOUR STEPS TO TAKE

What kind of action, then, should be taken once you have decided to put this program into effect? Basically, there are three steps:

- **Analyze the Records.** All your operating executives should be told of the plan, and asked to make a complete survey and listing of all their valuable records—reports, drawings, and other material—which are vital to the full operation of the activities they supervise.

—31004

- **Copy Key Items.** Make arrangements to reproduce all of these key items. Then accumulate all of the duplicates, carefully indexed or identified, and properly packed and protected for storage.
- **Arrange for Safe Storage.** After assembling this material, contact the warehouse, bank, or other safekeeping institution and describe your space needs. When you have arranged adequate storage, you should provide the executives of the storing company with the names of the persons representing your firm who have authority for access to these valuable documents.
- **Keep Things Current.** Once you have your system of safe storage in operation, check up on it regularly to see that the right material is stored, that it is up to date, and that material which is no longer useful is extracted and destroyed.

A WORD ABOUT MICROFILM

In connection with copying key records, the question of microfilm may well come to mind. Basically you can use microfilming in any one of three ways: (1) have it done for you on contract, (2) do it yourself with rented equipment, (3) do it internally with purchased equipment. The main deciding factors are cost, volume of work, and control requirements.

The great advantage of microfilm is space saving. This can be very important if the protected storage space you plan to use is relatively expensive. Obviously, when reduced to microfilm, a great many documents can be fitted into a space the size of an ordinary desk drawer. If, however, you can get well-protected storage space at relatively low cost, be very careful to compare the cost of storing duplicate, full-sized documents with the cost of microfilming. According to the National Records Management Council, full-sized records can sometimes be stored for several years at less expense than the initial cost of microfilming.

The classified pages of your local telephone directory should help you find both contract microfilming services if you want them, or concerns which rent or sell the equipment. Naturally, costs will vary a good deal, but rental charges for a microfilm recorder run typically from around $35 to $80 per month. To buy a recorder would cost anywhere from about $450 to $3,300 and the reader to go with it would involve some $165 to $800 more.

NOTE TO INDIVIDUAL PROPRIETORS AND PARTNERS

In the case of individual proprietorships, it is important to recognize that the person and the business are more closely identified than is true of corporations. As a consequence, it is imperative in guarding against disaster that a will, insurance policies, copies of income tax returns, deeds for property, and other essential records and legal instruments, be placed in a safe depository. In this way they can be preserved for reference—not only by the individual himself, but also by those who will have to take over the management of the estate in the event of the owner's death or incompetency.

The matter of protecting a will is particularly important. History demonstrates that healthy businesses can be forced to the wall because there is no owner's will. The fact that the will was destroyed in a disaster doesn't help.

Through the specific instructions in a will a proprietor can provide for executors to carry out plans he made during his lifetime for the management or sale of his business interests. Conversely, the lack of specific authorization to continue operations can result in immediate liquidation of the business—as ordered by the court having jurisdiction over the administration of the estate.

In partnerships, too, the preservation of business records can be essential. If, for example, key agreements and similar documents are destroyed at a time when the partnership has to be dissolved, management and legal problems can arise very quickly. For this reason, the wisest policy is often for the partners to provide individually for the safeguarding of records. When this is done, each has available the material he needs for his own use and protection.

GETTING A PROGRAM STARTED

Many small business owners will be inclined to say: "Fine! I agree with all that's been said. Something should be done. I'll get at it just as soon as my regular work lightens up a bit."

But then they get involved with other things. Memory dims, enthusiasm slackens, and the whole idea is forgotten. Or they put off positive action on the grounds that their "affairs are not in order."

These are natural tendencies, but they are also dangerous. For instance, a small manufacturer of a patented, food-packing machine experienced a heavy loss by fire. Unfortunately, no precaution had been taken to keep a complete duplicate set of drawings and specifications in a safe place. The delay in preparing a new set of dimensional drawings—secured by actually dismantling a complete machine in a customer's plant—was expensive. The problem could have been avoided if another set had been printed in the beginning and put away for safekeeping. The cost of such protective storage in a suitable vault would be only a few dollars a year.

However, an important word of caution is appropriate at this point. All changes, additions, or other information concerning these drawings and specifications should be made in the secondary source immediately after such changes take place in order to keep stored records constantly current.

The threat and risks of disaster exist whether you forget them or not. You seldom, if ever, get all your affairs in perfect shape. Furthermore, your business needs to have its important records protected more when the risks are not evident, and when affairs are not in "apple-pie order," than when they are. Procrastination increases the risks of loss and waste—and competitive disadvantages.

Putting off the start of a constructive program is a major reason for being caught short when misfortune occurs. Intelligent plans and positive action are essential if you are to give your business a reasonable chance of survival and recovery. Just as you insure a home and personal property against loss, so also you should protect your business against disaster by safeguarding its vital records. The time to begin is now.

GPO 936256

Financial Management

SMALL BUSINESS ADMINISTRATION

SMALL MARKETERS AIDS No. 49

Washington 25, D. C. October 1959

IMPROVING COLLECTIONS FROM CREDIT SALES

By *Clyde William Phelps*, Professor of Economics, University of Southern California.

SUMMARY

Most businesses face collection difficulty at one time or another. Not all men are honest; not all men are cautious in their purchases. That means that you need a collection system that works.

In such a system, four main areas demand special attention: (1) greater efficiency in credit granting; (2) increased precision in the collection policy; (3) more automatic operation in the collection system, and (4) improved timing in the collection procedure.

Of course, even a system need not and probably should not be totally impersonal. At times you may have to guess who among the customers who cause collection problems are unwilling (but able) to pay, and who are both unwilling and unable to take care of their commitments. Obviously, you should apply different collection tactics in each case.

But without a definite and established collection procedure, you may find yourself in an uncomfortable position. You need not let that happen: A little planning can save you a lot of grief.

Past-due accounts are a common problem encountered in businesses that sell on credit, as many firms -- even small firms -- do nowadays. Poor collections eat into profits in many different ways. If you feel that you are not getting the collections you should or as fast as you might, a little time spent on checking the possible causes and considering effective solutions may yield handsome returns.

COLLECTIONS AND CREDIT GRANTING EFFICIENCY

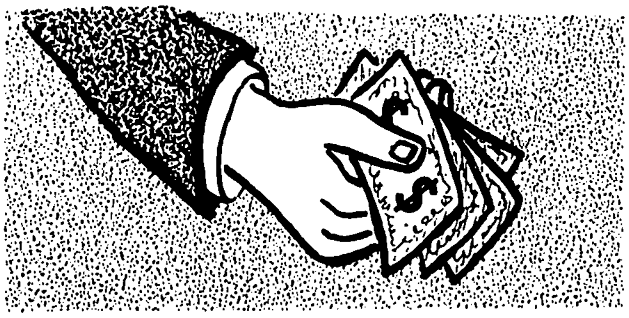
The place to begin looking for possible causes of collection difficulty is not in your collection setup but rather in your credit granting policies and procedures. There is a saying that an account properly opened is an account half collected. Poor collections may be due to inefficiencies that occur in the credit granting part of your operation before your collecting activity even starts. Hence it is desirable to check the following important factors in your credit granting mechanism to discover whether there are any weaknesses.

1. *Are you selecting your new customers carefully after thorough credit investigation?* If you are granting credit to applicants who are known to others (as shown by credit bureau records) as slow-pays or won't-pays, how can you expect anything but poor collections and bad-debt losses? When credit investigation is inadequate, poor accounts are put on the books to start with; often the account which turns out to be a problem was already a poor risk at the time it was opened.

2. *Are you making sure that each applicant and present customer clearly understands your credit terms?* Your credit terms should be stated clearly to each applicant at the time his account is being opened. They should be restated on your invoices or sales checks, on your monthly bills or statements of account, and on your collection notices. How can you expect good collections from a customer who never clearly understood, or has forgotten, just when he is supposed to pay?

3. *Are you controlling the credit limits you set for your various customers?* Customers who are allowed to exceed sound credit limits (based upon their ability to pay) become overloaded, and their accounts are certain to turn into collection problems or bad-debt losses.

4. *Are you sending statements promptly?* It is an old saw, but it is still true that the early bird gets the worm. People generally tend to *pay first*



those bills that *reach them first*, and rarely do they pay until they get a bill.

Check Up on Yourself. If you are handling your credit granting function efficiently, the great majority of your customers (from 55 percent up, depending upon the line of business) will pay in full upon receipt of your statement. It is with regard to the rest that you have the problem of improving the efficiency of your collecting function. Perhaps you should check the three important factors that are the basis for a possible improvement: your collection policy; your collection system; and your collection procedure and methods.

COLLECTION POLICY

Start off by examining your collection policy for possible causes of poor collections. Frequently the lack of a clear-cut collection policy is at the bottom of a firm's collecting inefficiency.

Rules for Collecting. Your collection policy should set up specific rules on such important matters as the following: (1) when accounts are to be payable; (2) how soon after the due date the first reminder shall be sent out; (3) how soon after the due date the credit privileges on a past-due account shall be suspended until the account is brought to terms; (4) how many steps there shall be in the standard follow-up and how much time shall elapse between the several steps; (5) which of the available tools and methods shall be used in the various stages of the follow-up; and (6) when past-due accounts shall be turned over to a collection agency or an attorney.

Be Firm -- Be Flexible. The adoption of a definite collection policy *does not* imply the establishment of absolutely rigid provisions from which no exceptions can be made in cases where there are extenuating circumstances. It *does* mean that clear-cut principles are set up as basic guides in everyday operations. Any deviation from these principles must be justified by sound considerations applicable to the specific case. After all, the secret of improving collections from credit sales is to be found in the achievement of clock-like regularity in the administration of the collection function.

COLLECTION SYSTEMS

You may improve your collections by improving your collection system: the setup of records, filing devices, forms, and office machines and equipment which you utilize in applying various collection methods according to a definite collection procedure. Collection systems vary in detail from firm to firm, but there are certain fundamental requisites to be met by any system if the best possible collection results are to be achieved.

These requisites are: (1) It (the system) should provide an accurate record of each step in the collection process until final disposition is made in the case of each account; (2) it should bring accounts to notice automatically at the proper time; (3) it should avoid unnecessary duplication of records and effort; (4) it should provide for classifying or segregating the accounts into three categories: current, past due, and suspense or attorney (customer's credit suspended or account turned over to an attorney for collection); (5) it should be arranged so that cash received is posted daily to the collection records before it goes to the general bookkeepers in order that these records will be kept up to date daily; and (6) it should have provisions for safeguarding the records from loss and destruction.

Collecting Mechanism. To be most effective, your collection system or mechanism must be organized so that the follow-up on each customer with past-due accounts will begin promptly and that succeeding efforts will be regularly directed to the account. Unless your system functions as automatically as possible, customers whose accounts have become past-due will not be promptly reminded, and those who have been reminded will not be regularly contacted again and again until results are secured. Probably the most important requisite for successful collection activity is the regularity and persistence with which past-due accounts are followed up. Hence the importance of checking every element in your collection system to make its operation truly automatic and efficient.

COLLECTION PROCEDURE AND METHODS

Your collection procedure should be deliberately planned so that it will move, in a regular and orderly way, through a series of steps, the collection effort gradually becoming more and more insistent until final decisive action is taken. The procedure should be organized into the following four logical steps: (1) reminding the customer; (2) requesting response; (3) insisting on payment; and (4) final action.

1. Reminding the customer. All those customers who do not respond to your invoice or statement within the time limit set by you must be reminded that their accounts have become past due.

Tone: The tone of this first reminder should be mild because the only reasonable assumption to make at this point is that the customer has simply overlooked the matter. He may have been negligent, or he may have been confronted by some emergency which made immediate response impossible. Thus far, then, his failure to pay is no indication of either unwillingness or inability to pay his bills.

Methods: Good methods for giving the past-due customer a reminder are: printed or mimeographed form notices in the shape of a card or a slip of paper about three by five inches in size; duplicate or short-form statements with or without a reminder message in the form of a sticker, insert, or written, typed, or rubber-stamped appeals; telephone calls. In most lines of business, collection letters and personal calls are best reserved for later steps in a firm's collection procedure.

Content: As for the content of this first reminder, at least it must bring to the customer's attention the amount owing, the fact that it is past due and no remittance has been received, and a request for payment. It should also restate your credit terms, and thus contribute toward educating your customer to pay promptly according to terms to which he agreed.

Timing: How soon after the due date the first reminder shall be sent out is, as indicated previously, a matter for you to decide in establishing your collection policy. Timing varies greatly in different lines. For example, instalment sellers and instalment lenders usually send the first reminder notice within a few days after an account becomes past due, whereas some manufacturers and wholesalers and many retailers may wait a month before reminding the customer.

Whether you wish to improve collections by reminding past-due accounts promptly is a matter that is up to you. But normally you need have no fear of incurring ill will by promptness in reminding, provided the content of the first reminder notice is not such as to give offense. Its impersonal form should be such as to indicate to the customer that he is not being singled out for discriminatory action but is receiving the same treatment accorded all others in similar circumstances.

2. *Requesting response.* Those customers who do not react to the simple reminder you give them in Step 1 should be automatically subjected to the second step of collection follow-up after a predetermined number of days. The message used here not only reminds the customer of his debt but also asks for a response.

Tone: The tone you use is still mild and courteous. While it cannot be assumed that the customer is simply overlooking the invoice or statement (since it has already been brought to his attention by the first reminder), the only logical attitude to take is that there is some valid reason why payment has not been made. And there are plenty of possible good reasons: There may have been a mistake in the billing; the customer may have been dissatisfied with the goods or the treatment received, or he may be temporarily financially embarrassed.

Methods: The purpose in this step is "to get a rise out of the customer" -- to find out *why* he is slow in paying so that you can figure out what can be done to remedy the difficulty. The methods used are generally similar to those employed in making up the first reminder. Impersonal notices on paper or three-by-five-inch cards are effective. So are telephone calls and short form letters.

Content: The content of the message in this second step is similar to that in the first step of the follow-up, but in addition you ask the customer to advise you of his reason for nonpayment.

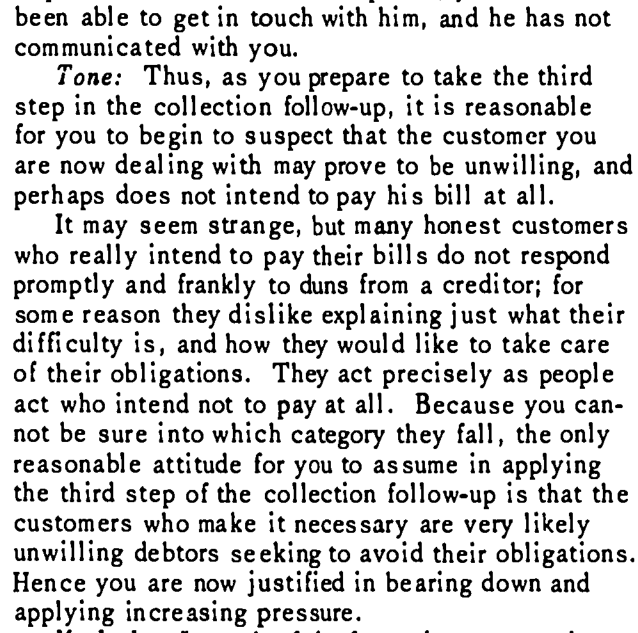
Timing: How much time should be permitted to elapse between the first and second steps of the follow-up depends on the type of business involved. For example, not more than five days, or at most a week, should be allowed between reminding and requesting response in case you are engaged in instalment selling or instalment lending. In the case of manufacturers, wholesalers, and retailers generally there is rarely any justification for waiting more than 15 days before requesting a response from a customer who has been sent a reminder.

3. *Insisting on payment.* Those customers who have not responded to the foregoing follow-up require a third step in which a still different procedure is applied. It has been some time now since you notified the customer by sending him an invoice or statement; later you reminded him of his failure to pay as agreed; then you reminded him again with a request for some kind of a response; you have not been able to get in touch with him, and he has not communicated with you.

Tone: Thus, as you prepare to take the third step in the collection follow-up, it is reasonable for you to begin to suspect that the customer you are now dealing with may prove to be unwilling, and perhaps does not intend to pay his bill at all.

It may seem strange, but many honest customers who really intend to pay their bills do not respond promptly and frankly to duns from a creditor; for some reason they dislike explaining just what their difficulty is, and how they would like to take care of their obligations. They act precisely as people act who intend not to pay at all. Because you cannot be sure into which category they fall, the only reasonable attitude for you to assume in applying the third step of the collection follow-up is that the customers who make it necessary are very likely unwilling debtors seeking to avoid their obligations. Hence you are now justified in bearing down and applying increasing pressure.

Methods: In each of the foregoing steps only one effort was made: one simple reminder, and one reminder requesting response. But in this third step a number of efforts, increasing in severity, are often called for. Here a variety of methods may be employed: collection letters utilizing appeals to



fairness, pride, self-interest, and fear; humorous or stunt letters; telephone calls; telegrams; registered letters; personal calls; a series of letters sent by a collection agency or an attorney to whom you have turned over the past-due account for collection.

Content: The content of the third step collection messages may include various pressures: temporary suspension of credit privileges on the past-due account; threats to report the account to the credit bureau, the firm's legal department, firm's outside collector, a collection agency or an attorney; and, in the case of instalment sales, threats to repossess the merchandise or to sue.

Timing: The time allowed to elapse between the request for response and the first message insisting on payment should not be more than a week in such lines as instalment selling and instalment lending. In such businesses the rule is that a customer who has missed an instalment payment must be reached before the date of his next payment arrives. Thus an instalment buyer who has missed a monthly payment will receive three notices before his next payment falls due; a reminder, a request for response, and a threat to reposses the merchandise unless the past-due payment is made or satisfactory arrangements are worked out.

In other lines more time is allowed, but it is difficult to justify permitting more than 15 days to elapse between an unanswered request for response and the beginning of the stage where you insist on payment. This stage may then extend over several weeks or months, depending upon the circumstances in each case, while succeeding efforts, increasing in severity, are made to collect the account.

4. Final action. In analyzing the customers who have failed to pay or make satisfactory arrangements to liquidate their indebtedness to you after the preceding three steps in collection follow-up, you will find that these customers fall into two main classes.

The first class consists of those who are able to pay but must be forced to do so. Some of these will be found to be "skips," and they should be traced if the expense is justified; and suits should be brought if the amount they owe merits the expense. Even if you are engaged in instalment selling, you may prefer to sue instead of repossessing in cases where you and your attorney are of the opinion that the account will be collectible under judgment.

The second class is composed of those who are willing but who cannot pay in full, or who cannot pay within a reasonable time. You may be able to induce these customers to re-evaluate their financial position and find some way to pay their debts within a reasonable period.

● ***What Can You Do?*** In the case of a customer who is so deeply involved that he apparently will not be able to pay in full, even over a long period, perhaps he can be induced to pool his obligations so that you and his other creditors may salvage as much as possible out of the situation. In case you are selling durables on the instalment plan and you find that the customer cannot pay in full or would take an unduly long time to do so, final action may be taken by repossessing the merchandise.

● ***What More Can You Do?*** If you attack your collection problems along the various lines that have been indicated, you will find that there will only be a very few accounts that you are unable to collect yourself. But to achieve the best recoveries on such accounts, you should follow a definite policy of turning them over to a collection agency or an attorney before they are too old. No general rule can be laid down for all cases in all lines of business, but certainly if you have been wrestling with a past-due account for six months and have got nowhere, it would seem undesirable to delay longer in turning it over to an agency or an attorney specializing in collections.

FOR FURTHER INFORMATION

Businessmen interested in pursuing further the subject of improving collections from credit sales will find additional information in the publications mentioned below. Space requirements permit listing only a few of the many sources dealing with collections, and no slight is intended toward authors whose works are not mentioned.

A detailed treatment of collections is to be found in Chapters 14, 15, 16, and 17 of *Retail Credit Fundamentals* and Chapter 7 of *Retail Credit Management*, official textbooks of the National Retail Credit Association, both by C. W. Phelps. National Retail Credit Association, 375 Jackson Ave., St. Louis 30, Mo. 1952 and 1949, respectively. $5 each.

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GPO: 1959 O—528640

GPO 930627

Case of the Vanishing $'s

DAVIS SERVICE STATION

This situation involves Mr. Davis and a service station that he opened in 1953 in a small Alabama coastal community. The station failed after about twelve months' operation. Mr. Davis, the owner-operator, had a high school education, and ten years' experience in co-managing a successful service station. He had a pleasing personality, was a willing worker and was well thought of in the community.

In addition to gasoline, Mr. Davis also sold boats, fishing equipment, and accessories. The station was located on a through highway in a small Gulf Coast town. The property was leased by Davis from a local real estate operator. The basis of payment on the lease was a fixed fee per gallon of gasoline sold. The lease could be voided by the lessor on very short notice in the event that the number of gallons pumped fell below a relatively high minimum figure. Mr. Davis sold unbranded gasoline on open credit.

Boats, motors, and other marine accessories were financed with a one-third down payment and two-thirds through a finance company. In practice, Mr. Davis usually put the one-third down payment on his own books, actually selling with no down payment. Mr. Davis had approximately ten thousand dollars invested in the business. His investment in marine equipment amounted to six thousand dollars with the remainder of his capital required for day-to-day operating expenses and inventory. From time to time, bank loans were used to increase his inventory.

Immediately after Davis opened his station, it was apparently very successful. Within three months the station was pumping twenty to twenty-five thousand gallons per month. Sales of marine equipment amounted to approximately four thousand dollars during this period.

Within six months of the opening of the business, a gasoline price war developed in the area. In order to stay competitive, Mr. Davis lowered his prices along with those of the other stations; however, the independent distributor from whom he purchased did not protect him from this price cut like the major oil companies protected their dealers. Soon Mr. Davis was selling gasoline two cents under his cost. Sales stayed up. After the price war had been under way for several months, Mr. Davis, losing more money than he could afford, raised his price to equal his cost. His gasoline volume fell off sharply and the lessor threatened to cancel his lease if the gallons pumped did not go back up above the minimum level required by the lease. Mr. Davis lowered his price and volume rose to a level satisfactory to the lessor.

About this time Davis began experiencing difficulty in collecting accounts receivable, particularly those from his financing of the normal down payment on boats and motors. Also, the finance company, which had purchased the boat paper with recourse, began to look to him for payment of some of the notes. Faced with a cash drain, Davis decided to raise prices to cover gasoline cost once more. True to his word, the lessor cancelled the lease and in three days Davis was out of business.

By liquidating most of his business and some of his personal assets and by diligent attention to the collection of accounts receivable, Mr. Davis managed to liquidate the finance company debt, both direct and contingent. However, now deprived of a regular place of business, he was left with approximately six thousand dollars in accounts receivable. He was of the opinion that most of the three thousand dollars in accounts he held (two years later) were uncollectable.

INSTRUCTOR'S NOTES ON CASE

Although Davis failed principally because of the lease cancellation, it appears that several decisions made at the inception of the business made his chances for survival very slim. First, his lease was not designed to give him adequate protection against the lessor. Second, his decision to stock marine equipment took him into an area in which he had no previous experience, and more importantly, involved him in financing operations completely unfamiliar to him. In the end, it was probably this excursion into unfamiliar credit operations which caused him the greatest personal loss.

In retrospect, it appears that Mr. Davis' partner had been responsible for policy decisions and credit extension in the former partnership. Although Mr. Davis was capable in routine station operations, he was inexperienced in decision-making. He now works for an industrial concern in a midwestern state, and is of the opinion that he is personally better off and better adjusted working for someone else.

SUGGESTED INCUBATOR ASSIGNMENT

RECORDKEEPING FOR A SMALL BUSINESS

QUESTIONS FOR DISCUSSION

Recordkeeping is essential to the successful operation of a small business. Many of the failures of small business have been due to poor records. Some of the important questions for every small business operator are listed below. Do you have the answers ?

1. Why have so many small businesses failed to keep adequate records despite the failures poor recordkeeping has caused ?

2. What is a good recordkeeping system for my business ?

3. Is it expensive to install a good recordkeeping system ?

4. Do I need to know double-entry bookkeeping to operate a recordkeeping system in my business ?

5. What are the things that I must watch every day, week, and month in my business ?

6. What types of records will I need ?

7. How can my recordkeeping system help me control my business ?

8. Is it possible to have a recordkeeping system that will not require a great deal of time to operate ?

9. Should I hire an outside bookkeeping firm to keep my records or do it myself ?

10. What are the best ways of recording items subject to the Federal Income Tax ?

11. What are the best-accepted methods of recording unemployment insurance items ?

12. How does the small retailer handle the Federal Excise Tax on his records ?

13. What happens when a small retailer handles merchandise of which only a part is subject to the State Sales Tax?

14. How does a small retailer record sales tax on his records?

15. What relationship do records have to credit and collections?

16. What are some of the pitfalls of slow accounts?

17. How may these be reduced and/or eliminated by sound record-keeping?

18. What are some of the techniques of credit that small business should consider?

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This selected bibliography is composed of books, articles, and scripts that are considered useful in a study of record keeping and credit in small business. Many of the cited publications may be obtained in libraries, bookstores, and from the publishers. Others, although not widely available, were considered to be of such value that they were included in the list. The free SBA leaflets listed may ordinarily be obtained from the nearest SBA office. Where book prices are known, they are noted in parentheses. An asterisk indicates acknowledgment to the authors and publishers for material that was of substantial value in preparing this volume.

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☆ U. S. GOVERNMENT PRINTING OFFICE : 1964 O - 737-136

SMALL BUSINESS ADMINISTRATION
LISTING OF FIELD OFFICES

Agana, Guam
Albuquerque, New Mexico
Anchorage, Alaska
Atlanta, Georgia
Augusta, Maine
Baltimore, Maryland
Birmingham, Alabama
Boise, Idaho
Boston, Massachusetts
Buffalo, New York
Casper, Wyoming
Charleston, West Virginia
Charlotte, North Carolina
Chicago, Illinois
Clarksburg, West Virginia
Cleveland, Ohio
Columbia, South Carolina
Columbus, Ohio
Concord, New Hampshire
Dallas, Texas
Denver, Colorado
Des Moines, Iowa
Detroit, Michigan
Fargo, North Dakota
Hartford, Connecticut
Helena, Montana
Honolulu, Hawaii
Houston, Texas
Indianapolis, Indiana
Jackson, Mississippi
Jacksonville, Florida
Kansas City, Missouri
Knoxville, Tennessee
Little Rock, Arkansas

Los Angeles, California
Louisville, Kentucky
Lubbock, Texas
Madison, Wisconsin
Marquette, Michigan
Marshall, Texas
Miami, Florida
Minneapolis, Minnesota
Montpelier, Vermont
Nashville, Tennessee
Newark, New Jersey
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Omaha, Nebraska
Philadelphia, Pennsylvania
Phoenix, Arizona
Pittsburgh, Pennsylvania
Portland, Oregon
Providence, Rhode Island
Richmond, Virginia
St. Louis, Missouri
St. Thomas, U. S. Virgin Islands
Salt Lake City, Utah
San Antonio, Texas
San Diego, California
San Francisco, California
Santurce, Puerto Rico
Seattle, Washington
Sioux Falls, South Dakota
Spokane, Washington
Syracuse, New York
Washington, D. C.
Wichita, Kansas

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- GREY — The Lesson Plan
- RUST — The Presentation
- BUFF — The Visual Aids
- GREEN — The Supply Department
- YELLOW — Cases in Point
- BLUE — The Incubator