

# How to Assess Your Financial Planning and Loan Proposals

By BizMove Management Training Institute

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## 1. Introduction

Small businesses often fail because owners are unaware of the many elements that can prevent the business from growing and being successful. Often, small businesses are organized around the manager's specific area of expertise, such as marketing, accounting or production. This specialized expertise often prevents the business owner from recognizing problems that may arise in other parts of the business.

This guide will provide you, the small business entrepreneur, with the essentials for conducting a comprehensive search for existing or potential problems in your Financial Planning and Loan Proposals. This guide was designed with small businesses in mind and addresses their unique problems and opportunities.

The author has combined case evidence, logical procedures, expert advice and systematic thinking to create this planning assessment guide. This instrument is not exhaustive, i.e., the business owner/manager still must rely on personal judgment and past experience. However, it does provide a systematic framework to ensure that critical areas have been addressed before action is taken. This guide is a tool, not a replacement for good management skill. Audits and handbooks cannot do the manager's job; however, effectively designed instruments, such as this audit, can save valuable time for the seasoned as well as the novice small business manager.

### **How to Use This Guide**

In order to gain maximum effectiveness from this guide, you should answer all questions in the audit, with an affirmative answer indicating no problem and a negative answer indicating the presence of a problem in a specific area.

After completing answering the preliminary questions, you can proceed to review the analysis of each section of the audit that follows to determine what action is most appropriate. The audit analysis provides an overview of how the various elements of the audit are related. This audit covers the critical function of the Financial Planning and Loan Proposals in a small business..

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## **2. Preliminary Questions**

Please answer each of the following questions with a 'Yes' or a 'No', then proceed to the analysis section:

### **A. The company has adequate cash flow.**

1. Prenumbered cash receipts are monitored and accounted for.
2. Checks are deposited properly each day.
3. Customer invoicing is done promptly (within two working days).
4. Collections are received within 60 days.
5. Accounts payable take advantage of cash discounts.
6. Disbursements are made by prenumbered check.

### **B. The company projects cash-flow needs.**

1. Payrolls are met without problems.
2. Money is set aside for expansion, emergencies and opportune purchases.
3. Short-term financing is used when needed.

4. Line of credit is established with a bank.

**C. The company understands the role of financial planning in today's highly competitive lending markets.**

1. The owner's personal resume is prepared and current.

2. Personal financial statements have been prepared.

3. The business has a written business plan.

4. Source and use of funds statements exist for the past two years, with a projection for the next two years.

5. An accurate balance sheet exists for the past two years and includes a projection for the next two years.

6. The owner has a good working relationship with a banker.

7. There is a strong debt-to-equity ratio (1:2/1:1).

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### **3. Financial Planning and Loan Proposals Assessment Analysis**

**A. The company has adequate cash flow.**

Inflation and fluctuating interest rates have made it mandatory for small businesses to closely manage their cash flow. Given the added problem that many small businesses owe money, it is little wonder that an adequate cash flow is essential to the firm's health and financial stability. Businesses that are otherwise healthy can become insolvent simply because of poor cash flow.

**1. Prenumbered cash receipts are monitored and accounted for.**

The use of prenumbered receipts is the simplest way to keep track of customers and sales. It is also the source document for building the accounting system. Another reason for using prenumbered receipts is that they can reduce inventory shrinkage and reduce the time spent on physical inventory audits.

**2. Checks are deposited properly each day.**

A basic principle of cash management is to keep it moving. The faster cash moves from the customer to the bank and into appropriate short-term investments, the better. Another benefit of daily check deposits is that they decrease the possibility of loss, which creates numerous other problems.

**3. Customer invoicing is done promptly (within two working days).**

Waiting to bill customers is a poor practice. It communicates to customers that it is okay to be late with their payments. Incorrect invoicing also creates delays and takes valuable time to correct.

#### **4. Collections are received within 60 days.**

When it takes longer than 60 days to collect payments, the business needs to examine its credit and collection policies. Long collection periods increase operating expenditures through additional billing costs, lost interest and the need to borrow to meet current operations.

#### **5. Accounts payable take advantage of cash discounts.**

Taking advantage of cash discounts that suppliers offer saves money and is an important step for the business in its attempts to establish itself as a primary customer. Being considered such a customer can facilitate delivery, improve services and can be an excellent source of new business leads.

#### **6. Disbursements are made by prenumbered check.**

Prenumbered checks are primary source documents for accurately determining expenses. Not using them increases the time spent on bookkeeping, makes it difficult to monitor expenses accurately, increases the probability of double payments and communicates to suppliers that the business is a marginal operation.

### **B. The company projects cash flow needs.**

Most small businesses use a cash basis rather than an accrual basis of accounting. Though a cash basis is easier and takes less time to maintain, it often gets the business into trouble, because the business has incurred expenses for which there is no proper accounting. By keeping track of accounts receivable and accounts payable, it is relatively easy to project cash flow needs.

#### **1. Payrolls are met without problems.**

When a business has a problem meeting its payroll, drastic action is generally needed to save it from financial ruin. Generally, the owner/manager has not been watching the books closely enough. When this happens, it is a sure sign that general business practices are poor. On the other hand, an ability to meet the payroll is usually a sign that the business is at least in a fair state.

#### **2. Money is set aside for expansion, emergencies and opportune purchases.**

Few small businesses have the advantage of being cash rich. Many fail simply because they do not have money set aside for emergencies, they operate too close to the margin. Having an emergency fund should be considered a necessity rather than a luxury. Having an expansion fund, or a special fund set aside to take advantage of opportunities, not only reduces stress for the owner, but can often provide an operational advantage for the business.

### **3. Short-term financing is used when needed.**

A small business should borrow money only when needed or when analysis proves it will be profitable to do so. Short-term financing is essential to a seasonal business. But poor analysis turns short-term loans into long-term debt, putting the business in a precarious financial position. Incorrect use of short-term financing was a major problem for a number of the cases studied.

### **4. A line of credit is established with a bank.**

Having a predetermined line of credit means the business is a good credit risk. It is a sign that the business is well managed. A preestablished credit line provides operational flexibility and, when used properly, can provide a source of funds to meet emergencies or to take advantage of investment opportunities. Another advantage of developing a line of credit is that it establishes a relationship between the business and the bank, facilitating later acquisition of long-term financing for expansion, etc.

## **C. The company understands the role of financial planning in today's highly competitive lending markets.**

In order to obtain credit in today's tight money markets, financial planning is essential. Lenders want to know as much about the person to whom they are lending as they do about the business. This means that a well-prepared business plan as well as a detailed personal statement will be required.

### **1. The owner's personal resume is prepared and current.**

A well-written and professionally prepared resume is an indispensable document for obtaining small business loans in today's market. Obtaining a small business loan takes personal salesmanship, and the owner must demonstrate competence to run the business. A well-prepared resume informs the loan officials that the owner is qualified to manage the business and repay the loan on schedule.

### **2. Personal financial statements have been prepared.**

Even when the business is incorporated, most lending institutions assume they are lending money to the owner personally. Having a well-prepared personal financial statement can increase the probability of obtaining a loan.

### **3. There is a written business plan.**

A written business plan is a road map that tells a loan officer what the business is, where it is going and how it is going to get there. Without a well-developed business plan, it is unlikely that a loan will be obtained.

### **4. There is a source and use of funds statement for the past two years, with a projection for the next two years.**

The source and use of funds statement, more than any other document, lets the loan officer know if the business is viable. It is also essential for the management of cash flow and is an essential operating document, even when a loan is not being requested.

**5. There is an accurate balance sheet for the past two years, with a projection for the next two years.**

Historically, the balance sheet has been the primary financial document used by loan officers and others in the financial community to determine the financial health of a business. It is still necessary to include balance sheets in the loan proposal package, though, by themselves, they are no longer sufficient documentation for obtaining loans.

**6. The owner has a good working relationship with the banker.**

The small businessperson must have a good professional relationship with the banker and must keep the banker informed about the business on a quarterly basis. A well-informed banker can provide valuable financial information and will be more likely to lend money when it is requested.

**7. There is a strong debt-to-equity ratio (1:2/1:1).**

It should be obvious that a banker only wants to lend money to a successful business. The banker also wants to know that the owner has at least as much at stake as the bank, and preferably twice as much.

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## **4. Essentials of Business Financing**

This chapter looks at the sources of capital that is available to a business.

### **Types and Sources of Capital**

**Capital management and capital budgeting** to finance a business has two major forms: debt and equity. Creditor money (debt) comes from trade credit, loans made by financial institutions, leasing companies, and customers who have made prepayments on larger-frequently manufactured orders. Equity is money received by the company in exchange for some portion of ownership. Sources include the entrepreneur's own money; money from family, friends, or other non-professional investors; or money from venture capitalists.

Debt capital, depending upon its sources (e.g., trade, bank, leasing company, mortgage company) comes into the business for short or intermediate periods. Owner or equity capital remains in the company for the life of the business (unless replaced by other equity) and is repaid only when and if there is a surplus at liquidation of the business - after all creditors are repaid.

Acquiring such funds depends entirely on the business's ability to repay with interest (debt) or appreciation (equity). Financial performance (reflected in the Financial Statements) and realistic, thorough management planning and control (shown by Pro Forma and Cash Flow Budgets), are the determining factors in whether or not a business can attract the debt and equity funding it needs to operate and expand.

Business capital can be further classified as equity capital, working capital, and growth capital. Equity capital is the cornerstone of the financial structure of any company.

**Equity** is technically the part of the Balance Sheet reflecting the ownership of the company. It represents the total value of the business, all other financing being debt that must be repaid. Usually, you cannot get equity capital at least not during the early stages of business growth.

**Working capital** is required to meet the continuing operational needs of the business, such as "carrying" accounts receivable, purchasing inventory, and meeting the payroll. In most businesses, these needs vary during the year, depending on activities (inventory build-up, seasonal hiring or layoffs, etc.) during the business cycle.

**Growth capital** is not directly related to cyclical aspects of the business. Growth capital is required when the business is expanding or being altered in some significant and costly way that is expected to result in higher and increased cash flow. Lenders of growth capital frequently depend on anticipated increased profit for repayment over an extended period of time, rather than expecting to be repaid from seasonal increases in liquidity as is the case of working capital lenders.

Every growing business needs all three types: equity, working, and growth capital. You should not expect a single financing program maintained for a short period of time to eliminate future needs for additional capital.

As lenders and investors analyze the requirements of your business, they will distinguish between the three types of capital in the following way:

- 1) fluctuating needs (working capital);
- 2) needs to be repaid with profits over a period of a few years (growth capital); and
- 3) permanent needs (equity capital).

If you are asking for a working capital loan, you will be expected to show how the loan can be repaid through cash (liquidity) during the business's next full operating cycle, generally a one year cycle. If you seek growth capital, you will be expected to show how the capital will be used to increase your business enough to be able to repay the loan within several years (usually not more than seven). If you seek equity capital, it must be raised from investors who will take the risk for dividend returns or capital gains, or a specific share of the business.

### **Borrowing Working Capital**

Working capital is defined as the difference between current assets and current liabilities. To the extent that a business does not generate enough money to pay trade debt as it comes due, this cash must be borrowed.

Commercial banks obviously are the largest source of such loans, which have the following characteristics:

The loans are short-term but renewable;

they may fluctuate according to seasonal needs or follow a fixed schedule of repayment (amortization);

they require periodic full repayment ("clean up");

they are granted primarily only when the ratio of net current assets comfortably exceeds net current liabilities; and

they are sometimes unsecured but more often secured by current assets (e.g., accounts receivable and inventory).

Advances can usually be obtained for as much as 70 to 80 percent of quality (likely to be paid) receivables and to 40 to 50 percent of inventory. Banks grant unsecured credit only when they feel the general liquidity and overall financial strength of a business provide assurance for repayment of the loan.

You may be able to predict a specific interval, say three to five months, for which you need financing. A bank may then agree to issue credit for a specific term. Most likely, you will need working capital to finance outflow peaks in your business cycle. Working capital then supplements equity. Most working capital credits are established on a one-year basis.

Although most unsecured loans fall into the one-year line of credit category, another frequently used type, the amortizing loan, calls for a fixed program of reduction, usually on a monthly or quarterly basis. For such loans your bank is likely to agree to terms longer than a year, as long as you continue to meet the principal reduction schedule.

It is important to note that while a loan from a bank for working capital can be negotiated only for a relatively short term, satisfactory performance can allow the arrangement to be continued indefinitely.

Most banks will expect you to pay off your loans once a year (particularly if they are unsecured) in perhaps 30 or 60 days. This is known as "the annual clean up," and it should occur when the business has the greatest liquidity. This debt reduction normally follows a seasonal sales peak when inventories have been reduced and most receivables have been collected.

You may discover that it becomes progressively more difficult to repay debt or "clean up" within the specified time. This difficulty usually occurs because:

Your business is growing and its current activity represents a considerable increase over the corresponding period of the previous year;

you have increased your short-term capital requirement because of new promotional programs or additional operations; or

you are experiencing a temporary reduction in profitability and cash flow.

Frequently, such a condition justifies obtaining both working capital and amortizing loans. For example, you might try to arrange a combination of a \$ 15,000 open line of credit to handle peak financial requirements during the business cycle and \$20,000 in amortizing loans to be repaid at, say \$4,000 per quarter. In appraising such a request, a commercial bank will insist on justification based on past experience and future projections. The bank will want to know: How the \$15,000 line of credit will be self-liquidating during the year (with ample room for the annual clean up); and how your business will produce increased profits and resulting cash flow to meet the schedule of amortization on the \$20,000 portion in spite of increasing your business's interest expense.

### **Borrowing Growth Capital**

Lenders expect working capital loans to be repaid through cash generated in the short-term operations of the business, such as, selling goods or services and collecting receivables. Liquidity rather than overall profitability supports such borrowing programs. Growth capital loans are usually scheduled to be repaid over longer periods with profits from business activities extending several years into the future. Growth capital loans are, therefore, secured by collateral such as machinery and equipment, fixed assets which guarantee that lenders will recover their money should the business be unable to make repayment.

For a growth capital loan you will need to demonstrate that the growth capital will be used to increase your cash flow through increased sales, cost savings, and/or more efficient production. Although your building, equipment, or machinery will probably be your collateral for growth capital funds, you will also be able to use them for general business purposes, so long as the activity you use them for promises success. Even if you borrow only to acquire a single piece of new equipment, the lender is likely to insist that all your machinery and equipment be pledged.

Instead of bank financing a particular piece of new equipment, it may be possible to arrange a lease. You will not actually own the equipment, but you will have exclusive use of it over a specified period. Such an arrangement usually has tax advantages. It lets you use funds that would be tied up in the equipment, if you had purchased it. It also affords the opportunity to make sure the equipment meets your needs before you purchase it.

Major equipment may also be purchased on a time payment plan, sometimes called a Conditional Sales Purchase. Ownership of the property is retained by the seller until the buyer has made all the payments required by the contract. (Remember, however, that

time payment purchases usually require substantial down payments and even leases require cash advances for several months of lease payments.)

Long-term growth capital loans for more than five but less than fifteen years are also obtainable. Real estate financing with repayment over many years on an established schedule is the best example. The loan is secured by the land and/or buildings the money was used to buy. Most businesses are best financed by a combination of these various credit arrangements.

When you go to a bank to request a loan, you must be prepared to present your company's case persuasively. You should bring your financial plan consisting of a Cash Budget for the next twelve months, Pro Forma Balance Sheets, and Income Statements for the next three to five years. You should be able to explain and amplify these statements and the underlying assumptions on which the figures are based. Obviously, your assumptions must be convincing and your projections supportable. Finally, many banks prefer statements audited by an outside accountant with the accountant's signed opinion that the statements were prepared in accordance with generally accepted accounting principles and that they fairly present the financial condition of your business.

### **Borrowing Permanent Equity Capital**

Permanent capital sometimes comes from sources other than the business owner/manager.

Venture capital, another source of equity capital, is extremely difficult to define; however, it is high risk capital offered with the principal objective of earning capital gains for the investor. While venture capitalists are usually prepared to wait longer than the average investor for a profitable return, they usually expect in excess of 15 percent return on their investment. Often they expect to take an active part in determining the objectives of the business. These investors may also assist the small business owner/manager by providing experienced guidance in marketing, product ideas, and additional financing alternatives as the business develops. Even though turning to venture capital may create more bosses, their advice could be as valuable as the money they lend. Be aware, however, that venture capitalists are looking for businesses with real potential for growth and for future sales in the millions of dollars.

#### Applying for Capital

Below is the minimum information you must make available to lenders and investors:

#### **1. Discussion of the Business**

Name, address, and telephone number.

Type of business you are in now or want to expand or start.

#### **2. Amount of Money You Need to Borrow**

Ask for all you will need. Don't ask for a part of the total and think you can come back for more later. This could indicate to the lender that you are a poor planner.

### **3. How You Will Use the Money**

List each way the borrowed money will be used.

Itemize the amount of money required for each purpose.

### **4. Proposed Terms of the Loan**

Include a payback schedule. Even though the lender has the final say in setting the terms of the loan, if you suggest terms, you will retain a negotiating position.

### **5. Financial Support Documents**

Show where the money will come from to repay the loan through the following projected statements:

Profit and Loss Statements (one year for working capital loan requests and three to five years for growth capital requests)

Cash Flow Statements (one year for working capital loan requests and three to five years for growth capital requests)

### **6. Financial History of the Business**

Include the following financial statements for the last three years:

Balance Sheet

Profit and Loss Statement

Accounts Receivable and Accounts Payable Listings and Agings

### **7. Personal Financial Statement of the Owner(s)**

Personal Assets and Liabilities

Resume(s)

### **8. Other Useful Information Includes**

Letters of Intent from Prospective Customers

Leases or Buy/Sell Agreements Affecting Your Business

Reference Letters

Although it is not required, it is useful to calculate the ratios described earlier in this section for your business over the past three years. Use this information to prove the strong financial health and good trends in your business's development and to

demonstrate that you use such management tools to plan and control your business's growth.