

10.5: The Three Threads

Learning Objectives

1. Understand that effective and efficient financial management can enhance value provided to customers.
2. Appreciate that effective financial management can improve the firm's cash-flow position.
3. Understand that the use of technologies can significantly reduce cost of operations and improve profitability.

Customer Value

In "[Your Business Idea: The Quest for Value](#)", "[Marketing Basics](#)", and "[Marketing Strategy](#)", there has been extensive discussion of the notion of market segmentation. By segmenting the market, one improves the probability that a business will be able to better serve particular customers' needs and thus provide better customer value. From a financial perspective, there may be an equivalent notion of segmentation. Earlier discussions on market segmentation were centered on how a business could provide value to particular sets of customers. A subsequent stage of this analysis would be to examine how and if these customers can provide value to a business. No one is served if the business provides significant value to its customers but the business goes broke in the process. The financial equivalent of customer segmentation examines the profitability of different groups of customers. Some customer groups may be extremely profitable to a firm, while others produce nothing but losses. Identifying these different groups requires a commitment to accounting and a financial analysis of each customer base. The first step is to determine the margin provided by each customer group. In many cases, this is a bit of a challenge. It may require more extensive record keeping. The business may have to use **activity-based costing systems**. (Activity-based costing systems were developed in the late 1970s and the early 1980s.) This approach to accounting "is a process where costs are assigned due to the cause and effect relationship between costs and the activity that drives the cost." Tiffany Bradford, "Activity-Based Costing," *Accounting @ Suite 101*, accessed December 2, 2011, tiffany-bradford.suite101.com/activitybased-costing-abc-a52148.

Done properly, activity-based accounting can help a business identify the true costs for serving particular customer groups and therefore identify their real profit margins. A business may discover that some customer groups are actually a source of losses for the firm.

It should be pointed out that activity-based accounting is complex, difficult to implement, and, in some instances, does not conform to the requirements of generally accepted accounting principles. This might mean that a business would have to have two coexisting accounting systems, which may be too much of a burden for the small business.

Cash-Flow Implications

It should not be too surprising to find that good financial management can benefit tremendously when a firm's cash flow is improved. Two areas where good financial management can help would be e-procurement and factoring. **E-procurement** involves managing the timing of invoices to customers and from suppliers to improve the cash flow of the firm. Peter Robbins, "E-Procurement—Making Cash Flow King," *Credit Control* 26, no. 2 (2005): 23–26. The electronic handling of orders and their associated invoices assures that customers will receive their orders in a more timely fashion. E-procurement means that fewer personnel are required to take and handle orders. This can be a tremendous source of cash saving in and of itself. E-procurement should be on any supply chain management program of a business. We discuss supply chain management in "[People and Organization](#)".

Another area where good financial management can improve cash flow is factoring. The most common form of factoring is associated with a business's accounts receivable. Trade credits involve purchasing and taking delivery of supplies now while planning to pay for it later. (See "[The Importance of Financial Management in Small Business](#)" for a discussion of trade credits.) Three key numbers often identify trade credits: a discount rate for early payment, the time to pay to take advantage of the discount rate, and the date by which the entire bill must be paid. We underscore the kinds of the factoring with the following example.

A firm makes a large sale of supplies—\$200,000. The trade credit program is 2/10/60. This means that the firm will give a 2 percent discount if the customer pays the entire \$200,000 within 10 days and expects the payment of the entire \$200,000 within the next 60 days. The firm knows that its customer never exercises the discount opportunity and always pays on the last possible date. Further, let us assume that this firm is having a problem with its cash flow. It would like to expedite payment as quickly as possible but does not expect that the customer will obtain a 2 percent discount by paying within 10 days. This firm could exercise the factoring option. This business goes to another firm that would provide as much as 80 percent of the cash receivable invoice

immediately for small fee. In other words, the firm would receive \$160,000 immediately rather than waiting 60 days. When its customer pays the bill, the firm would receive, in total, slightly less than the \$200,000 but would have expedited the payment and thus aided its cash flow. Factoring can be an important element in improving the overall cash flow of any firm.

Digital Technology and E-Environment Implications

We identify four sources of capital in "[The Importance of Financial Management in Small Business](#)", one of which is internally generated funds. Businesses can increase the supply of capital money by becoming more operationally efficient. Improved operational efficiency can save any organization considerable amounts of money. Many start-ups, particularly those with some technological savvy, use technology to produce significant cost savings. This recognition of the vital role of technology as a cost-saving tool came to the forefront at a recent GeeknRolla conference in London. This conference brings together new business start-ups and potential investors. There is a heavy emphasis on how new businesses (and established businesses) can successfully integrate a variety of technologies and improve their operational efficiencies. As one participant in the conference, Michael Jackson, an investor, said, "Companies that are cottoning on quickly to these tools are doing very well, and they are taking business away from those who are too slow to adapt." Sharif Sakr, "[GeeknRolla: Tech Start-Ups Reveal Cost-Cutting Tips](#)," *BBC Business*, accessed December 2, 2011.

The 2011 conference paid special attention to the concept of **cloud computing**. This term refers to having software programs and databases located on an outsourced site. As an example, rather than buying Microsoft's Office Suite for every computer in a business, one could access a word-processing program, a spreadsheet program, or a database as needed. The firm would be charged for each use or a monthly fee rather than having to purchase an entire package. "[The Three Threads](#)" mentions that one can even access an entire accounting system as a part of a cloud computing option. As Sharif Sakr said, "In addition to being 'pay-as-you-go,' cloud computing has the advantage of reducing the number of computers, servers and network connections that a small business needs." Sharif Sakr, "[GeeknRolla: Tech Start-Ups Reveal Cost-Cutting Tips](#)," *BBC Business*, accessed December 2, 2011.

In addition to reducing a small business's initial commitment to an information technology (IT) infrastructure—computers, software, network systems, and IT staff—cloud computing provides some of the following additional benefits:

- **Scalability.** Many cloud applications allow for the growth of a business. As an example, some cloud accounting packages charge on the basis of the number of users; therefore, a company could purchase as much capability as it needed.
- **Updates.** Businesses do not have to worry about purchasing the latest version of the software, uninstalling the old version, and installing the latest version. This is done automatically by the vendor.
- **Access.** Cloud programs can be accessed wherever one has a connection to the Internet. A business is not tied to its own computer or the network where the software resides. This results in tremendous flexibility; as an example, one can access the program and the data while on the road with a client.
- **Integration.** Having programs and databases on the cloud facilitates multiple members of an organization successfully working together. No one has to worry whether he or she is working with the latest version of the spreadsheet or the client list.
- **Security.** Cloud providers recognize that securing their client's data is a core issue for business survival. They will bring into play the required technology to ensure that every one's data are secure and safe. They have much greater capability of assuring this than almost any small business.
- **Customization.** Businesses can acquire the software that they need.
- **Extensions into the world of social media.** More and more businesses are using various forms of social media—Facebook, Twitter, LinkedIn, and so forth—yet many small businesses lack the technological savvy to fully exploit these new avenues of marketing. Cloud providers can assist these businesses in this vital area. Eilene Zimmerman, "A Small Business Made to Seem Bigger," *New York Times*, March 2, 2011, accessed December 2, 2011, www.nytimes.com/2011/03/03/business/smallbusiness/03sbiz.html?_r=1.

So how can smaller businesses aspire to efficiencies that much larger organizations have achieved through the use of IT while achieving it at a fraction of the cost? Entire accounting systems can be placed on the cloud. FreshBooks, which is free for solo location businesses, provides an accounting system that can be extended to allow business operators to submit invoices via the iPhone. Shoeboxed, another cloud-based company, allows small businesses to take digitalized receipts and turn them into invoices.

Owners and employees can more productively manage their time by using a variety of scheduling programs. TimeTrade is an effective personal scheduling assistant. It can show prospective clients available times and assist in arranging a scheduled appointment. Major companies, such as Microsoft and Google, provide cloud-based applications that can be employed by both large corporations and the smallest of businesses. Microsoft has an e-mail system—Exchange—that can be used by smaller

businesses for fees as low as \$50 per month. Google Voice can translate voice mail and e-mail messages and forward them anywhere in the world. Programs such as Mail-Chimp can send information packages to any or all of a business's clients and then automatically post the same information on the company's Facebook and Twitter sites.

KEY TAKEAWAYS

- Just as a business must identify what is of value to its customers, it should also determine how valuable its customers are to the business.
- It may not “pay” to attract and keep all customers.
- Techniques such as factoring accounts receivable may improve the cash flow of a firm.
- The use of cloud computing can significantly reduce costs and improve the financial position of a firm.
- Local, national, and international economic conditions can affect any firm. Businesses should plan on how to deal with major economic upheavals.

EXERCISES

1. Search the Internet to find out about the availability and price of activity-based accounting software.
2. Imagine your boss has asked you to prepare a small report on using factoring as an option in her auto parts business. Search the Internet to find out about the economics of factoring.
3. Prepare a report on accounting and finance software packages available through cloud computing. Discuss their pros, cons, and pricing structures.

Disaster Watch

At the beginning of "[Financial Management](#)", it was stated that a major cause of failure in small businesses is inadequate financial management. If one looks at that statement at face value, the only conclusion one can come to is that failure solely rests on the shoulders of the small business owner. This is far from the full story. Small businesses can face disastrous financial situations over which they have absolutely no control. This simple fact has been brought to the forefront in the last few years with the economic downturn.

For most small businesses, the major source of external financing comes from banks. Anything that affects the banks' ability or desire to lend to small businesses can have a profound effect. One of the first responses on the part of commercial banks to the crisis of 2008 was a severe restriction of credit. At the height of the crisis in October 2008, nearly 72 percent of large banks and 78 percent of small banks stated that they were tightening their credit standards for small businesses. "[How Will a Credit Crunch Affect Small Business Finance?](#)," *Federal Reserve Bank of San Francisco*, March 6, 2009, accessed December 2, 2011, . This slightly more restrictive approach on the part of smaller banks represented a change from some prior recessions. Berger and Udell (1994) found that during the credit crunch of 1990–92 smaller banks were more willing to lend than larger banks. Allen N. Berger and Gregory F. Udell, "[Did Risk-Based Capital Allocate Bank Credit and Cause a Credit Crunch in the US?](#)," *Journal of Money, Credit and Banking* 26 (1994): 585–628.

The current credit crunch has even more significance for small businesses. The originator of current economic difficulties was in the US real estate industry. The result has been a significantly depressed real estate market. Many small businesses use either personal residences or business property (real estate) as the basis for collateral to secure loans. A depressed real estate market reduces the viability of this option. Other negative consequences for small businesses in this current economic environment revolve around its impact on alternatives of raising capital via commercial bank loans. In earlier credit crunches, many small businesses turned to commercial finance companies. These types of companies would lend money to small businesses that pledged assets as collateral. Gregory F. Udell, *Asset-Based Finance: Proven Disciplines for Prudent Lending* (New York: Commercial Finance Association, 2004), 16. Since the early 1990s, many of these firms either disappeared or have been absorbed by larger commercial banking institutions. Today, many of the largest firms in the United States are holding onto cash (some estimate it in the neighborhood of \$2 trillion to \$3 trillion). Their unwillingness to spend or invest is impacting smaller businesses that operate further down the supply chain. Another impact of the current economic crisis has been that many banks have changed their lending practices for credit cards. They have raised rates, raised fees, and lowered credit limits. Many small businesses are sometimes reduced to using credit cards as a basis for attaining short-term financing for purchases or meeting bills. This sudden change in the “rules of the game” for credit cards has presented many small businesses with an unexpected challenge.

None of these changes in the financial landscape were brought about by the decision making or the knowledge of entrepreneurs and small business operators. Only an extraordinarily small number of financial experts saw the crisis coming. Nonetheless, entrepreneurs and small business owners have found that they must learn to rapidly adapt to what is simply a disastrous situation.

The financial lesson to be learned from the current crisis is that any business, particularly small businesses, must prepare to have alternative sources of financing available for the continued operations.

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