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ABSTRACT

This lesson on financing a business, the eighth in a series of 18 units, is part of the first level of a comprehensive entrepreneurship curriculum entitled: A Program for Acquiring Competence in Entrepreneurship (PACE). (Designed for use with secondary students, the first level of PACE introduces students to the concepts involved in entrepreneurship and helps them become aware of entrepreneurship as a career option.) The following topics are covered in the unit: the importance of financing to the success of a new business; the different types of costs that must be considered when starting a new business (start-up, operating, and personal expenses); major methods of financing a new business (equity financing and debt financing); sources of financing for a new business; and the financial statements that should be included in a business plan. Included in the lesson are instructional text organized in a question-and-answer format, individual and group learning activities, a case study, and assessment questions. (MN)

PACE
REVISED

Program for Acquiring Competence in Entrepreneurship

UNIT 8

- [x] Level 1
- [ ] Level 2
- [ ] Level 3

Financing the Business

Developed by M. Catherine Ashmore and Sandra G. Pritz

You will be able to:

- **Explain the importance of financing in the success of a new business.**
- **List the different types of costs that must be considered when starting a new business.**
- **Explain the two major methods of financing a new business.**
- **Identify the various sources for obtaining financing for a new business.**
- **List the financial statements that should be included in a business plan.**

Research & Development Series No. 240 AB 8

THE NATIONAL CENTER FOR RESEARCH IN VOCATIONAL EDUCATION
THE OHIO STATE UNIVERSITY
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BEFORE YOU BEGIN...

1. Consult the *Resource Guide* for instructions if this is your first PACE unit.
2. Read the Unit Objectives on the front cover. If you think you can meet these objectives now, consult your instructor.
3. Look for these business terms as you read this unit. If you need help with their meanings, turn to the Glossary in the *Resource Guide*.

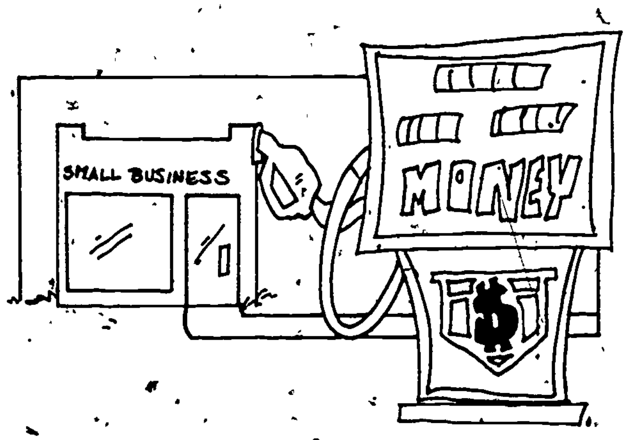
cash flow
debt financing
equity financing
venture capital

FINANCING THE BUSINESS

WHAT IS THIS UNIT ABOUT?

This unit looks at the money side of starting a business. Money is needed for many different reasons. In this unit you will discover the various expenses involved in getting your business started. Also, you will read about why it is so important to have enough money when you start your business.

Since many people don't have enough of their own money to get started, you will learn in this unit where you can go to borrow money. People who lend money will ask for a business plan. This plan helps the lenders to decide whether it is safe to lend the money for starting a new business. Included in the business plan will be a projected profit and loss statement, cash flow statement, and balance sheet. This unit will present these statements, too.



HOW IMPORTANT IS FINANCING TO THE SUCCESS OF A NEW BUSINESS?

Financing a new business means getting the money necessary to start it and to keep it going. Money is the fuel that powers the business. Just as a car won't run without fuel, neither will a business. Also, it is important to have the right kind of fuel and to have it at the right time.

Besides the decision to start the business, the next important decision is how to finance the business. Too many businesses fail because of lack of money to get them started and on their feet. If you were planning a 2,000 mile trip in your car, would you start out if you only had enough gas money for the first 500 miles? Probably not. Yet, many people do this when they start a business. Their chances for success are very limited.

If you are going to start a business, it is important that you have enough money to complete the trip. Financing is one of the keys to successfully starting a business. Without it, your chances of surviving and making a profit are poor.

WHAT DO YOU NEED THE MONEY FOR?

The first step in financing your new business is to determine what you need the money for. There are many costs and expenses to consider. If not all of your many needs are considered, you will be starting your trip without enough gas money. So, think very carefully about all of the things for which you will need money.

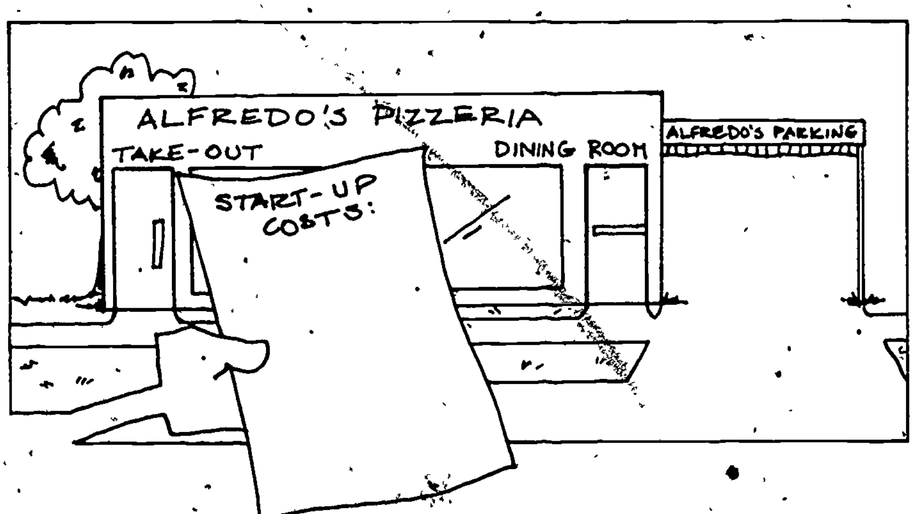
To help you think about your money needs, three groupings of costs and expenses are used. The first group is called *start-up costs*. The next group consists of *operating expenses*. And the other group is called *personal expenses*.

WHAT ARE START-UP COSTS?

Start-up costs are usually expenses that occur just once when getting the business off the ground. Once your business is started, you may not have these expenses again. Some examples of start-up costs are the following:

- Fixtures and equipment
- Starting inventory
- Deposits for rent and utilities
- Business licenses and permits
- Certain legal fees
- Advertising for the grand opening

If you were opening a restaurant, you would have many start-up costs. You would have to buy tables and chairs for your customers to sit on; ovens and fryers to cook your food; all the ingredients to make the items on the menu; and plates, knives, forks, and spoons. You would also have to buy or rent a building; pay for a business license and restaurant permit; and get your menu printed. And, these are just a few. Think of all the other start-up costs you would have.



WHAT ARE OPERATING EXPENSES?

Operating expenses come after the business has been started. They are necessary to get the business on its feet. Many businesses take a few months to maybe a year or longer to begin to show a profit. Until there is enough profit to keep the business running, money will be needed for operating expenses. Some examples of operating expenses are these:

- Inventory
- Supplies
- Advertising
- Payroll
- Taxes
- Repairs to equipment
- Insurance
- Monthly rent
- Utilities

Once your restaurant is open, you will have regular operating expenses. You will continually have to buy food, pay the cooks and waitresses, pay sales tax, make monthly rent payments, and much more. It is important to determine how much money is needed each month to operate the business.

WHAT ARE PERSONAL EXPENSES?

Personal expenses are those costs that are necessary for you to live. The money you need to start and operate the business is important. But don't overlook the money you need for personal or living expenses. Here are some examples:

- Rent or mortgage payment
- Food
- Transportation
- Insurance
- Clothing
- Utilities
- Medical bills
- Entertainment

Many new businesses will not be profitable right away. Sometimes it may take from one to three years for a business to become profitable.

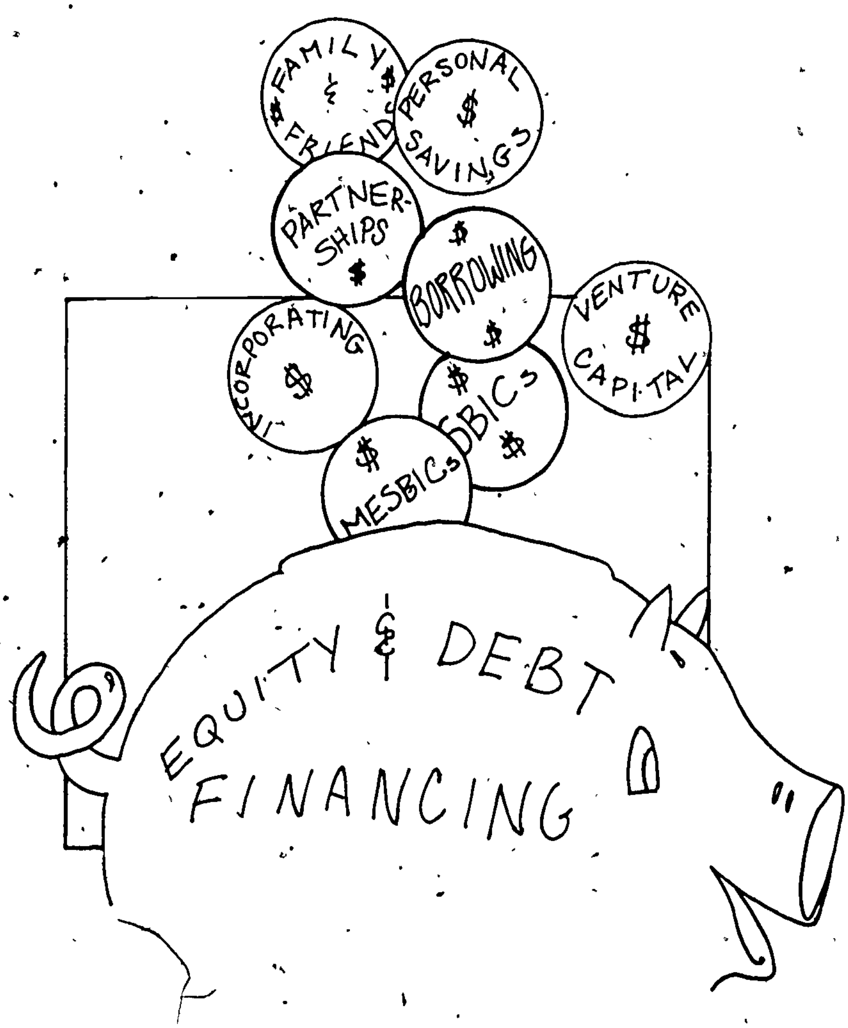
The owner of a new business may not make enough from the business to cover personal living expenses. You must plan for these expenses too when thinking about what you will need money for. Sometimes people will start a new business while working on another job, or they have a spouse who earns money from an outside job. This helps to limit the money needed to finance the business.

WHERE DO YOU GET THE MONEY FOR FINANCING THE BUSINESS?

After you determine what you need the money for, you need to find out where you can get it. There are two basic sources of money. First, many people who start businesses put in some of their own money. This is called *equity financing*. Second, the rest of the money that is needed is borrowed. This is called *debt financing*. Most businesses are started with both types of financing.

WHAT ARE THE SOURCES OF EQUITY FINANCING?

The main source of equity financing for most people is their savings. Some experts say that one-half of the money needed to start a small business should come from the owner. This may mean the future owner must work and save for several years before having enough to start.



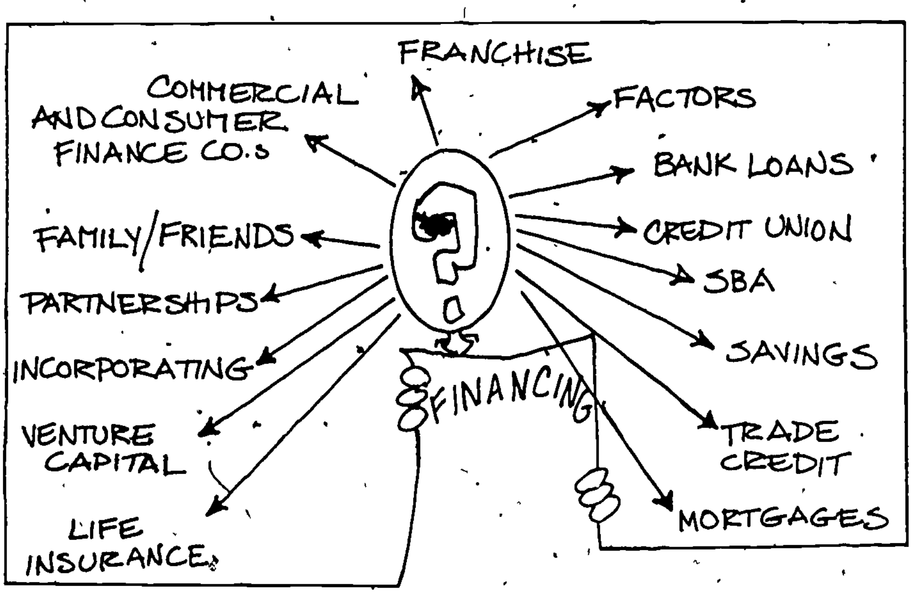
Another popular source of equity financing is money from family and friends. Family members such as mothers, fathers, brothers, sisters, aunts, and uncles frequently will provide money to help start a business. Friends, too, can be a good source. However, when using money from family and friends, there are a few points to consider. For example, will they want to get involved with operating the business? What happens if the business doesn't succeed? Will it ruin your relationship? Before using money from family and friends it is important to think it through carefully.

Equity financing can also be obtained by selling part of the business to others. This can be done several different ways. You could get one or more partners. With the partners putting in part of their own money, it is usually easier to raise the total amount needed. However, partners must be able to get along and make decisions that each accepts. Sometimes this is not easy. Since many people starting their own business want to make their own decisions, this way may not be realistic.

Incorporating the business and selling stock is also a way of raising equity capital. Again, this may not be acceptable to the owner, since it means giving up some control of the business. Legal and tax questions also must be considered.

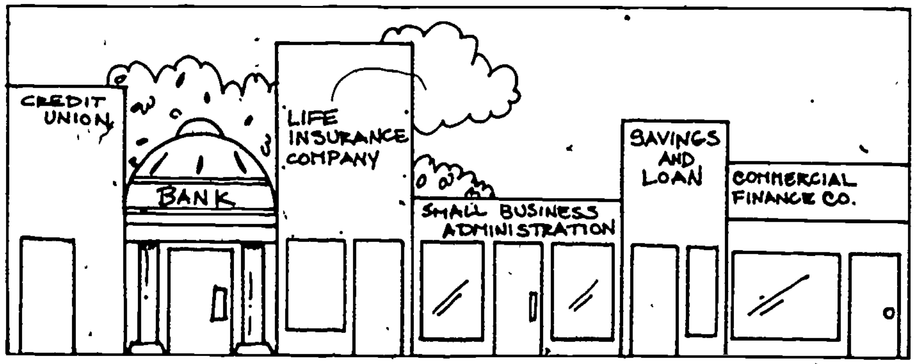
Venture capital is sometimes available from companies. This money is usually not easy to come by. It does come with some strings attached.

The most common arrangement is for the venture capital company to give money in exchange for a share in the new company in the form of stock. A form of venture capital is also available from Small Business Investment Companies. These companies are licensed and regulated by the federal government. They are eligible for federal loans that they may invest along with their own money.



WHAT ARE THE SOURCES FOR BORROWING MONEY?

The sources for borrowing money are limited only by the imagination of the owner. Whatever the source, lenders will usually lend money for starting businesses only to people they know and trust. Also, lenders are careful not to lend money if the risks are great. Lenders want to be sure they will not lose their money on businesses that fail. Most lenders, therefore, will want to review the business plan carefully. This plan describes how the business will be operated, how much money will be needed and how it will be used, and when the business will be profitable.



Most people think of banks when borrowing money. Although it is true that banks lend money to help businesses get started, it is not always easy to borrow from them. Banks lend money when the risk of losing it is very low. Frequently, they will only lend to their customers whom they have known for a long time.

If you are a member of a credit union, you may be able to borrow there. Many times, small loans are available for personal or business uses. Some loans can be obtained with just your signature. And, credit union interest rates are frequently lower than bank rates.

Both commercial and consumer finance companies may lend you money to start your business. Commercial finance companies arrange business loans. On the other hand, personal loans are made by consumer finance companies. Both types of finance companies tend to lend money to people that banks may turn down. Because they take greater risks, finance companies usually charge high interest rates.

Some people borrow money against their life insurance policies. This is an easy way to obtain some of the money needed to start a business. Since life insurance policy loans are based on the cash already paid in, they are not risky.

Life insurance companies usually offer these loans at lower interest rates. However, it should be remembered that the amount borrowed is deducted from the coverage available to the beneficiaries until the loan is repaid.

If you need to buy land or a building for a new business, you may be able to borrow the money from a savings and loan institution. They specialize in real estate financing. The loans they make are called mortgages. Their interest rates are similar to those of banks.

Another source of borrowing is the United States Small Business Administration (SBA). The SBA is a federal agency whose mission is to help small businesses get started and keep going. The SBA has two basic types of business loans. One type is called "Bank Guaranteed Loans." The money for these loans is actually provided by a private lender such as a bank. To convince the lender to make the loan, the SBA guarantees that it will be paid back. The SBA guarantees a percentage of the loan, not the total amount. The SBA may guarantee up to 90 percent of the loan. The lender assumes the risk for the other part. The other type of loan is made directly by the SBA. Therefore, they are called "direct loans."

SBA loans are available only if you are unable to borrow the money from a bank or other private lender. You have to try the other sources of borrowing previously mentioned before you are eligible for an SBA loan. The SBA has other programs, too. It is wise to check with your nearest SBA office to see what you might be eligible for.

ARE THERE OTHER SOURCES OF FINANCING?

Yes, there are other sources of financing for a new business. Three others that are commonly used are franchises, trade credit, and factors. Although franchises and trade credit can be used to get the business started, factors normally are not used until the business is actually started. All three will be explained next.

Starting a new business as a franchise, such as Dunkin' Donuts or Kentucky Fried Chicken, has advantages. One advantage is help in financing the business. Buying a franchise may help you go into business for less money than if you started a similar business by yourself. Sometimes the franchiser will let you put a small cash payment down and then lend you the rest of the money needed to get the business started.

Trade credit is another good source of financing. It is usually short-term credit that suppliers provide to their customers. In small businesses, it is widely used. Many small businesses buy the products they sell or the equipment they use on trade credit. Trade credit for *buying your inventory* may be for thirty, sixty, or ninety days. Trade credit for *buying equipment* is frequently longer.

Factors are businesses that buy another company's accounts receivable. Suppose you started a clothing store and provided your customers with charge accounts. Customers may buy clothes from you and then take several months to pay you back. Using a factor would help you get cash to pay your operating expenses. The factor would give you the cash and take over the credit charges or accounts receivable of your customers. The factor would charge you a fee for this service. However, it is a good way of getting cash when you need it without borrowing.

WHAT ARE THE FINANCING STATEMENTS INCLUDED IN THE BUSINESS PLAN?

Because of the risk involved in lending money to start new businesses, lenders want to see the business plan. This plan describes in detail how the business will operate and projects through financial statements how successful the business will be. Usually the business plan will include three financial statements: (1) a Projected Profit and Loss Statement, (2) Cash Flow Statement, and (3) Balance Sheet. All three are covered in more detail in PACE Unit 16, *Managing the Finances*.

WHAT IS A PROFIT AND LOSS STATEMENT?

The profit and loss statement is a financial tool that businesses use to compare costs and expenses to income. It shows the profit or loss for a business during a particular time period.

When you are planning a new business and looking for the money to get it started, you do not have a real profit and loss statement to show lenders or investors. You will have to estimate or project what will happen. Lenders and investors are interested in when you will make a profit and how large it will be. This information helps them decide the degree of risk and the terms of the agreement with you that they are willing to accept.

The projected profit and loss statement consists of five parts:

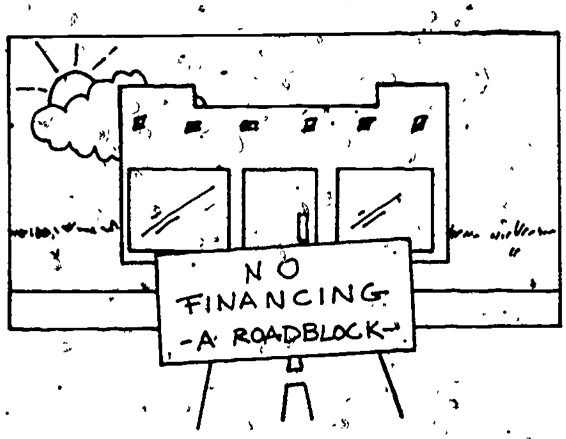
- Projected total sales
- Projected costs of goods sold/cost of sales
- Projected gross profit
- Projected operating expenses
- Projected net profit

As you can see by the example shown, for the first year of your business the profit or loss is presented monthly. Many small businesses do not make a profit right away. In this case, your business does not show profit until its fifth month.

WHAT IS THE CASH FLOW STATEMENT?

The cash flow statement estimates how much cash will come in and go out of your business each month. It tells you when you will need to find additional funds and when you will have cash left over. The sample cash flow statement provided points this out.

The first part lists the sources or where the cash will come from. The disbursements, or where the cash will go, is then presented. Subtracting the disbursement from the cash available tells you the amount of cash left over or the additional amount of cash needed to cover the expenses for the month.



WHAT IS THE BALANCE SHEET?

The projected cash flow of your business is important. Remember, cash is the fuel that makes your business function. You need to know the amount of cash available to buy new merchandise or whatever else you need to keep the business operating.

The balance sheet shows how the business stands at the end of the year. It balances the assets of the business with the liabilities and equity. Ideally, the assets of the business will be larger than the liabilities. This increases equity or net worth. This, of course, is the goal of the owner.

The following sample shows you exactly what a projected balance sheet looks like.

YOUR BUSINESS
PROJECTED PROFIT-AND-LOSS STATEMENT

	Jan.	Feb.	March	April	May	June	July	August	Sept.	Oct.	Nov.	Dec.
GROSS SALES	$1,000	$1,500	$1,750	$2,000	$3,000	$3,000	$3,500	$4,000	$4,500	$5,000	$6,000	$7,000
LESS COST OF SALES	750	850	900	950	1,150	1,150	1,250	1,350	1,450	1,550	1,750	1,950
GROSS PROFIT	250	650	850	1,150	1,850	1,850	2,250	2,650	3,050	3,450	4,250	5,050
EXPENSES												
SALARIES	1,000	1,000	1,000	1,000	1,000	1,000	1,000	1,000	1,000	1,000	1,000	1,000
PAYROLL TAXES	100	100	100	100	100	100	100	100	100	100	100	100
ADVERTISING	50	50	50	50	50	50	50	50	50	100	100	100
SUPPLIES	50	[illegible]	50	50	50	50	50	50	50	50	50	50
UTILITIES	100	100	100	100	100	100	100	100	100	100	100	100
AND OTHERS	200	250	300	300	350	300	350	400	400	450	450	500
TOTAL EXPENSES	1,500	1,550	1,600	1,600	1,650	1,600	1,650	1,700	1,700	1,800	1,800	1,850
NET PROFIT/(LOSS)	(1250)	(900)	(750)	(450)	200	250	600	950	1,350	1,650	2,450	3,200

YOUR BUSINESS
PROJECTED CASH FLOW

	Pre-Operating	Jan.	Feb.	March	April	May	June	July	August	Sept.	Oct.	Nov.	Dec.
SOURCES OF CASH	$20,000												
CASH ON HAND	25,000												
*NET PROFIT		(1,250)	(900)	(750)	(450)	200	250	600	900	1,350	1,650	2,450	3,200
TOTAL	45,000	(1,250)	(900)	(750)	(450)	200	250	600	900	1,350	1,650	2,450	3,200
DISBURSEMENTS													
START-UP COSTS	25,000												
OWNER'S DRAW		1,000	1,000	1,000	1,000	500	1,000	500	1,000	500	500	1,000	1,000
LOAN PAYMENTS				500			500			500			500
INSURANCE						400					400		
INCOME TAX					1,000								
OTHERS					300		600			200			700
TOTAL	25,000	1,000	1,000	1,500	2,300	900	2,100	500	1,000	1,200	900	1,000	2,200
NET CASH FLOW	20,000	(2,250)	(1,900)	(2,250)	(2,750)	(700)	(1,800)	100	(100)	150	750	1,450	1,000
CUMULATIVE CASH FLOW	$20,000	17,500	15,850	13,600	10,850	10,150	8,300	8,400	8,300	8,450	9,200	10,650	11,650

*Net profit is carried over from the Projected Profit-and-Loss Statement

YOUR BUSINESS
PROJECTED BALANCE SHEET
AT END OF FIRST YEAR

ASSETS	
Current Assets	
Cash on Hand	11,650
Accounts Receivable	3,900
Inventory	15,050
TOTAL	30,600
Fixed Assets	
Fixtures and Equipment	9,950
Less Depreciation	750
NET	9,200
Other Assets	
Deposit for Utilities	500
TOTAL FIXED	9,700
TOTAL ASSETS	40,300

LIABILITIES	
Loan (Current Balance	23,000
TOTAL	23,000
Equity	
Beginning Equity	20,000
Earnings	7,300
Less Draws	(10,000)
Net Equity	17,300
TOTAL LIABILITIES AND EQUITY	40,300

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ACTIVITIES

The following three activities are provided so that you can try out what you have learned about financing the business. After completing each one, pause and check your answers. This will help you measure your knowledge about financing the business.

INDIVIDUAL ACTIVITY

1. Identify each of the costs and expenses listed below as either—

   Start-up

   First-year operating

   Personal living

On a separate piece of paper, number from one to ten. Beside each number, write the first letter of the appropriate type of cost. Use S for start-up, F for first-year operating, and P for personal living.

1. Payroll
2. Business license
3. Monthly rent
4. House payment
5. Beginning inventory
6. Medical bills
7. Advertising for grand opening
8. Equipment repairs
9. Deposits for utilities
10. Clothing

2. Identify each of the sources of financing listed below as either equity financing or debt financing. On a separate piece of paper, beside each number, write the first letter of the appropriate answer. Use E for equity financing and D for debt financing.

1. Commercial bank
2. Personal savings
3. Forming a partnership
4. Life insurance company
5. Small Business Administration
6. Venture capital

7. Consumer finance company
8. Incorporating the business
9. Credit union
10. Family and friends

GROUP ACTIVITY

Divide into small groups of three to four students. First, have each group member privately list as many different start-up costs for opening a small pizza take-out restaurant as possible. Take five minutes to do this individually.

Next, as a group, compare everyone's individual lists. Make a comprehensive list that includes every different start-up cost mentioned by the group members. Discuss the start-up costs listed and determine whether there are others that no one thought of individually. If the group thinks of any more, add them to the list.

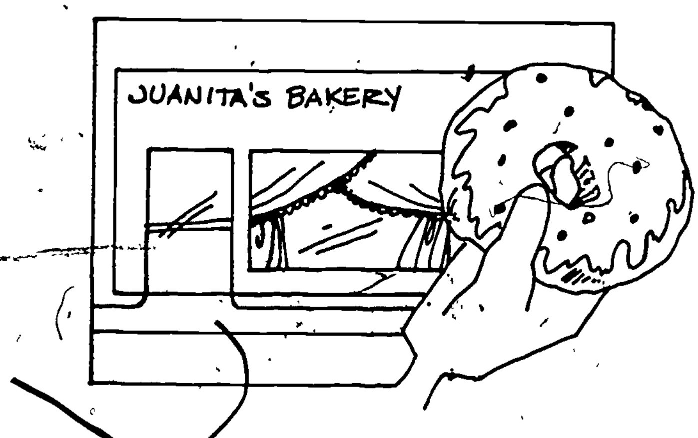
As an optional step to this activity, have the various groups in class share their lists. Check to see if your group left out any other start-up costs that others included.

Another option would be to either individually discuss start-up costs with a manager/owner of a pizza take-out restaurant or have this person talk to the group.

CASE STUDY

Juanita Owens has worked the past five years as the crew chief for the morning shift at a large bakery shop. She has had responsibility for overseeing the total operation from 4 a.m. until noon.

During this time she has learned much about the bakery business. She knows well both the backroom and front-end of the operation. In addition, Juanita has observed the customers carefully. She has learned the importance of satisfying the needs and wants of consumers.



Juanita has always wanted to start her own bakery. Within the last few months she has concluded that there is a need in her community for a bakery that also provides an in-store eating area with coffee, milk, and other beverages served.

Because of her experience in the bakery business, Juanita feels that she is now ready to open such a business. Of course, the first thing Juanita thinks of is money. She is not a wealthy person. She wonders where she could get the money to open her dream bakery.

Answer the following questions on a separate piece of paper.

1. Explain to Juanita the importance of financing to the success of her business.

2. Describe to her the two main methods of financing a new business.

3. Tell Juanita about the various sources for getting the money to start a new business.

ASSESSMENT

Directions: Read the following questions concerning financing the business. They are for you to check your knowledge about this topic. When you feel ready, ask your instructor to assess your knowledge on them.

1. Explain the importance of financing to the success of a new business.

2. List the three main types of costs and expenses that are necessary to start a new business.

3. Explain the two major methods of financing a new business.

4. Identify the various sources for obtaining the money needed to finance a new business.

5. List the three financial statements that should be included in a business plan.

SOURCES USED TO DEVELOP THIS UNIT

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Dickson, Franklyn J. *Successful Management of the Small and Medium-Sized Business.* Englewood Cliffs, NJ: Prentice-Hall, 1971.

Loffel, Egon W. *Financing Your Business.* New York: John Wiley & Sons, 1977.

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For further information, consult the list of additional sources in the *PACE Resource Guide.*

PACE

Units on the above entrepreneurship topics are available at the following three levels:

- Level 1 helps you understand the creation and operation of a business
- Level 2 prepares you to plan for a business in your future
- Level 3 guides you in starting and managing your own business

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