

How to Finance a Business

A Step by Step Guide to Financing a Small Business

By BizMove Management Training Institute

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Table of Contents

- [1. Essentials of Business Financing](#)
- [2. How the Need For Capital Arises](#)
- [3. Internal Financing Sources](#)
- [4. Trade Credit As a Viable Financing Source](#)
- [5. Fundamentals of Borrowing](#)
- [6. How to Obtain Equity Capital](#)
- [7. How to Obtain Loans the Easy Way](#)
- [8. How to Effectively Manage Your Borrowings](#)
- [9. How to Raise Venture Capital Money](#)
- [10. How to Plan Your cash Flow](#)
- [11. How to Forecast Your Profits](#)

12. How to Plan for Future Financing Needs

1. 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 Forms 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.

[Go to Top](#)

2. How the Need For Capital Arises

There is more than one way to skin a cat. You'd better remember this old adage when your business needs more inventory, personnel, and facilities. As your business grows, so does your need for more and more capital. Remember there is more than one way and more than one place to raise the money you need.

Causes of Additional Capital Needs

There are many factors that can create a need for additional capital. Some of the more common are as follows:

Sales growth requires inventories to be built to support the higher sales level.

Sales growth creates a larger volume of accounts receivable

Growth requires the business to carry larger cash balances in order to meet its current obligations to employees, trade creditors, and others.

Expansion opportunities such as a decision to open a new branch, add a new product, or increase capacity.

Cost savings opportunities such as equipment purchases that will lower production costs or reduce operating expenses.

Opportunities to realize substantial savings by taking advantage of quantity discounts on purchases for inventory, or building inventories prior to a supplier's price increase

Seasonal factors, where inventories must be built before the selling season begins and receivables may not be collected until 30 to 60 days after the selling season ends.

Current repayment of obligations or debts may require more cash than is immediately available.

Local or national economic conditions which cause sales and profit to decline temporarily.

Economic difficulties of customers that can cause them to pay more slowly than expected.

Failure to retain sufficient earnings in the business.

Inattention to asset management may have allowed inventories or accounts receivable to get out of hand.

Combination

Frequently, the cause cannot be entirely attributed to any one of these factors, but results from a combination. For example, a growing, apparently successful business may find that it does not have sufficient cash on hand to meet a current debt installment or to expand to a new location because customers have been slow in paying.

Short- and Long-Term Capital

Capital needs can be classified as either short- or long-term. Short-term needs are generally those of less than one year. Long-term needs are those of more than one year.

Short-term Financing

Short-term financing is most common for assets that turn over quickly such as accounts receivable or inventories. Seasonal businesses that must build inventories in anticipation of selling requirements and will not collect receivables until after the selling season often need short-term financing for the interim. Contractors with substantial work-in-process inventories often need short-term financing until payment is received. Wholesalers and manufacturers with a major portion of their assets tied up in inventories and/or receivables also require short-term financing in anticipation of payments from customers.

Long-term Financing

Long-term financing is more often associated with the need for fixed assets such as property, plant, and equipment where the assets will be used in the business for several years. It is also a practical alternative in many situations where short-term financing requirements recur on a regular basis.

Recurring Needs

A series of short-term needs could often be more realistically viewed as a long-term need. The addition of long-term should eliminate the short-term needs and the crises that could occur if capital were not available to meet a short-term need.

Steady Growth

Whenever the need for additional capital grows continually without any significant pattern, as in the case of a company with steady sales and profit from year to year, long-term financing is probably more appropriate.

[Go to Top](#)

3. Internal Financing Sources

Internal sources of capital are those generated within the business. External sources of capital are those outside the business such as suppliers, lenders, and investors.

For example, a business can generate capital internally by accelerating collection of receivables, disposing of surplus inventories, retaining profit in the business, or cutting costs.

Capital can be generated externally by borrowing or locating investors who might be interested in buying a portion of the business.

Internal Financing Sources

Before seeking external sources of capital from investors or lenders, a business should thoroughly explore all reasonable sources for meeting its capital needs internally. Even if this effort fails to generate all of the needed capital, it can sharply reduce the external financing requirement, resulting in less interest expense, lower repayment obligations, and less sacrifice of control. With a lower requirement, the business' ability to secure external financing will be improved. Further, the ability to generate maximum capital internally and to control operations will enhance the confidence of outside investors and lenders. With more confidence in the business and its management, lenders and investors will be more willing to commit their capital.

Basic Sources

Basically, there are three principal sources of internal capital. These are as follows:

Increasing the amount of earnings kept in the business.

Prudent asset management.

Cost control.

Increased Earnings Retention

Many businesses are able to meet all of their capital needs through earnings retention. Each year, shareholders' dividends or partners' drawings are restricted so that the largest reasonable share of earnings is retained in the business to finance its growth.

As with other internal capital sources, earnings retention not only reduces any external capital requirement, but also affects the business' ability to secure external capital. Lenders are particularly concerned with the rate of earnings retention, since the ability to repay debt obligations normally depends upon the amount of cash generated through operations. If this cash is used excessively to pay dividends or to permit withdrawals by investors, the company's ability to meet its debt obligations will be threatened.

Asset Management

Many businesses have non-productive assets that can be liquidated (sold or collected) to provide capital for short-term needs. A vigorous campaign of collecting outstanding receivables, with particular emphasis on amounts long outstanding, can often produce significant amounts of capital. Similarly, inventories can be analyzed and those goods with relatively slow sales activity or with little hope for future fast movement can be liquidated. The liquidation can occur through sales to customers or through sales to wholesale outlets, as required.

Fixed assets can be sold to free cash immediately. For example, a company automobile might be sold and provide cash of \$5,000 or \$8,000. Owners and employees can be compensated on an actual mileage basis for use of their personal cars on company business. Or if an automobile is needed on a full-time basis, a lease can be arranged so that a vehicle will be available. Other assets such as loans made by the business to officers or employees, investments in non-related businesses, or prepaid expenses should be analyzed closely. If they are nonproductive, they can often be liquidated so that cash is available to meet the immediate needs of the business.

Any of the above steps can be taken to alleviate short-term cash shortages.

On a long-term basis, the business can minimize its external capital needs by establishing policies and procedures that will reduce the possibility of cash shortages caused by ineffective asset management. These policies could include the establishment of more rigorous credit standards, systematic review of outstanding receivables, periodic analysis of slow-moving inventories, and establishment of profitability criteria so that fixed asset investments are more closely controlled.

Cost Reduction

Careful analysis of costs, both before and after the fact, can improve profitability and therefore the amount of earnings available for retention. At the same time, cost control minimizes the need for cash to meet obligations to trade creditors and others.

Before the fact, a business can establish buying controls that require a written purchase order and competitive bids on all purchases above a specified amount. Decisions to hire extra personnel, lease additional space, or incur other additional costs can be reviewed closely before commitments are made.

After the fact, management should review all actual costs carefully. Expenses can be compared with objectives, experience in previous periods, or with other companies in the industry. Whenever an apparent excess is identified, the cause of the excess should be closely explored and corrective action taken to prevent its recurrence.

[Go to Top](#)

4. Trade Credit as a Viable Financing Source

Trade credit is credit extended by suppliers. Ordinarily, it is the first source of extra capital that the small business owner turns to when the need arises.

Informal Extensions

Frequently, this is done with no formal planning by the business. Suppliers' invoices are simply allowed to "ride" for another 30 to 60 days. Unfortunately, this can lead to a number of problems. Suppliers may promptly terminate credit and refuse to deliver until the account is settled, thus denying the business access to sorely needed supplies, materials, or inventory. Or, suppliers might put the business on a C.O.D. basis, requiring that all shipments be fully paid in cash immediately upon receipt. At a time when a business is obviously strapped for cash, this requirement could have the same effect as cutting off deliveries altogether.

Planning Advantages

A planned program of trade credit extensions can often help the business secure extra capital that it needs without recourse to lenders or equity investors. This is particularly true whenever the capital need is relatively small or short in duration.

A planned approach should involve the following:

Take full advantage of available payment terms. If no cash discount is offered and payment is due on the 30th day, do not make any payments before the 30th day.

Whenever possible, negotiate extended payment terms with suppliers. For example, if a supplier's normal payment terms are net 30 days from the receipt of goods, these could be extended to net 30 days from the end of the month. This effectively "buys" an average of 15 extra days.

If the business feels that it needs a substantial increase in time, say 60 to 90 days, it should advise suppliers of this need. They will often be willing to accept it, provided that the business is faithful in its adherence to payment at the later date.

Consider the effect of cash discounts and delinquency penalties for late payment. Frequently, the added cost of trade credit may be far more expensive than the cost of alternate financing such as a short-term bank loan.

Consider the possibility signing a note for each shipment promising payment at a specific later date. Such a note, which may or may not be interest-bearing, would give the supplier evidence of your intent to pay and increase the supplier's confidence in your business.

Ready Availability

Trade credit is often available to businesses on a relatively informal basis without the requirements for application, negotiation, auditing, and legal assistance often necessary with other capital sources.

Usage

Trade credit must be used judiciously. Its easy availability is particularly welcome in brief periods of limited needs. Used imprudently, however, it can lead to curtailment of relations with key suppliers and jeopardize your ability to locate other, competitive suppliers who are willing to extend credit to your business.

[Go to Top](#)

5. Fundamentals of Borrowing

Debt capital is an amount of money borrowed from a creditor. The amount borrowed is usually evidenced by a note, signed by the borrower, agreeing to repay the principal amount borrowed plus interest on some predetermined basis.

Borrowing Term

The terms under which money is borrowed may vary widely. Short-term notes can be issued for periods as brief as 10 days to fill an immediate need. Long-term notes can be issued for a period of several years.

Payment Schedule

When the terms of a debt are negotiated, a payment schedule is established for both interest obligations and principal repayment.

Discounted Notes

In some cases, particularly in short-term borrowing, the total amount of interest due over the term of the note is deducted from the principal before the proceeds are issued to the borrower. Such a note is called a discounted note.

Short-term Borrowing

Short-term borrowing usually requires repayment within 60 to 90 days. Notes are often renewed, in whole or in part, on the due date, provided that the borrower has lived up to the obligations of the original agreement and the business continues to be a favorable lending risk.

Availability

Commercial banks are the ordinary source of short-term loans for small businesses.

Credit Lines

When a business has established itself as being worthy of short-term credit, and the amount needed fluctuates from time to time, banks will often establish a line of credit with the business. The line of credit is the maximum amount that the business can borrow at any one time. The exact amount borrowed can vary according to the needs of the business but cannot exceed its established credit line.

These arrangements give the business access to its requirements up to the credit limit, or line. However, it pays interest only on the actual amount borrowed, not the entire line of credit available to it.

Long-term Debt

Long-term debt is borrowing for a period greater than one year. This general classification includes "intermediate debt" which is borrowing for periods of one to 10 years.

Small Business Applications

For small businesses, borrowed capital for periods greater than 10 years is usually available only on real estate mortgages. Other long-term borrowing usually falls into the "intermediate" classification and is available for periods up to 10 years. Such loans are called "term loans."

Mortgage Payment Schedules

Principal and interest payments on mortgages usually involve uniform monthly payments that include both principal and interest.

Each successive monthly payment reduces the amount of principal outstanding. Therefore, the amount of interest owed decreases and the portion of the monthly payment applicable to principal increases. In the early years of a mortgage, the portion of the monthly payment applied against the principal is relatively small, but grows with each payment.

Term Loan Payment Schedules

For term loans, payment of principal and interest is ordinarily scheduled on an annual, semiannual, or quarterly basis. For example, a 5-year, \$50,000 term note bearing 10% interest might have the following payment schedule specified in the note agreement:

End of Year	Principal Repayment	Principal Outstanding	Interest Payment @ 10%
1	\$10,000	\$50,000	\$5,000
2	10,000	40,000	4,000
3	10,000	30,000	3,000
4	10,000	20,000	2,000
5	10,000	10,000	1,000

Repayment Schedules

The dates on which principal and interest payments are due should be scheduled carefully. For example, a manufacturer with heavy sales just before Christmas and receivables collections through January might best be able to schedule repayments in February. If a payment were due in October or November, when inventories were high and receivables were climbing, the payment could be crippling.

Collateral

Loans may be secured or unsecured. In a secured loan, the borrower pledges certain assets as collateral (security) to protect the lender in case of default on the loan or failure of the business. If the business defaults on the loan through failure to meet interest obligations or principal repayments, the note-holder (lender) assumes ownership of the collateral. If the business fails, the note-holder claims ownership of those specific assets pledged as collateral before the claims of other creditors are settled.

Typical Collateral

In long-term borrowing, fixed assets such as real estate or equipment are usually pledged as collateral. For short-term borrowing, inventories or accounts receivable are the usual collateral.

Inventory Financing

Inventory financing is most commonly used in automobile and appliance retailing. As each unit is purchased by the retailer, the manufacturer is paid by the lender. The lender is repaid by the retailer when the unit is sold. Interest is determined separately for each unit, based upon the actual amount originally paid by the lender and the period between the time the money is paid and the lender is reimbursed by the retailer.

Accounts Receivable Financing

Basically, accounts receivable financing falls into two categories as follows:

Assignments. The business pledges, or "assigns," its receivables as collateral for a loan.

Factoring. The borrower sells its accounts receivable to a lender ("factor").

Although these arrangements are not loans, in a pure sense, the effect is the same.

Receivables Assignments

When receivables are assigned, the amount of the loan varies according to the volume of receivables outstanding. Normally, the lender will advance some specified percentage of the outstanding accounts receivable up to a specific credit limit. For example, look at the schedule below. The company can borrow up to 80% of assigned receivables, up to a maximum of \$100,000.

Accounts Receivable	Amount Borrowed
100,000	\$80,000
125,000	100,000
150,000	100,000

On the first line, accounts receivable are \$100,000 and the amount loaned is 80% of \$100,000, or \$80,000.

On the second line, outstanding receivables are \$125,000. The amount loaned increases to \$100,000 ($\$125,000 \times 0.80$).

On the third line, accounts receivable are \$150,000. Eighty percent of this amount would be \$120,000. However, this exceeds the established limit of \$100,000. Therefore, borrowing is restricted to the \$100,000 limit.

In many industries, accounts receivable financing is considered a sign of weakness. However, it is quite common in others. This is particularly true in the garment industry and in personal finance companies.

When customers must pay invoices directly to a factor, it may create doubts about the company's financial stability and, therefore, its ability to deliver.

When accounts receivable are assigned, the borrower is still responsible for collection. Upon collection of any receivable, the amount borrowed should be repaid. Interest is based upon the amount borrowed and the time between receipt of proceeds by the borrower and repayment.

Factoring Accounts Receivable

When accounts receivable are factored, they are sold to the factor and the borrower has no responsibility for collection. The borrower pays the factor a service charge based

upon the amount of each receivable sold. In addition, the borrower pays interest for the period between the sale of the receivable and the date the customer pays the factor.

Since the factor is responsible for collection, it will only purchase those receivables for which it has approved credit.

Unsecured Debt

The secured creditor's risk is reduced by the claim against specific assets of the business. In default or liquidation, the secured creditor can take possession of these assets to recover any unpaid amounts due from the business.

Holders of unsecured notes do not enjoy the same protection. If the company defaults on a payment, the unsecured creditor under normal circumstances, can only re-negotiate the amount due, perhaps by seeking collateral, or force the company to liquidate. In liquidation, the holder of an unsecured note would normally have no rights that are superior to those of any other creditors.

Restriction on Business

Therefore, when accepting an unsecured note, the lender will often place certain restrictions on the business. A typical restriction might be to prevent the company from incurring any debt with a prior claim on the assets of the business in the event of default or failure. For example, a term note agreement might prevent a company from financing its receivables or inventories since this would result in a prior claim against the assets of the business in liquidation.

Such restrictions may have no effect on the business' ability to operate. However, in other cases, such restrictions could be severe. For example, a business may have a chance to sell to a major new customer. The new customer may insist upon 60-day credit terms which will require the business to seek additional external financing. Normally, this financing might be readily available on realistic terms from a factor. However, the restriction of the unsecured note could prevent the business from taking advantage of this significant opportunity for sales and profit improvement.

Personal Guarantees

The liability of a corporation's shareholders is generally limited to the assets of the business. Creditors have no normal claim against the personal assets of the stockholders if the business should fail. Therefore, many lenders, when issuing credit to small corporations, seek the added protection of a personal guarantee by the owner (or owners). This protects the creditors if the business fails, since they retain a claim against the personal assets of the owners to fulfill the debt obligation.

Interest Rates

The interest rates at which small businesses borrow are relatively high. Banks and other commercial lending institutions normally reserve their lowest available interest rate the so-called prime rate, for those low-risk situations such as short-term loans for major

corporations and public agencies where the chances of default are slim and the costs for collection, credit search, and other administrative tasks are minimal. Because of the higher risks involved in loaning to small businesses, lenders often seek greater collateral while charging higher interest rates to offset their added costs of credit search and loan administration.

[Go to Top](#)

6. How to Obtain Equity Capital

Unlike debt capital, equity capital is permanently invested in the business. The business has no legal obligation for repayment of the amount invested or for payment of interest for the use of the funds.

Share of Ownership

The equity investor shares in the ownership of the business and is entitled to participate in any distribution of earnings through dividends, in the case of corporations, or drawings, in the case of partnerships.

The extent of the equity investor's participation in the distribution of earnings of a corporation depends upon the number of shares held. In a partnership, the equity investor's participation will depend upon the ownership percentage specified in the partnership agreement.

Voting Rights

The equity investor's ownership interest also carries the right to participate in certain decisions affecting the business.

Legal Liability

The personal liability of equity investors for debts of the business depends upon the legal form of the organization. Basically, the investor who acquires equity in a partnership could be personally liable for debts of the business if the business should fail. In a corporation, the liability of equity investors (shareholders) is limited to the amount of their investment.

In other words, if a partnership should fail, creditors could have a claim against the personal assets of the individual partners. If a corporation should fail, the only claims of creditors would be against any remaining assets of the corporation, not against any personal assets of the shareholders.

Equity Investor's Compensation

The purchaser of an equity interest in a business expects to be compensated for the investment in any of the three following ways:

Income from earnings distribution of the business, either as dividends paid to corporate shareholders or as drawings in a partnership.

Capital gain realized upon sale of the business.

Capital gain realized from selling his or her interest to other partners.

Capital Gains

Capital gain is the term used to describe any excess of the selling price of an investment over the initial purchase price. For example, if you purchased an equity interest in a business for \$5,000 and later sold it for \$8,000, you would realize a capital gain of \$3,000.

Earnings Distribution

The equity investor in a partnership is entitled to a share of all drawings paid out to partners at a percentage established when the interest was purchased. For example, assume an investor acquired a 20% interest in a partnership. The distribution of earnings to all partners in a given year is \$20,000. The holder of the 20% interest would receive \$4,000.

The dividends received by the equity investor in a corporation depend upon the number of shares held. For example, if a corporation voted a dividend of \$1.50 per share in a given year, the owner of 1,000 shares would receive a dividend of \$1,500 (1,000 x \$1.50).

Sale (or Liquidation) of Business

If a business is sold or liquidated, the equity investor shares in the distribution of the proceeds. As with an earnings distribution, the share of the proceeds in a corporation sale depends upon the number of shares held. In a partnership, each partner's share of the proceeds is based upon the percentages specified in the partnership agreement.

If the proceeds received by the equity investor exceed the original purchase price, this excess is considered a capital gain and taxed accordingly.

If the business were liquidated, the assets would be sold and the proceeds would first be used to discharge any outstanding obligations to creditors. The balance of the proceeds, after these obligations had been fulfilled, would be distributed to the equity investors in accordance with their share-holdings or percentages of interest.

Sale of Equity Interest

As a business prospers and grows, the value of an equity interest grows with it. Therefore, the equity investor may be able to sell his or her interest at a price higher than the initial acquisition cost.

For example, an equity investor in a corporation may have purchased his or her interest at \$10.00 per share. As the business grows, he or she is able to sell the shares at \$15.00 per share, realizing a capital gain of \$5.00 on each share sold.

Capital Gains vs. Dividends

In many cases, the equity investor in a small business is primarily interested in capital gains. Aside from the tax advantages, the equity investor usually realizes that the earnings of the small business are better retained in the business than distributed as dividends or drawings. Retention of earnings permits the business to grow so that the value of the equity interest increases. The investor can realize a return on the investment through a capital gain derived from selling his or her shares or upon sale of the business.

Public Stock Offerings

When businesses are first organized, equity capital is usually secured from a combination of sources such as the original owners' personal savings and through solicitations from friends, relatives, or other persons known to have financial capability for such investments.

As the need for equity capital becomes greater, say \$200,000 to \$1,000,000, it is customary to seek capital through the services of professional finders, who receive a fee for securing the capital needed. These finders normally have access to wealthy individuals, capital management companies, estates, trusts, and others with sufficient capital to make such an investment.

At higher levels of capital need, shares are sold through public offerings. The public offering seeks to attract a large number of investors to purchase stock, in large or small amounts. A market is then created for the stock. Shares purchased by the public, as well as the shares held by the original owners, and any subsequent equity investors can also be sold at the going market price. These transactions do not have a direct effect on the business' capital position since it does not receive the proceeds from the sale.

The equity investor can realize a capital gain by selling shares at prices higher than the original purchase price.

Risks of Equity Investment

The equity investor assumes substantial risk. Unlike the secured creditor, the equity investor has no specific claim against any assets of the business. In liquidation, all claims of all creditors must be satisfied before any remaining assets become available for distribution to the owners. Even then, the equity investor's participation in the proceeds is restricted to a share that is proportionate to the number of shares held or the partnership interest.

Since the risks of equity investment are so substantial, particularly in the case of small businesses, equity investors expect a considerably higher return than the lender.

A lender might be willing to loan money to a business at an interest rate of 10% or 12% since it has certain legal protections in the event of default or liquidation. The investor of equity capital in the same business might seek

a far higher return, perhaps 20%, 50%, or even more in order to compensate for the added risk of equity investment.

[Go to Top](#)

7. How to Obtain Loans the Easy Way

Some businesspersons cannot understand why a lending institution refused to lend them money. Others have no trouble getting funds, but are surprised to find strings attached to their loans. Such owner-managers fail to realize that banks and other lenders have to operate by certain principles just as do other types of business.

This Guide discusses the following fundamentals of borrowing: (1) credit worthiness, (2) kinds of loans, (3) amount of money needed, (4) collateral, (5) loan restrictions and limitation, (6) the loan application, and (7) standards which the lender uses to evaluate the application.

Introduction

Inexperience with borrowing procedures often created resentment and bitterness. The stories of three businesspersons illustrate this point.

"I'll never trade here again," Bill Smith said when his bank refused to grant him a loan. "I'd like to let you have it, Bill," the banker said, "but your firm isn't earning enough to meet your current obligations." Mr. Smith was unaware of a vital financial fact, namely, that lending institutions have to be certain that the borrower's business can repay the loan.

Tom Jones lost his temper when the bank refused him a loan because he did not know what kind of or how much money he needed. "We hesitate to lend," the banker said, "to business owners with such vague ideas of what and how much they need."

John William's case was somewhat different. He didn't explode until after he got the loan. When the papers were ready to sign, he realized that the loan agreement put certain limitations on his business activities. "You can't dictate to me," he said and walked out of the bank. What he didn't realize was that the limitations were for his good as well as for the bank's protection.

Knowledge of the financial facts of business life could have saved all three the embarrassment of losing their tempers. Even more important, such information would have helped them to borrow money at a time when their businesses needed it badly.

This Guide is designed to give the highlights of what is involved in sound business borrowing. It should be helpful to those who have little or no experience with borrowing.

More experienced owner-managers should find it useful in re-evaluating their borrowing operations.

Is Your Firm Credit Worthy?

The ability to obtain money when you need it is as necessary to the operation of your business as is a good location or the right equipment, reliable sources of supplies and materials, or an adequate labor force. Before a bank or any other lending agency will lend you money, the loan officer must feel satisfied with the answers to the five following questions:

1. What sort of person are you, the prospective borrower? By all odds, the character of the borrower comes first. Next is your ability to manage your business.
2. What are you going to do with the money? The answer to this question will determine the type of loan, short or long-term. Money to be used for the purchase of seasonal inventory will require quicker repayment than money used to buy fixed assets.
3. When and how do you plan to pay it back? Your banker's judgment of your business ability and the type of loan will be a deciding factor in the answer to this question.
4. Is the cushion in the loan large enough? In other words, does the amount requested make suitable allowance for unexpected developments? The banker decides this question on the basis of your financial statement which sets forth the condition of your business and on the collateral pledged.
5. What is the outlook for business in general and for your business particularly?

Adequate Financial Data Is a "Must"

The banker wants to make loans to businesses which are solvent, profitable, and growing. The two basic financial statements used to determine those conditions are the balance sheet and profit-and-loss statement. The former is the major yardstick for solvency and the latter for profits. A continuous series of these two statements over a period of time is the principal device for measuring financial stability and growth potential.

In interviewing loan applicants and in studying their records the banker is especially interested in the following facts and figures.

General Information: Are the books and records up-to-date and in good condition? What is the condition of accounts payable? Of notes payable? What are the salaries of the owner-manager and other company officers? Are all taxes being paid currently? What is the order backlog? What is the insurance coverage?

Accounts Receivable: Are there indications that some of the accounts receivable have already been pledged to another creditor? What is the accounts receivable turnover? Is the accounts receivable total weakened because many customers are far behind in their payments? Has a large enough reserve been set up to cover doubtful accounts? How

much do the largest accounts owe and what percentage of your total accounts does this amount represent?

Inventories: Is merchandise in good shape or will it have to be marked down? How much raw material is on hand? How much work is in process? How much of the inventory is finished goods?

Is there any obsolete inventory? Has an excessive amount of inventory been consigned to customers? Is inventory turnover in line with the turnover for other businesses in the same industry? Or is money being tied up too long in inventory?

Fixed Assets: What is the type, age, and condition of the equipment? What are the depreciation policies? What are the details of mortgages or conditional sales contracts? What are the future acquisition plans?

What Kind Of Money?

When you set out to borrow money for your firm, it is important to know the kind of money you need from a bank or other lending institution. There are three kinds of money: short term, term money, and equity capital.

Keep in mind that the purpose for which the funds are to be used is an important factor in deciding the kind of money needed. But even so, deciding what kind of money to use is not always easy. It is sometimes complicated by the fact that you may be using some of the various kinds of money at the same time and for identical purposes.

Keep in mind that a very important distinction between the types of money is the source of repayment. Generally short-term loans are repaid from the liquidation of current assets which they have financed. Long-term loans are usually repaid from earnings.

Short-Term Bank Loans

You can use short-term bank loans for purposes such as financing accounts receivable for, say 30 to 60 days. Or you can use them for purposes that take longer to pay off - such as for building a seasonal inventory over a period of 5 to 6 months. Usually, lenders expect short-term loans to be repaid after their purposes have been served: for example, accounts receivable loans, when the outstanding accounts have been paid by the borrower's customers, and inventory loans, when the inventory has been converted into salable merchandise.

Banks grant such money either on your general credit reputation with an unsecured loan or on a secured loan.

The unsecured loan is the most frequently used form of bank credit for short term purposes. You do not have to put up collateral because the bank relies on your credit reputation.

The secured loan involves a pledge of some or all of your assets. The bank requires security as a protection for its depositors against the risks that are involved even in business situations where the chances of success are good.

Term Borrowing

Term borrowing provides money you plan to pay back over a fairly long time. Some people break it down into two forms: (1) intermediate - loans longer than 1 year but less than 5 years, and (2) long-term - loan for more than 5 years.

However, for your purpose of matching the kind of money to the needs of your company, think of term borrowing as a kind of money which you probably will pay back in periodic installments from earnings.

Equity Capital

Some people confuse term borrowing and equity (or investment) capital. Yet there is a big difference. You don't have to repay equity money. It is money you get by selling a part interest in your business.

You take people into your company who are willing to risk their money in it. They are interested in potential income rather than in an immediate return on their investment.

How Much Money?

The amount of money you need to borrow depends on the purpose for which you need funds. Figuring the amount of money required for business construction, conversion, or expansion - term loans or equity capital - is relatively easy. Equipment manufacturers, architects, and builders will readily supply you with cost estimates. On the other hand, the amount of working capital you need depends upon the type of business you're in. While rule-of-thumb ratios may be helpful as a starting point, a detailed projection of sources and uses of funds over some future period of time - usually for 12 months - is a better approach. In this way, the characteristics of the particular situation can be taken into account. Such a projection is developed through the combination of a predicted budget and a cash forecast.

The budget is based on recent operating experience plus your best judgment of performance during the coming period. The cash forecast is your estimates of cash receipts and disbursements during the budget period. Thus, the budget and the cash forecast together represent your plan for meeting your working capital requirements.

To plan your working capital requirements, it is important to know the "cash flow" which your business will generate. This involves simply a consideration of all elements of cash receipts and disbursements at the time they occur. These elements are listed in the profit-and-loss statement which has been adapted to show cash flow. They should be projected for each month.

What Kind of Collateral?

Sometimes, your signature is the only security the bank needs when making a loan. At other times, the bank requires additional assurance that the money will be repaid. The kind and amount of security depends on the bank and on the borrower's situation.

If the loan required cannot be justified by the borrower's financial statements alone, a pledge of security may bridge the gap. The types of security are: endorsers; co-makers and guarantors; assignment of leases; trust receipts and floor planning; chattel mortgages; real estate; accounts receivables; saving accounts; life insurance policies; and stocks and bonds. In a substantial number of States where the Uniform Commercial Code has been enacted, paperwork for recording loan transactions will be greatly simplified.

Endorsers, Co-makers, and Guarantors

Borrowers often get other people to sign a note in order to bolster their own credit. These endorsers are contingently liable for the note they sign. If the borrower fails to pay up, the bank expects the endorser to make the note good. Sometimes, the endorser may be asked to pledge assets or securities too.

A co-maker is one who creates an obligation jointly with the borrower. In such cases, bank can collect directly from either the maker or the co-maker.

A guarantor is one who guarantees the payment of a note by signing a guaranty commitment. Both private and government lenders often require guarantees from offices of corporations in order to assure continuity of effective management. Sometimes, a manufacturer will act as guarantor for customers.

Assignment of Leases

The assigned lease as security is similar to the guarantee. It is used, for example, in some franchise situations.

The bank lends the money on a building and takes a mortgage. Then the lease, which the dealer and the parent franchise company work out, is assigned so that the bank automatically receives the rent payments. In this manner, the bank is guaranteed repayment of the loan.

Warehouse Receipts

Banks also take commodities as security by lending money on a warehouse receipt. Such a receipt is usually delivered directly to the bank and shows that the merchandise used as security either has been placed in a public warehouse or has been left on your premises under the control of one of your employees who is bonded (as in field warehousing). Such loans are generally made on staple or standard merchandise which can be readily marketed. The typical warehouse receipt loan is for a percentage of the estimated value of the goods used as security.

Trust Receipts and Floor Planning

Merchandise, such as automobiles, appliances, and boats, has to be displayed to be sold. The only way many small marketers can afford such displays is by borrowing money. Such loans are often secured by a note and a trust receipt.

This trust receipt is the legal paper for floor planning. It is used for serial-numbered merchandise. When you sign one, you (1) acknowledge receipt of the merchandise, (2) agree to keep the merchandise in trust for the bank, and (3) promise to pay the bank as you sell the goods.

Chattel Mortgages

If you buy equipment such as a cash register or a delivery truck, you may want to get a chattel mortgage loan. You give the bank a lien on the equipment you are buying.

The bank also evaluates the present and future market value of the equipment being used to secure the loan. How rapidly will it depreciate? Does the borrower have the necessary fire, theft, property damage, and public liability insurance on the equipment? The banker has to be sure that the borrower protects the equipment.

Real Estate

Real estate is another form of collateral for long-term loans. When taking a real estate mortgage, the bank finds out: (1) the location of the real estate, (2) its physical condition, (3) its foreclosure value, and (4) the amount of insurance carried on the property.

Accounts Receivable

Many banks lend money on accounts receivable. In effect, you are counting on your customers to pay your note.

The bank may take accounts receivable on a notification or a non-notification plan. Under the notification plan, the purchaser of the goods is informed by the bank that his or her account has been assigned to it and he or she is asked to pay the bank. Under the non-notification plan, the borrower's customers continue to pay you the sums due on their accounts and you pay the bank.

Savings Accounts

Sometimes, you might get a loan by assigning to the bank a savings account. In such cases, the bank gets an assignment from you and keeps your passbook. If you assign an account in another bank as collateral, the lending bank asks the other bank to mark its records to show that the account is held as collateral.

Life Insurance

Another kind of collateral is life insurance. Banks will lend up to the cash value of a life insurance policy. You have to assign the policy to the bank.

If the policy is on the life of an executive of a small corporation, corporate resolutions must be made authorizing the assignment. Most insurance companies allow you to sign the policy back to the original beneficiary when the assignment to the bank ends.

Some people like to use life insurance as collateral rather than borrow directly from insurance companies. One reason is that a bank loan is often more convenient to obtain and usually may be obtained at a lower interest rate.

Stocks and Bonds

If you use stocks and bonds as collateral, they must be marketable. As a protection against market declines and possible expenses of liquidation, banks usually lend no more than 75 percent of the market value of high grade stock. On Federal Government or municipal bonds, they may be willing to lend 90 percent or more of their market value.

The bank may ask the borrower for additional security or payment whenever the market value of the stocks or bonds drops below the bank's required margin.

What Are the Lender's Rules?

Lending institutions are not interested in loan repayments. They are interested in borrowers with healthy profit-making businesses. Therefore, whether or not collateral is required for a loan, they set loan limitation and restrictions to protect themselves against unnecessary risks and at the same time against poor management practices by their borrowers. Often some owner-managers consider loan limitations a burden.

Yet others feel that such limitation also offer an opportunity for improving their management techniques.

Especially in making long-term loans, the borrower as well as the lender should be thinking of: (1) the net earning power of the borrowing company, (2) the capability of its management, (3) the long range prospects of the company, and (4) the long range prospects of the industry of which the company is a part. Such factors often mean that limitation increase as the duration of the loan increases.

What Kinds of Limitation?

The kinds of limitations, which an owner-manager finds set upon the company depends, to a great extent, on the company. If the company is a good risk, only minimum limitations need be set. A poor risk, of course, is different. Its limitation should be greater than those of a stronger company.

Look now for a few moments at the kinds of limitations and restrictions which the lender may set. Knowing what they are can help you see how they affect your operations.

The limitations which you will usually run into when you borrow money are:

- (1) Repayment terms.
- (2) Pledging or the use of security.
- (3) Periodic reporting.

A loan agreement, as you may already know, is a tailor-made document covering, or referring to, all the terms and conditions of the loan. With it, the lender does two things: (1) protects position as a creditor (keeps that position in as protected a state as it was on the date the loan was made) and (2) assures repayment according to the terms.

The lender reasons that the borrower's business should generate enough funds to repay the loan while taking care of other needs. The lender considers that cash inflow should be great enough to do this without hurting the working capital of the borrower.

Covenants - Negative and Positive

The actual restrictions in a loan agreement come under a section known as covenants. Negative covenants are things which the borrower may not do without prior approval from the lender. Some examples are: further additions to the borrower's total debt, non-pledge to others of the borrower's assets and issuance of dividends in excess of the terms of the loan agreement

On the other hand, positive covenants spell out things which the borrower must do. Some examples are: (1) maintenance of a minimum net working capital, (2) carrying of adequate insurance, (3) repaying the loan according to the terms of the agreement, and (4) supplying the lender with financial statements and reports.

Overall, however, loan agreements may be amended from time to time and exceptions made. Certain provisions may be waived from one year to the next with the consent of the lender.

You Can Negotiate

Next time you go to borrow money, thrash out the lending terms before you sign. It is good practice no matter how badly you may need the money. Ask to see the papers in advance of the loan closing. Legitimate lenders are glad to cooperate.

Chances are that the lender may "give" some on the terms. Keep in mind also that, while you are mulling over the terms, you may want to get the advice of your associates and outside advisors. In short, try to get terms which you know your company can live with. Remember, however that once the terms have been agreed upon and the loan is made you are bound by them.

The Loan Application

Now that you have read about the various aspects of the lending process and are ready to apply for a loan. Banks and other private lending institutions, require a loan application on which you list certain information about your business

Evaluating the Application

Once you have supplied the necessary information, the next step in the borrowing process is the evaluation of your application. The officer considers this kind of thing when determining whether to grant or refuse the loan:

- (1) The borrower's debt paying record to suppliers, banks, home mortgage holders, and other creditors.
- (2) The ratio of the borrower's debt to net worth.
- (3) The past earnings of the company.
- (4) The value and conditions of the collateral which the borrower offers for security.

[Go to Top](#)

8. How to Effectively Manage Your Borrowings

Poor management is the reason why some owner-managers have trouble when they try to borrow. Those managers often fail to forecast and to plan for cash needs. The resulting business ailment is a "cash crisis."

Sound management must be practiced if loans are to be obtained and used profitably. Such management included: knowing the firm's cash flow, forecasting cash needs, planning to borrow at the appropriate time, and substantiating the firm's payback ability.

This Guide includes examples of the following: a cash budget forecast, a projection of borrowing requirements, and a cash flow schedule for repaying a loan.

In spite of respectable sales volumes, many owners of businesses run into financial trouble. Some get in so deep that they are barely able to pull their heads back above water. Others find themselves only weeks or months away from tacking "out of business" signs on their doors.

Often these owner-managers have three things in common. First, they know their line of business. Their technical ability is first rate. Second, they are poor managers. In many instances, they fail to plan ahead because of their enthusiasm for the operating side of their business. In the third place, most of them feel that additional money will solve their problems. They think that a loan will pull them out of the red.

Lending Officer's Viewpoint

Often a bank lending officer refuses or "declines" that loan request of such manager-owners. It is not that a banker lacks appreciation for the hard work and long hours which these owners put into their businesses. Nor does the bank question their good intentions.

Foremost in the lender's mind is the question: Can the firm pay back the loan? Thus, in many cases, the lender refuses the loan because the owner-manager hastily and haphazardly prepared the loan application under pressuring circumstances. As a result, the lending officer detects an air of instability and lack of planning in the owner-manager's description of his or her affairs. "how is the borrower really going to repay,"

the lending officer asks, "if the borrower doesn't actually know how much money is needed and how it is going to be used?"

If your request for a loan is turned down, the best bet is to accept the refusal gracefully and look for weaknesses in the presentation, You can correct these weaknesses when applying for a loan in the future.

Pertinent Questions

The lender needs the answers to several pertinent questions to determine whether or not the borrower can repay the loan. One of these questions is: What does the borrower intend to use the money for?

What Kind of Money? When you consider borrowing determine what kind of money you need. A business uses four basic types of money in its operations. Your purpose in borrowing will determine the type.

- 1. Trade Credit.** This type of "money" is not borrowed. It is money you owe your suppliers who permit you to carry your fast-moving inventory on open account. A good credit experience is proven evidence of your ability to repay borrowed funds.
- 2. Short-Term Credit.** Banks and other lenders will provide this type of money to carry you in your purchases of inventory for special reasons, such as buying inventory for the next selling season. Such loans are self-liquidating because they generate sales dollars. You repay short-term credit in less than a year.
- 3. Long-Term Credit.** Such loans - for more than a year - are used for expansion or modernization of your business. They are repaid out of accumulated profits. Usually, the evidence of this type of loan in a business is a mortgage or a promissory note with terms.
- 4. Equity Funds.** This type of money is never repaid. You get it by relinquishing a part of your profits to an investor. That is you sell an interest in your business.

Many owner-managers fail to recognize the difference between the four types of money. You should keep in mind that money borrowed for a temporary purpose should be used in the profit producing areas of your business and will be repaid out of that operation. Equity funds are those which remain in the business and increase the net worth for the owner.

Are Your Sales Adequate? Are you asking for a loan to bolster sagging sales volume? To buy additional stocks of high-volume merchandise which you feel has even greater potential? To create a new image by an over-all advertising campaign?

What Is Your Receivables Position? Are your accounts going uncollected and getting old? In effect, do you really need money to carry old accounts?

Is Your Profit Margin Adequate? Are you doing a lot of business and showing a lack of profit thus indicating that expenses are not controlled? Or is your market insufficient? What is your break-even point for profits?

What Is Your Plan For Repayment? Do you forecast your cash income and expenditures realistically?

The lender scrutinizes the cash flow of the business to determine whether or not the owner-manager is providing sufficient cash to meet the firm's obligations. The lender also has to make sure that cash needed for working capital is not being absorbed by the business into other areas of equity and thereby reducing liquidity.

The "Cash Crisis"

The experience of counselors is that all too often the business owner feels that his or her needs are financial when they are actually managerial. In such firms, money can ease the pressure temporarily, but further indebtedness only intensifies the basic problem. Money alone cannot provide the sound management needed to continue the business.

Counselors to business owners are continually faced with the "cash crisis" problem. This cash deficiency results from the lack of planning.

A mistake many purchasers of a business make is that they buy something beyond their means. They take possession of a business of some value but without one important asset - sufficient operating cash. When a buyer does not put aside working capital (cash), he or she cannot pay current bills and the rest of the story is easy to foretell.

It is the "cash crisis."

Sound management consists of arranging matters so that current liabilities are provided for as they become due and hence paid promptly. When such coordination is not present, the result is a constant "cash crisis."

Without a floating supply of cash, a business will experience occasional convulsions which distort, confuse, embarrass, and alarm everyone concerned with the enterprise. The owner-manager's employees and suppliers are the first to sense the nervousness of the situation. When they do, they begin to consider their futures in the light of these emergencies.

Lack of cash can drive a firm into bankruptcy even though its products are first rate and its operations are profitable.

Avoid A "Cash Crisis"

To avoid a "cash crisis" you should determine how much cash your firm needs for its normal operations. Then plan your finances to achieve the goal. The amount of cash which a business will need differs because all businesses are not alike. Usually, for comfort, five to ten percent of a firm's working capital should be in cash.

In a sense, financial planning is what you anticipate your financial statements will show on a specific date and how you intend to get there. A cash forecast will indicate whether or not your plan of operation is feasible. A budget will indicate the availability of cash at all points of operations.

Cash Budgeting

When the subject of budgeting comes up, some owner-managers say, "That's for the big fellow. I know what my volume is and my bank account tells me how much money I have." These owners fail to realize that budgeting can help to eliminate errors of judgment made in haste or made on assumptions rather than facts.

The first thing you must know in budgeting is what your anticipated expenses are going to be for the period being budgeted. Then how much in sales must be generated to pay these expenses? What will be left? You must try to determine the high and low points in your operations in order to provide the adequate amount of cash. A sales analysis of previous periods will indicate when the high and low points occur.

This forecasting helps you to plan for financing the purchase of inventory and for carrying your accounts receivable. Controlling inventory and accounts receivable can help to take the strain off of your working capital.

Uses Of A Cash Budget

The cash budget is the most effective tool for planning the cash requirements and resources of your business. With it you plan your financial operations - the cash you expect to take in and pay out. Your goal in budgeting is to maintain a satisfactory cash position for any contingency. When used to project the cash flow of the business, the cash budget will:

Provide efficient use of cash by timing cash disbursements to coincide with cash receipts. These actions may reduce the need for borrowing temporary additional working capital.

Point up cash deficiency periods so that predetermined borrowing requirements may be established and actual amounts determined to reduce excessive indebtedness.

Determine periods for repayment of borrowings.

establish the practicability of taking trade discounts or not taking them.

Determine periods of surplus cash for investment or purchase of inventory and equipment.

Indicate the adequacy or need for additional permanent working capital in the business.

Be Factual

The important thing to keep in mind in making a cash budget is the word "cash." Be as factual as you can. Try not to over-estimate sales or under-estimate expenses. Your sales forecast must be as accurate as possible because it is the basis for figuring your cash and expenses.

Use your experience to determine your cash sales. In seasonal businesses and those which have high-ticket merchandise, the percent of sales that are for cash will vary from month to month if they apply to your business.

A format such as that shown in the example below can help you to be factual. This example of a cash budget forecast uses two columns for each month. The second column allows you to insert the actual figures as they occur and helps in correcting mistakes for future forecasts.

Sound Management - Success Story

With sound management a firm can often achieve a goal by borrowing only a nominal amount. The experience of two partners in a Southeast business provides an example.

They obtained a contract to manufacture and install kitchen cabinets for a large builder. The contract called for installation in 4 months. To meet this deadline, the partners figured that they needed \$56,500 in extra working capital.

Because this amount was more than they wanted to borrow, they asked for help from a counselor. The counselor helped the partners to come up with a borrowing requirement of only \$16,000. This solution was arrived at by:

Arranging with their supplier to ship and bill for the materials monthly over a 3-month period.

Contracting with the builder to make an initial payment and 4 monthly payments.

Agreeing not to take any drawings from the business until the cash flow forecast indicated it was free and available.

Based on these facts, the partners estimated that during the 5 months (July through November) the firm should take in \$88,000, pay out \$56,500, and have a balance of \$31,500 at the end of November. However, the problem was in July and August when expenses would run far ahead of the firm's income. To determine how a loan of \$16,000 (including interest) could see the firm through these months, the following estimates were made:

**Estimate of Borrowing Requirements
To Take On Additional Contract**

	July	Aug.	Sep	Oct.	Nov.
Cash Requirements					
Inventory	15,000	10,000	7,000		
Operating Expenses	4,000	6,000	6,000	4,000	2,000
Extra Equipment	2,500				
Total	21,500	16,000	13,000	4,000	2,000
Cash Available					
Cash on Hand	2,000			2,000	18,000
Collections	10,000	10,000	15,000	20,000	31,000
Total	12,000	10,000	15,000	22,000	49,000
Excess Cash Over Receipts	0	0	2,000	18,000	47,000
Additional Cash Required	9,500	6,000	0	0	0

According to these estimates, at the end of November the partners would have cash on hand amounting to \$47,000. Certain obligations would be outstanding against this cash. The first one would be the repayment of the loan of \$16,000. Other obligations would be those which the partners planned to accumulate during the early months of the contract when cash on hand was at a premium, such as reserve for taxes and the partners' draw.

These estimates convinced the partners that they could perform the contract if they could get a loan. The next step was to convince the bank that their plan was sound.

For the bank lending officer's benefit, as well as their own, the partners projected the loan funds through a cash flow plan for the entire business. The cash flow schedule that was prepared is shown below. It showed: (1) that the amount of money requested would be adequate for the firm's needs and (2) the margin of cash that was expected to be available both during the contract and at the end of the contract.

Keep in mind that records are a reflection of the quality of a firm's management. Nobody knows this fact better or uses it more often than a banker.

The efficiency of an owner-manager portrays itself on the profit and loss statement (income statement). The P&L of an effective operation will show adequate profits for the particular line of business. Sales, promotion, expense control, merchandise turnover, and net profit application are the points on which you will be judged.

To determine trends, the lender looks at your current financial statement and those for the past several years. The current statement also shows the lender the makeup of your net worth.

Cash Budget Forecast

	January Est.	Actual	February Est.	Actual
1. Cash in Bank (Start of Month)	1,400	1,400*	1,850	2,090*
2. Cash in Register (Start of Month)	100	100	150	70
3. Total Cash (add (1) and (2))	1,500	1,500	2,000	2,160
4. Expected Cash Sales	1,200	1,420	900	
5. Expected Collections	400	380	350	
6. Other Money Expected	100	52	50	
7. Total Receipts (add (4),(5) and (6))	1,700	1,852	1,300	
8. Total Cash and Receipts (add (3) and (7))	3,200	3,352	2,200	
9. All Disbursements (For Month)	1,200	1,192	1,000	
10. Cash Balance at End of Month in Bank Account and Register (Subtract (9) from (8))	2,000	2,160	2,300	

*The owner-manager writes in these figures as they become available.

Cash Flow Schedule - Period of Contract to Repayment of Loan

	July	Aug.	Sept.	Oct.	Nov.
Estimated Receipts					
Cash Sales	800	600	700	1,200	2,800
Accounts Receivable	10,000	10,000	15,800	20,000	31,600
Other Income	200	400	200	480	250
Total Receipts	<u>11,000</u>	<u>11,200</u>	<u>16,700</u>	<u>21,680</u>	<u>34,650</u>
Estimated Disbursements					
Accounts Payable	17,000	11,000	8,200	2,700	2,200
Payroll & Drawing	2,600	4,200	4,200	7,900	5,800
Expenses	1,200	1,800	2,000	2,700	600
Interest Expense	130	130	130	130	130
Plant & Equipment	2,500	460	600	800	100
Reserve for Taxes				3,800*	3,800*
Total Disbursements	<u>23,430</u>	<u>17,590</u>	<u>15,130</u>	<u>18,030</u>	<u>12,630</u>
Estimated Excess Receipts over Disbursements	(12,430)	(6,390)	1,570	3,650	22,020
Estimated Cash Balance at Start of Month	4,200	7,770	1,380	2,950	6,600
Borrowings	16,000				
Loan Repayment					16,000
Estimated Cash Balance at End of Month	7,770	1,380	2,950	6,600	12,620

*To be allotted in October and November so that available cash can be kept at the maximum during the months of heavy cash outflows.

Good managers recognize that occasional borrowing is one of the accepted business tools. Your long range plan for borrowing should be based on the fact that each of the various types of money in your business has its specific and appropriate purpose.

Recognizing this fact is important in preventing the misuse of fund. Keep in mind that misuse can cause a shaky financial operation. This point is especially true when operating cash seeps into long term investment in the business. As a result, the business requires a constant renewal of short term borrowings. Such borrowings indicates a capital deficiency in the business and the need for additional permanent capital.

Bear in mind that financial planning is the first step when borrowing. Such planning must be based on facts that come from your records if you are to secure loans and use them profitably.

[Go to Top](#)

9. How to Raise Venture Capital Money

Venture capital financing is a method used for Raising Cash For Business and Getting Investments for Business, but less popular than borrowing. Venture capital firms, like

banks, supply you with the funds necessary to operate your business, but they do it differently. Banks are creditors; they expect you to repay the borrowed money. Venture capital firms are owners; they hold stock in the company, adding their invested capital to its equity base. While banks may concentrate on cash flow, venture capital firms invest for long-term capital. Commonly, these firms look for their investment to appreciate three to five times in five or seven years.

One way of explaining the different ways in which banks and venture capital firms evaluate a small business seeking funds is: Banks look at its immediate future, but are most heavily influenced by its past; venture capitalists look to its longer run future.

To be sure, venture capital firms and individuals are interested in many of the same factors that influence bankers in their analysis of loan applications from smaller companies. All financial people want to know the results and ratios of past operations, the amount and intended use of the needed funds, and the earnings and financial condition of future projections.

But venture capitalists look much more closely at the features of the product and the size of the market than do commercial banks.

What Venture Capital Firms Look For (Raising Cash For Business)

Banks are creditors. They're interested in the product/market position of the company for assurance that this product or service can provide steady sales and generate sufficient cash flow to repay the loan. They look at projections to be certain that owners/managers have done their homework.

Venture capital firms are owners. They hold stock in the company, adding their invested capital to its equity base. Therefore, they examine existing or planned products or services and the potential markets for them with extreme care. They invest only in firms they believe can rapidly increase sales and generate substantial profits. The reason for this is that venture capital firms invest for long-term capital, not for interest income. A common estimate is that they look for three to five times their investment in five or seven years.

Of course, venture capitalists don't realize capital gains on all their investments. Certainly they don't make capital gains of 300 to 500% except on a very limited portion of their total investments. But their intent is to find venture projects with this appreciation potential to make up for investments that aren't successful.

Venture capital is risky due to the difficulty of judging the worth of a business in its early stages. Therefore, most venture capital firms set rigorous policies for venture proposal size, maturity of the seeking company, management of the seeking company, and "something special" in the plan that is submitted. They also have rigorous evaluation procedures to reduce risks, since their investments are unprotected in the event of failure.

Size of the Venture Proposal

Most venture capital firms are interested in investment projects requiring an investment of \$250,000 to \$1,500,000. Projects requiring under \$250,000 are of limited interest because of the high cost of investigation and administration; however, some venture capital firms will consider smaller proposals if the investment is intriguing enough.

The typical venture capital firm receives over 400 proposals a year. Probably 90% of these will be rejected quickly because they don't fit the established geographical, technical or market area policies of the firm - or because they have been poorly prepared.

The remaining 10% are carefully investigated. These investigations are expensive. Firms may hire consultants to evaluate the product, particularly when it is the result of innovation or is technologically complex. The market size and competitive position of the company are analyzed by contacts with present and potential customers, suppliers, and others. Production costs are reviewed. The financial condition of the company is confirmed by an auditor. The legal form and registration of the business are checked. Most importantly, the character and competence of the management are evaluated by the venture capital firm, normally via a thorough background check.

These preliminary investigations may cost a venture firm between \$2,000 and \$3,000 per company investigated. They result in perhaps ten to fifteen proposals of interest. Then, second investigations, more thorough and more expensive than the first, reduce the number of proposals under consideration to only three or four. Eventually, the firm invests in one or two of these.

Most venture capital firms' investment interest is limited to projects proposed by companies with some operating history, even though they may not yet have shown a profit. Companies that can expand into a new product line or a new market with additional funds are particularly interesting. The venture capital firm can provide funds to enable such companies to grow in a spurt rather than gradually as they would on retained earnings. Raising Money From Investors.

Companies that are just starting or that have serious financial difficulties may interest some venture capitalists, if the potential for significant gain over the long run can be identified and assessed. If the venture firm has already extended its portfolio to a large risk concentration, they may be reluctant to invest in these areas because of increased risk of loss. Getting Investments for Business.

Although most venture capital firms will not consider a great many proposals from start-up companies, there are a small number of venture firms that will do "start-up" financing. The small firm that has a well thought-out plan and can demonstrate that its management group has an outstanding record (even if it is with other companies) has a decided edge in acquiring this kind of seed capital.

Most venture capital firms concentrate primarily on the competence and character of the management. They feel that even mediocre products can be successfully manufactured, promoted, and distributed by an experienced, energetic management group.

They look for a group that is able to work together easily and productively, especially under conditions of stress from temporary reversals and competition problems. Obviously, analysis of managerial skill is difficult. A partner or senior executive of a venture capital firm normally spends at least a week at the offices of a company being considered, talking with and observing the management to estimate their competence and character.

Venture capital firms usually require that the company under consideration have a complete management group. Each of the important functional areas product design, marketing, production, finance, and control - must be under the direction of a trained, experienced member of the group. Responsibilities must be clearly assigned. And, in addition to a thorough understanding of the industry, each member of the management team must be firmly committed to the company and its future. Raising Money From Investors.

Next in importance to the excellence of the management group, most venture capital firms seek a distinctive element in the strategy or product/market/process position of the company. This distinctive element may be a new feature of the product or process or a particular skill or technical competence of the management. But it must exist. It must provide a competitive advantage.

Elements of a Venture Proposal - Getting Investments for Business

Purpose and Objectives

Include a summary of the what and why of the project.

Proposed Financing: You must state the amount of money you will need from the beginning to the maturity of the project proposed, how the proceeds will be used, how you plan to structure the financing, and why the amount designated is required.

Marketing: Describe the market segment you've got or plan to get, the competition, the characteristics of the market, and your plans (with costs) for getting or holding the market segment you're aiming at.

History of the Firm: Summarize the significant financial and organizational milestones, **description of employees and employee relations**, explanations of banking relationships, recounting of major services or products your firm has offered during its existence, and the like.

Description of the Product or Service: Include a full description of the product (process) or service offered by the firm and the costs associated with it in detail.

Financial Statements: Include statements for both the past few years and pro forma projections (balance sheets, income statements, and cash flows) for the next three to five years, showing the effect anticipated if the project is undertaken and if the financing is secured. (This should include an analysis of key variables affecting financial

performance, showing what could happen if the projected level of revenue is not attained.)

Capitalization: Provide a list of shareholders, how much is invested to date, and in what form (equity/debt).

Biographical Sketches: Describe the work histories and qualifications of key owners and employees.

Principal Suppliers and Customers, Problems Anticipated and Other Pertinent Information

Provide a candid discussion of any contingent liabilities, pending litigation, tax or patent difficulties, and any other contingencies that might affect the project you're proposing. List the names, addresses and the

telephone numbers of suppliers and customers; they will be contacted to verify your statement about payments (suppliers) and products (customers).

Provisions of the Investment Proposal

What happens when, after the exhaustive investigation and analysis, the venture capital firms decides to invest in a company? Most venture firms prepare an equity financing proposal that details the amount of money to be provided, the percentage of common stock to be surrendered in exchange for these funds, the interim financing method to be used and the protective covenants to be included.

This proposal will be discussed with the management of the company. The final financing agreement will be negotiated and generally represents a compromise between the management of the company and the partners or senior executives of the venture capital firm. The important elements of this compromise are: ownership, control, annual charges, and final objectives.

Ownership

Venture capital financing is not inexpensive for the owners of a small business. The partners of the venture firm buy a portion of the business' equity in exchange for their investment.

This percentage of equity varies, of course, and depends on the amount of money provided, the success and worth of the business, and the anticipated investment return. It can range from perhaps 10% in the case of an established, profitable company to as much as 80 or 90% for beginning or financially troubled firms.

Most venture capital firms, at least initially, don't want a position of more than 30 to 40% because they want the owner to have the incentive to keep building the business. If additional financing is required to support

business growth, the outsiders' stake may exceed 50% but investors realize that small business owner/managers can lose their entrepreneurial zeal under those

circumstances. In the final analysis, however, the venture firm, regardless of its percentage of ownership, really wants to leave control in the hands of the company's managers because it is really investing in that management team in the first place.

Most venture firms determine the ratio of funds provided to equity requested by a comparison of the present financial worth of the contributions made by each of the parties to the agreement. The present value of the contribution by the owner of a starting or financially troubled company is obviously rated low. Often it is estimated as just the existing value of his or her idea and the competitive costs of the owner's time. The contribution by the owners of a thriving business is valued much higher. Generally, it is capitalized at a multiple of the current earnings and/or net worth.

Financial valuation is not an exact science. The final compromise on the worth of the owner's contribution in the equity financing agreement is likely to be much lower than the owner thinks it should be and considerably higher than the partners of the capital firm think it might be. In the ideal situation, of course, the two parties to the agreement are able to do together what neither could do separately: 1) the company is able to grow fast enough with the additional funds to do more than overcome the owner's loss of equity; and 2) the investment grows at a sufficient rate to compensate the venture capitalists for assuming the risk.

An equity financing agreement with an outcome in five to seven years which pleases both parties is ideal. Since the parties cannot see this outcome in the present, neither will be perfectly satisfied with the compromise reached.

It is important, though, for the business owner to look at the future. He or she should carefully consider the impact of the ratio of funds invested to the ownership given up, not only for the present, but for the years to come.

Control

Control is a much simpler issue to resolve. Unlike the division of ownership over which the venture firm and management are likely to disagree, control is an issue in which they have a common interest. While it is understandable that the management of a small company will have some anxiety in this area, the partners of a venture firm have little interest in assuming control of the business. They have neither the technical nor the managerial personnel to run a number of small companies in diverse industries. They much prefer to leave operating control to the existing management.

The venture capital firm does, however, want to participate in any strategic decisions that might change the basic product/market character of the company and in any major investment decisions that might divert or deplete the financial resources of the company. They will, therefore, generally ask that at least one partner be made a director of the company.

They also want to be able to assume control and attempt to rescue their investment if severe financial, operating or marketing problems

develop. Thus, they will usually include protective covenants in their equity financing agreements to permit them to take control and appoint new officers if financial performance is very poor.

Annual Charges

The investment of the venture capital firm may be in the final form of direct stock ownership which does not impose fixed charges. More likely, it will be in an interim form - convertible subordinated debentures or preferred stock. Financings may also be straight loans with options or warrants that can be converted to a future equity position at a pre-established price.

The convertible debenture form of financing is like a loan. The debentures can be converted at an established ratio to the common stock of the company within a given period, so that the venture capital firm can prepare to realize their capital gains at their option in the future. These instruments are often subordinated to existing and planned debt to permit the company invested in to obtain additional bank financing.

Debentures also provide additional security and control for the venture firm and impose a fixed charge for interest (and possibly principal) on the company. The owner/manager of a small company seeking equity financing should consider the burden of any fixed annual charges resulting from the financing agreement.

Final Objectives

Venture capital firms generally intend to realize capital gains on their investments by providing for a stock buy-back by the small firm, by arranging a public offering of stock of the company invested in or by providing for a merger with a larger firm that has publicly traded stock. They usually hope to do this within five to seven years of their initial investment. (It should be noted that several additional stages of financing may be required over this period of time.)

Most equity financing agreements include provisions guaranteeing that the venture capital firm may participate in any stock sale or approve any merger, regardless of their percentage of stock ownership. Sometimes the agreement will require that the management work toward an eventual stock sale or merger. Clearly, the owner/manager of a small company seeking equity financing must consider the future impact upon his or her own stock holdings and personal ambition of the venture firm's aims, since taking in a venture capitalist as a partner may be virtually a commitment to eventually sell out or go public.

Types of Venture Capital Firms

Traditional Partnerships are often established by wealthy families to aggressively manage a portion of their funds by investing in small companies.

Professionally Managed Pools are made up of institutional money and which operate like the traditional partnerships.

Investment Banking Firms usually trade in more established securities, but occasionally form investor syndicates for venture proposals.

Insurance Companies often have required a portion of equity as a condition of their loans to smaller companies as protection against inflation.

Manufacturing Companies have sometimes looked upon investing in smaller companies as a means of supplementing their research and development programs.

In addition to these venture capital firms, there are individual private investors and finders. Finders, which can be firms or individuals, often know the capital industry and may be able to help the small company seeking capital to locate it, though they are generally not sources of capital themselves. Care should be exercised so that a small business owner deals with reputable, professional finders whose fees are in line with industry practice. Further, it should be noted that venture capitalists generally prefer working directly with principals in making investments, though finders may provide useful introductions.

The Importance of Formal Financial Planning

In case there is any doubt about the implications of the previous sections, it should be noted that it is extremely difficult for any small firm especially the starting or struggling company - to get venture capital.

There is one thing, however, that owner/managers of small businesses can do to improve the chances of their venture proposals at least escaping the 90% which are almost immediately rejected. In a word - plan.

Having financial plans demonstrates to venture capital firms that you are a competent manager, that you may have that special managerial edge over other small business owners looking for equity money. You may gain a decided advantage through well-prepared plans and projections that include: cash budgets, pro forma statements, and capital investment analysis and capital source studies.

Cash budgets should be projected for one year and prepared monthly.

They should combine expected sales revenues, cash receipts, material, labor and overhead expenses, and cash disbursements on a monthly basis. This permits anticipation of fluctuations in the level of cash and planning for short term borrowing and investment.

Pro forma statements should be prepared for planning up to three years ahead. They should include both income statements and balance sheets.

Again, these should be prepared quarterly to combine expected sales revenues; production, marketing and administrative expenses; profits; product, market or process investments; and supplier, bank or investment company borrowings. Pro forma statements permit you to anticipate the financial results of your operations and to plan intermediate term borrowings and investments.

Capital investment analyses and capital source studies should be prepared for planning up to five years ahead. The investment analyses should compare rate of return for product, market, or process investment, while the source alternatives should compare the cost and availability of debt and equity and the expected level of retained earnings, which together will support the selected investments. These analyses and source studies should be prepared quarterly so you may anticipate the financial consequences of changes in your company's strategy. They will allow you to plan long term borrowings, equity placements, and major investments.

There is a bonus in making such projections. They force you to consider the results of your actions. Your estimates must be explicit; you have to examine and evaluate your managerial records; disagreements must be resolved - or at least discussed and understood. Financial planning may be burdensome but it is one of the keys to business success.

Now, making these financial plans will not guarantee that you'll be able to get venture capital. Not making them will virtually assure that you won't receive favorable consideration from venture capitalists.

[Go to Top](#)

10. How to Plan Your Cash Flow

To be competitive, small business owners must plan and prepare for all future events and market changes. Possibly the most important aspect of preparation is effective cash-flow planning. Failure to properly plan cash flow is one of the leading causes for small business failures.

Experience has shown that many small business owners lack a general understanding of accounting principles. For this reason, a few of the basic principles will be covered.

The Basics

Cash in business serves several purposes. First, it is used for meeting normal cash obligations (i.e., paying bills). Second, it is held as a precautionary measure for unanticipated problems. Third, it is held for potential investment purposes. The term "cash" refers to:

Cash

Checks

Checking Accounts

The Operating Cycle

The operating cycle can be defined as the system through which cash flows, from the purchase of inventory through the collection of accounts receivable.

It measures the flow of assets into cash and is, in effect, a "business stopwatch."

For example, the operating cycle may begin with both cash and inventory on hand. Additional inventory is purchased on account to work as a cushion for future sales to guarantee that you will not deplete your stock. Except for cash sales, when some of your inventory is sold, accounts receivable increase, but your cash doesn't. Typically, you pay for the inventory you have purchased thirty days after it is received. When the payment for inventory is made, both cash and accounts payable are reduced. Thirty days after the sale of inventory, receivables are usually collected, which increases cash. Now your cash has completed its flow through the operating cycle and is ready to begin again.

Current Assets

Cash and other balance sheet items which convert into cash within twelve months are referred to as current assets. Typical current assets are:

Cash

Marketable Securities

Receivables

Pre-Paid Expenses

A Plan is Necessary

Cash-flow analysis shows whether your daily operations have generated enough cash to meet your obligations, and it shows how major outflows relate to major inflows. As a result, you can tell if inflows and outflows from your operation combine to result in a positive cash-flow from operations or in a net drain. Any significant changes over time will also appear. Understanding this will lead to better control of cash-flows and will allow adequate time to plan and prepare for the growth of your business.

It is best to have enough cash on hand each month to pay the cash obligations of the following month. A monthly cash-flow projection helps to project funds and compare actual figures to past months. It is important to project your monthly cash-flow to identify and eliminate deficiencies or surpluses in cash. When cash-flow deficiencies are found, business financial plans must be altered to provide more cash. When excess cash is revealed, it might indicate excessive borrowing or idle money that could be invested. The objective is to develop a plan which will provide a well-balanced cash flow.

Planning a Positive Cash Flow

To achieve a positive cash flow, you must have a sound plan. Cash reserves can be increased by:

Collection of receivables

Tightened credit requirements

Price of products

Loans

Increased sales

Collection of Receivables

Actively manage accounts receivable and quickly collect overdue accounts. Revenues are lost when a firm's collection policies are not aggressive. The longer your customer's balance remains unpaid, the less likely it is that you will receive full payment.

Tightened Credit Requirements

As credit and terms are tightened, more customers must pay cash for their purchases, thereby increasing the cash on hand and reducing the bad debt expense.

While tightening credit is helpful in the short run, it may not be advantageous in the long run. Looser credit allows more customers the opportunity to purchase your products or services. But, be certain that the increase in sales is greater than the increase in bad-debt expenses.

Pricing of Products

The primary goal of business is to make a profit. Many small businesses fail to do so because they do not know how to price their products or services. Pricing is the critical element in achieving a profit as well as in maintaining positive cash flow, and is a factor all firms can control.

Before setting your prices, you must understand your product's market, distribution costs, and competition. Remember, the marketplace responds rapidly to technological advances and international competition. You must keep abreast of the factors that affect pricing and be ready to adjust.

Loans

Loans from various financial institutions are often necessary for covering short-term cash-flow problems. Revolving credit lines and equity loans are common types of credit used in this situation.

Increased Sales

Increased sales would appear to increase cash flow, but be careful. For many companies, a large portion of sales are purchased on credit. Therefore, when sales increase, accounts receivable increases, not cash. Collection of receivables is usually 30 days after the purchase date, and sales expenses are most often incurred before receivables are collected. When sales rise, inventory is depleted and must be replaced. Because receivables have not yet been collected, a substantial increase in sales can

quickly deplete a firm's cash reserves. Again, by using a computer, you can maintain this critical data, as well as speed the time required to consider the "what if" concept.

Other Helpful Tips

Cash Reserve

You should always keep enough cash, as an added cushion for security, on hand to cover expenses. But, it is unwise to keep more money on hand than is necessary to cover your obligations. Excess cash should be invested in an accessible, interest bearing, low-risk account, such as a savings account, short-term CD or T-bill. Keeping excess cash on hand reduces both the growth and the return on investment.

Projections

Good accounting records and projections are important tools for a small business. Qualified accountants are necessary to help keep your records accurate and current. However, you can reduce your accounting expenses by producing your own summary statistics and projections.

Using A Personal Computer

With a personal computer, your business can have the added advantage of quick cash-flow projections as well as many other useful financial planning tools.

A good financial-management package and computer will enable you to review projected inflows and outflows of cash from month-to-month or year-to-year. By analyzing these projections you can see the fluctuations in cash flow and create management policies to avoid potential shortfalls.

There are numerous computer programs for making projections and keeping records and many advantages to having a personal computer for your business. The capabilities of modern computers are almost unlimited--they can aid in nearly every situation, from basic bookkeeping and "what if" analysis to inventory control or market demand projections. While a computer is not a specific requirement to success for a small business, it is a business tool which in the future will separate the competitive from the mediocre.

[Go to Top](#)

11. How to Forecast Your Profits

Forecasting, particularly on a short-term basis (one year to three years), is essential to planning for business success. This process, estimating future business performance based on the actual results from prior periods, enables the business owner/manager to modify the operation of the business on a timely basis. This allows the business to avoid losses or major financial problems should some future results from operations not conform with reasonable expectations. Forecasts - or Pro Forma Income Statements

and Cash Flow Statements as they are usually called - also provide the most persuasive management tools to apply for loans or attract investor money. As a business expands, there will inevitably be a need for more money than can be internally generated from profits.

Facts Affecting Pro Forma Statements

Preparation of Forecasts (Pro Forma Statements) requires assembling a wide array of pertinent, verifiable facts affecting your business and its past performance. These include:

Data from prior financial statements, particularly:

- a. Previous sales levels and trends
- b. Past gross percentages
- c. Average past general, administrative, and selling expenses necessary to generate your former sales volumes
- d. Trends in the company's need to borrow (supplier, trade credit, and bank credit) to support various levels of inventory and trends in accounts receivable required to achieve previous sales volumes

Unique company data, particularly:

- a. Plant capacity
- b. Competition
- c. Financial constraints
- d. Personnel availability

Industry-wide factors, including:

- a. Overall state of the economy
- b. Economic status of your industry within the economy
- c. Population growth
- d. Elasticity of demand for the product or service your business provides (Demand is said to be "elastic" if it decreases as prices increase, a demonstration that consumers can do without or with less of the goods or service. If demand for something is relatively steady as prices increase, it is "inelastic.")
- e. Availability of raw materials

Once these factors are identified, they may be used in Pro Formas, which estimate the level of sales, expense, and profitability that seem possible in a future period of operations.

The Pro Forma Income Statement

In preparing the Pro Forma Income Statement, the estimate of total sales during a selected period is the most critical "guesstimate." Employ business experience from past financial statements. Get help from management and salespeople in developing this all-important number.

Then assume, for example, that a 10 percent increase in sales volume is a realistic and attainable goal. Multiply last year's net sales by 1.10 to get this year's estimate of total net sales. Next, break down this total, month by month, by looking at the historical monthly sales volume. From this you can determine what percentage of total annual sales fell on the average in each of those months over a minimum of the past three years. You may find that 75 percent of total annual sales volume was realized during the six months from July through December in each of those years and that the remaining 25 percent of sales was spread fairly evenly over the first six months of the year.

Next, estimate the cost of goods sold by analyzing operating data to determine on a monthly basis what percentage of sales has gone into cost of goods sold in the past. This percentage can then be adjusted for expected variations in costs, price trends, and efficiency of operations.

Operating expenses (sales, general and administrative expenses, depreciation, and interest), other expenses, other income, and taxes can then be estimated through detailed analysis and adjustment of what they were in the past and what you expect them to be in the future.

Comparison with Actual Monthly Performance

Putting together this information month by month for a year into the future will result in your business's Pro Forma Statement of Income. Use it to compare with the actual monthly results from operations. Preparation of the information is summarized below:

Revenue (Sales)

List the departments within the business. For example, if your business is appliance sales and service, the departments would include new appliances, used appliances, parts, in-shop service, on-site service.

In the "Estimate" columns, enter a reasonable projection of monthly sales for each department of the business. Include cash and on-account sales. In the "Actual" columns, enter the actual sales for the month as they become available.

Exclude from the Revenue section any revenue not strictly related to the business.

Cost of Sales

Cite costs by department of the business, as above.

In the "Estimate" columns, enter the cost of sales estimated for each month for each department. For product inventory, calculate the cost of the goods sold for each department (beginning inventory plus purchases and transportation costs during the month minus the inventory). Enter "Actual" costs each month as they accrue.

Gross Profit

Subtract the total cost of sales from the total revenue.

Expenses

Salary Expenses: Base pay plus overtime.

Payroll Expenses: Include paid vacations, sick leave, health insurance, unemployment insurance, Social Security taxes.

Outside Services: Include costs of subcontracts, overflow work farmed-out, special or one-time services.

Supplies: Services and items purchased for use in the business, not for resale.

Repairs and Maintenance: Regular maintenance and repair, including periodic large expenditures, such as painting or decorating.

Advertising: Include desired sales volume, classified directory listing expense, etc.

Car, Delivery and Travel: Include charges if personal car is used in the business. Include parking, tolls, mileage on buying trips, repairs, etc.

Accounting and Legal: Outside professional services.

Rent: List only real estate used in the business.

Telephone.

Utilities: Water, heat, light, etc.

Insurance: Fire or liability on property or products, worker's compensation.

Taxes: Inventory, sales, excise, real estate, others.

Interest.

Depreciation: Amortization of capital assets.

Other Expenses (specify each): Tools, leased equipment, etc.

Miscellaneous (unspecified): Small expenditures without separate accounts.

Net Profit

To find net profit, subtract total expenses from gross profit.

The Pro Forma Statement of Income, prepared on a monthly basis and culminating in an annual projection for the next business fiscal year, should be revised not less than quarterly. It must reflect the actual performance achieved in the immediately preceding three months to ensure its continuing usefulness as one of the two most valuable planning tools available to management.

Should the Pro Forma reveal that the business will likely not generate a profit from operations, plans must immediately be developed to identify what to do to at least break even - increase volume, decrease expenses, or put more owner capital in to pay some debts and reduce interest expenses.

Break-Even Analysis

"Break-Even" means a level of operations at which a business neither makes a profit nor sustains a loss. At this point, revenue is just enough to cover expenses. Break-Even Analysis enables you to study the relationship of volume, costs, and revenue.

Break-Even requires the business owner/manager to define a sales level - either in terms of revenue dollars to be earned or in units to be sold within a given accounting period - at which the business would earn a before tax net profit of zero. This may be done by employing one of various formula calculations to the business estimated sales volume, estimated fixed costs, and estimated variable costs.

Generally, the volume and cost estimates assume the following conditions:

A change in sales volume will not affect the selling price per unit;

Fixed expenses (rent, salaries, administrative and office expenses, interest, and depreciation) will remain the same at all volume levels; and

Variable expenses (cost of goods sold, variable labor costs, including overtime wages and sales commissions) will increase or decrease in direct proportion to any increase or decrease in sales volume.

Two methods are generally employed in Break-Even Analysis, depending on whether the break-even point is calculated in terms of sales dollar volume or in number of units that must be sold.

Break-Even Point in Sales Dollars

The steps for calculating the first method are shown below:

1. Obtain a list of expenses incurred by the company during its past fiscal year.
2. Separate the expenses listed in Step 1 into either a variable or a fixed expense classification. (See sample below under "Classification of Expenses.")
3. Express the variable expenses as a percentage of sales. In the condensed income statement of the Small Business Specialities Co. (below), net sales were \$1,200,000. In Step 2, variable expenses were found to amount to \$720,000. Therefore, variable

expenses are 60 percent of net sales (\$720,000 divided by \$1,200,000). This means that 60 cents of every sales dollar is required to cover variable expenses. Only the remainder, 40 cents of every dollar, is available for fixed expenses and profit.

4. Substitute the information gathered in the preceding steps in the following basic break-even formula to calculate the break-even point.

[Go to Top](#)

12. How to Plan for Future Financing Needs

Studies overwhelmingly identify bad management as the leading cause of business failure. Bad management translates to poor planning by management.

All too often, the owner is so caught up in the day-to-day tasks of getting the product out the door and struggling to collect receivables to meet the payroll that he or she does not plan. There never seems to be time to prepare Pro Formas or Budgets. Often new managers understand their products but not the financial statements or the bookkeeping records, which they feel are for the benefit of the IRS or the bank. Such overburdened owner/managers can scarcely identify what will affect their businesses next week, let alone over the coming months and years. But, you may ask, "What should I do? How can I, as a small business owner/manager, avoid getting bogged down? How can I ensure success?"

Success may be ensured only by focusing on all factors affecting a business's performance. Focusing on planning is essential to survival.

Short-term planning is generally concerned with profit planning or budgeting. Long-term planning is generally strategic, setting goals for sales growth and profitability over a minimum of three to five years.

The tools for short- and long-term plans have been explained previously in this section: Pro Forma Income Statements, Cash Flow Statements or Budgets, Ratio Analysis, and pricing considerations. The business's short-term plan should be prepared on a monthly basis for a year into the future, employing the Pro Forma Income Statement and the Cash Flow Budget.

Long-Term Planning

The long-term or strategic plan focuses on Pro Forma Statements of Income prepared for annual periods three to five years into the future. You may be asking yourself, "How can I possibly predict what will affect my business that far into the future?" Granted, it's hard to imagine all the variables that will affect your business in the next year, let alone the next three to five years. The key, however, is control - control of your business's future course of expansion through the use of the financial tools explained in this section.

First determine a rate of growth that is desirable and reasonably attainable. Then employ Pro Formas and Cash Flow Budgets to calculate the capital required to finance the inventory, plant, equipment, and personnel needs necessary to attain that growth in sales volume. The business owner/manager must anticipate capital needs in time to make satisfactory arrangements for outside funds if internally generated funds from retained earnings are insufficient.

Growth can be funded in only two ways: with profits or by borrowing. If expansion outstrips the capital available to support higher levels of accounts receivable, inventory, fixed assets, and operating expenses, a business's development will be slowed or stopped entirely by its failure to meet debts as they become payable. Such insolvency will result in the business's assets being liquidated to meet the demands of the creditors. The only way to avoid this "outstripping of capital" is by planning to control growth. Growth must be understood to be controlled. This understanding requires knowledge of past financial performance and of the future requirements of the business.

These needs must be forecast in writing - using the Pro Forma Income Statement in particular - for three to five years in the future. After projecting reasonable sales volumes and profitability, use the Cash Flow Budget to determine (on a quarterly basis for the next three to five years) how these projected sales volumes translate into the flow of cash in and out of the business during normal operations. Where additional inventory, equipment, or other physical assets are necessary to support the sales forecast, you must determine whether or not the business will generate enough profit to sustain the growth forecast.

Often, businesses simply grow too rapidly for internally generated cash to sufficiently support the growth. If profits are inadequate to carry the growth forecast, the owner/manager must either make arrangements for working growth capital to be borrowed, or slow growth to allow internal cash to "catch up" and keep pace with the expansion. Because arranging financing and obtaining additional equity capital takes time, this need must be anticipated well in advance to avoid business interruption.

To develop effective long-term plans, you should do the following steps:

1. Determine your personal objectives and how they affect your willingness and ability to pursue financial goals for your business. This consideration, often overlooked, will help you determine whether or not your business goals fit your personal plans. For example, suppose you hope to become a millionaire by age 45 through your business but your long-term strategic plan reveals that only modest sales growth and very slim profit margins on that volume are attainable in your industry. You must either adjust your personal goals or get into a different business. Long range planning enables you to be realistic about the future of your personal and business expectations.

2. Set goals and objectives for the company (growth rates, return on investment, and direction as the business expands and matures). Express these goals in specific numbers, for example, sales growth of 10 percent a year, increases in gross and net profit margins of 2 to 3 percent a year, a return on investment of not less than 9 to 10 percent a year. Use these long-range plans to develop forecasts of sales and

profitability and compare actual results from operations to these forecasts. If after these goals are established actual performance continuously falls short of target, the wise business owner will reassess both the realism of expectations and the desirability of continuing to pursue the enterprise.

3. Develop long-range plans that enable you to attain your goals and objectives.

Focus on the strengths and weaknesses of your business and on internal and external factors that will affect the accomplishment of your goals. Develop strategies based upon careful analysis of all relevant factors (pricing strategies, market potential, competition, cost of borrowed and equity capital as compared to using only profits for expansions, etc.) to provide direction for the future of your business.

4. Focus on the financial, human, and physical requirements necessary to fulfill your plan by developing forecasts of sales, expenses, and retain earnings over the next three to five years.

5. Study methods of operation, product mix, new market opportunities, and other such factors to help identify ways to improve your company's productivity and profitability.

6. Revise, revise. Always use your most recent financial statements to adjust your short- and long-term plans. Compare your company's financial performance regularly with current industry data to determine how your results compare with others in your industry. Learn where your business may have performance weaknesses. Don't be afraid to modify your plans if your expectations have been either too aggressive or too conservative.

Planning is a perpetual process. It is the key to prosperity for your business.

[Go to Top](#)