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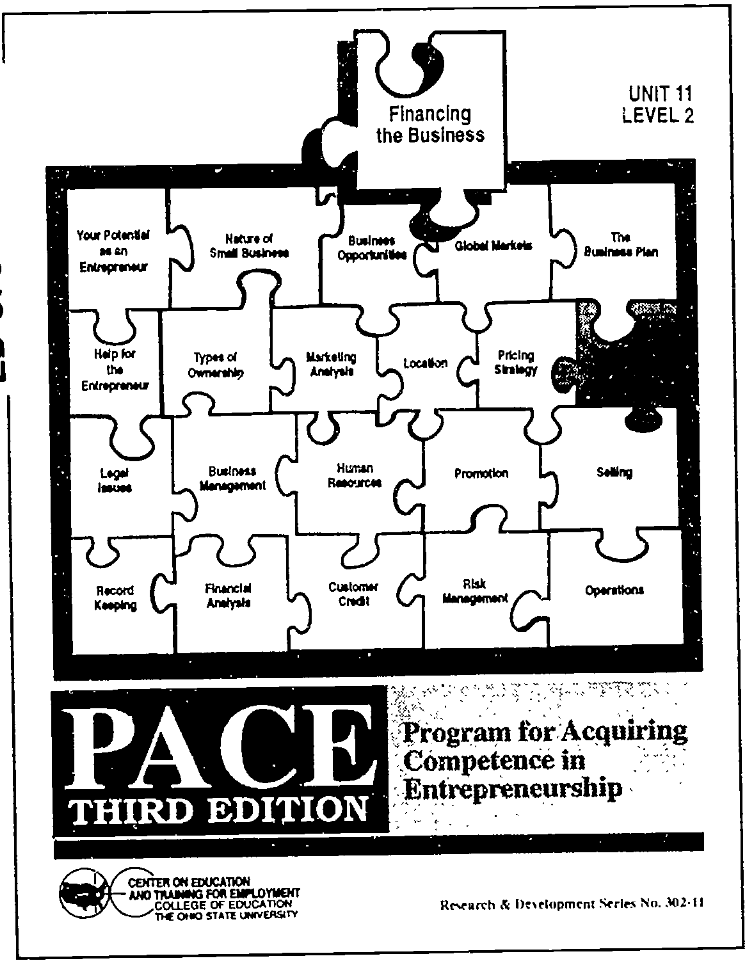
ABSTRACT

This instructor guide for a unit on business financing in the PACE (Program for Acquiring Competence in Entrepreneurship) curriculum includes the full text of the student module and lesson plans, instructional suggestions, and other teacher resources. The competencies that are incorporated into this module are at Level 2 of learning--planning for a business in one's future. Included in the instructor's guide are the following: unit objectives, guidelines for using PACE, lists of teaching suggestions for each unit objective/subobjective, model assessment responses, and overview of the three levels of the PACE program. The following materials are contained in the student's guide: activities to be completed in preparation for the unit, unit objectives, student reading materials, individual and group learning activities, case study, discussion questions, assessment questions, and references. Among the topics discussed in the unit are the following: factors to consider in financing a business, determining different types of costs, and advantages and advantages of different loan sources. (KC)



INSTRUCTOR GUIDE

Unit 11

Financing the Business

Level 2

Objectives:

- Discuss the factors to consider in financing a business.
- Explain how to determine the different types of costs.
- Compare the advantages and disadvantages of different sources of loans.

HOW TO USE PACE

- Use the objectives as a pretest. If a student is able to meet the objectives, ask him or her to read and respond to the assessment questions in the back of the module.
- Duplicate the glossary from the *Resource Guide* to use as a handout.
- Use the teaching outlines provided in the *Instructor Guide* for assis‑‑ce in focusing your teaching delivery. ‑ne left side of each outline page lists objectives with the corresponding headings (margin questions) from the unit. Space is provided for you to add your own suggestions. Try to increase student involvement in as many ways as possible ‑o foster an interactive learning process.
- When your students are ready to do the *Activities*, assist them in selecting those that you feel would be the most beneficial to their growth in entrepreneurship.
- Assess your students on the unit content when they indicate they are ready. You may choose written or verbal assessments according to the situation. Model responses are provided for each module of each unit. While these are suggested responses, others may be equally valid.

Objectives	Teaching Suggestions
1. DISCUSS THE FACTORS TO CONSIDER IN FINANCING A BUSINESS	
What factors affect the cost of starting a new business?	Engage students in a discussion about risks associated with underestimating and overestimating the amount of financing needed to start a business. Use the list provided in this unit to help students understand factors to be considered when estimating the amount of financing (e.g., the nature, size, location of the business, economic conditions, etc.).
2. EXPLAIN HOW TO DETERMINE THE DIFFERENT TYPES OF COSTS	
How do you estimate your cash needs?	Ask students to define in their own words costs and operating expenses and give examples of each. Next, use a chart to list factors to be considered when estimating operating expenses and start-up costs. Choose a particular business and ask students to complete the calculations in Figure 1.
3. COMPARE THE ADVANTAGES AND DISADVANTAGES OF DIFFERENT SOURCES OF FINANCING LOANS	
What are the sources of financing for a new business?	Assist students in defining the concepts of debt and equity financing. Ask students to give examples of each. Invite a local entrepreneur to speak about advantages and disadvantages of equity financing. The entrepreneur should discuss personal savings, financing with funds from family and friends, incorporating the business, using venture capital, small business investment companies (SBICs), and minority enterprise small business investment companies (MESBICs).
What are the advantages and disadvantages of debt financing?	Invite a local banker to speak about advantages and disadvantages of debt financing. The banker should explain the concepts of prime interest rate, negative and positive covenants, etc.
What are the advantages and disadvantages of other financing sources?	Use a chart to show advantages and disadvantages of franchises, trade credit, factors, and cost reduction.

Objectives	Teaching Suggestions
What are the different types of loans for financing a new business?	The guest banker should also discuss different types of loans offered by banks. Help students remember these concepts by using a chart with different categories of commercial lenders. Also, discuss government sources of borrowing.
Who are the commercial lenders?	Use the above suggestion. Ask the banker to explain the meaning of secured/unsecured loans, collateral, mortgages, trust receipts, line of credit, etc. In addition, show a chart with companies engaged in the business of lending money (e.g., lending institutions such as banks, savings and loans, financing companies, life insurance companies, etc.).
What are government sources of loans?	Encourage students to offer their understanding of the purpose and function of the SBA. Complete the discussion by using a chart showing the purpose and function of the SBA. Use the information provided in this section and additional information provided in the *Resource Guide* for an extensive discussion.
What is a loan application package?	Have students explain what a loan application package is.
What is in the loan application package?	Secure a commercial loan application package from a local bank or use the Bank One Loan Application Kit provided in Level 3 of this unit. Help students learn how to fill out such applications.

MODEL ASSESSMENT RESPONSES

1. Before starting a business, entrepreneurs need to estimate (1) start-up costs and (2) operating expenses. These costs are to be estimated based on personal experience or experiences of other entrepreneurs who have been in business for a while. Start-up costs and operating expenses are to be estimated based on information gathered from trade associations, government agencies, libraries, and other institutions. Although no rule of thumb or foolproof procedure exists, it is important to estimate these costs as accurately as possible to avoid future underfinancing or overfinancing problems.

2. A suggested answer is included in the following table:

Type of financing	Advantages	Disadvantages
A. Equity financing		
Use of personal funds	• The entrepreneur has complete freedom in decision making. • The entrepreneur benefits exclusively from the profits. • Reduced interest expense due to reduced borrowing. • Complete freedom motivates the entrepreneur. • Shows investors and lenders that the entrepreneur is committed to succeed.	• The entrepreneur cannot share the risk with partners, etc. • The entrepreneur takes the risk of losing personal assets pledged as collateral. • The entrepreneur's lifestyle might change dramatically. • Lost opportunities to earn interest in personal savings.
Involving family and friends	• Money is easy to obtain. • Significantly less pressure towards business profitability compared to pressure exercised by lenders and investors.	• May possibly lead to destruction of personal relationships.
Forming a partnership	• Each partner brings a pool of money, skills, and expertise to the business. • Shared risk.	• Possible dissensions due to disagreements on decision making. • Problems related to dissolving the partnership. • The entrepreneur loses part of its decision-making freedom.
Forming a partnership	• Shared risk among many investors (the entrepreneur is not personally liable). • Oftentimes easier to raise capital.	• The entrepreneur loses certain freedom. • High costs associated with the formation of the legal structure. • High costs associated with disclosure of financial information.
Using venture capital	• The entrepreneur can borrow large amounts of money. • The entrepreneur keeps his/her freedom in decision making. • Financial assistance is offered by venture capitalists.	• Not many businesses qualify. • High interest expense.
Working with SBICs	• Entrepreneurs overlooked by venture capitalists qualify.	• Tend to favor expanding businesses rather than businesses just starting off.
B. Debt financing	• Funds are obtained easier and quicker. • Some loans allow for deferred payments allowing the business to fully benefit from cash. • Tax savings based on the fact that interest payments are tax deductible.	• High cost of interest. • Many businesses fail because of their inability to repay what they borrowed. • Entrepreneurs must often disclose confidential financial information to obtain credit. • Entrepreneurs's freedom is limited by covenants.
C. Other financing sources		
Franchise	• All advantages of debt financing.	• All disadvantages of debt financing. • The business must operate within the restrictions imposed by the franchisor.
Trade credit	• All advantages of debt financing. • Entrepreneurs accumulate inventory without paying for it right away.	• All disadvantages of debt financing.
Factors	• Source of immediate cash.	• Factors pay less for accounts receivable than their actual value.
Cost reduction	• Reduces financing amount needed. • Prepared the business for future growth and efficient operations.	

3. Loans may be provided by commercial lenders (i.e., banks), commercial finance companies, other financial institutions (such as credit unions, consumer finance companies, savings banks, and life insurance companies), government agencies through SBA, SBICs, etc.

4. The information provided in a loan package includes: the type of business the entrepreneur plans to establish, the entrepreneur's and his/her managers's experience, estimation of equity financing, forecasts of one-year balance sheet, monthly income statement and cashflow statement, a list of collateral, start-up costs breakdown, etc.

5. Loan institutions evaluate applicants based on their credit rating, this is the entrepreneur's credit history, the business's profitability profile, personal savings invested by entrepreneur to start the business, etc.

PACE THIRD EDITION

Program for Acquiring Competence in Entrepreneurship

Incorporates the needed competencies for creating and operating a small business at three levels of learning, with experiences and outcomes becoming progressively more advanced.

Level 1 — Understanding the creation and operation of a business.
Level 2 — Planning for a business in your future.
Level 3 — Starting and managing your own business.

Self-contained **Student Modules** include: specific objectives, questions supporting the objectives, complete content in form of answers to the questions, case studies, individual activities, group activities, module assessment references. **Instructor Guides** include the full text of each student module and lesson plans, instructional suggestions, and other resources. **PACE,Third Edition, Resource Guide** includes teaching strategies, references, glossary of terms, and a directory of entrepreneurship assistance organizations.

For information on PACE or to order, contact the Publications Department at the
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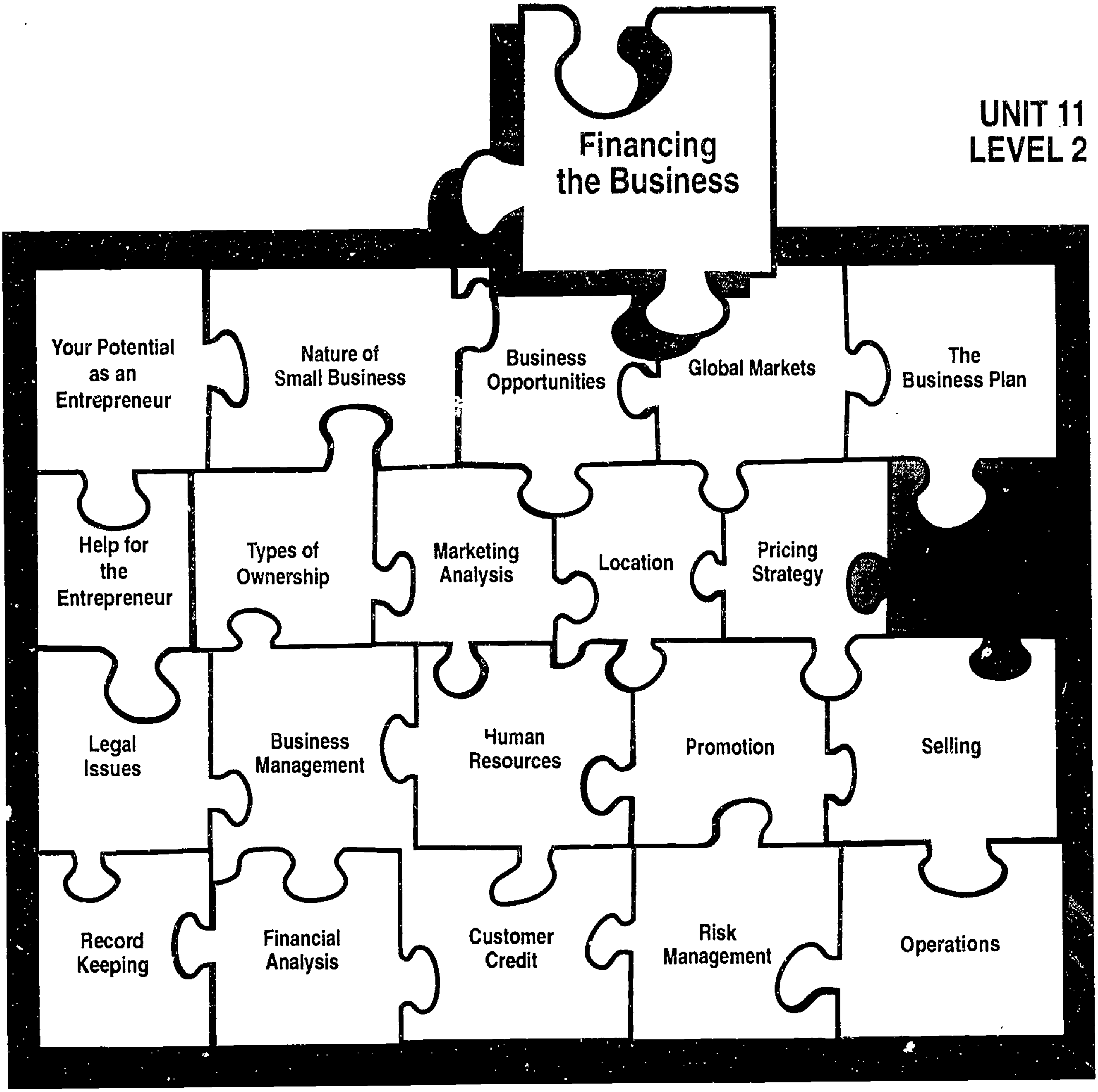
UNIT 11
LEVEL 2



PACE
THIRD EDITION

Program for Acquiring Competence in Entiepreneurship

CENTER ON EDUCATION AND TRAINING FOR EMPLOYMENT
COLLEGE OF EDUCATION
THE OHIO STATE UNIVERSITY

Research & Development Series No. 302-11

FINANCING THE BUSINESS

BEFORE YOU BEGIN . . .

1. Consult the *Resource Guide* for instructions if this is your first PACE unit.

2. Read What are the Objectives for this Unit on the following page. If you think you can meet these objectives now, consult your instructor.

3. These objectives were met in Level 1:

   - Discuss the personal risks involved in financing a business.
   - Explain the difference between operating expenses and start-up costs.
   - Describe methods of financing a new business.
   - Discuss the importance of having a good credit rating.

4. Look for these business terms as you read this unit. If you need help with the meanings, ask your instructor for a copy of the PACE Glossary contained in the *Resource Guide*.

Bad debts
Chattel mortgage
Collateral
Covenants
Credit union
Direct loan
Industry ratios
Intermediate term loan
Life insurance company
Limited/general partners
Line of credit
Minority Enterprise Small Business Investment Company (MESBIC's)
Negative covenants/Positive covenants
Prime interest rate
Savings bank
Secured loan
Short-term loan
Small Business Investment Company (SBIC's)
Trade assistance/Trade credit
Trust receipt
Unsecured (Signature) loan

FINANCING THE BUSINESS

WHAT ARE THE OBJECTIVES FOR THIS UNIT?

Upon completion of this unit you will be able to—

- discuss the factors to consider in financing a business,
- explain how to determine the different types of costs, and
- compare the advantages and disadvantages of different sources of financing.

WHAT IS THIS UNIT ABOUT?

This unit examines the financing needed to start a new business. Finding adequate financing, or the money necessary to get a business started, is a roadblock that many aspiring entrepreneurs face. Although the financing barrier may seem insurmountable, it can be overcome. This unit will help you to plan for the financial needs of your new business.

The basic factors you need to consider when developing your financing plan for a business are presented first. Next, you have the opportunity to consider the different types of costs that must be considered when starting a new business. This topic deals with what you need financing or money to cover and concludes with an evaluation of the different sources for financing the new business.

Since many people need to borrow money to start their businesses, this unit looks at the various sources of loans that are available, the procedures for obtaining a loan, and the criteria that lenders use to evaluate credit applicants.

WHAT FACTORS AFFECT THE COST OF STARTING A NEW BUSINESS?

Often, prospective entrepreneurs underestimate the amount of money it takes to start a new business and make it prosper. Sometimes this happens because people are swept up in their dreams of owning a business. They plunge in without thinking about financing. Other times it may be caused by a lack of knowledge about the amount of money that is really necessary.

Underestimating the amount of financing needed to start a business may seriously hamper its chances for success. On the other hand, overestimating leads to painfully heavy debt load and dramatic financing problems. Or, good business ideas may be abandoned because anticipated financing cost are unrealistically high. This leads to the question, "Exactly how much money do I need to start my business?" The answer depends upon the following factors:

- The nature of the business
- The size of the business
- The location of the business
- Current economic conditions
- Available trade assistance
- The nature of the inventory required
- Credit policies
- The time it takes between obtaining start-up funds and earning your first sales
- The timing of the flow of your expenses vs. revenues

The *nature* of the business you wish to start has a great deal to do with the amount of financing needed. Generally, manufacturing businesses require more money to start than wholesale, retail, or service enterprises. The reason for this is that usually manufacturing firms require large and expensive pieces of machinery and larger facilities. More employees may be needed, too. Retail stores may need more financing than service businesses. Normally, the retailer's inventory of merchandise to sell is a large expense. Since service businesses may not need an inventory, they may be started with less money.

The *size* of the business when it is started is another important factor to consider. Large businesses usually take large amounts of money. Small businesses usually do not need as much financing to start. Therefore, it may be smart to start with a small operation and finance its growth through self-generated profits. This should help to avoid taking on too much debt at the very beginning.

The *location* of a business may have a great deal to do with its success. Having a convenient location with ample parking may be a critical factor to the success of a retail business. To bring customers into the store, a retailer may have to locate in a shopping district or along a heavily traveled street. Since these locations are very desirable, they are also usually expensive. Store location may be costly for the retailer; small manufacturing and service businesses may not require such expensive locations. The decision on a location may be a difficult one. It usually is not based just on cost. It is wise to think carefully about the part that location plays in the eventual success of a business. See PACE Unit 9 for more information on selecting a business location.

When you start a business, it is crucial to remember that you are a part of a very large economic system. This system is based upon the interaction of consumers and businesses. You will be dependent upon other businesses and consumers. If *current economic conditions* are bad, you may face various financing problems. Interest rates may be high, which will make the cost of borrowing very expensive. It frequently takes longer to get a business on its feet during a recession or slump in the economy. Therefore, you may need more money to start your business. If the economy is healthy and robust, you may not need as much money to start since you may become profitable sooner.

Trade assistance usually refers to suppliers and equipment manufacturers who may help in financing some of the costs of starting a business. If you are starting a retail business, perhaps some of the companies you purchase your inventory from will allow you favorable credit terms instead of requiring cash upon receipt of the merchandise. With the extra time this will give you, you could sell the merchandise to generate the cash you need to pay the bill. Or, suppose you are opening a service operation, such as a quick, one-stop printing business. Maybe some of the manufacturers of the printing equipment you need will allow you to lease it or pay for it over several months. This would make it possible to open your business for less money than if cash were necessary to pay for the equipment fully when it was delivered.

If you start a business that carries an *inventory*, the type of merchandise you handle will affect the costs of starting and operating the business. It usually takes more money to start a furniture store than a clothing store. The main reason, of course, is that furniture inventory costs more than clothing inventory. The selection of items you offer affects costs, too. For example, if your inventory includes all types of men's, women's, and children's clothing, it may cost more than an inventory limited to women's shirts/blouses and pants/slacks. Many small businesses start with a limited inventory and then expand as the business becomes profitable.

Will your business be cash-and-carry only, or will you provide *credit* to your customers? This decision will affect the financing necessary to get your business going. Generally, it takes more money to start a business that provides customer credit. This is because it takes longer for you to receive payment, which slows down the amount of cash that flows through your business. Unfortunately, there will be some bad debts. Bad debts occur when your firm never receives all the payments for the credit it extended to the customers.

You will have to absorb these losses. In addition, rapidly growing credit sales will tend to produce a cash drain because you will have to pay for inventory from your suppliers prior to the time your customers pay their bills. However providing customer credit may increase sales in the long run. Many small businesses cannot afford too many credit sales in the beginning.

As you plan the financing of your new business, keep these factors in mind. In addition, there may be other *special factors* that apply to your situation. Therefore, before you jump to a conclusion about how much financing you will need, think carefully and thoroughly about the factors that will affect it.

HOW DO YOU ESTIMATE YOUR CASH NEEDS?

Now that you are aware of the factors that affect the financing needed to start a business, consider the types of costs or expenses you will have and how you can estimate them. There are basically three types of costs or expenses to finance when starting a new business.

Start-up costs are usually one-time expenses you have when opening the business. Examples of these costs would be your business license, your starting inventory, and advertising for your opening.

Once your doors are open, you will have monthly *operating expenses*. Since most businesses are not profitable immediately, it is wise to plan for monthly operating expenses for at least the first 3 months the business is open. Operating expenses include items like monthly rent, utilities, payroll, and inventory.

When you are planning the financing of your business, remember your *personal expenses* too. You will have a rent or house payment, food costs, clothing expenses, and other living costs to pay. If you plan to depend solely upon profits of the business to provide for your personal living expenses, how will you survive .f the business doesn't make money?

The biggest and most challenging question is how do I determine start-up costs, monthly operating expenses, and personal living expenses needed to get my business on its feet? Unfortunately, there is no foolproof, easy, or convenient solution to this problem. Ultimately, the answer will be an estimate based upon your knowledge, experience, and investigation.

It is crucial to gather as much information about financing as you can. Other business owners, including thos who have succeeded and those who have failed, could be helpful. The various trade associations or organizations usually have a great deal of data about their particular industry. They may have various "rules of thumb", usually in the form of ratios of different expenses to sales. Once you are able to forecast your expected sales, it is relatively easy to calculate the other expenses using the industrial ratios as a guide. However, because these "rules of thumb" are averages based upon what businesses have done in the past, be careful about using this method exclusively for determining your cash needs. Ideally, the more you investigate the financing of your new business, the more knowledgeable you will become and the more accurate your estimates will be.

Another logical approach is to use a checklist or worksheet that lists the various types of costs and expenses that you may incur. Although there may be various formats available, one that has frequently been used for calculating start-up costs and operating expenses is the following worksheet developed by the Small Business Administration and adapted for this PACE unit. See Figure 1.

As you examine the worksheet, you will see that it is broken into two major sections. The top half contains the monthly operating expenses. The bottom half is concerned with initial start-up costs. You'll notice that column one is headed with the estimated

ESTIMATED MONTHLY EXPENSES			
Item	Your estimate of monthly expenses based on sales of $______ per year	Your estimate of how much cash you need to start your business (See column 3.)	What to put in column 2. (These figures are typical for one kind of business. You will have to decide how many months to allow for in your business.)
	Column 1	Column 2	Column 3
Salary of owner	$	$	2 times column 1
All other salaries and wages			3 times column 1
Rent			3 times column 1
Advertising			3 times column 1
Delivery expense			3 times column 1
Supplies			3 times column 1
Telephone and telegraph			3 times column 1
Other utilities			3 times column 1
Insurance			Payment required by insurance company
Taxes, including Social Security			4 times column 1
Interest			3 times column 1
Maintenance			3 times column 1
Legal and other professional fees			3 times column 1
Miscellaneous			3 times column 1
STARTING COSTS YOU ONLY HAVE TO PAY ONCE			Leave column 2 blank
Fixtures and equipment			Fill in worksheet 3 on page 12 and put the total here
Decorating and remodeling			Talk it over with a contractor
Installation of fixtures and equipment			Talk to suppliers from whom you buy these
Starting inventory			Suppliers will probably help you estimate this
Deposits with public utilities			Find out from utility companies
Legal and other professional fees			Lawyer, accountant, and so on
Licenses and permits			Find out from city offices what you have to have
Advertising and promotion for opening			Estimate what you'll use
Accounts receivable			What you need to buy more stock until credit customers pay
Cash			For unexpected expenses or losses, special purchases, etc.
Other			Make a separate list and enter total
TOTAL ESTIMATED CASH YOU NEED TO START WITH		$	Add up all the numbers in column 2

Figure 1. Sample worksheet for going into business

annual sales. This is to help the entrepreneur keep in mind the relationship of sales and expenses. Although your sales will not necessarily reach your projected level, the expenses more than likely will. Column three assists in determining how many months of operating expenses you need in cash at the time the business is started. It is common to have at least 3 months of operating expenses in cash prior to starting. However, it may be more or less than 3 months on any of the individual monthly expenses. Your investigation of the industry and the business will help you decide the number of months to use for figuring this cash reserve. After adding the entries in column two, you will have an estimate of the cash needed to start the business.

The worksheet will help you estimate the cash you need to start your business. It considers only the costs and expenses of the business. Therefore, you may need another worksheet to figure the cash you will need to cover your living expenses until the business generates sufficient profit for you to pay yourself. The personal living expense worksheet (shown in Figure 2) is a guide to calculate how much money you need to live on each month. If you believe it will take 4 months before the business is profitable enough for you so you can take a paycheck, then 4 months of living expenses should be added to the total estimated cash needed at the bottom of the worksheet.

Financial advisers suggest that you will feel more comfortable about your first few months in business if you have set aside a minimum of 3 months' living expenses. Many advisers state that, on the average, businesses take between 3 and 9 months before they can begin to show enough profit to support the personal living expenses of the owners.

WHAT ARE THE SOURCES OF FINANCING FOR A NEW BUSINESS?

Now that you have determined how much money you need to start your business, the next serious question is where to get the money. When prospective entrepreneurs dream of starting their businesses, they usually underestimate the amount of money necessary to get started. When they get serious and systematically calculate the financing needed using the worksheet approach, they may see for the first time how large their cash needs are. To many, this experience is demoralizing. They have a plan and the ambition, but not the money. They frequently ask themselves, "Where will I ever get this much money?"

Usually a combination of various sources is used to come up with the money needed to start a business. Since there are so many potential sources of financing, let's approach them by categories. Basically, there are two categories of financing. One is *equity financing* and the other is *debt financing.* Equity financing consists of money that the owner(s) and others invest in the business. Debt financing involves borrowing money to get the business started. In addition, there are a few other sources of financing that do not fit neatly into either one of the categories.

DETAILED BUDGET

Regular Monthly Payments	
• Rent or House Payments (including taxes)	$_____
• Car Payments (including insurance)	$_____
• Appliances/TV Payments	$_____
• Home Improvement Loan Payments	$_____
• Personal Loan Payments	$_____
• Health Plan Payments	$_____
• Life Insurance Premiums	$_____
• Other Insurance Premiums	$_____
• Miscellaneous Payments	$_____
TOTAL	$_____

Household Operating Expenses	
• Telephone	$_____
• Gas and Electricity	$_____
• Water	$_____
• Other Household Expenses, Repairs, Maintenance	$_____
TOTAL	$_____

Food Expense	
• Food—At Home	$_____
• Food—Away From Home	$_____
TOTAL	$_____

Personal Expenses	
• Clothing, Cleaning, Laundry, Shoe Repair	$_____
• Prescriptions	$_____
• Gifts and Contributions	$_____
• Travel	$_____
• Newspapers, Magazines, Books	$_____
• Auto Upkeep, Gas, Parking	$_____
• Spending Money, Allowances	$_____
TOTAL	$_____

Figure 2. Personal living expenses worksheet

WHAT ARE THE ADVANTAGES AND DISADVANTAGES OF EQUITY FINANCING?

Equity financing in its simplest form involves the owner(s) putting his or her own money into the business. Frequently, a small business is started by one person. The entrepreneur's personal savings that are used are called equity financing. On the other hand, there may be more than one owner, for example partners. One or more partner may use his or her money to get started. If a large amount of financing is necessary, the business may be incorporated and shares of ownership in the business sold to many people. Then, too, there are special companies called venture companies that buy partial ownership in promising new businesses for investment purposes. Let's now examine the advantages and disadvantages of each of these sources of equity financing.

Using personal savings. Many small businesses are started by one person. This entrepreneur is frequently an independent and self-reliant person. This individual is not interested in sharing the decision making, operation, or ownership of the business. Consequently, the small business owner does not share any of the risks either. Equity financing in this situation consists of the personal savings of the entrepreneur. The advantages of the sole owner using personal savings are as follows:

- All profits are the sole possession of the owner.
- The amount of money that may have to be borrowed is reduced. In turn, this reduces the amount of interest that must be repaid.
- It may provide the entrepreneur with a high degree of motivation and incentive to succeed.
- It shows good faith and confidence on the part of the owner when applying for a loan or other credit arrangements.

The disadvantages of putting one's personal savings into the business include the following:

- The owner takes the risk of losing what may have taken him or her many years of sacrifice to accumulate.
- The owner may be forced to lower his or her style of living or to make even greater sacrifices.
- The owner may lose future returns that the personal savings may be earning in an alternate interest bearing account or investment.

Involving family and friends. Another source of equity financing is using money invested by family members and friends. The main advantage of involving family members and friends is that the money is usually easy and quick to come by. The arrangement, whether it is an investment or a loan, may be somewhat informal. The money is provided on *good faith*. The entrepreneur may not have pressure exerted from family and friends to meet a certain goal of return on investment or to pay the money back by a specific date.

The central disadvantage is the potential for business problems to destroy personal relationships. If the money is lost or not returned when promised, hurt feelings, guilt, and anger may turn father against son, brother against sister, or friend against friend. Many financial advisers suggest that money from family and friends not be used unless the business relationship is established separate from the social ties.

Forming a partnership. Two or more persons may form a partnership to start a new business. The formation of a partnership raises questions about who makes the decisions and who is liable for the losses. Arrangements can be made to establish general partners and limited partners. *General partners* are involved with the day-to-day operations of the business and are liable for the debts of the business. *Limited partners* are usually not directly involved in operating the business, and their liability is limited to just their investment in the business.

Partnerships may be advantageous because each partner will bring a source of money to the business. Just like the old saying, "Two heads are better than one," two savings accounts are better than one. Also, if each partner's skills complement those of the other, the partners may be more convincing when borrowing money or securing additional investors. On the other side, partners may disagree and have difficulty making decisions. This may interfere with the growth and success of the business.

Incorporating the business. If your new business is in need of a very large amount of cash, forming a corporation and selling shares of stock may be appropriate. In terms of financing the business, this is the corporation's biggest advantage. There are other advantages that deal with legal liability and taxes, too. As with the partnership, the entrepreneur usually loses a certain degree of control and authority when the business is incorporated. Another disadvantage of the corporation is the complexity and costs involved in forming it. Many entrepreneurs are not interested in a legally complicated, long, or expensive process of financing their businesses.

Using venture capital. Another form of equity financing is money provided by venture capital businesses. These are private companies and individuals that specialize in investing money in new and somewhat risky businesses that have potential for returning very large profits. Venture capitalists are very selective about the businesses they choose to finance. Although they may not have limits on dollar investments, venture capitalists may have minimums. This is because they have certain investment return goals. Some small investments would not return enough dollars to make it worthwhile to them. Many venture capital firms exchange their money for common or preferred stock. As partial owners of the business, they may contribute to major decision making, but they normally do not participate in daily operations.

The advantages of using venture capital financing are as follows:

- These companies usually have lots of money to invest and they are willing to take certain calculated risks.

- The entrepreneur is normally allowed to operate the business independently.

- If the owner needs managerial or additional financial assistance, creative capital businesses may provide it.

The main drawback to venture capital financing is that most small businesses do not qualify. Because many small businesses do not have a large enough dollar return or profit, venture capital operations tend not to be interested. Also, venture capitalists are looking for sophisticated, creative, and high-technology businesses that will grow and expand quickly. Again, most small businesses do not fit this pattern.

Working with SBICs. Since many venture capital companies have not been able to meet the financing needs of small businesses, the federal government has decided to help. A law was passed in 1958 that authorized *small business investment companies* (SBICs). They are private venture capital operations that are eligible for loans from the Small Business Administration. SBICs in turn invest their money in small businesses. A spinoff on the SBIC occurred in 1969, *when minority enterprise small business investment companies* (MESBICs) were also established. The MESBICs specialize in investing in small businesses in which at least 51 percent of them are owned by ethnic minority entrepreneurs.

SBICs and MESBICs are licensed and regulated by the Small Business Administration. They must have at least $500,000 of private capital. Then, for every dollar of their own capital, they may borrow $3 to $4 from the SBA. SBICs and MESBICs may also make loans to small businesses. Like other venture capitalist firms, SBICs and MESBICs exchange their money for some type of ownership in the business. Frequently, they take common or preferred stock.

The obvious advantage of the SBICs and the MESBICs is that they are designed specifically for small businesses, especially those overlooked by many venture capitalists. The other advantages include those previously mentioned for venture capital financing.

Unfortunately, SBICs and MESBICs tend to favor expanding businesses rather than small businesses just getting started. This appears to be their biggest drawback to the aspiring entrepreneur trying to arrange the financing to start a business. Each of the above sources of equity financing is in business to make a profit, not to extend financing to less than solid business proposals.

WHAT ARE THE ADVANTAGES AND DISADVANTAGES OF DEBT FINANCING?

Debt financing means borrowing the money needed to start the business. Like equity financing, there are several available sources, each having its own advantages and disadvantages. Since an upcoming major section of this unit discusses the various sources of borrowing money to start a business, here the discussion will be limited to the advantages and disadvantages that apply to debt financing in general.

Advantages. Borrowing money to start a business may be easier and quicker than using equity capital. Considering that it might take $30,000 to $40,000 to get into business, how many years might it take an entrepreneur to save that much? If you were looking for a partner to share in raising the equity financing, you would be very selective and careful to find just the "right" person. You may be sharing your "dream," and you will be sharing ownership and control. It may take a long time to find this person, and sometimes it is desirable not to find a partner. Some entrepreneurs cannot work successfully with a partner. Borrowing may be the only means of raising the money needed. Fortunately, getting a loan approved is a relatively short process. For example, a bank can usually make a lending decision within a few weeks after a completed loan application package is presented. It will normally take you much longer to develop the business plan and loan application package (at least several months).

Many loans provide for repaying the money at some later time. This allows the borrower the luxury of using the money now, when it is needed. It can then be paid back when the owner is in a better financial condition to do so.

The owner of a small business may actually be able to save money by borrowing. Although this may sound contradictory, it is true. For example, if you found a real bargain in purchasing inventory, and the amount you saved by buying it now exceeded the cost of borrowing, you would actually come out ahead. Another example might be borrowing the money to buy a piece of equipment that is more efficient and productive. In the long run, this equipment would save you more than enough to make up for the borrowing costs. If your profits will expand at a greater rate by borrowing than they would without borrowing, it is advantageous to see a lender.

Another advantage to borrowing is that the interest and other costs are tax deductible as legitimate business expenses. Since these interest expense deductions reduce the amount of tax owed, they are in effect partially offsetting themselves. Hence, the real cost of borrowing is less than the actual dollars paid in interest. Inflation is another factor to consider when considering borrowing costs. During inflationary times, loans are paid back with "cheaper" dollars. The dollars borrowed actually bought more than the dollars will that are being paid back.

Disadvantages. Although debt financing has its positive points, it has its drawbacks, too. The most obvious disadvantage is cost. The *prime interest rate* is what the biggest, best, and safest business customers pay.

Unfortunately, most small businesses do not fit into this category. Many entrepreneurs are faced with interest rates several points above the prime rate. For example, prime may be at a 9 percent rate of interest, however a small business might face 4 points over prime, or a 13 percent interest rate. Therefore borrowing can be very expensive.

Borrowing can become the habitual stopgap measure that is always the easy answer to cash management problems. Many businesses have failed because they borrowed more money than could be repaid. When you take a loan, you are assuming that future profits will allow you to repay the loan with interest. That, of course, is a calculated risk.

Obviously, lenders are careful to ensure that loan applicants are good risks. Therefore, entrepreneurs may have to share private and confidential financial and business information. Some small business owners find this distasteful. However, this is part of the price of borrowing.

Another disadvantage to borrowing is accepting the limitations of the lender's agreement. Most lenders will attach "strings" to the money they loan. That is, the lender will place loan limitations and restrictions on the borrower. The limitations and restrictions are known as covenants. *Negative covenants* set out what the borrower cannot do without prior approval of the lender. An example might be borrowing additional money while increasing the total debt. *Positive covenants*, on the other hand, include what the borrower must do. These usually include maintaining adequate insurance coverage and filing periodic financial statements with the lender. Some entrepreneurs may view these covenants as infringements on the operation of their businesses. Business owners are usually expected to sign a personal guarantee for any loan, pledging personal assets to back up the loan.

WHAT ARE THE ADVANTAGES AND DISADVANTAGES OF OTHER FINANCING SOURCES?

If you become involved with a *franchised business*, you may receive considerable financial assistance. Since it is a form of debt financing or borrowing, the advantages and disadvantages of each correspond. Basically, this means that you must pay back the money borrowed with interest and must operate the business within the restrictions of the franchisor. In exchange for this, you will be able to arrange the financing of your new business.

Trade credit is similar to debt financing, too. For the most part, trade credit is credit that suppliers provide their customers. Inventory and equipment are frequently purchased this way. The advantage, of course, is that you can obtain the inventory you need to generate sales, without paying for it right away. The cash that the sales bring in can then be used to pay the supplier. Trade credit, like other borrowing, implies payment of interest or foregoing the "cash" discount on purchases.

Once a business is started, another way to raise cash is to *sell the accounts receivable.* Companies specializing in buying another business's accounts receivable are called *factors*. Since factors pay cash for accounts that may not be paid for several weeks or months, they pay less for them than their actual face value. This, of course, is the disadvantage of dealing with factors. Yet selling accounts receivable is a relatively quick and easy way of raising cash without borrowing, especially for companies seeking to grow rapidly.

Finally, consider *cost reduction* as an alternate financing source. Every dollar you save from start-up and operating costs, reduces the amount of financing required and also the various costs and disadvantages associated with obtaining the financing. Cost reduction often prepares you for future growth by assuring that your business has the necessary financial controls in place to operate in a cost-effective manner. This will ensure future financing as well as an efficient current operation.

Examples include the following:

- Securing used equipment and start-up furnishings
- Bargaining for the most favorable lease and supplier terms
- Rigorous control of direct expenses such as travel, postage, long-distance telephone calls, and office supplies
- Aggressive pursuit of accounts receivable collections
- Effective management of accounts payable to maintain both a solid credit rating and to take advantage of appropriate discounts

Figure 3 offers a summary of the advantages and disadvantages of equity and debit financing.

WHAT ARE THE DIFFERENT TYPES OF LOANS FOR FINANCING A NEW BUSINESS?

Generally speaking, there are three major types of loans.

Short-term loans must usually be repaid within 1 year. They ordinarily satisfy some immediate, temporary, or seasonal need. For example, prior to your busy season, you may need additional cash to purchase extra inventory for the increased demand you soon will have. Because the length of the loan is short, the amount of interest that must be paid is small compared to other types of loans. Also, since the risk to the lender may be limited, short-term loans normally are less expensive. Different types of lenders provide different types of short-term loans.

Intermediate-term loans usually last from 1 to 5 years. This type of loan may be used to buy new equipment, replace long-term indebtedness, or expand the business. It will be more costly than short-term credit.

Long-term loans normally are set up for more than 5 years. They are used to get the business started, purchase or construct facilities, buy real estate, or obtain expensive assets that may take several years to pay off. Like the other types of loans, long-term credit is offered by different types of lenders under a variety of terms for assorted purposes.

It is critical for you to plan for the timing of your need for funds and discuss anticipated future needs with your banker or other lender **now**, not just before you need the funds.

When examining the different types of lenders and the loans they make, keep in mind that the best sources and type of loan depends on the purpose for which the money will be used. It is important to consider the intended purpose of the money, the characteristics of the available financing, and your ability to repay before you commit yourself to borrowing.

Loans are made by both commercial and government lenders. As a general rule, there are more sources of commercial money than government money, but government sources usually charge less than the commercial

Types of Financing	Advantages	Disadvantages
I. EQUITY FINANCING		
A. Using personal savings	1. Keep all of the profits 2. Reduce amount of debt 3. Risk of loss provides motivation to succeed 4. Shows good faith to any potential lender	1. Chance of loss 2. May force personal sacrifices 3. Loss of return from use of savings
B. Involving friends and family	1. Easy and quick source of cash 2. Less pressure and restrictions 3. Informal arrangements	1. Risk of destroying personal relationship 2. May encourage unwanted involvement in the business
C. Forming a partnership	1. Brings in more cash 2. May be able to borrow more 3. Share financial risks	1. Give up part of profits 2. Give up part of the ownership
D. Incorporating the business	1. Raise large amounts of money 2. Share financial risks 3. Reduce legal liability 4. Tax savings	1. Give up part of profits 2. Give up share of control and ownership
E. Using venture capital	1. Large amounts of money available 2. Money available for calculated risks 3. Maintain control and operation of business 4. Additional assistance usually available	1. Most small businesses don't qualify 2. Must give up part of ownership of business
F. Working with SBICs	1. Set up specifically to help small business 2. Provide loans 3. Special assistance for minority businesses 4. Other advantages applicable from venture capital	1. Favor expanding business vs. starting businesses
II. DEBT FINANCING (Includes all forms of borrowing)	1. Relatively easy and quick to obtain 2. Maintain control and ownership of the business 3. Repay at more advantageous time 4. May actually be able to save money 5. Interest and other costs are tax deductible 6. Inflation allows repayment in cheaper dollars	1. Interest costs are expensive 2. Risk that future profits will cover repayment 3. Easy to abuse and overuse 4. Must share financial and other confidential information 5. Lender may impose limitations or restrictions on borrower

Figure 3. Summary of advantages and disadvantage. of equity financing

sources for the use of the money. Each source has its own special loans, credit terms, and pros and cons.

The commercial lenders discussed in the following pages include—

- banks,
- credit unions,
- commercial finance companies,
- consumer finance companies,
- life insurance companies, and
- savings and loan associations.

The government sources of borrowing presented in this section include—

- The Small Business Administration,
- The Economic Development Administration,
- The Farmers Home Administration, and
- The Bureau of Indian Affairs.

Other types of financing that you need to explore include—

- free professional business counseling as you set up your business and
- business incubator services that include discounted space, shared resources and equipment, and clerical services.

WHO ARE THE COMMERCIAL LENDERS?

Banks. Conservative by nature, banks make a large number of assorted loans to small business owners who have been carefully screened. Like other commercial lenders, banks must make money by lending money. Therefore, they scrutinize small-business borrowers very carefully before agreeing to make them loans. In reviewing small business applicants, bankers are keenly interested in the owner's personal credit history, management skill, and ability to repay. They also consider the financial position of the business, its expected profits, and its chances for growth and success.

The interest rates charged by banks for small business loans are based upon several factors. They use the money of depositors and the funds they borrow in the money market. Therefore, the cost of the money they use affects the rate they charge. Short-term loan rates tend to fluctuate, depending upon supply and demand in the marketplace money market. You need to be aware that the rate you planned for in your initial financial plan will not always be available when you actually use the money. A fairly accurate gauge for short-term borrowing is the prime rate. The prime rate is the level of interest that is charged for the most reliable and trustworthy large businesses. Although most small businesses do not qualify for the prime rate, its increase or decrease generally parallels the interest charges for the more expensive small business loans.

Another factor that affects the cost of borrowing money is the degree of risk that the loan may not be repaid. Time is one variable. The risk of default is greater when there is a long loan period. The stability and strength of the business is another variable. Established businesses with proven credit worthiness are better risks than new and untested small businesses.

Loans to small businesses may be secured or unsecured. A *secured loan* is one in which the borrower has pledged some type of asset that will be forfeited if the money is not repaid. This pledged asset is called *collateral*. It may be any number of items that have value and may be exchanges for money. The following are frequently used forms of collateral that small businesses use:

- Personal savings
- Accounts receivable
- Life insurance
- Real estate
- Chattel mortgages
- Trust receipts
- Warehouse receipts

Personal savings may be assigned to a bank as security for a loan. Some banks will only loan on a dollar-for-dollar arrangement. This means, for example, if you have $5,000 in savings, the bank will lend you $5,000. This obviously is a very safe loan and it is one that is simple to arrange.

The money that is owed you by your customers may also serve as collateral. These accounts receivable may be paid to you, and you in turn send payment to the bank. Or the accounts could be notified to return their payments directly to the bank. This is another common method that small businesses use to secure loans.

If your life insurance policy builds cash value, you may be able to use it as collateral, too. To do this you must assign the policy's cash value to the bank. If you, the policyholder, were to die prior to repayment of the loan, the bank would be paid out of the proceeds of the policy before your beneficiary would be paid. Before using the cash value of your insurance policy as collateral on a bank loan, compare the interest rates charged on the proposed bank loan with your insurance company's. Frequently, the life insurance company charges a lower rate of interest than banks do, and you would save on the amount of interest that must be paid by borrowing directly from the insurance company.

The next two types of collateral are similar. The real estate or property you own can serve as security for the repayment of a loan. You may assign an interest in the property through a mortgage. The *mortgage* is the legal document that established a lien on the property. A *chattel mortgage* is like a real estate mortgage, except the property involved is personal property, instead of real property (and or buildings). The personal property that is pledged as security for small business loans is usually some type of large piece of equipment used in the business. A pizza restaurant might, for example, pledge its ovens. If the loan is not repaid, the ovens would be taken by the bank and sold to recover the money that was lent but not repaid.

A *trust receipt* is like a chattel mortgage. It is mainly used by retailers to buy big-ticket merchandise for their inventories. A small appliance store owner may borrow the money to buy TV sets, microwave ovens, refrigerators, and other items with a trust receipt. This is the document that identifies the merchandise, usually by a serial number, that you have in stock. When you sell the merchandise, you repay the bank.

An *unsecured loan* is made without putting up collateral. It is frequently called a signature loan. A borrower's excellent credit rating, including previous satisfactory loan experience, may promote a bank to make a signature or unsecured loan. The amount of money that may be borrowed on an unsecured basis depends upon the credit worthiness of the entrepreneur. However, such loans are usually relatively small.

When a small business has developed a good credit rating and established a positive working relationship with a bank, it may be possible to set up a *line of credit*. This is an ongoing loan that is used, repaid, used, and repaid continually. The small business owner does not reapply each time additional money is needed as long as the credit limit has not been reached. A line of credit is used commonly with inventory financing.

Commercial finance companies. Banks, because of their conservative nature, turn down the loan request of many new small businesses trying to get started. Commercial finance companies are usually willing to take on some of the risks that banks reject. This is because they usually charge higher interest rates and, in a sense are willing to take a chance to earn a larger profit. As a business that specializes in making commercial loans, the commercial finance company is keenly interested in the quality of the borrower's collateral. Inventory, equipment, and real estate are three forms of collateral most frequently accepted.

Short-term accounts receivable financing and intermediate 2- to 5-year loans backed by equipment as collateral are the two most commonly used loan arrangements provided by commercial finance companies. However, longer-term mortgages are written for commercial and industrial real estate. To compete with banks, some commercial finance companies make partially unsecured long-term loans of up-to-10 years. Of course, this type of loan would probably not be available to the entrepreneur looking for money to get the business started. Loans from commercial finance companies normally do not take as much financial information about the business or as much time as bank loans do.

If an entrepreneur cannot obtain a commercial loan, some financial institutions offer personal loans that can be used for starting a business. *Credit unions*, *consumer finance companies*, *savings banks*, and *life insurance companies* provide personal loans that can be used for business purposes.

Credit unions. Although credit unions operate for the personal savings and loan needs of their members, they do make loans for starting a business. Personal loans may be secured or unsecured, but they are usually short-term or intermediate-term. To obtain a loan you must be a member of the credit union. The entrepreneur should look at the credit union as a limited source of business financing. The credit union might be advantageous for obtaining a small loan with a reasonable interest rate that can be used with other loans and financing to start a business.

Consumer finance companies. If you have personal property (car, camper, or boat) or real estate (house) that you would pledge as collateral, you might be able to borrow money to start your business from a consumer finance company. They may lend you from $30,000 to $50,000 for up to 15 years if your security warrants it. However, since consumer finance companies usually are willing to take risks that banks and commercial finance companies will not take, they charge higher rates of interest. Besides considering the higher rates when thinking about starting a business with money borrowed from a consumer finance company, contemplate, too, the risk of losing your collateral if you default on the loan. What would you do if you mortgage your home to the consumer finance company and then the business failed? You might be forced to sell your home or have it taken from you through foreclosure to pay back the loan.

Life insurance company loans. Life insurance policies that build cash values may be used for borrowing money. This is usually a standard part of the life insurance contract. Because the cash value of the insurance policy is based upon cash that the policyholder has already paid in, there is very little risk for the insurance company to assume. Thus, these loans are relatively easy to get and at interest rates substantially below the prime rate. The money may be used for personal or business reasons.

Life insurance companies also make mortgage loans for commercial or industrial real estate. However, these mortgages are usually for very substantial projects that only large businesses would be undertaking. Many small businesses would not qualify for such a loan.

Savings and loan associations. Besides making loans so people can buy homes, savings and loan institutions also make commercial and industrial property loans. Savings and loan associations tend to be as conservative as banks.

They will analyze the entrepreneur's personal and business financial situation. Savings and loan associations will usually not make a loan unless the business's profits will be adequate to repay the money. They will also make personal loans that may be used for business purposes, as in "home equity" loans at quite low interest rates for long terms. However, as personal loans, the savings bank does not invest the time to review the repayment ability of the underlying business venture. In a sense your personal credit history and equity in a home, may lead you into dangerous territory without a second opinion from a conservative loan officer.

WHAT ARE THE GOVERNMENT SOURCES OF LOANS?

The Small Business Administration (SBA) was created by the Congress to serve as the advocate for small business. The SBA provides counseling, managerial, and financial assistance. Other federal agencies, including the departments of commerce and agriculture, have or have had programs to assist small business owners financially.

It is important to keep in mind that the SBA and other governmental loan programs may change periodically. The annual budgeting process may add to and take away from these financial assistance programs. Therefore, for current information you should contact your closest SBA district or branch office.

The Small Business Administration defines small business as an independently owned and operated firm that is not dominant in its field. To be eligible for SBA loans, small businesses must meet certain size standards. These vary according to the industry but almost all start-up businesses will qualify on the size standard.

The SBA loan program is available to those small businesses that cannot borrow from commercial lenders under reasonable terms. There are two types of basic or regular business loans. Almost all SBA loans are guaranteed loans. With this type, the SBA guarantees up-to-90 percent of the loan that a bank or private lender makes. The other type is the direct loan. In this case, the SBA actually lends the money to the small business. On direct loans the maximum is $150,000. The maximum loan is $750,000 on the guaranteed SBA loans. It is critical to recognize that SBA loans are almost always made in cooperation with local commercial banks. For this reason, you always need to develop a positive relationship with your local banker.

Besides its regular loan programs, the SBA also sponsors special financial assistance. Some examples of these specific programs follow.

- **Physical Damage Natural Disaster Recovery Loans** may be used to repair or replace damages caused by hurricanes, floods, and other natural disasters.

- **Economic Injury Natural Disaster Loans** may be used for working capital and to pay bills that could have been met had the natural disaster not happened.

- **Small General Contract Loans** provide short-term financing to small construction businesses.

- **Pollution Control Financing** allows the use of federal tax-exempt industrial revenue bonds to pay for pollution control systems.

- **Economic Opportunity Loans** are available to minorities who are at a social or economic disadvantage, Vietnam-era veterans, and those people handicapped physically.

- **Seasonal Line of Credit Guarantees** provide short-term financing to handle seasonal increases in business.

- **Surety Bonds** guarantee up-to-90 percent of losses incurred under bid, payment, or performance bonds issued to small contractors.

The interest rates on SBA loans vary. On the direct loans, the rate is based upon what it costs to borrow money from the government. This is less than commercial interest rates. The interest rate on guaranteed loans is based on local market conditions and will vary.

Other government agencies provide financial assistance to small businesses. The U.S. Department of Commerce provides both guaranteed and direct loans to businesses in high-unemployment and low-income areas. The Economic Development Administration handles this program. In the U.S. Department of Agriculture, the Farmer's Home Administration has a guaranteed loan program for businesses in rural areas. The Bureau of Indian Affairs has a loan program to help native Americans start new businesses. The SBA or your local Small Business Development Center office will help you to identify other government programs.

Numerous state and local governments, as well as private nonprofit development organizations, will assist in financing new and expanding businesses.

Rather than beginning to shop around for financing deals it is usually more prudent to spend time developing a credit worthy proposal and to utilize your local business assistance network (Small Business Development Centers) to assist in "scouting" for financing sources. This has two advantages:

- It saves you valuable time and allows you to concentrate on your business plan.

- It avoids having you shop your "deal" around all over town before it is fully presentable.

To determine whether an entrepreneur is a good risk, any potential lender will want detailed information about the business and its chances of success. The presentation of this information is in a loan application. Because this information is so detailed and may take many pages to present, it is called a loan application package.

WHAT IS A LOAN APPLICATION PACKAGE?

The loan application package contains information entrepreneurs need to provide to obtain a loan. If it is not complete and not presented in a businesslike manner, there is a good chance the loan will not be granted. It is always a shame to see a worthy entrepreneur with a good idea for a successful venture that can not get the necessary financing because the loan application was incomplete.

Before beginning to prepare the loan application package, you should first of all determine what should be included. By talking with potential lenders and business assistance resources, you can identify exactly what needs to be included. Then, you need to obtain the required forms.

WHAT IS IN THE LOAN APPLICATION PACKAGE?

The SBA suggests that the following information be supplied in a loan application for entrepreneurs starting a new business.

- Describe the type of business you plan to establish.

- Describe your experience and management capabilities.

- Prepare an estimate of how much you or others have to invest in the business and how much you will need to borrow.

- Prepare a current balance sheet listing all personal assets and all liabilities.

- Prepare a detailed (monthly) income statement for the first year the business will operate with less detailed projections for the next 2 years.

- Prepare a detailed (monthly) cashflow forecast for the first year the business will operate.

- List collateral to be offered as security for the loan, indicating your estimate of the present market value of each item.

Other items included in the loan application package are at the discretion of the lender. Some lenders will require further information, such as copies of leases, income tax statements, life and casualty insurance policies, ownership papers, and other contracts. Many lenders may want to review your business plan as well.

Understanding how to finance a business is critical to its success. Yet, the process of defining your financial package can be quite difficult. In order to estimate your financial needs, you must identify your start-up costs, operating expenses, and personal expenses. To obtain financial backing, you must have a thorough understanding of your business and describe it in terms that investors and creditors will understand. In addition, you must be able to sell your own personal qualifications to investors and creditors.

ACTIVITIES

The following activities are designed to help you apply what you have learned in this unit.

INDIVIDUAL ACTIVITIES

A.

Interview an entrepreneur in your community. Ask how the different types of costs were determined to get the business started. Use as discussion points the factors listed in this unit that affect costs. See how many applied to the entrepreneur you interviewed. Ask whether his or her personal expenses were handled by the spouse or if the personal living standards were affected. Ask who provided help in determining the different types of costs incurred to get the business started.

B.

On a separate paper, write the type of financing that matches the advantages and disadvantages BESIDE EACH LETTER in the first column.

Type of Equity

Financing	Advantage	Disadvantage
A.	Share financial risks with many others	Must share ownership of the business
B.	Shows good faith on your part to lenders	Loss may force many personal sacrifices
C.	Money available for certain types of calculated risks	Many small businesses don't qualify
D.	Can be set up in an informal arrangement	Risk of destroying personal relationship
E.	Brings in more cash	Share profits with someone else
F.	Special assistance for minority businesses	Favor expanding businesses, not starting new ones

C.

On a separate piece of paper, match the different types of commercial lenders in column 1 with their appropriate characteristic in column 2.

1. Bank	A. Essentially borrowing against money you have already paid in.
2. Credit Union	B. Writes mainly commercial and industrial mortgages.
3. Commercial finance company	C. Grants personal loans, usually with high interest rates.
4. Consumer finance company	D. May use personal savings as security for loan.
5. Life insurance company	E. Commonly uses short-term accounts receivable financing.
6. Savings and loan association	F. Must be a member to qualify for a loan.
7. Franchise company	G. May offer favorable long and short term credit terms.
8. Supplier	H. May offer training, technical support and cooperative advertising opportunities.

GROUP ACTIVITY

Divide into small groups of three to four students. Identify the sources available for borrowing money to start a business in your community. This may be done in several ways. The Yellow Pages of the telephone directory may provide you a listing. Your own bank may know of other sources, too. Newspaper advertisements might give you names. You might recognize other sources by just driving through town.

Each person in the group should volunteer to interview one of the sources. See, if it is possible, that a variety of different lenders are included. For example, try to avoid interviewing at three banks or three commercial finance companies.

Each interviewer should ask the following questions:

- What types of commercial loans do you provide?
- What are the advantages of borrowing money from you?

- What are the disadvantages of borrowing money from you?

- What types of collateral do you accept?

- Do you have any unsecured commercial loans?

- What information do you require in a loan application package? (obtain sample forms)

- What procedures do you use to review the loan application?

- What criteria do you use to evaluate commercial loan applications?

After the interview has been completed, your group should discuss its findings. Identify the similarities and the differences among the various lenders. Make a list and compare it with those compiled by other groups in the class.

CASE STUDY

Jim Perkins, a friend of yours, was recently rejected by a bank for a commercial loan to open a musical instrument store. Jim, who is a music teacher and band director, felt there was a need for a store in your community to sell and rent musical instruments. Lessons could also be provided.

Very discouraged, Jim has called you to discuss the problem. Jim just can't seem to understand why his loan request was denied. He knows that the community needs this type of business and that it would be very successful, if he could just get it started.

As you talk with Jim, the following points come out:

- Jim asked for a $15,000 unsecured loan to open his store.
- The unemployment rate in the community is relatively high.
- Jim had $1,000 saved to put into the business.
- Jim has been a music teacher for the past 3 years in your community.

Jim says the interview with the commercial loan officer was strange, almost as if they were talking two different languages. Evidently, the loan officer asked him about insurance, projected income statements, management experiences and motivation. Jim told the loan officer about the inventory he wanted to buy and how he planned to organize a community music festival for all his customers.

1. Explain what criteria may have been used by the bank's loan officer to evaluate Jim's credit worthiness.
2. Evaluate Jim's loan application using the six Cs. Point out to Jim his strengths and weaknesses as a commercial loan applicant.
3. Suggest to Jim what he might do to improve his chances of obtaining a loan.
4. Provide Jim with additional sources of borrowing besides the bank.

ASSESSMENT

Read the following questions to check your knowledge of the topics presented in this unit. When you feel prepared, ask your instructor to assess your competency on them.

1. Explain how to determine the different types of costs that must be considered when starting a new business.

2. Compare the advantages and disadvantages of the various sources of financing for a new business.

3. List the sources of loans that may be available for financing a new business.

4. Describe the information that must be provided in a loan application package.

5. Explain the criteria used by lending institutions to evaluate loan applicants.

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PACE

Units on the above entrepreneurship topics are available at the following 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