Financing the small business; Management services by CPAs, 3

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Financing the Small Business
This is the third in a series of five bulletins on Management Services by CPAs available on a subscription basis at $10. Additional copies may be ordered at $3.50 each.
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To the reader

§ Finding money with which to grow is a major problem of the small business community.
§ The high cost of borrowing by small concerns and the dearth of risk capital available to them complicates the problem.
§ The reason cited most frequently for rejection of small business requests for loans is "defects in management." Here is additional evidence of the need of small business for the help and advice of the CPA.
§ This bulletin is devoted to the areas of financial management in which CPAs can provide valuable assistance to small business managements in meeting their financial needs.
§ The objective of the bulletin is limited—to provide a review of the financial world in which the CPA's clients do business, and to provide ideas which the local CPA may use in advising his small business clients where to find and how to obtain money.
Financing the Small Business

THE FUNCTION OF THE CPA IN THE FINANCIAL MANAGEMENT OF SMALL BUSINESS

Finance is a vast field of study. It cannot be treated as a separate subject, but must be discussed in its elements. A CPA may be called upon to render advice to small business on problems within many of the areas of finance and should be competent to assist to some extent in any of them. Since all of the areas cannot be covered in a single bulletin, this bulletin will review the four areas of the greatest importance to the successful financial management of small business.

Simply stated, they are:

1. The determination of the financial requirements of small business clients.

2. Methods and sources of financing for small business clients.

3. Assisting small business clients in obtaining funds.

4. The dynamic financial world—its relation to the financial management of small business.

This bulletin will not discuss such important areas of finance as the investment of idle funds (few small businesses are afflicted with this happy problem) and, the tax considerations that vitally affect all financial decisions (CPAs are conversant with these factors).

The treasurers of larger companies devote perhaps a majority of their time and attention to the four financial areas explored
in this bulletin. It is generally felt that the large company treasurer is required to concentrate on these areas in a degree of intensity not necessary in the smaller business. But, is this really true? While the treasurer will have to exhibit a highly trained skill in determining how a million dollar merger may be adequately financed, the same basic problems will confront a CPA advising on the merger of two smaller businesses. Only the figures change. Moreover, as the figures on the balance sheet grow smaller, the financing problems can sometimes become larger.

The determination of the short- and long-term financial requirements of the smaller, growing business, the choice it elects as to type of organization and the determination of its capital structure are as important and often as complex as that of a company listed on the New York Stock Exchange. CPAs can regularly aid their clients in planning their financial requirements and can provide valuable service in assisting in the mechanical methods which are often necessary to make an adequate determination.

For the larger company treasurer, it can often be a difficult task to continually find new sources of capital for a rapidly expanding operation. No matter how difficult for the big company, it is even more difficult for the smaller business. To function as a public treasurer to small business managements, a CPA must know at least as much about methods and sources of financing as the private treasurer, as his knowledge must extend to the many sources available only to small business.

While a competent CPA may never be able to assist an insolvent client in obtaining a loan merely through excellent presentation of a loan application, he can still provide valuable assistance in raising the credit worthiness of his clients in the eyes of lenders. In spite of a large company's firmly established basic credit worthiness, its treasurer may still be confronted on occasion with the problem of raising every cent of borrowed funds that he can find. Only through translation of the financial planning to budgets, forecasts, cash flow and historical trend statements is the treasurer able to convince a lender and himself that capital requirements will not result in overextension or borrowing of excess funds at needless cost.
Through the presentation of supplementary data by a CPA, a lender can often be instilled with a confidence that a small business loan can be repaid before it is made, and otherwise marginal situations may often become acceptable. If these presentation techniques are of assistance to the credit worthiness of big business, who can deny their value to the smaller business whose basic credit worthiness offers a prospective lender so much less as a starting point?

The corporate treasurer must keep abreast of economic conditions, capital markets and money availability and its related cost, inasmuch as these factors are vital in the financial management of his large company. During periods of credit restraint, for example, lending agencies logically raise their credit standards to all sizes of borrowers. Since small businesses generally are not as credit worthy as large businesses, and since their credit worthiness tends to deteriorate more rapidly, the various credit restraints and accelerations affect small businesses more adversely than large businesses. With a continuing knowledge of the economic picture, and of the outlook for changes in the money market, particularly on a regional basis, the CPA can become a better public treasurer to small business.

There is no reason why every CPA cannot supplement small business managements competently in these areas of finance. It will require additional time and effort on the CPA's part, and several of the functions must be continuously applied and reviewed. Small companies with potential can only grow at a rate in direct relation to their ability to finance expansion. As clients expand, of course, so will the extent of the CPA's services.
THE DETERMINATION OF THE FINANCIAL REQUIREMENTS OF SMALL BUSINESS CLIENTS

The forecasting of financial requirements lies at the heart of the financial management of any company.

There are no statistics on the number of small businesses that make formal forecasts of their financial requirements. However, since only a small percentage do any budgeting, it is doubtful that many have formalized their financial planning.

The extent of formality required in the financial planning of the small and medium-sized business will vary from company to company. Although the need for planning in the small company is as great or greater than in the big one, the job is likely to be easier. The more intimate knowledge of the affairs and plans of a smaller company by the few management people and the CPA can result in a high degree of accuracy.

How does a smaller company go about formally planning its financial requirements?

The determination, of course, must be broken into two parts—the need for short-term funds and the need for long-term funds. While each will affect the other to some extent, seasonal needs within the annual financial cycle of any company will ordinarily bear no specific relation to the long-term planning of its capital requirements or long-range expansion needs. It is never adequate merely to plan cash flow for the next ninety days in a small business that is looking forward to growth. There are many, probably a majority, of small businesses that informally plan their cash flow for the next few weeks. This practice, however, is often defensive in nature. In other words, can the payroll be met and will officers’ salaries or partners’ draw stand at least an even chance of being paid in regular installments? Yet, many of these
rudimentary forecasters want to see their businesses grow. While this defensive forecasting theoretically qualifies as financial planning, it contributes little or nothing to an over-all plan for expansion.

Nonetheless, these "forecasters" are on the right track. To determine if the payroll will be met on Saturday, the owner of a small machine shop knows that all he need do is add estimated receipts to his check book balance and his financial planning has been satisfied until next week. The fundamental steps in short-term forecasting have been performed, identical in principle with methods used by General Motors.

Short-term cash forecasting for a business, big or small, is not particularly difficult. Installation of a system of short-term cash forecasting is a management service area in which few, if any, doubts arise with respect to the competence of the CPA.

There are several methods of projecting short-term financial requirements. One is the familiar approach of directly estimating cash receipts and disbursements. Other methods can become considerably more technical. While the technical methods can, in some cases, enhance the value and accuracy of forecasting, they still, nonetheless, involve and rely on judgment and an understanding of the kinds of operations in which the company is engaged. Attention is best given here to a limited review of only the traditional approach, and how it may effectively be employed in the small and medium-sized business. While this bulletin will not be a study course in short-term forecasting, a few of the principles, approaches and end results will be reviewed.

1. The answer to providing accurate forecasts at close periodic intervals lies in the utilization of an operating budget system. If budgetary detail is not available, however, sound estimates can often be developed from data available in any company that employs even the simplest accounting system. It is obviously impossible to forecast cash requirements without knowing what will occur. The client who forecasts his cash requirements for any reasonable period of time without a formal budget program being in existence, probably has only to formalize the process in order to develop an operating budget, as a good deal of the operational planning will have been performed within the fore-
casting of cash requirements. Actually, the forecasting of cash is the conversion of an estimated income statement for a future period into a statement of receipts and expenditures. Forecasting can become simple and accurate if a budget system has produced a formal estimated income statement.

2. There is no magic formula to the forecasting of cash requirements. It is a matter of logically resolving, to written figures, facts and estimates that are already known. The cash forecast will emerge out of the application of historical relationships to these facts and estimates. By reducing the forecast to writing experience dictates that the resulting figures often differ sharply from those previously envisioned by the management. As in budgeting, the system and methods selected for cash forecasting will vary in each circumstance.

3. Financial planning of short-term requirements should include estimates of events throughout an entire cycle of operations. A forecast of financial condition at widely spaced intervals can be entirely inadequate because of seasonal and other fluctuations. Like budgeting as a whole, cash forecasting is a spiral thing. It must be reviewed continuously and should continually project the entire cycle of the business. If this is not done, most of its advantages will be lost.

What are the primary advantages of cash forecasting? How can this technique add to the profits of a smaller business?

1. Forecasting of cash will indicate, well in advance, the need for obtaining funds from outside sources and can determine accurately the duration of loan requirements. The cost of borrowed money is always low, regardless of rate, when it is producing a profit, but it is always expensive, even at the lowest going rate, if the funds are left idle.

2. Conversely, cash forecasting will enable intelligent planning of the investment of idle funds. There are few small businesses that are afflicted with this problem, but for those that are, the investment of even a few dollars determined to be unneeded can raise profits.

3. It provides for the preplanning of tax payments, or liquidation
of obligations and dividend payments. In the large corporation, cash forecasting enables the treasurer to co-ordinate the cash needs of divisions and subsidiaries. In the smallest business, it assists in planning the proprietor’s draw and in turn assists him in his personal budgeting.

4. Cash forecasting will often enable the small business to avail itself continuously of purchase discounts and permit planning of forward purchasing. Both will increase profits.

5. A cash forecast will assist in obtaining loans or arranging for loans or lines of credit well in advance of actual need. A continual cash forecasting process, if proved to be sound to lenders, can always benefit the credit standing of any company. Reliable cash forecasts are the best method of proving to a lender that a loan will be repaid even before it is made.

6. Short-term forecasting, in turn, lies at the heart of, and serves as a starting point for, long-range cash projections. The long-range forecasting is, in turn, of significant value to any business. The primary advantages of the long-range forecasting, now made easier, will be the determination of over-all long-range financial policy, which must be firmly established on a formal basis. Long-range policies and planning are constantly under review of our national corporations. It is an equally important function to the entrepreneur who would like to add a third bakery to his “chain” two years from now.

From short-term forecasting, longer range projection will stem. Only by long-range projection will sound financial policy and growth plans be determinable.

The CPA who convinces his client of the desirability of cash forecasting should not feel he has provided management with all of the tools for determining financial requirements. The advice a CPA can render in this area goes far beyond this. The forecasting will merely indicate when funds will be available or when they must be obtained from outside sources.

There are other elements to be continuously preplanned. In view of the primary determination of needs, which the forecasting will satisfy, a CPA must next provide answers to at least the following questions.
1. Will the projections of cash, determined to be available from internal sources, be adequate to meet planned requirements? If not, where will the additional funds be found? Based on projections of the financial position, what can be expected of lenders? If bank loans will not be available to the extent of requirements, which other sources should be considered and perhaps contacted at this time?

2. Does the present type of business structure enable the client to fulfill adequately his financial needs? Which form of organization will result in the largest rate of return to the owners of the small business? Will this be compatible with the quest for additional funds? The capitalization of the corporation, for example, must be balanced to provide for the greatest profit potential while creating a structure that will prove advantageous in arranging for future financing. The optimum capital structure, to accomplish each of these objectives, is generally at complete opposition with each other. For example, the small company that elects debt financing may obtain tax benefits and a high rate of return on equity capital employed in the short run, but it must then accept the risk of encountering greater difficulties in raising future capital. Will the capital structure be too “thin,” in view of the planning? While this and other tax considerations entering financial planning will not be explored in this bulletin, they can never be forgotten by the CPA.

3. What type of financing will be required? Are short-term funds adequate or do projections and plans indicate a need for intermediate or long-term funds? Does the analysis disclose that additional permanent capital is required?

In short, where will the money come from, and what additional planning—now—will help to assure its availability when needed?

If the client is a proprietorship, state usury laws may preclude him, for example, from accounts receivable financing with a commercial finance company. If this form of financing can be profitable, and may be the only available method, the CPA will have to consider carefully the pros and cons of business structure in providing advice on financial management.

There are other considerations within each individual business.
If small business, however, is guided properly by the CPA in determining its financial requirements through cash forecasting and in the other financial planning areas these few pages have suggested, many financially weak small businesses will be strengthened and many growing businesses will grow at an even faster rate.
METHODS AND SOURCES OF FINANCING
FOR SMALL BUSINESS CLIENTS

One of the most valuable services a CPA can give his clients is guidance to sources of funds. Although there are many sources, the smaller business often looks only to its commercial bank for capital. If a proposal is rejected by the banker, plans for growth, product additions, or new plant and equipment may be discarded.

While the commercial bank is the dominant lender to small business, there are many types of financing available that commercial banks cannot or will not provide. The policies and offerings of commercial banks vary from region to region and even within regions, partly as a result of variations in economic conditions and the money markets. Since CPAs and small business are normally familiar with the offerings of their local banking connections, this bulletin will be devoted to other sources of funds.

Sources should be investigated only after a business has adequately planned its financial requirements and has carefully determined the type of financing which will best satisfy its needs. The sources vary depending on the types of funds required. They will be dealt with here under three categories: short-term funds, intermediate or long-term funds, and permanent funds.

Sources of short-term funds

Before advising a small business to seek short-term funds from any outside source, the CPA should be sure that the available funds aren’t right under the nose of the client. Several lending agencies have expressed concern at the number of small loan
applications they receive for temporary funds that are not actually needed, because internal sources appear capable of generating the funds. The CPA is in the best position to determine whether internal sources are properly exploited before his client needlessly incurs interest cost. The following questions are among those that a CPA should answer, by reviewing his clients' operations, before he goes any further.

1. Does the accounting system and policy followed for income tax purposes generate optimum working capital? For example, has the business elected the most favorable treatment in establishing allowances for bad debts? How about its depreciation policies? Are other tax write-offs fast enough? Is the basis for reporting for tax purposes, cash, accrual, or installment method, best for the retention of cash? Is the client on the proper fiscal basis, or are the bulk of his tax payments due when the working capital is tied up in inventories or receivables?

2. Is the business looking for additional funds while considerable working capital is needlessly tied up in inventories, receivables or other assets that are not properly controlled? For example, a relatively large amount of capital can bury itself in inventories if purchase or production control is lacking. The CPA will often be able to put his finger on balance-sheet items that are taking more than their fair share of the business capital.

3. What of the relations with customers and vendors? Are collection and payment policies sound, or just habit? How long has it been since the collection practices have been reviewed or the selling terms revised? Big business selling terms have been galloping off in all directions in recent years. The pattern is not uniform nor can it be ascertained that there has been a significant trend in any direction. The changes have occurred by industry, by competitive influence and through changing economic conditions. Big business watches its own selling terms continuously, as well as watching the terms offered by principal suppliers. Does the client buy and sell on the best possible terms? Are the collection and payment policies balanced to provide maximum working capital at lowest cost? For example, is the client losing 2 per cent cash discounts from vendors because it is
against "tradition" to offer 1 per cent to customers? A periodic review of these policies by the CPA in collaboration with the management of a small business client can prove fruitful.

There are other internal sources from which cash can be drawn, all of which should be explored before running to outside sources.

**The balance sheet as a source of short-term funds**

The usual assets on the small business balance sheet will often provide the avenues for raising money.

A small business may have established an enviable reputation for paying its debts and for the integrity of its management. While these are of great value in any borrowing negotiation, it generally takes more than a sense of responsibility and integrity to raise more than nominal amounts of funds. The so-called three "C's" of credit—character, capacity and capital—are sometimes not enough to obtain money. Some people add a fourth "C" for competence, or substitute this word for capacity. Others add a fifth for condition; others add an important sixth "C" for collateral.

The assets found on any typical small business balance sheet may be available as collateral for financing purposes and, therefore, become a potential source of funds.

*Accounts receivable* are often available for pledge. Some CPAs apparently still feel that any business that has to "hock" its receivables is on the verge of bankruptcy, but this is no longer a widespread attitude. Many CPAs will know of at least one or more businesses that are currently financing through accounts receivable. It is a prevalent practice, especially among smaller, growing businesses. The sales strategy of many of the smaller aggressive companies demands unusually favorable selling terms of customers. A liberal selling policy will often leave a sizeable, but dormant, asset on the balance sheet. Yet the company may need cash before the asset can be re-employed profitably.

There are a number of ways to convert receivables to cash. The most direct method, of course, is to persuade customers to pay their bills. This can obviously be done, very practically, by merely raising the discount rate for quick payment or allowing anticipa-
A customer can often be persuaded to pay in ten days if he is offered 2 per cent 10-day terms, net, say even ninety days. The customer who is usually sold on extended due dates or other special dating arrangements can sometimes be persuaded to pay quickly if it is pointed out that a 1 per cent discount earned in ten days is worth 36 per cent per year to him. If he retains the funds, where else could he earn this much on his money? If the customer can borrow money at 6 per cent, he will have saved a good deal more than the loan cost. Keep in mind, of course, that it costs the grantor 30 per cent, if funds can be borrowed at 6 per cent! This technique will not always work, but it's worth a try in appropriate circumstances.

Accounts receivable may be taken to some banks for pledge, or purchase, or as general collateral for a line of credit. Individual banking practices vary, however, and CPAs and their clients will be most familiar with the lending arrangements available at local banks.

Accounts receivable provide the principal basis of loans made by commercial credit companies. The companies themselves will be discussed later in this bulletin. First, the techniques. When receivables are pledged with a commercial credit company, the amount received will, of course, be less than the amount pledged. The client may request that customers are not to be notified that his debt has been pledged. If the advance represents 80 per cent of the face amount pledged, the borrower is charged interest only on funds actually received, not on the amount pledged, as is often believed. The words "actually received" are important. The client need accept advances for only the amount of cash he needs, so that he will not be paying interest on excess idle cash. Many finance companies have reported that both the percentage advanced and the cost will vary depending on the circumstances. An industry representative speaking recently before a group of small businessmen stated that 75 to 80 per cent of the total amount of receivables pledged is generally advanced to the borrower. A survey conducted recently by the Federal government found the typical advance to be 80 per cent—with a range, however, of 65 to 85 per cent. Cost, too, is an individual problem. Statistical studies indicate that the cost of this type of financing may range
from 8 to 24 per cent. The median typical rate was 14 per cent and the median highest rate was 16 per cent. The rate will almost always be higher for smaller advances. A small business must expect to face this when it asks a finance company for a proposal. However, in comparing these rates with a straight bank loan at say 6 per cent, it should be remembered that compensatory bank balances, generally of 20 per cent of the outstanding loan, also make the effective bank rate higher.

Per annum interest of 15 per cent seems to be a staggering rate to some CPAs who presumably would never advise borrowing at such a rate. Perhaps they should reconsider. Research into business failures discloses few, if any, that are forced out of business by interest cost. On the contrary, many small businesses have borrowed money at 20 per cent, made 30 per cent on it, and have outstanding records of quick growth to levels which would never have been reached by financing "economically" from retained earnings and "character" loans. The records of many "growth" companies of the country suggest that borrowing cost is never too high if the funds can be employed to produce profits in excess of the cost.

Instead of pledging accounts receivable, the receivables may be sold outright to a factor. This is generally done on a nonrecourse basis—meaning that full liability for collection becomes the factor's problem. It can be arranged that the factor will have recourse, however, in circumstances that require it. Accounts can be sold on a notification or non-notification basis—that is, the customers owing the money will or will not be notified to remit directly to the factor. Non-notification, however, is difficult to arrange and rarely found in practice.

A factor will want to reassure himself of the credit standing of the accounts. Sometimes, of course, he will reject them. A factor who buys accounts makes a flat charge on the face amount, which will vary depending usually on the length of time the accounts have to run. In addition, interest is charged from the time of purchase to the maturity of the account, plus a collection period time allowance, generally of five to ten days. For example, if 1 per cent is the flat charge made on an account that has thirty days to run, this is equivalent to 12 per cent a year and if an additional 6 per
cent per year is charged to maturity, the combined effective cost to the borrower is 18 per cent a year.

Rates charged by factors vary according to circumstances. A recent survey of charges made by factors shows a weighted average typical rate of 6.7 per cent on cash advanced, and a median typical factoring charge of 1½ per cent. As in the case of loans by commercial finance companies, these rates tend to be higher as the volume of receivables purchased becomes smaller. The flat factoring charge is subject to the widest variation. Factors recently reported that they are charging rates as low as one-half of 1 per cent or as high as 2½ per cent.

Will commercial credit companies and factors do business with small business? Many CPAs seem to believe that these facilities are available only to companies generating a large volume of receivables. And many CPAs think that only certain industries can obtain funds from these sources. Research discloses that neither of these points is true.

There seems to be no established minimum of receivables that will be considered for financing by commercial finance companies or factors. Some place the minimum at $50,000, others at $25,000, some still lower; but each statement is hedged with a “depending on circumstances.” A recent survey of nineteen commercial finance companies showed that five of them would consider making loans on receivables to a business doing less than $75,000 in annual sales; five more said they would talk to companies doing $75,000 to $150,000; the next eight preferred a minimum volume in the $150,000 to $375,000 sales range. The minimum amounts of credit which would be advanced by these companies, ranged from $10,000 to $60,000. Fifteen of the companies also stated that they would consider providing financing to businesses having a net worth of no more than $50,000 and even as low as $10,000. Their only other requirements were that a prospective client be potentially profitable, well managed and of good character. They generally prefer that the business be in existence for at least a couple of years. Client location was rarely mentioned as a deterrent to the availability of their services.

These qualifications will exclude the corner drug store, but accounts receivable financing is available from commercial finance
companies to a good proportion of CPAs' small business clients.

While no studies of the qualifications for factoring are available, discussion with factors themselves leads to the conclusion that minimum requirements are generally higher. Only companies having a sales volume of at least $225,000—with say $20,000 of receivables to sell—are likely to interest the factors.

Type of industry appears to be immaterial to commercial credit companies, if other requirements are met. Factoring is most prevalent in the textile and garment field, but in recent years some factors have actively sought and done business in many other industries.

There are many technical considerations with which CPAs should be familiar before they can competently guide a client into any form of accounts receivable financing. While this bulletin attempts only to review the general availability and cost to small business, a few of the advantages and disadvantages of accounts receivable financing ought to be mentioned. Some of the advantages often ease the pain of the high interest cost.

1. Accounts receivable financing either on a pledge or outright sale basis can become a method of long-term financing. This type of borrowing never has to be repaid. The first $100 received, if repeatedly replaced with invoices for the same amount can be retained for use in the business for as long as the money is needed. As sales increase, cash advances also increase in proportion and constitute a revolving fund available as long as required.

2. Accounts receivable financing will affect the current ratio in different ways—and this, in turn, may affect relations with other creditors. Factoring receivables, for example, will almost always improve the current ratio. It is worthwhile to consider in advance what the effect on the current ratio will be in determining whether pledge or sale of receivables is the better arrangement. Obviously, factoring accounts receivable should not be recommended at a typical rate of say 15 per cent per year just because it sweetens the client's balance sheet—particularly if adequate funds are available at cheaper rates.

3. Commercial finance companies and factors can often offer
more than accounts receivable financing. In addition to the other financing offered by commercial finance companies, particularly on inventory, equipment, and conditional sales, they will often provide valuable assistance in helping a CPA and his client in formulating a sound financing program. Factors will also contribute advice, particularly regarding credit arrangements with customers. They are, of course, interested in avoiding losses, and this interest impels them to serve as a built-in credit department for a small business not otherwise able to afford a good credit manager. If accounts are sold to a factor on a notification basis, an obvious advantage is that the collection function, and its costs, are eliminated.

Reliable trade estimates are that at least $11 billion of accounts receivable financing have been serviced by over 400 commercial finance companies and factors in each of the last two years. This is more than two and a half times the amount financed ten years ago. This, even taking into account the impact of inflation, indicates an increasing use of this form of financing. More than 400 commercial finance sources are fairly well distributed throughout the country, but the factors can generally be found only in larger cities, with heaviest concentration in the northeast.

A word of caution in the selection of a finance company or a factor is in order. A reputable finance company or factor will never charge or demand an advance fee. The demand for the advance fee is the practice of the so-called "lender's service agencies" which, in return for the fee, promise to locate a source of financing. The fee is a complete waste of money most of the time. It is far more preferable to consult local banks which can generally provide information or recommend a finance company or factor. If not, the banker can check with a correspondent bank in the nearest larger city. It is advisable to check the credit rating of a finance company or factor. If other measures fail, the National Commercial Finance Conference, Inc. at 29 Broadway, New York City, will provide a roster of members in any area. Investigation and selection, however, will be left to the client.
Installment sales financing

While discussing the availability of funds from accounts receivable, consideration should be given to the possibility of selling the product on installment terms and selling the paper to someone willing to buy it. Has the client given adequate consideration to selling on this basis? The nature of the product will, of course, be a significant factor in determining the feasibility of installment selling. Sales finance companies do not restrict their activity to autos, TV sets and jewelry, as is sometimes believed. If a client's product has a reasonable life, if its value will stay as high as, or higher than, the unpaid installments, and if repossession would not be too costly or impractical, selling "on time" could prove to be a valuable technique in keeping working capital in the business. In addition, it can also prove to be a spur to sales.

Many sales finance companies handle this type of financing only. Some of the commercial finance companies also do so. Some banks offer this financing service beyond the usual auto and appliance loans, but the tendency has been for banks in most parts of the country to become more restrictive in this field. It is a specialized, heavy paper-work operation. The bank's position is understandable. A reputable sales finance company can probably be found through the local bank. The finance rate and recourse arrangements between the client and the finance company is a matter of negotiation, in a wide range. They will depend on product, size of account, type of customer, basis of collection method (direct or indirect) to be used, and other factors. Installment selling has become a tremendous economic force in recent years. Small business clients should not ignore its potential.

Other receivables

Other receivables on the balance sheet can also be converted to cash. Notes receivable taken from delinquent customers originally sold on open account offer few attractive possibilities, but more and more businesses in recent years have notes arising from installment sales or deferred payment sales. These notes are gen-
erally welcomed at commercial banks either as a pledge for a note of the seller or as an endorsed discount sale to the bank. In either way, the bank has two parties from whom it can collect.

The *trade acceptance* is not extensively used, but it provides an avenue through which a small business might quickly convert sales to cash. A trade acceptance is nothing more than a draft upon a buyer by a seller for the amount of the sale. On the margin is the statement that the trade acceptance arises from a current transaction and that the maturity is within the usual credit period. The acceptance is sent to the customer with the invoice and the buyer writes "accepted" and signs his name. A commercial bank or others will not discount the document, as it would any other note. If a client can utilize trade acceptances without his open account customers feeling their character and integrity are being attacked, it can enhance his working capital position.

*Bankers' acceptances* are another negotiable paper arising from a sale. A buyer arranges with his bank to authorize a seller to draw a time draft on the buyer's bank for the amount of the invoice. The seller attaches the invoice to the authorization, generally takes it to his own bank for dispatch through banking channels to the buyer’s bank. The draft is accepted by the bank and returned through the bank channels to the seller’s bank. The draft is now a banker's acceptance which may be discounted by the seller’s bank. The customer relation problem is present, of course, as in the use of trade acceptances.

A client would be well advised to talk over these possibilities with the bank. If the bank is not interested, a commercial credit or sales finance company will often purchase this form of negotiable paper. Local private sources may also be available. Two or more small businesses, for example, can sometimes buy each other's paper when their cycles of business and working capital needs are the opposite of each other.

*Raising money from inventories*

Although inventories are not as liquid as accounts receivable, there is a good deal that can be done with them, even in a small
business. Generally, a business will have to exhaust its ability to borrow on receivables before a lender will consider inventory loans. Finance companies usually insist that this type of financing be only a part of an over-all financing plan. A review of the principal methods of thawing out inventories appears particularly valuable for small business clients, for the typical small business does not turn over inventories nearly as fast as a big business.

Before a CPA assists in finding a method and a source of funds from inventories, he ought to review the inventory policy of his client to see if the house is in order. The key to many small business working capital problems is often in a low stock turn, created by any of several deficiencies. Is the inventory policy sound? Are levels predetermined or otherwise budgeted? Are older items cleared out? Is the timing of purchase proper, and is adequate attention given to the production planning and scheduling functions? Could all or part of the inventory be taken on consignment? In other words, can borrowing on inventory really be justified, or is borrowing necessary merely because there is too much inventory? These questions should be considered carefully. If the answers are satisfactory, the following ways of raising money from inventories may be approached with some assurance that the lender's investigation will show that there is sound economic reason for inventory financing and that the inventories will be liquidated within the normal course of business. If the lender does not have these assurances, the client will not get his money.

A lender will also give careful consideration to other questions. It is wise to have the answers before the possibilities of financing inventories are recommended.

1. Can the client's product safely be stored, and for what period of time? Is there danger of obsolescence or deterioration during this period?

2. Are the price and demand for the product reasonably stable, or can they fluctuate sharply? How broad and consistent is the market for its sale? What would the cost of liquidation be?

Warehouse receipts, factors' liens and trust receipts are the usual methods by which inventory may be pledged. Unless there is a specific statutory provision to the contrary, it is a general
legal principle that a pledge of inventory as security for a loan is invalid unless the property is physically delivered to the lender or to a third party to be held for the account of the lender. This can obviously render inventory financing impracticable in cases where segregation will impede production and sales. To meet this problem the factors’ lien and the trust receipt have been legalized in some states. Only twenty-four states have enacted legislation authorizing the creation of factors’ liens and only thirty-one have authorized the use of the trust receipt. These laws, further, are not uniform. Consequently, the point must be underscored that each client’s potential for certain types of inventory financing will be contingent upon local law. The local finance company will undoubtedly have a thorough knowledge of what is legal in the states in which they operate, but a CPA should recommend that local counsel review any inventory financing arrangements to ensure that the client has a clear understanding of his rights and obligations.

The warehouse receipt arises when inventories are delivered to a public or “field” warehouse. When the use of a far removed public warehouse is prohibited by transportation cost, the “field” warehouse is put into play. This is actually a branch public warehouse established in the borrower’s plant at a nominal rental under lease, by a public warehouse company. There are many legal technicalities in arrangements of this type. Warehouse receipts, issued as collateral in either public or field warehousing, are governed by the Uniform Warehouse Receipts Act.

The use of warehouse receipts requires some form of distinct segregation. As already noted this poses complications for the manufacturer who wishes to convert pledged raw materials to work in process and pledged work in process to finished goods. The other security devices are employed in this case. While there are legal differences, both trust receipts and factors’ liens provide for additional freedom of inventory movement by the borrower. Through use of either or both of these, the small business may find workable arrangements.

The cost of inventory financing and the percentage of funds advanced vary. The rate will depend upon the risk occasioned by the nature of the inventory, size of loan, supervision of inventory
required, general credit rating of the client and so forth. The best information available indicates that rates are generally about the same or slightly higher than accounts receivable financing.

Many aggressive smaller businesses have grown rapidly through implementation of inventory financing. It is well to remember that sale of pledged inventories can lead to the pledging of accounts receivable. Thus, a cycle can be established that permits rapid sales expansion on limited initial working capital.

Includable with inventory financing is export and import financing. While there is limited application or opportunity for the use of this financing, it is an area that deserves brief review. If a client has a product that may be saleable in foreign markets or if a business could reduce costs or otherwise advantageously purchase requirements abroad but hesitates to do so in view of apparent financial restrictions, discussion of possible arrangements with banks and finance companies could prove valuable. It is a specialized form of financing, apparently largely misunderstood or unknown to many businessmen, according to representatives of some of the sources that offer it.

An often neglected source of funds is drop shipment financing. If a client lacks the capital to establish or expand existing manufacturing facilities, but can accept more orders than can be produced, a drop shipment financing plan—available from many finance companies and factors—might provide a solution to the dilemma.

Simply stated, a client arranges to have a product produced and drop shipped to his customers by a manufacturer. The manufacturer, who, like others, would not otherwise grant credit, is guaranteed by the finance company or factor. The lender, of course, will demand the right to inspect customers' orders and pass on them before guaranteeing the manufacturer from loss. The accounts receivable arising from these orders serve, of course, as the security for these obligations. There are other facets to the plans offered such as share of risk of returned merchandise with the manufacturer and whether the receivables will be financed on a notification or non-notification basis. They will all be brought out in discussion with a prospective lender.

Other balance-sheet assets will often be available for pledge
against short-term loans. The usual mortgages on machinery and equipment, for example, may often be helpful, and on some balance sheets there will often be other items of tangible value that can help to secure short-term money. The pledge or mortgage of land and buildings will be discussed under the heading of “Sources of Intermediate or Long-Term Funds.”

There are still other methods of increasing a working capital position. A CPA can often see these trees in the financial forest where a client cannot. A smaller company can often avoid the headaches attached to the financing of land, buildings, equipment and inventory by contracting some of its products for manufacture by others. Big business consistently contracts work to others, sometimes for technical reasons, but often to avoid additional investment in facilities. Smaller business often seems to insist on a do-it-yourself program. If cost, quality, and trademark problems can be resolved, subcontracting can be a valuable lesson taken from the practices of big business. Each business has its strengths and weaknesses. For example, if it can be done without offending a sales-oriented client, it might be suggested that a qualified contractor could make a product as well as, or better than, the client—and that this approach would preserve working capital for the purpose of additional advertising or promotion.

When prepaid insurance is present, the question might logically be raised as to why it is not being purchased on an installment basis.

Another obvious, but often overlooked, method of preserving working capital is to rent rather than buy. The pride of ownership appears to be important to many smaller businessmen and a reluctance to rent equipment, buildings, or autos often seems to be based on emotional rather than economic grounds. Buying on “time” also appears to distress the more conservative element in the small business public. Business can rent almost anything—butchers’ tools or steamships—from a variety of sources; manufacturers, leasing companies, etc. Long-term leasing (three years or more) of production equipment, excluding real estate, buildings, trucks or autos, exceeded $227 million in 1958. There is no doubt about the trend since this was 26 per cent higher than
rentals of the same items during the previous year. There are many pros and cons in leasing. The rent-or-buy decisions can usually be made easier for management after some calculation and advice by a CPA. The correct decisions cannot always be determined by pure mathematical formula. Each client must be advised to inspect comparative costs of purchasing versus renting in relation to his special circumstances. At the root of the decision is the forecast of whether the profits on the freed capital will outweigh the additional cost of leasing, which is generally the story the mathematical formulas tell. The income tax implications of rental, sale and leaseback, or related decision must also receive the careful attention of the certified public accountant. However, expert tax analysis alone, like the mathematical formula still cannot always come up with the right answer. Actuarial validity will only be as good as the facts placed in formulas and the only way to achieve the right answer is to evaluate all of the facts and mathematically computed answers in the light of sound business judgment.

Sources of intermediate or long-term funds

It is in the area of intermediate or long-term and equity financing that small business faces its greatest problem.

Banks, as a rule, will not make term loans, thereby eliminating from consideration the dominant short-term lender to small business. While the revolving financing of accounts receivable and inventory can provide working capital for a considerable period of time, a finance company can generally become a source of intermediate term money only through equipment financing. While rental of equipment or buildings will also preserve working capital and perhaps obviate the necessity for long-term debt financing, it may have been decided to rent only for the reason that long-term money could not be found. What are the sources of long-term funds for small business, and under what conditions will these sources make loans? In this discussion it will continue to be assumed that CPAs and small business are familiar with the offerings of their local banks.
Commercial finance companies

Equipment financing may be available to clients through a commercial credit company, if the local bank or the manufacturer will not finance it. Finance companies specializing in equipment financing usually purchase the installment contracts from the seller of the equipment. The typical maturity of equipment financing by these companies is one and a half to two and a half years but it is possible to obtain longer maturities if the type of equipment and the credit standing of the borrower warrants it. Typical charges for equipment financing as reported in late 1957 by a group of finance companies ranged from 11 per cent to 24 per cent per year. The median was 13½ per cent and, as usual, the smaller the financing, the higher the rate.

In terms of company size requirements to qualify for equipment financing, it can be stated that a finance company is likely to welcome a discussion if the client meets the qualifications given earlier for accounts receivable financing.

Insurance companies

Life insurance companies are the leading institutional source of long-term debt financing of American business, and corporate bonds and business mortgages represent by far the majority of their investments. Their fiduciary responsibilities to policy holders and a vast network of state regulations governing their investment policy tend to limit business loans to borrowers of large amounts, generally large corporations, with high credit ratings.

The financing that life insurance companies do with small business is almost exclusively long-term and is done through real estate mortgages.

Corporate bond issue financing to small business, unfortunately, can be dismissed quickly. In 1956, a group of life insurance companies controlling 75 per cent of the industries' loanable funds reported that only 2 per cent of their industrial bond investments were made with businesses having assets of less than a million dollars and only 15 per cent were made with businesses
with assets of less than five million. In terms of money, two-tenths of 1 per cent went to businesses with assets of less than a million. It is clear that small clients require an exceptional circumstance before they will find a life insurance company receptive to a bond financing arrangement.

While the mortgage loans to small business, in terms of dollars, are a minor portion of the loans outstanding, they are a large proportion of the total loans made. During 1956, the same group of life insurance companies already mentioned made nearly 5,000 business mortgage loans. Nearly 2,000 were in amounts of less than $50,000; more than 4,000 of them were in amounts of less than $250,000. It is not as easy, however, for all small businesses to obtain mortgage loans as these statistics might lead one to believe. It is extremely difficult for the millions of small businesses with assets of less than $100,000; and virtually impossible for the new business.

In 1956, only 16 per cent of the total mortgage loans made by life insurance companies went to businesses with assets of less than $100,000, and only 5 per cent went to those with assets of less than $50,000. Put in numbers, only about 800 of the 5,000 mortgage loans made in 1956 went to these firms. However, to the group above this—those in the $100,000-$500,000 asset size class—went 38 per cent of all of the mortgage loans. Twenty-two per cent of all loans went to those with assets of $500,000 to $1 million. In other words, more than three-fourths of the loans went to businesses with assets of a million dollars or less. The purpose in providing complete statistics has been to clearly identify that segment of small business that has been able to secure mortgage loans.

Maturities, incidentally, ranged up to thirty years on these loans with most in the fifteen to twenty-five year range. Interest rates ranged from 4½ to 5½ per cent; the smaller loans generally in the higher end of this range.

By law and tradition, caution is dictated in the investment of institutional funds. The primary factor in the investment policy of life insurance companies is safety of principal. Life insurance companies do not seek loans, regardless of interest rate, with a high degree of risk, and this policy obviously eliminates from
consideration those businesses that are not firmly established, are undercapitalized or have weak management. Even those businesses which do qualify may expect to find one or more financial covenants in their mortgage document relative to continual maintenance of working capital, dividend restriction, etc.

To provide further insight to the depth of investigation clients may anticipate from life insurance companies, there is included in the illustration on page 79 an instruction sheet used by one of the large life insurance companies in requesting information from prospective borrowers.

Loans on life insurance policies and mortgage of residential property to raise business capital is also, of course, a source of funds provided by life insurance companies. It is believed these methods of raising funds are universally familiar to the small business in need of money.

Other institutional sources

Life insurance companies are by no means the only institutional source from whom a qualified small business can borrow long-term funds. The loan policies and practices of life insurance companies establish the character of institutional lending in general. A check list of other institutional sources will, therefore, be the limit of further discussion.

1. Fire or other insurance companies
2. Savings banks
3. Pension funds
4. Universities or educational foundations
5. Investment trusts or banks
6. Charitable organizations

Sources of bond issue financing

With institutional sources virtually eliminated as a purchaser of small business bond issues, where else can the smaller company sell its long-term obligations?
Its officers, employees, customers, vendors or other local investors can always be considered as possibilities, but purchases by these sources generally help only when modest amounts are needed. If a small business seeks to sell its obligations to a broader segment of the public, how would a CPA suggest that it go about it? And what are the results likely to be?

The first technical consideration for the CPA would be Securities and Exchange Commission registration requirements. An investigation of these to determine their specific effect on the contemplated issue should be undertaken before the decision to finance in this manner is made. The regulations and related costs of registered issues could have important bearing. SEC requirements will be discussed briefly in the equity financing section of this bulletin.

The selection of an underwriter is the next important consideration. The principal problem will often be to find an investment banker willing to attempt distribution of a small issue of an unknown company. Few, if any, small issues of small business are ever purchased by underwriters on a firm commitment basis. In other words, they will not buy the entire issue and then resell to others. Rather, they will only act as agent for the seller on a "best efforts" basis and earn a fee commensurate with the number of units they sell. As will be evidenced by cost data, the least expensive method of debt financing through underwriters is generally on a direct private placement basis. Underwriters will often know of private investors or groups that will be interested in all or a significant part of the issue. If they can arrange this, the client will be charged an agent's, or finder's, fee.

The costs of small debt issue flotation through underwriters will significantly reduce proceeds. The average costs for the smallest bond issues run about ten times as high as the relative costs of the largest issues. For recent bond issues of $750,000—of those manufacturing companies that underwriters have been willing to work with—average flotation costs have run about 12 per cent of the face amount issued.

It can logically be concluded that debt financing through underwriters is not a practical consideration for the great majority of the country's small businesses.
State development credit corporations

One of the often neglected sources of long-term funds is the offerings of local industrial development groups which have been formed on the state and community level. Those formed on the community level—and there are thousands of them—are undoubtedly familiar to the local CPAs of these communities.

The state development credit corporations are relatively new, the first one having been organized in 1949. They are private financial institutions with the purpose of using financing as a method of developing the economies of their states. They are distinctly different from State Credit Authorities which are public agencies, using public funds in their development work.

State development credit corporations have been established primarily for the purpose of aiding the states’ economies by increasing employment through the use of a specially created pool of private funds. Financing of small business is not their explicit aim, but most of their financial aid has gone to smaller business. Their loans generally are made to three types of companies: (1) profitable companies with expansion plans that require more financing than can be obtained from conventional sources; (2) businesses that will begin operations in a community if financing can be obtained to provide the necessary facilities, and (3) businesses in a marginal status that will probably discontinue operations unless their financial position can be strengthened. A concern may formally apply to a credit corporation only if it cannot obtain enough credit from conventional sources, which generally means from commercial banks. It is reasonable to infer, therefore, that bank standards, as respects earning ability, capital and collateral, are higher than those of the credit corporations.

Credit corporations provide loans, in a variety of ways, for fairly long terms.

The experience of a group of New England development corporations indicates that less than 10 per cent of the number and amount of loans have been for less than five-year maturities. Most have been in the six-ten year range, but some 8 per cent have been for periods of more than ten years. Almost all borrow-
ers of the New England group have been manufacturers. These businesses generate more income to an area through larger payrolls than most other types of business. Less than 5 per cent of the loans have been made to nonmanufacturing businesses. This same group of credit corporations has made almost 75 per cent of their loans to businesses with less than 100 employees, and almost 35 per cent of those with less than twenty employees. Borrowers with ten to nineteen employees have received an average of $26,000 each. Those with fifty to ninety-nine employees have received, on average, a loan of $81,000 each. Interest cost experiences indicate that rates have averaged 6 to 7 per cent—a few points, as a rule, higher than the prime rate.

Under the proper circumstances, a client may appropriately be guided to a development corporation. They may prove to be a valuable source.

According to current information, the following states have passed legislation authorizing credit corporations:

- Maine
- New Hampshire
- Massachusetts
- Rhode Island
- Connecticut
- Vermont
- New York
- North Carolina
- Kansas
- Michigan
- Wisconsin
- Minnesota
- South Dakota
- Hawaii

In other states (Florida, Georgia, Montana, South Carolina, West Virginia, Virginia and New Jersey) legislation has been introduced at least once to authorize the charter of development corporations. Officials in Alabama, Alaska, Arizona, Illinois, New Mexico, Oregon and Washington have been considering the formation of these organizations, but no legislation has yet been introduced.

**U. S. Government sources of long-term funds**

Any review of sources of funds must include some discussion of the offerings available from Federal government agencies.
A few of these can be mentioned and dismissed quickly on the grounds that the source is of diminishing importance or of limited applicability. Where there is smoke there may be fire, however, and any of the following might be a potential source for a client.

1. It is theoretically possible to obtain Federal Reserve bank loans, still made under certain conditions. This program was relatively important until the early 1940's but is of little practical value today. Only four loans were made under this program in 1957.

2. The V-Loan program, authorized by the Defense Production Act of 1950, may still be a source worth investigating by certain businesses in defense-related production industries, or those that contemplate entry into this area of production. Again, however, this source is of diminishing importance. Only thirty-two businesses received assistance under this program in 1957.

3. The Fisheries Loan program was established in 1956 to assist commercial fishermen with their financing problems. Some 357 applications for direct loans were made in its first year of operation and 174 loans, or about 50 per cent were approved at a rate of 5 per cent with an average maturity of eight years. Have clients in this particular industry contact the Small Business Administration or the Department of the Interior for further details.

The Small Business Administration is the only federal agency with a loan program designed specifically to promote the welfare of small business. This program was inaugurated in 1953 to provide funds to small business concerns on either a participation or direct loan basis when longer term financing is not available on a reasonable basis from banks or other private lenders. The program also provides for loans to be made to victims of disasters—floods, hurricanes and droughts, for example. SBA's share of a loan cannot exceed $350,000 except when groups of small concerns request a "pool" loan. The law governing SBA originally set a maximum interest rate of 6 per cent in 1953 for business loans. This was reduced by the Small Business Act of 1958 to 5% per cent and all loans made to date, of course, have been at or
below these rates. Maturities may run as long as ten years. In its first three and a half years of operations, SBA approved about 8,600 business loans and some 6,900 disaster loans for the rehabilitation of homes and businesses. The 8,600 business loans were granted to 19,500 formal applicants and the average loan granted was about $45,000. Thirty per cent of the loans were made on a direct basis, the remainder were granted on either an immediate or deferred participation basis with a private lender. SBA will make a direct loan only if participation is unavailable.

While the bulk of the money went to manufacturers, a majority of the loans were made to wholesale, retail and service businesses. Professional people, incidentally, can now also apply to the SBA for a small business loan.

SBA loans are assisting more small businesses as the program develops. In contrast to 8,600 loans which were made in the first three and one-half years of operation, there were 4,014 loans aggregating $150 million made in the year ended June 30, 1958 and 5,582 aggregating $267 million were made in the year ended June 30, 1959.

The SBA has recently attempted to simplify its processing procedures to expedite its lending program.

Until 1955, authority to take action on applications was reserved largely to SBA officials in Washington. Since then, regional offices have been granted additional authority and the regional directors in turn have been permitted to delegate authority to managers of SBA branches. As a result, more than one-half of the branch offices are authorized to take final action on business participation loans up to $15,000 and disaster loans up to $20,000. Some have been authorized to approve participation loans and disaster loans up to $100,000 and $50,000, respectively. Some may approve or decline direct business loans up to $20,000. Regional directors may now approve business participation loans up to $100,000 where there is at least 25 per cent bank participation and approve disaster loans up to $50,000.

This delegation of authority has improved the service to small business concerns and has eliminated some of the red-tape heretofore associated with the processing and administrative operations.
Some of the more significant SBA requirements that must be met are:

1. **All loans must be secured by adequate collateral.** In applying this rule, however, SBA varies its emphasis on collateral as compared with earning ability in each case. This, of course, is of particular significance to prospective nonmanufacturing borrowers with less tangible collateral than the typical manufacturing business.

2. A **manufacturing concern must have fewer than 1,000 employees in all cases and, depending on the nature of the business, it may be required to have as few as 250 people to qualify.**

3. **Nonmanufacturing concerns must also meet certain “smallness” standards.** A wholesaler must have annual sales of less than $5 million; the retail and service trades less than $1 million. Specific rules apply to trucking, warehousing, construction and other businesses.

4. Loans are rarely granted to finance a change in ownership, unless such a change is necessary to keep the business in existence. Loans will not be made to most recreational facilities or lending institutions.

These are only the highlights of the SBA program. Further information can be obtained from local SBA offices or the SBA in Washington.

**Equity financing sources for small business**

**Small business clients** who have elected to sell stock to raise capital or are considering this step will almost always require the advice of their CPA. Smaller stock issues, sold privately to vendors, customers, friends, employees or other local sources will not generally present the same problems that will be encountered in registering, with the SEC, a larger public offering. Regardless of the market to be sold, however, the CPA can advise on the type of security to be issued, preferred or common stock, or perhaps a convertible debt issue if this can properly be categorized as a
form of equity financing. A CPA can also perform a valuable service by advising the client to obtain an attorney in equity financing situations. Equity financing is not so much related to the assets of a business but is predicated primarily on its earning power. When a small business has been operating long enough to develop a trend of earnings and a potential for higher earnings, a market can generally be located for equity funds. The CPA may be able to assist in finding that market.

At what price can your clients' equity be sold?

This is another important opportunity for service by the CPA. The market, whether it is Wall Street or Main Street, tends to value stock in proportion to earnings and the risk of the operation. For some larger “blue chip” growth corporations, there currently seems to be no limit to an acceptable price-earnings ratio. The “market” is often willing to pay $50, or more, for every $1 of earnings of these growth companies. For the average company, a price-earnings ratio of ten to fifteen times is common. But for the small business, the price-earnings ratio will often drop to three to five times earnings. All of these ratios will, of course, rise and fall with investor sentiment and economic conditions. For small businesses that often have indeterminate risk, public offerings of common stock are always expensive and often uncertain of success. The advice of the CPA, with respect to alternative sources, offering price, estimated expenses of flotation, and timing of sale can be of incalculable value to the small business management.

It is worth repeating that local sources of stock sales should be fully considered before an expensive public offering of a small issue is attempted. Particular consideration might be given to employee sale. Many large companies make stock available below market prices to employees, not for the specific reason of raising funds, but because of the benefits that have been proved to accrue in employee motivation and morale by assisting them to become stockholders. Here is a method by which a smaller business can “kill two birds with one stone.” The investment power of a group of fifty clerks, toolmakers, and assemblers might not appear impressive, but consider the cumulative effect of annual stock purchase of, say $300 by each. A small business could raise $75,000 in five years, at very little expense.
Some private investors, not necessarily local, are interested in equity purchase in outstanding situations. The investment banker or other specialists that handle private placements of equity issues can often help to locate them. Confidential connections may sometimes be made with these people through your local banker or his larger correspondents in larger cities. The simple medium of advertising what you have to sell in financial media should not be overlooked as a method of interesting a private investor.

In addition to these private investors, another source of equity capital for manufacturing concerns are those firms which operate in the venture capital field, seeking capital gains through investment mostly in radical new products. They seek investment in companies which are new, small, and financially weak. Generally, they buy a substantial stock interest. And often, as capital requirements increase with growth, they increase their investment. They often end up with voting control—an important point to keep in mind.

Other sources are the Small Business Investment Companies which are licensed under the Small Business Investment Act of 1958.

Small Business Investment Companies, referred to as SBIs, are private corporations chartered under state law, or by the Small Business Administration, whose specific function is that of providing long-term funds to small business through the purchase of convertible debenture bonds or through loans. It is well to remember that these corporations are also authorized to provide consulting and advisory services to small businesses on a fee basis. While SBI activity is to be actively policed by the SBA, "advisory" fees might become an avenue for effectively compensating for low interest rates. Investigate an SBI as any other lending agency. This SBI program, incidentally, does not supplant the regular loan program of the SBA. There has been some confusion on this point.

It has been predicted that some 200 to 300 SBIs will be in operation by the end of 1959. However, so few have been licensed to date that it appears doubtful whether these estimates will be reached.

An SBI can be formed with a minimum capital of $300,000, of
which the SBA will provide up to $150,000. There are to be some SBIs of considerable size, however. The Bank of America, for example, recently announced plans to invest $7.5 million in sponsoring a West Coast SBI. The Electronics Capital Corporation recently filed an SEC registration statement covering a stock offering of $12 million in what they call a nondiversified SBI. It intends to provide equity capital to selected electronic companies. Additional information on SBIs organized in each area can be obtained from the SBI division of the SBA.

SBIs are authorized to make long-term loans to incorporated or unincorporated businesses, as well as providing funds through purchase of convertible debentures. This aspect of the program appears generally overlooked or de-emphasized in most literature that has been written about the program. Perhaps there is reason to de-emphasize it. There would appear to be little advantage to an SBI through merely loaning long-term money at the nominal rate authorized. If an SBI is to be successful, it will be because of its ability to pick good growth companies, help them along, and sell their equity for capital gains. How many small businesses will lose voting control will have to be seen later.

This program is still in the experimental stages. Only the future will reveal the value of SBIs to small business.

Public offerings as a method of raising equity funds can become a complicated and technical task for a smaller business.

This bulletin cannot discuss in any detail SEC requirements relative to public offerings, but CPAs who are unfamiliar with them will obviously need to undertake some research before they can work with or advise a client in this area. Of particular significance is (1) a review of the types and sizes of security transactions which are exempt from registration—generally those aggregating less than $300,000, and (2) the form and content of information required to be filed under circumstances that often vary in small issue offerings.

The CPA can also help in selecting an investment banker. As already mentioned, investment bankers are seldom interested in handling small issues. The larger investment bankers ordinarily will not undertake public issues of less than the $500,000 to $1 million range. There also seems to be general agreement among
them that a smaller company cannot obtain capital from the se-
curities markets on reasonable terms if a company's net earnings
after taxes are less than $100,000 to $150,000. However, not all
security underwriters or investment bankers are big businesses.
Many of them are small businesses themselves specializing in sale
of small issues, and small offerings will be considerably more
attractive to them. There should be little difficulty in locating the
latter through either a local banker or a large investment banker
who may be willing to provide guidance to others whom they
feel may be interested. A friendly CPA in a larger city might also
be of assistance.

The CPA can do a good deal for a client in reviewing the fees
and expenses of security distribution. Compensation to underwrit-
ers takes the form of a spread between the price paid by under-
writers to purchase a security issue and the price at which the
issue will be sold in “firm commitment” underwriting. As pre-
viously mentioned, a small issue of an unknown company stands
little chance of acceptance on this basis. A client's costs of flota-
tion will probably be for “best efforts” underwriting, based on
units sold. In addition, there will be costs attributable to SEC
regulation, if the issue is subject to regulation, and costs that will
not be related to the SEC regulations. Compensation to under-
writers will ordinarily represent 75-85 per cent of the total costs
in a stock flotation.

Cost of flotation is proportionately greater for small security
issues than for large ones. Total costs for an issue of $1 million on
a registered basis, average slightly less than 20 per cent of the
proceeds. For issues of $500,000, total costs average about 25 per
cent of the proceeds. A common stock issue costs more than a
preferred issue and both cost considerably more than the flota-
tion of a debt issue of similar size. Average costs have been stated.
A client’s costs will vary according to industrial activity and other
factors that can make averages misleading. In general, however,
costs of public issues are high—perhaps prohibitively high—in
many circumstances.
ASSISTING SMALL BUSINESS CLIENTS IN OBTAINING FUNDS

Most practicing CPAs have accompanied a client to a bank, or to another lender, in order to lend support and provide financial information that has been, or may be, requested.

It often appears in these informal conferences with local credit executives who know the client, the CPA, or both, that all of the questions can quickly be resolved in friendly conversation. This is true in many cases, particularly if the loan requirement is small. But more than friendly relations or sound reputation is often required to obtain the “top dollar.” Further, the “sales pitch” is rarely effective with a lending agency. The small businessman who claims he “talked funds out of a lending agency” is kidding himself. What was really talked about were facts, and it was on these facts alone that the loan was granted. CPAs undoubtedly recognize this. But even the sophisticated CPA may not always provide a client with enough facts to present to a prospective lender—particularly when the client is negotiating with an unfamiliar source.

The evaluation of credit risks can never be reduced to an exact formula. Neither can the lender determine precisely the maximum amount that may be loaned with a predetermined assurance that it will be repaid.

How can a CPA assist a client in assuring a lender that a loan will be repaid before it is made?

Here are a few ways.

The CPA should make sure the audit report—either in a long-form presentation or in supplemental information—will give the lender a thorough insight into the operations and the financial picture. A lender will almost always be concerned about these items:

44
1. The aging of receivables and details regarding any concentration in a few customers, the details of notes receivable, and the full story on allowances for bad debts.

2. Inventories, which are always scrutinized. Break them up by classification, comment on their salability, mention turnover.

3. Investments, fixed assets, other assets. If the client is to receive appropriate credit for ownership of these assets, detail them in supplementary schedules. Give market or appraisal values where applicable. Show a lender what they are worth.

4. Liabilities and reserves should also be explained. The latest tax year examined should be stated.

Only a few items have been mentioned, but the principle is established. The lender should be given as much information as possible. This will almost always help the client’s case—and rarely, if ever, hurt it.

Mention has been made only of audit reports. Other supplementary information will also help. These are some.

1. Budgets and forecasts. Show the lender operating forecasts and the cash flow anticipated. If practical, submit budget data and cash forecast data of past periods and prove, through comparisons of actual results to budget, that the forecasts are worth more than the paper they are written on.

2. Schedule the provisions for repayment, if these are not clearly indicated in the cash forecast. Every lender, without exception, will be receptive to seeing just how the money is going to be repaid. The precise need and purpose of the funds can also be shown in this way.

3. Advise the preparation of, or help prepare a document outlining the history and basic facts about the client. It will be advantageous to include:
   (a) Past earnings history and other historical financial data. Explain any losses in past years.
   (b) The date formed, the history of growth, and changes that have taken place in financial structure.
   (c) Facts about the management and officers—ages, background, experience, attitudes.
(d) Explain the operation. Its products, markets, customers, etc. Tell how the products are made or dispensed, and what they do. If new products are involved, explain the marketing scheme. Submit a catalogue.

(e) Competitive position can be important information. Prove the client's status through sales records of some of the better customers or other available means.

The client can help himself in other ways. For example:

1. Maintain a continuous relationship with lenders or prospective lenders. Send interim financial statements to them, inform them of new products or other significant changes in the operations.

2. Establish a line of credit in advance of needs. Several CPAs have reported that nearly every commercial client served has been assisted in arranging for a credit line. Many of the clients never use it. However, if money is wanted—even in excess of the established amount—it will make the negotiations faster and generally more successful.

The CPA, through his knowledge of finance, can perform a real service to small business clients who are generally unfamiliar with lender's requirements and attitudes. Providing supplementary data for a small business will not require much additional time. It will assist clients to obtain the "top dollar" and can often transform what would appear to be a marginal situation because of a sketchy application, into a considerably better risk in the lender's eyes.

The essence of deciding whether funds will be made available to a small business lies basically in the determination of the effectiveness of its management. The over-all effectiveness will manifest itself through financial statements, as well as management attitudes and practices themselves. Lenders are sophisticated financial experts. Consequently, the first weaknesses apt to be noted are those in the area of financial management of a small business applicant. The opportunity to evaluate the soundness of production control or personnel practices will probably not present itself. When lenders cite "unbalanced management," as a common reason for denying a loan, it is logical to assume that much of the
"unbalance" is evident in the area of financial management.

CPAs can fill the financial management void in many small businesses. By investing only a little additional time, a CPA can capably function as an advisory public treasurer to small business clients. By doing so, he will not only contribute to the strength and profitability of these clients, but also to the strength and profitability of his own practice.
Financial management decisions and timing are often dependent upon interest rates, money availability, or security market conditions—all of which are ever changing with the economic cycle.

A CPA can enhance the value of his financial advice if he maintains a continuing knowledge of the national economic outlook—particularly as it affects the principal industries and the area which he serves. The pressure of business, the never ending delivery of technical literature—these and other factors make it a tall order to stay up to date with the state of our economy.

A continual insight into the economic situation requires a reasonable knowledge of the workings of the banking system. The banking system of the United States is not merely a subject to be studied in school and then quickly forgotten. It is not merely academic. It has a practical and ever-changing influence—not only upon the monetary policies of the World Bank, but also on the small shoelace manufacturer in Johnstown, Pennsylvania, or a grass seed company in Hays, Kansas.

Attention shall briefly be turned to a review of the practical side of the banking system of our country, and the relation that changes in monetary policies, created by this system, have to small business, and to the advice rendered by CPAs.

The commercial banking system of the United States is organized through twelve districts into the Federal Reserve System. Only about one-half of the commercial banks are members of the Federal Reserve System, but these members control 85 per cent of the country's commercial banking activity. The nonmember
banks—most of them are small or local banks—generally maintain deposits in, or are correspondents of, one or more member banks and, for the most part, follow their policies.

The nation's money markets are strongly influenced by the lending position of commercial banks. They dominate the short-term money market, and the market for long-term funds (even equity funds) which the banks themselves do not provide.

The looseness or tightness of commercial bank credit, in turn, is significantly affected by the Federal Reserve System. The Board of Governors of the Federal Reserve banks control the over-all policies of the member banks. Its powers of control significantly determine the financial operations of the banks, and, in turn, their customers and the CPA's clients.

There are three methods that may be used by the Board of Governors which will influence the money markets.

1. The strongest is their ability to change the Reserve requirement. Member bank reserve requirements vary. Recently the banks in the New York and Chicago reserve districts have been required to place 18 per cent of their deposits with the Federal Reserve bank in their area. In other larger cities, the requirement has been 16-2/3 per cent, while the "country bank" members have placed only 11 per cent of their deposits with the Federal Reserve bank. All members have also been required to place 5 per cent of savings deposits on reserve. The Board can tighten or loosen credit at any time by merely changing this reserve requirement. Will a change of a few percentage points significantly affect the lending position of a bank? Let us illustrate. If a bank has been required to keep 16-2/3 per cent of its deposits on demand, $5 out of every $6 is available for lending or investment. If the reserve requirement is raised to 20 per cent, only $4 out of every $5 will now be available. In order to meet the higher reserve requirement, the member banks often call in loans, sell investments, or they themselves borrow from Federal Reserve Banks. Money, therefore, is "tighter" than before. Interest rates go up.

This, of course, is a two-way street. During the recessionary period of 1958 the reserve requirement was lowered three times in the nine months following November 1957 in an attempt to "loosen" credit. With a general business improvement in late 1958
and 1959 the trend reversed. If a small business had been trying to find money, it is safe to say that its chances were generally better in 1958 than in 1959.

2. The discount rate is the second control used by the Board to influence money supply and cost. Member banks are privileged to borrow from their Federal Reserve Banks when the demand for money by their customers places them near their lending capacity as determined by the reserve requirement. The sum borrowed is added to their reserve deposit and thus increases their lending position. To encourage or discourage members from borrowing, the interest rate charged to members is varied at the discretion of the Board. As costs to members are increased, the member must pass on the added cost to borrowers—and, in view of their higher costs, will screen loan applications more carefully. The borrowers, in turn, obviously react to interest cost by re-examining their ability to employ loans profitably. If the discount rate becomes very high, business may not only find it detrimental to borrow for expansion, but may curtail even normal operations.

Adjustment of the discount rate is generally not an immediate brake or spur to the level of business or the money markets. The direction the rate is taking, however, will affect future business levels and money availability. During 1959, for example, the trend of the discount rate was toward higher rates. Money cost more than in 1958. For most of 1958, the reverse was true. During the ten-month period between November 1957 and August 1958, the discount rate was lowered four times. With an upturn in business activity, the rate was then increased late in the summer of 1958. It was raised again in October 1958; once more in March 1959 and still again in May. Its effect on the “tightened” availability of money, and its high cost during 1959 was undoubtedly evident.

3. The other control the Board exercises is through its activity in “open market operations.” This is, in effect, a simple buy or sell device wherein Federal Reserve purchase of government securities on the open market places additional cash in the hands of sellers. They, in turn, place the cash with commercial banks. The sale of securities from its own portfolio takes money out of the banking system, and thus can significantly influence the amounts
available for loan by the commercial banks. This control applies, of course, to the banking system as a whole. The effects on each specific bank, and the attendant impact on its customers and the CPA’s clients, will vary.

These are not the only factors affecting money rates and availability. Business recovery, inventory building, a booming stock market—these and other factors will contribute to higher interest cost and scarcity of loanable funds. The demands of the U. S. Treasury for funds to finance the cost of government also affect the money markets. All of these factors and their interrelationships cannot be dealt with in this bulletin.

How can all of this “high finance” be related to the financial operations of smaller business clients? The changing money markets and the controls exercised to loosen or tighten credit affect small business the same way they affect big business. If a big business has difficulty in finding money, so will a small business. If interest cost is low for big business, it will be somewhat higher, but still relatively low, for smaller companies. However, money should be available. If the cost of borrowing is high, all businesses will pay expensive rates, if they can get it. But in a scarce money market small business will find its financing problems more difficult. While fluctuations in the availability of money will not determine loan approval or disapproval to small business, experience dictates that rejections of small business loan applications increase disproportionately to those of big business in periods of monetary restraint.

All financing—whether it be the small ninety-day loan from the bank, the mortgage from the insurance company, or the first flotation of stock by a family-held corporation—is made easier or harder by money markets and economic conditions. The CPA need not be an expert economist. He will not be expected to forecast economic turns, stock market levels or changes in interest rates. This may be left to the economists, bankers and other experienced money men. The CPA, however, must remain alert to the dynamic forces in the economy which can significantly affect his advice on the financial affairs of his small business clients.
AN ILLUSTRATION OF HOW A SMALL BUSINESS SUCCESSFULLY SOLD STOCK TO THE PUBLIC

Tronic Company, Inc., first discussed the possibilities of public stock offering with its CPA late in 1957. The electronic components manufactured by the company for use in computers, radar, and missiles, were in great demand and with the stepped up government moon rocket program, the demand became even greater during 1958. Tronic was unable to capture its potential share of the market due to a restricted working capital position and need for additional equipment.

The two stockholders were research engineers who had successfully supplemented their own engineering genius by employing an aggressive and talented sales engineer and production manager. They relied exclusively on the CPA to guide the accounting and financial functions. The company had already exhausted its borrowing ability for bank loans and the two sole stockholders had put every cent they could get their hands on into the business. The company had been approached by a few wealthy private investors and a private venture capital corporation, but here the question of loss of operating control, if not ownership control, presented a potential threat to the two stockholders. They decided that large amounts of stock could not be advantageously sold to these sources.

The CPA was asked to investigate the potential for public sale of their stock in early 1958. He sought out underwriters specializing in the sale of small (Regulation A) issues, discussed the possibilities with them and shortly thereafter advised the management that the anticipated proceeds from sale of even 49 per cent of the shares under a simple plan of recapitalization he could propose would probably be a mistake at this time. Even though
the space age was becoming the talk of the nation, the security markets were becoming more depressed every day. With investors rejecting present values of “blue chips,” the CPA quickly agreed with those underwriters who advised that a public issue at this time would be likely to fail. Further, with a net loss anticipated for the current fiscal year, the result of contract negotiation errors by management, conditions were even less attractive. The management, desperate for funds, was reluctant to accept the CPA’s advice—probably because two underwriters had recommended they go ahead—but as the CPA explained to management, the underwriters had nothing to lose.

There was general agreement that securities’ markets should turn up with the economy in late 1958, and the loss for the year ended September 30, 1958, would then be behind the company. By waiting less than a year, management had to agree with the CPA that Tronic had everything to gain and nothing to lose. The plan was temporarily shelved. The company could solve its financial dilemma temporarily by signing a short-term contract with a large customer agreeing to supply this national company’s entire requirements of a product in exchange for a guarantee of an additional bank loan. This would have the immediate effect of limiting the availability of this new product to other customers, which from a marketing viewpoint, was not sound. Nonetheless, they proceeded on this basis, despite the sales head’s protestations, as little other choice appeared available. (The CPA, incidentally, was asked to review this contract before it was signed to avoid a repetition of previous contract errors.)

By early 1959, the company had returned to profitable operations, the security markets turned up with the economy as anticipated, and the CPA was contacted by an underwriter who suggested the market was quickly becoming “right.” The CPA had carefully investigated the underwriter and knew that he was reputable and competent.

The underwriter felt that a public sale would now have an excellent chance of success—not only with respect to sale of the entire issue, but at an offering price of $2 per share, which was twice as high as he would have suggested nine months earlier. He backed up his enthusiasm with an offer to dispose of the
shares at a 10 per cent commission, plus an option on 14,000 shares, plus expenses. This was a better deal than he had offered to handle the sale earlier, if management had decided, despite his advice, to sell at that time. He reviewed briefly with the CPA the financial information required for presentation in the prospectus and to the SEC in order to obtain exemption from registration.

The CPA was asked to be present at a director's meeting the next day. It was then decided to recapitalize, and go ahead with the issue. One of the stockholders preferred to offer more shares at a lower price, still enabling retention of control, but, he felt, a surer way to sell $250,000 worth of stock. The CPA respectfully disagreed, and with the support of others helped to guide the mildly dissident, but mostly confused party, to what was to become the proper management decision.

Excerpts and the CPA's financial statements taken from the prospectus are presented on pages 55-61. There have been changes and deletions in presentation from those originally presented to the SEC in order to qualify for exemption under Regulation A. It should also be kept in mind that there are significant differences between information presented under Regulation A issues and a regular registered issue which must be certified by independent accountants as defined in the SEC regulations. The following, therefore, is intended only to familiarize you further with the situation faced by Tronic.

The costs and results

The issue was quickly oversubscribed. Statistics disclose that costs of small public stock offerings often run in excess of 25 per cent of the total offering. In the case of Tronic, costs eventually aggregated about $38,000 or about 15 per cent of the amount offered. The fact that a potentially valuable stock option was given to the underwriters and favorable market conditions undoubtedly contributed to the relatively low costs.

What would you have paid for the stock? By using two conventional standards of measure we find the book value per share of the 383,000 outstanding shares after receipts from public sale
to be a little less than 90 cents per share. Assuming, on the basis of the five months' profits of the period preceding public offering, that the company's present rate of profit continues during the last seven months of the year, net profits would be about $60,000 resulting in share earnings of about 16 cents. The offering price of $2 would, therefore, represent a price-earnings ratio of about 12½ to 1—again significantly higher than the generally acceptable ratio for small issues. The first day the security was cleared for trade in the over-the-counter market, the shares sold for $4.50.

To what can this be attributed? The CPA feels the success of the offering was due to several factors—but primarily to proper timing. By offering the stock of a small company associated with electronics and missiles, through a capable underwriter, when investor sentiment was distinctly oriented to this industry, it was simpler and less expensive to achieve success than it would have been at other times. The pulse of the market for small issues is difficult to measure. After evaluating the advice of others, and reviewing market conditions, the CPA saw little hope for his client's success of stock sale for even $1 per share at one point. He then assisted in raising the desired funds a short time later at twice the price. While the management of Tronic recognizes that the underwriter was basically responsible for the success of the offering, the evaluations made for them and the sound advice given to them by the CPA has resulted, since then, in his attendance at several director's meetings that have been devoted to many other business problems.

OFFERING CIRCULAR

125,000 SHARES

TRONIC COMPANY, INC.
(a Delaware corporation)

COMMON STOCK
(Par Value 20¢ Per Share)

Offering Price: $2 Per Share

These securities are offered pursuant to an exemption from registration with the United States Securities and Exchange Commission. The Commission does not pass upon the merits of any securities nor does it pass upon the accuracy or completeness of any offering circular or other selling literature.
**Price to Public**

<table>
<thead>
<tr>
<th>Per Share</th>
<th>$2</th>
</tr>
</thead>
<tbody>
<tr>
<td>Total</td>
<td>$250,000</td>
</tr>
</tbody>
</table>

**Underwriting Commission**

<table>
<thead>
<tr>
<th>Commission</th>
<th>$0.20</th>
</tr>
</thead>
<tbody>
<tr>
<td>Total</td>
<td>$25,000</td>
</tr>
</tbody>
</table>

**Proceeds to Issuer**

<table>
<thead>
<tr>
<th>Proceeds</th>
<th>$1.80</th>
</tr>
</thead>
<tbody>
<tr>
<td>Total</td>
<td>$225,000</td>
</tr>
</tbody>
</table>

1. As more fully set forth herein under “Underwriting” on the successful completion of the entire offering, the Underwriters shall be entitled to purchase all or part of 10,000 shares of the common stock (20¢ par value) at $2 per share for a period commencing thirteen months after the settlement date and terminating five years after such date. In addition, the Underwriters will be entitled to purchase 4,000 shares of the common stock at $4 per share for a period commencing thirteen months after the settlement date and terminating five years after such date. All of the above shares will be taken for investment and not for distribution. The Underwriters will also have the right to designate one member of the Company's Board of Directors for a period of five years commencing with the execution of the Underwriting Agreement and the right of first refusal for five years with respect to any future Company offering.

2. The Company has also agreed to pay the Underwriters $8,000 for their expenses incurred in connection with the offering which includes advertising, legal and printing charges. Any unexpended portion of such monies will be returned to the Company. The Company is responsible for its own legal and accounting expenses which, it is estimated, will not exceed $3,000. Unless all the shares offered hereunder are sold within sixty days after the effective date of the offering, all funds received will be returned to the subscribers.

**HISTORY AND BUSINESS**

Tronic Company, Inc. was incorporated in the State of Delaware on December 13, 1946.

The Company manufactures components for computers, radar, missiles, and other electronic equipment.

The Company spent most of its early years in the manufacture of electrical hardware. However, within the last three years, it has been expanding its electronic component lines. Approximately two years ago it obtained a contract from a national company to manufacture retard and repeat relays which are used in rockets and missiles. These items are also sold to other national companies. The first shipments under this program were made in April 1958.

Two years ago Tronic hired additional engineering personnel and purchased equipment to manufacture high frequency resistors for the electronic trade and the Federal Government.

Within these last two years, the Company has begun the design and manufacture of other missile and electronic equipment, such as special electronic tubes.

The Company has approximately eighty employees. Its production employees are represented by a union and employee relationship is considered to be excellent. For key employees, or those not enjoying union benefits, Tronic has a profit-sharing plan and a major medical plan with insurance benefits.

**CAPITALIZATION**

The following tabulation sets forth the capitalization of the Company as of April 3, 1959, and as adjusted to give effect to the sale and issuance of the 125,000 shares of common stock offered hereby:
Outstanding
Title Class Authorized Outstanding as adjusted
Common 20¢ par value............. 650,000 shares 258,000 shares 383,000 shares*

The Company duly effected a recapitalization by appropriate action and amendment of its Certificate of Incorporation to provide for the increase of the number of authorized shares of common stock no par value (500 shares) to 20¢ par value each (650,000 shares).

One hundred and twenty-five thousand shares of the common stock are being offered to the public hereunder, and these, together with the shares owned by two present stockholders will be the only shares outstanding at the successful termination of the offering. The Company's stock has no pre-emptive right to subscribe for additional shares which may at any time be issued, and the holders of all shares shall be entitled to one vote for each share of stock held of record by them. All shares shall have equal rights to participate in any dividend if, as and when declared, and in the event of voluntary or involuntary liquidation, dissolution or winding up, the net remaining assets of the Company shall be payable and distributed ratably among the holders of record of the common stock.

APPLICATION OF PROCEEDS

There is no firm commitment by the Underwriters to purchase any or all of the securities offered, hence there is no assurance of the receipt of any or all of the net proceeds of the shares offered hereby.

It is anticipated that the net proceeds to the Company from the sale of the 125,000 shares of common stock, 20¢ par, offered hereby will aggregate approximately $214,000 after deduction of the Underwriting discounts and commissions and expenses of $11,000. The Company contemplates that such proceeds will be devoted to the following purposes in the order of priority indicated:

<table>
<thead>
<tr>
<th>Purpose</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Test machinery and equipment</td>
<td>$40,000</td>
</tr>
<tr>
<td>Retiring loans and notes outstanding</td>
<td>$60,000</td>
</tr>
<tr>
<td>Research and development</td>
<td>$25,000</td>
</tr>
<tr>
<td>Working capital</td>
<td>$89,000</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>$214,000</strong></td>
</tr>
</tbody>
</table>

The Board of Directors reserves the right, however, to make changes in the above allocations, as the Company's business and circumstances shall warrant.

Unless the entire 125,000 shares offered hereby are sold within the sixty-day period as provided in the Underwriting Agreement and $250,000 realized therefrom, all funds subscribed will be returned to the subscribers. The Underwriters have opened an account wherein the funds subscribed will be segregated for the benefit of Tronic. Should the entire offering not be sold, such funds as are received will, of course, be returned to the subscribers.

FINANCIAL DATA

The following financial statements, that is, the Balance Sheet of the Company as of February 28, 1959, and its Profit and Loss Statements for the fiscal year ended September 30, 1957 and September 30, 1958 and the interim period October 1, 1958 to February 28, 1959, are taken from the books and records of the Company and are unaudited.

*Assuming all shares offered hereby are sold. Such amount, however, does not include the 14,000 shares which the Company, pursuant to the Underwriting Agreement (see "Underwriting") may be called upon to issue to the Underwriters for a period commencing thirteen months after the settlement date and terminating five years thereafter, at $2 (10,000 shares) and $4 (4,000 shares) per share.
TRONIC COMPANY, INC.
BALANCE SHEET
As at February 28, 1959

**ASSETS**

**Current Assets:**

Cash (Banks named) ........................................ $9,398
Petty Cash ....................................................... 125
Notes Receivable .............................................. 2,547
Accounts Receivable ........................................ 82,609
Due from United States Treasury Department ........ 9,533
Merchandise Inventory (Note A) .......................... 80,400
Unexpired Insurance ......................................... 4,137

Total Current Assets ........................................ $188,749

**Fixed Assets:**

<table>
<thead>
<tr>
<th>ASSET</th>
<th>Cost</th>
<th>Accumulated Depreciation</th>
<th>Book Value</th>
</tr>
</thead>
<tbody>
<tr>
<td>Land</td>
<td>$30,000</td>
<td>................................</td>
<td>$30,000</td>
</tr>
<tr>
<td>Buildings</td>
<td>69,408</td>
<td>41,655</td>
<td>27,753</td>
</tr>
<tr>
<td>Improvements</td>
<td>7,764</td>
<td>4,814</td>
<td>2,950</td>
</tr>
<tr>
<td>Machinery and Equipment</td>
<td>99,161</td>
<td>41,208</td>
<td>57,953</td>
</tr>
<tr>
<td>Furniture and Fixtures</td>
<td>15,620</td>
<td>10,005</td>
<td>5,615</td>
</tr>
<tr>
<td>Automobiles</td>
<td>8,564</td>
<td>5,716</td>
<td>2,848</td>
</tr>
<tr>
<td>Total Fixed Assets</td>
<td>$230,517</td>
<td>103,398</td>
<td>127,119</td>
</tr>
</tbody>
</table>

**Other Assets:**

<table>
<thead>
<tr>
<th>ASSET</th>
<th>Cost</th>
</tr>
</thead>
<tbody>
<tr>
<td>Security Deposits</td>
<td>$250</td>
</tr>
<tr>
<td>Organization Expense</td>
<td>79</td>
</tr>
<tr>
<td>Total Other Assets</td>
<td>329</td>
</tr>
<tr>
<td>Total Assets</td>
<td>$316,197</td>
</tr>
</tbody>
</table>

**Notes:**

A. Merchandise Inventory consists of the following:

<table>
<thead>
<tr>
<th>ITEM</th>
<th>Cost</th>
</tr>
</thead>
<tbody>
<tr>
<td>Finished Goods</td>
<td>$8,200</td>
</tr>
<tr>
<td>Work in Process</td>
<td>27,300</td>
</tr>
<tr>
<td>Raw Materials</td>
<td>44,900</td>
</tr>
<tr>
<td>Total</td>
<td>$80,400</td>
</tr>
</tbody>
</table>

And is valued at cost or market, whichever is lower. Wherever cost has been used, the method of determining cost has been first-in, first-out.
TRONIC COMPANY, INC.
BALANCE SHEET
As at February 28, 1959

LIABILITIES AND CAPITAL

Current Liabilities:

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Accounts Payable</td>
<td>$24,214</td>
</tr>
<tr>
<td>Notes Payable (Bank named)</td>
<td>28,000</td>
</tr>
<tr>
<td>Notes Payable—Others</td>
<td>3,642</td>
</tr>
<tr>
<td>Accrued Expenses and Taxes Payable</td>
<td>18,734</td>
</tr>
<tr>
<td>Federal Income Tax Payable</td>
<td>8,440</td>
</tr>
<tr>
<td>First Mortgage Payable (Bank named)</td>
<td></td>
</tr>
<tr>
<td>Installments due within one year</td>
<td>4,212</td>
</tr>
<tr>
<td>Notes Payable—Officers (Note B)</td>
<td>32,000</td>
</tr>
</tbody>
</table>

Total Current Liabilities: $119,242

Fixed Liabilities:

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>1st Mortgage Payable (Bank named)</td>
<td>$41,420</td>
</tr>
<tr>
<td>Less: Installments due within one year (Contra)</td>
<td>4,212</td>
</tr>
<tr>
<td>Balance</td>
<td>37,208</td>
</tr>
<tr>
<td>Notes Payable—Officers</td>
<td>$65,500</td>
</tr>
<tr>
<td>Less: Notes Payable—Officers (Contra)</td>
<td>32,000</td>
</tr>
<tr>
<td>Total Fixed Liabilities</td>
<td>70,708</td>
</tr>
</tbody>
</table>

Total Liabilities: $189,950

Capital:

Capital Stock—Common—No Par

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Authorized</td>
<td>.500 Shares</td>
</tr>
<tr>
<td>Issued and Outstanding</td>
<td>.200 Shares</td>
</tr>
<tr>
<td>Retained Earnings</td>
<td>113,607</td>
</tr>
</tbody>
</table>

Total Capital (Note C): $126,247

Total Liabilities and Capital: $316,197

B. Notes Payable—Officers is included in current liabilities only since it is anticipated that this liability will be paid out of the proceeds of the offering.

C. After giving effect to a subsequent recapitalization the Capital as of February 28, 1959 is reflected as follows:

Capital Stock—Common $.20 par value

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Authorized</td>
<td>650,000 shares</td>
</tr>
<tr>
<td>Issued and Outstanding</td>
<td>258,000 shares</td>
</tr>
<tr>
<td>Retained Earnings</td>
<td>74,647</td>
</tr>
</tbody>
</table>

Total Capital: $126,247
## TRONIC COMPANY, INC.
### STATEMENT OF OPERATIONS

For the Years Ended September 30, 1957, September 30, 1958 and For the Period October 1, 1958 to February 28, 1959

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Sales</strong></td>
<td>$326,484</td>
<td>$704,699</td>
<td>$736,121</td>
</tr>
<tr>
<td>Less: Returns and Allowances</td>
<td>9,748</td>
<td>50,402</td>
<td>41,804</td>
</tr>
<tr>
<td><strong>Net Sales</strong></td>
<td>316,736</td>
<td>654,297</td>
<td>694,317</td>
</tr>
<tr>
<td>Less: Sales Discounts</td>
<td>825</td>
<td>3,614</td>
<td>4,714</td>
</tr>
<tr>
<td><strong>Net Income from Sales</strong></td>
<td>315,911</td>
<td>650,683</td>
<td>689,603</td>
</tr>
</tbody>
</table>

### Cost of Goods Sold:

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Inventory at Beginning</strong></td>
<td>62,400</td>
<td>59,000</td>
<td>52,600</td>
</tr>
<tr>
<td><strong>Purchases—Net</strong></td>
<td>81,218</td>
<td>231,835</td>
<td>240,004</td>
</tr>
<tr>
<td><strong>Freight In</strong></td>
<td>1,776</td>
<td>3,788</td>
<td>2,978</td>
</tr>
<tr>
<td><strong>Total Material Available</strong></td>
<td>145,394</td>
<td>294,623</td>
<td>295,582</td>
</tr>
</tbody>
</table>

### Direct Labor:

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Factory Labor</strong></td>
<td>71,120</td>
<td>146,418</td>
<td>139,867</td>
</tr>
<tr>
<td><strong>Engineers' Salaries</strong></td>
<td>13,936</td>
<td>37,994</td>
<td>30,444</td>
</tr>
<tr>
<td><strong>Payroll Taxes</strong></td>
<td>3,196</td>
<td>7,464</td>
<td>6,987</td>
</tr>
<tr>
<td><strong>Union Pension and Welfare Funds</strong></td>
<td>5,944</td>
<td>8,749</td>
<td>7,218</td>
</tr>
<tr>
<td><strong>Total Direct Costs</strong></td>
<td>239,590</td>
<td>495,248</td>
<td>480,098</td>
</tr>
<tr>
<td><strong>Indirect Manufacturing Costs</strong></td>
<td>62,831</td>
<td>148,618</td>
<td>155,903</td>
</tr>
<tr>
<td>-----------------------------</td>
<td>--------------------------</td>
<td>--------------------------</td>
<td></td>
</tr>
</tbody>
</table>

**Building Expenses:**

<table>
<thead>
<tr>
<th></th>
<th>1958</th>
<th>1957</th>
</tr>
</thead>
<tbody>
<tr>
<td>Interest on Mortgage</td>
<td>874</td>
<td>1,897</td>
</tr>
<tr>
<td>Real Estate Taxes</td>
<td>3,812</td>
<td>7,419</td>
</tr>
<tr>
<td>Sundry Expenses</td>
<td>19</td>
<td>484</td>
</tr>
</tbody>
</table>

**Total Available for Sale**

|                         | 307,126       | 653,666       | 644,694       |

**Less: Inventory at End**

|                         | 80,400        | 62,400        | 59,000        |

**Cost of Goods Sold**

|                         | 226,726       | 591,266       | 535,694       |

**Gross Profit Sales**

|                         | 89,185        | 59,417        | 103,909       |

**Expenses and Deductions:**

<table>
<thead>
<tr>
<th></th>
<th>1958</th>
<th>1957</th>
<th>1958</th>
</tr>
</thead>
<tbody>
<tr>
<td>Selling Expenses</td>
<td>30,461</td>
<td>65,664</td>
<td>42,899</td>
</tr>
<tr>
<td>General and Administrative Expenses</td>
<td>14,330</td>
<td>37,726</td>
<td>30,404</td>
</tr>
</tbody>
</table>

**Total Expenses and Deductions**

|                         | 44,791        | 103,390       | 73,303        |

**Net Profit (or Loss) before Depreciation**

|                         | 44,394        | (43,973)      | 30,606        |

**Depreciation—Building & Improvements**

|                         | 1,147         | 2,482         | 2,212         |

**Depreciation—Machinery & Fixtures**

|                         | 3,978         | 10,421        | 7,421         |

**Depreciation—Automobiles**

|                         | 847           | 1,733         | 497           |

**Total Depreciation**

|                         | 5,972         | 14,636        | 10,130        |

**Net Profit (or Loss) for the Period (Before Provision for Federal Income Tax)**

|                         | 38,422        | (58,609)      | 20,476        |

**Less: Provision for Federal Income Tax**

|                         | 10,953        | —             | 4,609         |

**Refund of Federal Income Tax Resulting from Carry-Back**

|                         | —             | 17,276        | —             |

**Net Profit (or Loss)**

|                         | $ 27,469      | ($ 41,333)    | $ 15,867      |

*(Transferred to Earned Surplus)*
AN ILLUSTRATION OF HOW A SMALL COMPANY EFFECTIVELY FINANCED ITS ACCOUNTS RECEIVABLE AND INVENTORIES

The Lucas Candy Company was a typical example of a small company whose production demand suddenly caught fire. Although the sudden demand was most welcome to Cy Lucas, the sole proprietor, it created a series of financial and business dilemmas that caused him many sleepless nights. His problems could be directly attributed to a colt named Pink Clover—so could the fact that a CPA was able to convert a relatively small tax client into a far more valuable one.

For more than ten years Cy Lucas and his wife had made and sold high quality, specialty candies from a converted barn on their small farm, located on a main highway just outside a city of approximately 300,000 people. They had sold their candy along with other farm produce originally on a part-time basis, but when people returned again and again to purchase their candies, they concentrated only on these products. Within a couple of years, the roadside shop had an annual sales volume of almost $25,000. It was at this point that Cy Lucas decided to quit his job, discharge the woman who had been helping his wife produce the candies, and go into business on a full-time basis. He enlarged and modernized his roadside facilities and with the help of a little advertising, showed a sales volume of almost $60,000 in his first year of full-time operation.

He had made arrangements with four retail outlets in the city—one of which was the leading department store—to carry his small line of specialty candies during his second and third year of busi-
ness. However, he had not aggressively sought other outlets because he could just about keep up with the requirements of his four customers and his own roadside shop. In his third year of operation, sales were averaging about $10,000 a month.

The problem of meeting increased demand started when Cy decided to spend a few dollars in local newspaper advertising. One of the attractions of his candy shop was the few farm animals he still retained. As Mom and Dad made their selection, the children could usually be found behind the shop petting the horses or chasing the chickens. Most of his business was done on weekends—obviously the result of a drive out of town so the kids could see the animals. This, coupled with the sales thesis involving the association of candy produced "on the farm," gave Cy an advertising idea he could swing on a limited budget. The following spring, when the farm was blessed with a colt, he decided to run a "Name-the-Colt" contest. The advertising, in local newspapers and through handbills, took the form of an open letter inviting the children of the city to visit the farm, make friends with the colt, suggest an appropriate name for a prize and receive a free pony ride while on the premises. It was, of course, also pointed out that suggested names could be left at the four retail outlets handling Cy's products in town.

The contest was closed with a free picnic on the farm, at which time the winning name, Pink Clover, was announced. The winner was a blue-eyed blonde of four, whose picture made for good public relations and some "free" advertising in local newspapers. Although the CPA became very close to Lucas, he never did find out if the contest was rigged or not.

This bit of homey advertising was an immediate success, and the demand for Cy's candy doubled immediately.

He quickly decided his present equipment could not produce enough candy, even with two shifts of workers. He would require approximately $10,000 worth of new equipment. He called upon his CPA for the first time to prepare financial statements for him, and together they were successful in arranging with the bank to finance the better part of this equipment. However, as he later learned, this move exhausted his ability to borrow additional funds from the bank. The CPA, aware of this danger, had suggested
that some of the nonspecialized equipment be rented, but Cy had preferred outright ownership.

The demand for his candy could now be met, and in order to capitalize further on his markets, Cy succeeded in arranging for the sale of his products through three more large retail outlets in the city and two local grocery chains. With the new customers, with new equipment, and with small advertising expenditures, he was doing a monthly sales volume of close to $30,000 within six months after his successful contest promotion.

It was about this point that Cy found he could not pay his bills. Although his financial statements indicated that profits were running higher each month, his creditors were not only becoming angry over nonpayment of his bills, but a few of them refused to deliver additional supplies to him. He again found it impossible to produce the additional requirements called for by the larger orders.

The statement that the CPA prepared for him at the close of the previous month had approximately the following figures within the current asset and liability sections:

**ASSETS**

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash</td>
<td>$ 5,000</td>
</tr>
<tr>
<td>Accounts receivable</td>
<td>48,000</td>
</tr>
<tr>
<td>Inventory</td>
<td>17,000</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>$70,000</strong></td>
</tr>
</tbody>
</table>

**LIABILITIES**

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Accounts payable—current</td>
<td>$20,000</td>
</tr>
<tr>
<td>Accounts payable—past due</td>
<td>21,000</td>
</tr>
<tr>
<td>Bank loan</td>
<td>7,500</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>$48,500</strong></td>
</tr>
</tbody>
</table>

The CPA had previously pointed out to him that he had lost $275 in the prior month alone in vendors' discounts. It was a simple case of a small company that had grown so rapidly that it was no longer able to finance itself and its customers, at least on present customer payment arrangements, at the same time.
A visit to the local bank by the CPA and Cy resulted in the offer of a small additional loan. But this was not nearly sufficient, in the opinion of the CPA, to accomplish additional expansion. He explained to Cy that the same situation would only arise again quickly and recommended that a local commercial finance company be contacted to determine if it would advance monies against the accounts receivable. The CPA had some previous experience with finance companies, and while he believed that Cy's principal customers would be considered reasonably good credit risks, he was concerned over the fact that the average invoice values were only about $350 and was afraid that the finance company might not be interested in accepting them as collateral. Cy's capital at this point was still small—about $30,000.

The finance company was impressed with Cy's growth and potential and was relatively happy with the credit status of Cy's accounts. However, its officers pointed out that the operation, at this sales volume was relatively new and that, therefore, they did not feel able to advance as much as they would for a longer established or larger business. They did agree to advance up to 70 percent against pledge of the accounts receivable at a rate of 15 percent per annum. This rate was somewhat distressing to Cy, but after a few words of explanation from his CPA he realized that it was his only choice. Moreover, it would enable him to achieve considerably higher profits and a higher rate of return on his capital because of the increased sales he could handle. There was one other problem—he would have to incorporate. This was done quickly by an attorney the CPA contacted.

After the appropriate arrangements were made, Cy first requested $30,000 from the finance company, upon the CPA's recommendation, the current sections of his balance sheet now looked like this:

<table>
<thead>
<tr>
<th>ASSETS</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash</td>
<td>$ 35,000</td>
</tr>
<tr>
<td>Accounts receivable</td>
<td>48,000</td>
</tr>
<tr>
<td>Inventory</td>
<td>17,000</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>$100,000</strong></td>
</tr>
</tbody>
</table>
LIABILITIES

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Accounts payable—current</td>
<td>$20,000</td>
</tr>
<tr>
<td>Accounts payable—past due</td>
<td>$21,000</td>
</tr>
<tr>
<td>Due to finance company</td>
<td>$30,000</td>
</tr>
<tr>
<td>Bank loan</td>
<td>$7,500</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>$78,500</strong></td>
</tr>
</tbody>
</table>

One of the points the CPA had made relative to the high rate of interest charged by the finance company was that Cy could now discount his bills to vendors and with 2 per cent terms offered by the majority of them, he would find himself earning 36 per cent a year by timely payments to those who offered 2 per cent ten-day terms and as much as 12 per cent on a few who offered only 1 per cent net thirty-day terms.

After Cy applied cash to put his vendors on a current basis, and paid off the bank loan which the bank now demanded because of the lack of security, there would still be enough left over to finance additional purchases to boost production. As the sales volume increased, the CPA explained, higher receivable balances would be produced and through the terms of the agreement with the finance company he could immediately receive up to 70 per cent of this additional amount, but only if it was needed, with which to keep the operation liquid.

Within another six months, Cy was selling at an average rate of $40,000 per month, but averages can be very misleading. It became clear at this volume that the sales around the holiday seasons were now significantly larger than they were at other times of the year. This became painfully evident when Cy was unable to fill all orders during the following Easter season. The financing of receivables had enabled him to meet the steadily increasing demands but it still could not provide enough working capital during the months when he should logically have built inventories for a holiday. The CPA suggested that the commercial finance company might provide additional funds for this purpose—either by financing the inventory directly or by taking the inventory as additional collateral and advancing a higher percentage on the accounts receivable. The original proposal to the
The finance company was on the latter basis because the CPA felt that it would prefer to finance only the receivables. In this case, however, the finance company felt that it could only be of assistance on a straight inventory financing arrangement, and that they would be unable to advance a very large percentage of funds because the materials and finished goods were both perishable. Furthermore, the raw materials were subject to fluctuating market prices. Cy did not have to be told the latter. He knew that he could save money by buying materials in advance when the prices were low—if he could get the money to pay for them. The finance company and Cy agreed to enter a field warehousing arrangement if Cy would make certain improvements and additions to his refrigerated storage area. The collateral, inventory and accounts receivable, would be crisscrossed, of course, so that either could become security, regardless of the nature of the advance. The improvements would cost approximately $5,000. The finance company indicated that it would be unable to finance this as it did not offer this type of financing service. There was no difficulty, however, in arranging for time payment with the manufacturer.

The finance company agreed to advance, at an interest rate of 18 per cent per year, 60 per cent against inventory values of raw materials and finished goods. This posed a question to the CPA and Cy, who did not understand how they could arrange for the transfer of raw materials to work-in-process and then to finished goods while at the same time keeping the paper work on the releases of merchandise simple. The finance company's representative explained that this was not particularly difficult. A plan was mapped out wherein Cy would report the value of inventory taken from the raw material stock on a weekly basis, and report the values of finished goods' inventories placed into the field warehouse, and through a system of offsets settle the balance with the finance company on a weekly basis. At the recommendation of the CPA, an attorney was consulted on this maneuver. He concurred that such an arrangement would be perfectly legal for both Cy and the finance company.

There was no need for inventory financing until August. Cy planned then to purchase materials in advance for his stepped up production cycle in September and October in anticipation of a
30 per cent increase in business during November and December. Based on previous experience, the finance company had been willing to accept this estimate as factual. This was one of their considerations in agreeing to advance monies on the inventories. In August and September approximately $40,000 of additional inventory was purchased, processed, and placed in the field warehouse. By October 31 this amount had grown to an inventory of close to $55,000 against which the finance company had advanced almost $35,000. When Cy saw his financial statement and the interest expense recorded by his CPA during these months, he again wondered if this was a good deal or not. The CPA pointed out that the cost of the inventory financing of $35,000 at 18 per cent for the three-month period admittedly resulted in an extra cost of about $1,500. However, based on the average mark-up of the candy, this required only $5,000 worth of increased sales to more than offset the added expense. Experience last year indicated that at least $10,000 worth of extra business was lost in each of the months of November and December. This year Cy could handle all of this increased business, and the interest cost was actually quite small in relation to the increased profits to be made.

As it turned out, Cy did a sales volume of $55,000 in both November and December. As of January 1 of the following year, he had $85,000 worth of receivables on his books against which the finance company now only had to advance 40 per cent in order to provide adequate working capital. Late in January a new arrangement was worked out with the finance company wherein inventory was given as collateral but a higher percentage was advanced against receivables—this was the plan proposed by the CPA earlier. The finance company was quite flexible, and special financial requirements, created by the cycle of Cy’s business, could generally be arranged. It was always apparent that the finance company was primarily in business to finance receivables, and that the inventory financing was merely an adjunct or a method of promoting additional receivables for Cy that it could then finance. The company was never particularly happy about financing the inventory, under any conditions.

In its third full year after “Pink Clover,” the Lucas Candy Company did a sales volume of $750,000 and is now operating on an
extremely profitable basis. The CPA is again exploring the possibility of financing all of the present requirements with the local bank, and he believes the finance company and high interest cost can soon be eliminated.

It is difficult to evaluate whether the finance company, the assistance of the CPA, or "Pink Clover" was the prime reason for the rapid growth of Cy's small candy business. All made valuable contributions.
Bill Noree was convinced, about 10 years ago, that he had an approach to retail merchandising that couldn't miss.

Bill was forty-four. His first job was as a stock clerk in a department store. By the time he had advanced to buyer he had acquired an extensive knowledge of retailing. He was aggressive, personable, and a great salesman. He had a "feel" for merchandising. One look at a product, the promotional plan, and price, and he could predict with remarkable accuracy whether it would sell. When he went into business he had only a few assets: a wife and three children with faith, $28,000 in cash, and a father-in-law who had advanced an additional $17,000 to him.

He had become acquainted with a CPA through a local bridge group, and one evening he outlined to the CPA his plan to enter business. His merchandising policy plan was to offer nationally advertised merchandise with proved consumer acceptance at radically reduced prices. More important, all merchandise would be exactly as represented; the year, model number, and regular retail price would never be misrepresented. This was not true of most so-called "discount" operations previously attempted. He believed that if he offered customers a fairly liberal return privilege, it would also be advantageous to repeat sales. He had thoroughly studied fair trade laws and practices and had discussed this risk with his attorney. The greatest danger appeared to be that sooner or later the fair trade laws would be declared invalid. With everyone then dropping prices, serious competition could develop.
Although gross profit margins would be low, he would compensate for this by making his store largely self-service. Since people will inconvenience themselves for a bargain—particularly on a nationally advertised item—he could keep rental very low in proportion to the substantial volume he would produce at the low mark-ups. He, therefore, planned to operate in a loft, only a few blocks from the high rent district. He was confident he could obtain reasonable terms from suppliers and, with the quick stock turn he was sure he could achieve, he would require a relatively small inventory investment.

The CPA recommended they spend a few minutes in formally putting the plan on paper. After projecting anticipated sales and expenses, Bill was even more confident of success. Two months later he was in business—and the CPA had a new client. The operation was an immediate success and net profits exceeded even the forecasts, because Bill found that discounts didn’t have to be as large as he had thought to pull in a crowd.

He was now convinced that this success could be repeated at other locations—but only if personnel with the necessary motivation and merchandising know-how were managing the operations carefully. He had two experienced employees, both old friends with retail experience whom he had trained in his selling methods. His primary problem, however, was the money needed to expand. At present earning levels, it would be another year, and perhaps two, before retained earnings—plus a favorable bank loan—would provide enough capital to set up a second store.

His CPA was able to provide the answer to the problem.

The first year profits to be taxed placed the corporation in the 52 per cent Federal bracket, which with another 3 or 4 per cent siphoned off by other taxes on income would leave only 45 per cent of the profit for growth. The CPA suggested that, in view of the low salaries, sizeable bonuses could reasonably be paid to the two employees which, net of taxes, could then be used by the employees to purchase nonvoting stock of a new corporation to be organized for the next venture. Bill would then buy the voting stock of the new venture. Since the employees had not received large salaries, a sizeable bonus still left both in effective tax brackets much below that of the corporation. This simple strategy
resulted in the retention of about 60 per cent of the funds necessary to finance the second store. A small bank loan and Bill's purchase of the voting stock provided the balance. The second store was equally successful—primarily as a result of the attitude of the two stockholder employees who, with an ownership interest, conducted the operation as if it were their own business.

This technique was repeated in each of the three succeeding years with key employees capable of managing additional stores. Nonvoting stock was also offered to the other employees at attractive prices. Caution was always exercised in explaining to each employee that there could be no guarantee against loss through stock purchase; but, on the other hand, part of the plan provided for company repurchase at current values in the event of termination of employment, etc. It was a rapidly growing business. As new personnel saw that the stock of older employees had tripled in value in as little as three years, management's only problem was in determining how much stock should be made available to the employees. There was no difficulty in selling it. And no one was fired, incidentally, if they declined to buy it.

Bill Noree and his employees now own a number of stores. All of them are several times the size of the first one. He attributes, to this day, his quick success to this simple technique for retaining money suggested by his CPA. He and his family still own all of the voting stock. The first two employees to whom he offered stock are now wealthy vice presidents in the administrative office. Bill considers them to be his most valuable management men, but when they violently disagree with him on policy, as vice presidents will do, he jokingly reminds them that he can fire them any time he feels like it.
AN ILLUSTRATION OF HOW A SPECIALIZED EXPORT FINANCING ARRANGEMENT PERMITTED A SMALL BUSINESS TO GROW

In the late 1940's, Hans Ludwig was employed by a large auto parts manufacturer as a sales engineer. In connection with the sale and application of its products, he was sent to Latin America to perform some engineering research. Ludwig was about thirty years old at the time. Although he was only out of the country for a short period, he returned to the United States with an excellent picture of the foreign market for automobile parts, and had garnered a tremendous amount of knowledge as to which manufacturer's parts were best adaptable to these foreign markets, as well as which ones could best be sold at the lowest prices. He was tremendously impressed with the great demand for these products in this area. He logically asked himself why his newly acquired knowledge could not be put to work in his own business.

He performed a bit of basic market research by contacting, on a personal basis, certain of the foreign buyers whom he had serviced during his trip, and through correspondence with other potential customers, whose names had been obtained from Latin American marketing guides. He pointed out in his correspondence that his personal experience in the market, primarily from a technical viewpoint, could be of significant value to his prospective customers, and he indicated that his prices would be lower than those of the larger exporters at that time. The reaction was good and in a short while he knew he had a market.

His total available capital was approximately $5,000. From his experience and connections in the automotive trade, he knew that he could obtain the necessary parts, some of which were still in
short, postwar supply, from domestic manufacturers. Through another connection, he had been assured that he could obtain the necessary letters of credit, in at least two Latin American countries. He had no knowledge of financial export transactions, and after a short discussion with a banker and a supplier he learned that it would be impossible for him to do business on credit from these sources. They had both suggested other methods which he didn’t understand.

He thought that the logical thing to do at this point was to contact a certified public accountant, whom he felt would undoubtedly be familiar with the techniques of foreign finance. He knew of a CPA who had given him some astute tax advice in connection with his employment outside the country.

The extent of the CPA’s association with foreign financing had been through brief experience in connection with the audit of an export firm as a semi-senior accountant for a national CPA firm. He had once attended a series of seminars on financing in which export financing was discussed, but had no practical experience in the field. He made this clear to Ludwig. At Ludwig’s insistence, however, he agreed to assist Ludwig in evaluating any situations that Ludwig could turn up and offer whatever advice he felt he could. He also volunteered to investigate a few possible sources for Ludwig.

He first spoke with the foreign departments of two banks and quickly determined, as Ludwig had, that a bank would not extend credit to an exporter with a capital of only $5,000. The bankers recommended that he seek out a commercial finance company specializing in export transactions, and through a series of phone calls he ultimately located one that handled transactions for small exporters and would be interested in discussing the situation.

The finance company offered the following arrangements. It would accept assignment of the letters of credit, but would not notify the foreign bank. In order to be protected, it would arrange for the merchandise to be shipped to a packer of its own selection who in turn would confirm to it that the packed cases would be shipped to forwarders, also selected by the finance company, for final shipment to the foreign customers. The charges under these letters of credit transactions would average about 3 per cent of
the invoice value plus an interest charge of 15 per cent per annum if payment was not effected by the end of three months. The 15 per cent would run for only the first year in the event that foreign currency restrictions prevented payment of the letter of credit. The interest rate after this time would be reduced to 6 per cent. On this basis, after working out a few calculations as to profitability, the CPA recommended that Ludwig actively solicit orders and finance the sales on this basis.

The operation had a moderate beginning, but working with the smaller amounts proved to be good practice for both the CPA and Ludwig for the bigger things to come. In approximately six months, Ludwig, who lived rather frugally, had built up a capital of approximately $15,000 and started to make lengthy trips, especially to Brazil.

During these journeys he found that he could increase his business substantially, by what bankers and customers informed him was the granting of sight draft transactions. He asked his CPA by letter to investigate this method for him. After research, the CPA advised Ludwig that the consequences of such transactions might not only be involvement in a significant foreign credit risk, but also create additional prolongation of at least thirty days of time between payment to the domestic manufacturer and receipt of the money from the foreign buyer. This, of course, would result in additional interest cost, but if Ludwig could sell at slightly higher prices, he felt it could be absorbed. Before the CPA could approach the finance company, he asked Ludwig to submit the names of the customers with whom he could do business on this basis. After doing a little more basic research as to the credit standing of these customers, the CPA discussed the new proposition with the commercial finance company.

The commercial finance company, in view of Ludwig's previous record, was interested in financing these larger amounts, and after its own check of the customers to whom Ludwig would sell, on sight draft terms, it agreed to finance shipments as long as they did not tentatively exceed $10,000, and on the condition that Ludwig provide 20 per cent margin deposits. The CPA was informed that the procedure would be about the same as under the letter of credit transactions, but that the finance company would require
additional protections. To assure that the "right type" of merchandise was being sent, the finance company would insist on receiving shipment certificates from packers relative to the contents of the cases involved, and such contents would have to correspond with the merchandise ordered by the foreign buyers—copies of such orders having been sent by Ludwig to the finance company. The freight forwarder would also be authorized to send all of his documents pertaining to the shipments to the finance company, and Ludwig was to provide all of the necessary invoices and drafts to the finance company, who in turn would insist on processing the papers for collection. The finance charges under the higher credit risk would be 5 per cent of invoice value, plus the same rate of interest that had been charged under the letter of credit transactions. The possibilities of the currency restrictions becoming more serious in many Latin American countries had become distinctly more significant at this point, and the CPA was extremely cautious in assuring the reduction of interest after a period of one year from 15 per cent to 6 per cent per annum.

In view of Ludwig's new selling policies, which would still not provide for the conventional mark-up on auto parts, the CPA now faced a difficult analysis of whether, in view of the higher interest charges and the added possibility of blocked currency situations, Ludwig could conduct a profitable operation. He reviewed the proposal of the finance company with an officer of the foreign department of a local bank in order to clarify, in his own mind, some of the details and arrangements. He then carefully prepared a forecast of estimated profits by collecting the direct costs and applying interest costs to gross profits based on various collection periods. He sent these analyses to his client together with a letter explaining the arrangements he had been able to make. He also reported all of the current information that he had been able to gather from bankers and other financial men on the possibilities of further currency restrictions. He suggested that Ludwig also discuss this with financial people in Latin America.

Ludwig called the CPA after receiving the facts and during a fifteen minute cable call his decision was made. What did the CPA think, was the first thing he asked. It was the advice of the CPA that Ludwig should proceed with the new sales financing plan,
but to maintain close scrutiny on the banking situation in the foreign countries, while he did the same in the United States. If remittances became significantly delayed, the profitability picture would change in view of the interest charges—but until such time it seemed well worthwhile.

With this advice which, Ludwig said, represented a confirmation of his own thinking, he proceeded. His merchandising plans worked very well with new financial arrangements offered, and with good luck blessing his operations he accumulated a capital of $40,000 in two and one-half years. He had come to be recognized as one of the better suppliers of auto parts in the foreign markets because of his reliable deliveries and field service, and even when the cream had been skimmed off the auto parts market, the CPA’s reports still indicated that operations were profitable and that sales were continuing to increase.

It was about this time that a few orders received were close to a half million dollars. Ludwig seemed to prefer not to realize, as the CPA did, that under the recourse arrangements with the finance company, one big loss on a shipment of this magnitude could put Ludwig out of business. The finance company was still anxious to handle Ludwig’s business, which the CPA knew, so with Ludwig’s permission he arranged successfully a separate agreement with the finance company wherein Ludwig would only be liable for $50,000 worth of losses during any one year. The finance company agreed that the $50,000 would cover any normal losses and that it would absorb the risk of losses over this amount.

Success continued, and Ludwig accumulated additional capital during another year of operation. The CPA had kept in close contact with the banks offering export financing and had kept several of them informed of Ludwig’s progress. With the operation now established and with a capital position, he arranged for a bank to handle the financing of the regular business, at a lower interest cost, and made arrangements with the finance company to handle only special large transactions.

Ludwig is still in business—although he now continually varies his operation depending on the demand for various products that may be successfully exported. Ludwig is still not forty years old; yet he is worth in excess of half a million dollars. And the CPA
has a life-time client. The CPA modestly feels that any other CPA with a little research could have done as much for Ludwig in arranging and evaluating the export financing. Ludwig is inclined to feel that without the assistance of this CPA who served as his general business adviser, as well as his financial adviser and negotiator, he would probably still be doing engineering research in Latin America.
AN ILLUSTRATION OF A LIFE INSURANCE COMPANY’S REQUIREMENTS FOR SUPPLEMENTARY INFORMATION TO BE SUBMITTED WITH MORTGAGE LOAN APPLICATIONS

The following is a reproduction of the instructions of a typical life insurance company on the letter of information to be furnished by an industrial company applying for a mortgage loan. A review will provide a check list of what supplementary data is not only desirable for any lender, but mandatory in negotiating with life insurance companies for long-term mortgage money. It also provides some insight to the standards that have been set by life insurance companies in the making of mortgage loans to small businesses.

Letter of Information—Industrial

1. Audit Reports—Furnish complete, original, annual audit reports for the last ten years certified by independent certified public accountants. These will include balance sheets, earnings statements, surplus accounts, and supporting schedules. If the last annual statement is over three months old, include the latest available interim earnings and balance sheets with comparative data for the previous year.

2. History of the Company—Give an outline of the growth of the business to include significant changes in financial structure, management, physical plant, products, processes and any important contracts or agreements—either new or old. List location of all plants and offices presently occupied. Explain any loss years or poor earnings during the past ten years. For the past five years,
state separately sales to Government, and to domestic civilian customers.

3. **List of Products and Marketing Scheme**—Describe market area covered or to be covered, selling organization and methods, advertising policy, the effects of important patents or royalties, the sources of raw materials, and the principal vendors. Indicate if all products are manufactured by the company or if some are purchased. Submit sample catalogues and circulars.

4. **Competitive Position**—Include a list of principal competitors and their relative standing with relation to the company (annual sales, net worth, etc.). Relate how the company secured its standing in the industry and what steps are taken to maintain this position, such as product or market research.

5. **Principal Customers**—List names and sales records for each customer during the past five years. In addition, state length of association with each.

6. **Forecast of Future Sales and Earnings**—Give brief explanation of the basis of the estimate. State current backlog of orders by products or departments. Describe budgeting practices and other methods of expense control.

7. **Real Estate**—Briefly describe real estate offered as security. Include land area, building (including square feet of usable floor area and also gross area), cost when acquired or constructed, and estimated cost of any new construction. Tell what additional property the company owns, such as machinery or other plants, and how title to real estate is held. If a change is being made, include for each of the last ten years previous rental costs which are to be eliminated and explain what further economies are anticipated.

8. **Purpose of the Loan**—Explain the benefits to be obtained and the application of proceeds. Include a Proforma Balance Sheet giving effect to proposed loan at the time it is contemplated to be closed.

9. **Equity Funds**—Explain the source of all required funds if purchase or construction of additional facilities is planned.

10. **Officers and Directors**—List, with names and operating
titles. Show principal stockholders or stock control by number of shares or percentage of total.

11. Principal Executive and Technical Experts—State background and experience, age and compensation. Discuss availability of "second-men."

12. Labor Information—Include number of employees, membership in unions, strike history, and labor relations. Give number of employees hired and number terminated in each of last three years.

13. References—List bank and trade references.

Reference list for further study

A reference list on the entire field of finance could in itself require all of the space in this bulletin. This listing, therefore, will be confined to the subjects discussed in the bulletin. It will include, within each subject, only a limited number of suggestions, which are believed, however, to be the best books and articles for further study by individuals or groups.

For guidance in obtaining the best reference material on areas of finance not covered in this bulletin, or where reference coverage provided does not extend to a specific problem, the American Institute's library will welcome the opportunity to assist members.

General


Basic texts on corporation finance recommended for the benefit of the CPA who wishes to review the ground covered in a college course in corporate finance. There have been new developments in corporate finance since most CPAs first studied the subject in school. It should prove interesting reading to any CPA and pro-
vide an excellent review of many matters that may have been forgotten over the years.


While this handbook may be elementary to the CPA, it is recommended as a brief review. Some CPAs have found that distribution of this or other booklets in the SBA management aids series to their small clients can be a valuable service to them, as well as a builder of sound client relations.


An excellent review of all the significant methods of financing, for short-term, long-term and equity funds. These chapters also briefly cover the forecasting of working capital requirements, presentation of loan applications, considerations in selection of the type of financing to be used or type of security to be issued. A reasonably thorough orientation course within the financial areas covered by this bulletin could be prepared quickly from the contents of these chapters alone.

**The determination of financial requirements**

**Cash Forecasting**

Any of the basic budgeting books in the reference list provided in the management services bulletin on budgeting will be of value.

**Other Sources**


The definition, methods and considerations in the planning and preparation of long-term forecasts. This is excellent for use in
the preparation of course material or for reference by the CPA already somewhat familiar with the area.


   An article based on research into the more refined and technical methods of cash forecasting employed by some of the bigger businesses of America. While use of these techniques may not be necessary in the small business, a CPA wishing to make an advanced study of cash forecasting methods should read this material.


   An article providing a step-by-step method for forecasting financial needs for a medium-sized manufacturing or trading company. It provides a brief, but excellent review of CPAs preparing forecasts for smaller companies.


   Chapter 1 provides discussion of the various factors in the evaluation of the use of corporations, partnerships, or other form of business, with consideration given to the financing implications of the various forms. Chapter 2 discusses capital structure considerations, ways and means of equity and long-term debt financing and other factors in planning the financing of a business.

**Methods and sources of financing**

**U. S. Government Publications**

1. *Financing Small Business*. A report to committees on banking and currency and the select committees on small business by the Federal Reserve System. Issued April 1958. New copies are no longer available from the U. S. Government Printing Office but copies should be found in most financial libraries.

   A 550-page report on the financing of small business with emphasis on the policies and practices of all of the sources of funds for small business. A certain amount of technical data describing
the workings of the various methods of financing offered by the sources is also included. Governmental sources of funds are described in detail.


A 200-page report on a briefing session on the Small Business Investment Act of 1958 sponsored by the American Management Association in December 1958. This report includes, not only the text of the Small Business Investment Act, but also includes reprints of explanatory talks and the questions and answers of the session. The act, and its practical applications to small business through SBI’s, is thoroughly covered.

Other Sources

3. Accounts Receivable and Inventory Financing by Walter S. Seidman. Masterco Press, Ann Arbor, Michigan, 145 pages of text, and a 75-page appendix exhibiting sample loan agreement forms for all forms of financing discussed in text.

An excellent text which covers in detail the techniques of accounts receivable and inventory financing as well as the activity of commercial finance companies and factors in providing funds via these methods.


This is one of the most complete articles on this method of financing ever written. It explains in detail how these financing methods work and who in the small business community can effectively utilize them. It also discusses other methods of financing offered by finance companies and factors.


A 22-page publication which concisely explains the techniques of financing imports and exports. It is believed that these articles alone will provide the CPA with a well grounded orientation in these methods of financing.

6. Financing Foreign Operations, Management Report No. 23, published by the
An excellent but specialized reference recommended only to the CPA who wishes to review methods of financing foreign operations through U. S. Government sources such as the Investment Development Program, the Export-Import Bank of Washington, the Investment Guaranty Program and PL 480 Loans, the Development Loan Fund, etc. The report also provides information on international financial organizations and the role of private lenders in financing foreign operations.


An article that gives both the advantages and disadvantages of financing through rentals. It includes a detailed illustration of the effect of leasing on cash flow, and discusses leasing as a marketing aid to manufacturers of equipment.


Another excellent article on the use of leasing as a method of financing. Comparative cost factors in straight rentals and leasebacks are emphasized, but the article also discusses the tax factors and financial statement disclosures required of CPAs in the financial statements of companies using this form of financing.

**Assisting in obtaining funds**


This 35-page outline was prepared to serve as a convenient guide in analyzing company management for credit purposes. It can be of value to the CPA as a convenient check list of supplementary data on operations and management that may advantageously be submitted to lenders with loan applications of small business clients.

2. *40 Questions and Answers About Audit Reports*, published by the American Institute of Certified Public Accountants.
This 35-page publication was prepared with the assistance of the Robert Morris Associates and the American Bankers Association in order to provide answers to questions that bankers and other lending agencies are likely to ask about CPA audits and audit programs. It will help to define the CPAs' responsibilities in the submission of audit reports to lenders.


A 12-page guide on the financial information the lender wants and a small business ought to submit.


An excellent article which reviews for the CPA an outline of procedures for both banker and CPA in handling financial reports for credit purposes. Provides a check list of report disclosures to be made in reports to lenders.

Keeping up with the dynamic financial world


An article which defines the CPAs' responsibilities in remaining informed on the financial outlook and offers some suggestions on how the CPA can best accomplish this task.