SMALL BUSINESS PRACTICES IN MUNCIE

An Honors Thesis (ID 499)

by

Tamara Sample

Thesis Director

[Signature]

(advisor's signature)

Ball State University

Muncie, Indiana

May 23, 1986

Expected date of graduation (Spring/1986)
SMALL BUSINESS PRACTICES IN MUNCIE

PURPOSE

The purpose of this study is to examine the finance and accounting practices of small businesses in Muncie, and to determine whether or not their results will be in line with the findings of Grablowsky and Rowell six years ago.

JUSTIFICATION

From 1976 to 1982, nearly 1.3 million small businesses failed from an original small business population of 4.3 million (Statistical Abstract of the United States). That is approximately one out of every three small firms. This high mortality rate discourages many people from pursuing a dream of owning their own business. Since 1982, business has been through a recession which pushed many small businesses under. As the country prepares itself for what may or may not be still another recession, small businesses need to look for areas they can change in order to survive economic conditions (Posner, March 1986, p. 113). By studying small businesses in the Muncie area, I hope to find some of the common problems. Once the problems have been pointed out, business managers can take steps to correct them.

The shift toward small service and retail businesses in the last few years is another reason for the study. In the retail industry alone, small shops now account for 55% of the total market share (Buchsbaum, p.66). And the service sector is the fastest growing sector of American business today. As these small businesses become more and more competitive, managers will
want to know what they are failing to do and how they can change to run their business better.

LITERATURE REVIEW

Nearly all the literature I read fell into one main conclusion category. They concluded that for the most part small business managers are focused on the short-term and do not plan for the unexpected. One offered suggestions for successful business strategies. Although no studies similar to Brigham and Rowell's 1980 survey were found, the following literature was analyzed related topics.

A recent study by Brigham indicated that managers do in fact use very little quantitative analysis when they manage inventory. They primarily rely on subjective judgement. He concludes quantitative methods could reassure them that they are making the right choices when investing in one of the firm's most costly assets, inventory (Brigham, July 1984, p. 59).

In another study by O'Neill and Duker, the findings indicate that the two most successful strategies for small firms are the prospector and defender strategies. The prospector strategy must maintain sharp price competitiveness, so financial practices become important as profit margins decrease. Defender strategists need solid financial practices because they must pay close attention to their costs. They focus on the product rather than the customer (O'Neill and Duker, Jan 1986, p. 30).

My survey was developed based on the following study. In 1980, Professor Bernie Grablowsky and Dexter R. Rowell of
Dominion University conducted a survey and analysis of small businesses in the Norfolk, Virginia area. They found that small businesses in that area indeed did not follow the practices which were taught. Their findings are listed in Brigham's text, *Fundamentals of Financial Management*. In summary, small business managers did not follow cash management strategies. Nor did they have a credit policy per se. They had no quantitative method to balance inventory. They did take discounts for the most part but did not realize how much they were actually paying for trade credit. Most of the managers did not use criteria such as net present value, internal rate of return, or even payback for capital budgeting. The equity in the firm was the owner's investment, and no efforts were being made to seek other long term funds. The conclusions stated that the small business managers were so heavily involved in day-to-day functions that they failed to plan for the long-term which may have been the reason for such high mortality rates in small businesses (Cited from Brigham, p. 770).

In another recent article in *INC.* magazine entitled "Real Entrepreneurs Don't Plan," the author hypothesized based on his interviews that many entrepreneurs are actually afraid to plan. It is much easier for them to get into the business activities than to try to determine a long-term projection for capital needs. Richard Chambers, president and chief operating officer of Nashville City Bank & Trust Co., stated, "From my experience, most small-business men don't even think about the forces that
affect them. And when those conditions begin to change, they don't know what's hit them, let alone what to do about it." (Posner, Nov 85, p. 130). The article concluded that the best way to beat the competition in the marketplace was to plan and be prepared for the unexpected even if it did not happen.

METHODOLOGY

To obtain data for my study, I contacted 50 small businesses in Muncie and conducted phone interviews with 30 of those. At each business I spoke with the accountant, bookkeeper, owner-manager, or a combination of the three depending on who was ultimately responsible for the determination and execution of various financial policies.

The survey included 28 questions involving cash, accounts receivable, inventory, accounts payable, and capital budgeting management policies. It also asked about the type of the firm, determination of sources and uses of funds, and the policy for obtaining long-term funds. Each business was categorized by the number of employees including the owner-manager.

The businesses selected had to meet Brigham's definition of small business. For retail stores the cutoff was $2.5 million in sales; and for service businesses, the cutoff was $2.0 million in sales. They also had to have policies for the areas which I queried about except one. But for the most part, all the firms did have definite practices in each of the areas.

Realizing that businesses often do use certain techniques but may not use the same terms as I when referring to them, I did
explain the techniques involved in the questions whenever necessary. However, in doing so, I tried not to indicate which of the alternatives I personally felt was the proper choice. I tried to maintain a neutral and unbiased role in the questioning.

I found the names and numbers for the small businesses in the yellow pages in the most recent edition of the local telephone directory. Rather than call businesses at random, I selected them. By doing so, I was able to obtain a wider variety in the type, size, and location of the business. Those I chose were mostly retail and service businesses. I selected those categories because the Small Business Administration recognizes those groups as the primary areas of small business. I tried to select some that were well-known in the city and others which were not so well-known, some that had many employees and some that had few, and some which were located near the university and others which were not.

The questions which I used in my survey are listed at the end of this report.

RESULTS

Considering the test group as a whole, over half did not prepare any type of cash budget. Many were from seasonal businesses where revenues and expenses were quite volatile. Nonetheless, they felt they just knew "from experience" how much they should spend and how much revenue they would pull in. In addition, many had not even heard of such a budget.
Of those firms which did prepare a budget, the most common time sector within the budget was a month. In this area they followed the standardized practice of annually preparing a budget for each month of the upcoming year. However, a few of the firms did prepare a budget for the year as a whole and for semi-annual periods rather than monthly ones.

The most commonly complained about area was accounts receivable. Although 87% of the firms extend credit to customers to increase sales, nearly half of those do not have even a minimal credit checking policy. By minimal, I mean they do not even ask for a reference or query their other colleagues. This could lead easily to lending to bad-risk customers.

Fifty-four percent of the businesses do have a credit checking procedure. Usually customers simply fill out an application and their credit is checked at the local banks. They feel that such a policy is necessary to protect themselves, and with good cause since they are carrying all of their receivables themselves.

Unfortunately, three-fourths of those extending credit do not try to speed up the collection of their accounts receivable. Overall, I found that most of them did not realize that their receivables had an opportunity cost and could be invested in their other necessities if only the receivables were collected early. A very few offered discounts of 1/10, n/30 or 2/10, n/30.
Fifty percent had a finance charge of some type for overdue accounts. The typical charge was 1.5% per month. For all their good intentions about discouraging late payments, only a little over half of the managers actually enforced the policy. One-fourth of the managers enforced it leniently, often deferring it until after 60 days. The last quarter did not bother to enforce it at all.

As far as aging accounts receivable was concerned, it was a draw. Half aged them; half did not. However, in this area in particular many of the small businesses mentioned a reliance on computer software. Some of the firms which do not presently age their receivables will soon do so, as they are in the process of installing an office computer system which will handle it.

Inventory was typically monitored through observation and experience. When asked about a quantitative method, they often responded that in their line of business it just wasn't necessary. This was very much in line with the responses discussed in Posner's article. All in all 63% of the businesses had no quantitative method for inventory.

Almost half of them did, however, calculate inventory turnover, reordering points, carrying costs, or reordering costs through their accounting system. This too was often mentioned as a duty of a software package. Usually, the turnover ratios and reordering points were monitored more closely than the costs.

Accounts payable was another area which was studied. An overwhelming 87% of the businesses did try to take most or all of
the discounts of the discounts available to them. But nearly every manager was quick to point out that in the last couple of years nearly all of their discounts have disappeared or decreased drastically. The typical discount was 1/10, n/30 or maybe 2/10, n/30 if they were lucky.

Although they did try to take the discounts, most of the managers had no idea about the cost they were paying for trade credit. Sixty-three percent thought that the cost to them when they missed a discount, if it was considered a cost at all, was equal to or very near the specified 1% or 2%. They had no comprehension that a 2% discount missed cost them 37%. Indeed, most of them thought it quite humorous that I would even ask if they would borrow money from the bank at current interest rates in order to take a 2% discount.

Fifty-seven percent made no effort at all to slow down their disbursement. They often pay as soon as they receive the invoice or as soon as they have an adequate cash inflow. Unpredictable cash flow was cited most often as the reason for not "taking the gamble" by holding it until the end of the payment period or discount period.

In the area of capital budgeting, the businesses for the most part did not bother to follow any guidelines or criteria at all. In particular, only one of the businesses I spoke with used NPV or IRR. That particular business used both. The other businesses did use their own criteria based on estimated volume of sales, earnings, or the accounting formula for ROI. However,
for the most part they did not consider the time value and cash flows.

The next area was the business type. Most of the firms were incorporated. Specifically, 63% were corporations, and 10% were Sub-S corporations. This clearly reflects the owners' desire to take advantage of the limited liability associated with a corporation. However, among those which were not incorporated, 88% were sole proprietorships. This led me to conclude that partnerships are much more likely to incorporate than sole proprietorships in small business.

For every one of the firms, the primary source of equity was the owner's personal investment with very few others investing. Other long-term funds always came from a bank if they were necessary and allowable. Two of the firms refused to have any debt in their capital structure. One firm in particular had been in the family for three generations and had never had any debt. Unfortunately, that aspect which the grandson prided himself on also prevented him from leveraging a firm that was secure enough to endure several decades of economic shifts. But overall, the businesses considered the local bank the only source of outside long-term funding.

Sources and uses of funds can be evaluated often to indicate what area is "eating up" excessive funds and what area is generating more funds than expected. This process is required annually in the preparation of The Statement of Changes in Financial Position. Of the firms I spoke with in the survey, 73%
only evaluated sources and uses of funds for the annual statement. The others usually evaluated them if they felt they were needed to make a decision. Only 13% made a sources and uses statement on an established time period, such as quarterly or monthly, so they could monitor the business.

From a more focused aspect, there are exceptions to the overall findings when the test group is broken down into three groups by number of employees: 1-9, 10-19, 20 & up. In the next section, I will point out those exceptions.

Although the overall consensus for the cash budget indicated that over half of the small businesses did not prepare a cash budget, in the 10-19 group 70% of the firms did prepare one. This indicates that the large and small group weighted the overall data heavily.

In accounts receivable management, the 1-9 group differed substantially from the overall results. Among the businesses which extended credit, most did not try to speed up the collection of the receivables. The 1-9 group was an extreme case of this. In that employee group, 92% of the businesses made no attempt to speed receivables. This group also deviated from the norm as far as credit checking procedures were concerned. Overall, 54% had a credit checking procedure; whereas in the 1-9 group, 67% did not. Finally, the overall results reflected half of the businesses aged their receivable, while half did not. Actually, over two-thirds of the medium and large groups did age
their receivables, but that was balanced by the fact that three-fourths of the 1-9 group did not.

As far as inventory is concerned, in the overall picture 63% did not have a quantitative method to optimize inventory. However, it should be noted that in the 20 & up group, 67% of the firms did utilize a quantitative method. Therefore, it was the small and medium groups which pulled the overall result down. Also, the presence of an inventory method which allows the manager to calculate turnover ratios, reordering points and costs, and carrying costs proved to be in just under half of the firms. This was weighted downward heavily by the 1-9 group which reported that 71% of its members did not have an inventory system which could perform those tasks.

Looking at the accounts payable, a little over half of the whole test group did not try to slow disbursement. The 10-19 group was an extreme case. Eighty percent of that group did not slow disbursement; whereas 67% of the 20 & up group did try to slow all outlays of cash.

As far as capital budgeting results are concerned, the overall picture showed that approximately two-thirds of the firms had no criteria. Actually, the 10-19 and 20 & up groups were fairly even, but it was the small 1-9 group which once again pulled the average down. Eighty-six percent of that group had no criteria.

Sources and uses of funds were usually evaluated only on an annual basis for the required accounting reports. However, among
the 10-19 group, 50% of the businesses calculated them monthly. The group's effort is outstanding compared to the others in this area.

CONCLUSIONS

Overall, the survey does indicate that the practices of small business managers in Muncie today are very similar to those in Grablowsky and Rowell's survey and analysis in Norfolk, Virginia six years ago. For the material tested, the results of this study have a positive correlation of 0.7113 with the results of Grablowsky and Rowell's survey and analysis. This correlation was derived based on the following comparisons.

************************************************************

COMPARATIVE RESULTS

<table>
<thead>
<tr>
<th>TOPICS</th>
<th>G&amp;R</th>
<th>SAMPLE</th>
</tr>
</thead>
<tbody>
<tr>
<td>Variables for correlation equation</td>
<td>(y)</td>
<td>(x)</td>
</tr>
<tr>
<td>Prepare a cash budget-----------yes</td>
<td>30%</td>
<td>40%</td>
</tr>
<tr>
<td>Speed up collection-------------yes</td>
<td>34%</td>
<td>27%</td>
</tr>
<tr>
<td>Slow disbursements-----------------------yes</td>
<td>34%</td>
<td>43%</td>
</tr>
<tr>
<td>Credit check procedure-------------------no</td>
<td>95%</td>
<td>46%</td>
</tr>
<tr>
<td>Late charge enforced----------------------yes</td>
<td>50%</td>
<td>27%</td>
</tr>
<tr>
<td>Age accounts receivable-------------------no</td>
<td>34%</td>
<td>50%</td>
</tr>
<tr>
<td>Quantitative inv. method to optimize inv.</td>
<td>6%</td>
<td>37%</td>
</tr>
<tr>
<td>Inv. system allows costs &amp; turnover ratios</td>
<td>54%</td>
<td>53%</td>
</tr>
<tr>
<td>Take discounts on payables----yes</td>
<td>69%</td>
<td>87%</td>
</tr>
<tr>
<td>Cost when miss discount----------equal</td>
<td>40%</td>
<td>63%</td>
</tr>
<tr>
<td>Criteria for capital budgeting--no</td>
<td>50%</td>
<td>67%</td>
</tr>
<tr>
<td>Primary source of equity--------owner</td>
<td>100%</td>
<td>100%</td>
</tr>
<tr>
<td>Long-term funds--------------------------bank</td>
<td>100%</td>
<td>100%</td>
</tr>
</tbody>
</table>

************************************************************

There are a few topics which I was unable to compare with Grablowsky and Rowell. The effect of the lack of a credit checking policy would be observable if the specific sales and bad
debts figures were available. Unfortunately, local business owners were not willing to divulge that information. They also would not release figures relating to the amount of capital invested in inventory which Grablowsky and Rowell do cite in their study.

The subject of criteria for capital budgeting was not limited to NPV, IRR, NTV, PI, or payback methods. This was done primarily due to the fact that from the answers I was receiving, I felt they were using cash flows analysis to some degree in their criteria. However, whenever I would mention the previously listed terms, the manager inevitably did not understand exactly what I meant and "read" too much into the question.

The question relating to whether or not the manager would borrow in order to take a discount on accounts payable was difficult to obtain a straight answer from. The managers often qualified their answers by saying that if the amount was large enough they would borrow. However, since they had small businesses, the invoices were rarely large; therefore, the discounts were not really worth the effort. One manager stated that his typical discount would amount to $0.50 per invoice.

The findings of this study are of course limited due the potential for error inherent in any survey. For instance, not every small business advertises in the yellow pages. And although I tried to remain unbiased in my approach, perhaps I asked the question different ways to different people. Finally, the data base was fairly small even though it was representative
of several small businesses in the two categories which make up a large portion of small businesses. The values which seem to be so definite, such as 100%, are of course subject to change as the data base grows larger.

Even with the limitations mentioned, the study did show that Muncie small business practices are similar in many ways to the practices in the previous study; and some improvements have evolved. Hopefully, this thesis will provide information to small businessmen in the area and see the area in their particular businesses which need improvement.
QUESTIONS FROM SURVEY

1. Would you classify your business as retail or service?

2. How many employees, including the owner, work for your business?

3. Can you give me a rounded figure which estimates your sales from last year?

4. Do you prepare a cash budget?

5. What is the periodic breakdown within the budget?

6. Do you extend credit to customers and carry your own receivables?

7. Do you try to speed up collections of your accounts receivable? In other words, do you have a policy which encourages customers to pay before the actual due date?

8. Do you have a credit checking procedure for those customers who would like credit?

9. Do you have a charge for late payments?

10. What is the typical charge?

11. Is it strictly enforced, leniently enforced, or not enforced?

12. Do you age your accounts receivable? In other words, do you classify them into groups like less than 30 days, 30-60 days, 60-90 days, etc.?

13. What is the amount of your average bad debt as a percent of sales?

14. What percent of your capital is invested in inventory?

15. Do you use a quantitative method to determine the optimal level of inventory, that inventory level which does not cost too much for you to maintain but is enough to meet customer needs?

16. Does your inventory system allow you to generate inventory turnover, reordering points, ordering costs, or carrying costs?

17. Do you take discounts on your accounts payable?

18. What is a typical discount on accounts payable?
19. If you had a choice between (A) missing a discount on an account payable or (B) borrowing from the bank to pay the bill and take the discount, which would you do?

20. When you miss a discount of ((their typical discount)), what do you consider the cost to you to be?
   (A) Much greater than ((typical discount))
   (B) A little greater than ((typical discount))
   (C) Equal to ((typical discount))
   (D) Less than ((typical discount))

21. Do you try to slow your disbursements? In other words, do you time your payment so that it just arrives at the end of the discount or payment period, or do you attempt to pay your bill as soon as you have enough cash available?

22. When you evaluate a new capital budgeting project, such as an expansion, buying new equipment, carrying a new line of products, or moving to a new location, do you have any formal criteria that you use to decide whether or not the project will be good for your business in the long run?

23. What is your criteria?

24. Do you use IRR, NPV, NTV, PI, or payback?

25. Is your business a sole proprietorship, partnership, corporation, Sub-S corporation?

26. What is the primary source of equity in the firm?

27. Where would you seek other long-term funds if you needed them?

28. Do you evaluate sources and uses of funds more often than for the annual year-end statement of changes in financial position?
THE RESULTS OF THE SURVEY

<table>
<thead>
<tr>
<th></th>
<th>OVERALL</th>
<th>(1-9)</th>
<th>(10-19)</th>
<th>(20 &amp; UP)</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>YES</td>
<td>NO</td>
<td>YES</td>
<td>NO</td>
</tr>
<tr>
<td>Cash budget?</td>
<td>40%</td>
<td>60%</td>
<td>21%</td>
<td>79%</td>
</tr>
<tr>
<td>Credit?</td>
<td>87%</td>
<td>13%</td>
<td>86%</td>
<td>14%</td>
</tr>
<tr>
<td>Speed A/R?</td>
<td>27%</td>
<td>73%</td>
<td>8%</td>
<td>92%</td>
</tr>
<tr>
<td>Credit check?</td>
<td>54%</td>
<td>46%</td>
<td>33%</td>
<td>67%</td>
</tr>
<tr>
<td>Late charge?</td>
<td>50%</td>
<td>50%</td>
<td>42%</td>
<td>58%</td>
</tr>
<tr>
<td>Enforced?</td>
<td>54%</td>
<td>33%</td>
<td>100%</td>
<td>----</td>
</tr>
<tr>
<td>Lenient?</td>
<td>23%</td>
<td>50%</td>
<td>----</td>
<td>----</td>
</tr>
<tr>
<td>Not enforced?</td>
<td>23%</td>
<td>17%</td>
<td>----</td>
<td>100%</td>
</tr>
<tr>
<td>Age A/R?</td>
<td>50%</td>
<td>50%</td>
<td>25%</td>
<td>75%</td>
</tr>
<tr>
<td>Quant. inv.?</td>
<td>37%</td>
<td>63%</td>
<td>21%</td>
<td>79%</td>
</tr>
<tr>
<td>Inv sys allow turnover and costs?</td>
<td>47%</td>
<td>53%</td>
<td>29%</td>
<td>71%</td>
</tr>
<tr>
<td>Disc on A/P?</td>
<td>87%</td>
<td>13%</td>
<td>79%</td>
<td>21%</td>
</tr>
<tr>
<td>Cost?</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Little &gt; disc</td>
<td>12.5%</td>
<td>21%</td>
<td>10%</td>
<td>33%</td>
</tr>
<tr>
<td>Equal to disc</td>
<td>63.0%</td>
<td>71%</td>
<td>70%</td>
<td>67%</td>
</tr>
<tr>
<td>Less than disc</td>
<td>12.5%</td>
<td>8%</td>
<td>20%</td>
<td>---</td>
</tr>
<tr>
<td>Slow disbursements?</td>
<td>43%</td>
<td>57%</td>
<td>50%</td>
<td>50%</td>
</tr>
<tr>
<td>Criteria for projects?</td>
<td>33%</td>
<td>67%</td>
<td>14%</td>
<td>86%</td>
</tr>
<tr>
<td>Type of firm?</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Sole proprietor</td>
<td>23%</td>
<td>36%</td>
<td>10%</td>
<td>17%</td>
</tr>
<tr>
<td>Partner</td>
<td>4%</td>
<td>7%</td>
<td>---</td>
<td>---</td>
</tr>
<tr>
<td>Corp</td>
<td>63%</td>
<td>36%</td>
<td>90%</td>
<td>83%</td>
</tr>
<tr>
<td>Sub-S Corp</td>
<td>10%</td>
<td>21%</td>
<td>---</td>
<td>---</td>
</tr>
<tr>
<td>Primary Source of Equity</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Owner</td>
<td>100%</td>
<td>100%</td>
<td>100%</td>
<td>100%</td>
</tr>
<tr>
<td>Other L.T. Funds</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Bank</td>
<td>100%</td>
<td>100%</td>
<td>100%</td>
<td>100%</td>
</tr>
<tr>
<td>Evaluate S&amp;U?</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Annually</td>
<td>73%</td>
<td>100%</td>
<td>30%</td>
<td>67.0%</td>
</tr>
<tr>
<td>Quarterly</td>
<td>3%</td>
<td>----</td>
<td>10%</td>
<td>---</td>
</tr>
<tr>
<td>Monthly</td>
<td>10%</td>
<td>----</td>
<td>50%</td>
<td>16.5%</td>
</tr>
<tr>
<td>As needed</td>
<td>14%</td>
<td>----</td>
<td>10%</td>
<td>16.5%</td>
</tr>
</tbody>
</table>

***********************************************
BIBLIOGRAPHY


