Financial Planning *for* Small Business

Alberta Economic Development and Tourism

FOREWORD

Financial Planning for Small Business is designed to provide an introduction to the basics of financial planning.

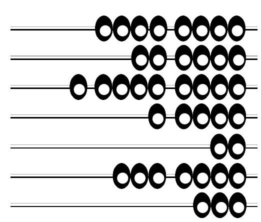
It is one in a series of guides which has been developed and published by Alberta Economic Development and Tourism (ED&T) to assist small business owner/ operators in Alberta. The other guides are the following:

- Starting a Small Business
- Starting a Home-Based Business
- Marketing for Small Business
- Managing a Small Business
- Recordkeeping for Small Business

These publications are available at all ED&T offices listed in the back of this publication.

Before developing a financial plan for your small business, you may wish to consult with an accountant, lawyer, business mentor, business management consultant, educational institution, government agency, business or other association suitable to your type of business.

Various federal, provincial, and municipal agencies also provide counselling and advice on financial planning for small business. Please check for services in your area.



This Small Business Series is supported by Western Economic Diversification Canada (WD), the federal department responsible for leading and coordinating federal economic activities in western Canada. The business guides are available through WD's network of business services listed in the back of this publication.

Alberta Treasury Branches has also supported the production of this guide series. The guides are available at any of the Treasury Branch locations listed in the back of this publication.

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Introduction

Financial planning is at the heart of every successful business. A financial plan, which includes detailed financial statements and projections, forms the core of your overall business plan. For more information on preparing a business plan, refer to ED&T's *Starting a Small Business.*

Financial planning should be completed at least once a year and revised monthly to incorporate actual results. It has two main purposes:

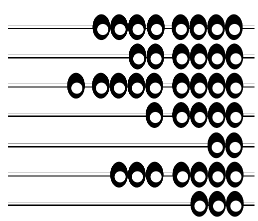
1. It enables you to make sound business decisions about what financial resources your company actually needs, and about what financial moves your company needs to make, to be successful.
2. It helps you plan for and obtain the necessary financing to establish your business, continue its operation, and help it grow.

Solid financial planning demonstrates to potential investors and lenders that you are planning for success and that you are serious, thorough, knowledgeable and realistic.

In addition to impressing upon investors and lenders that you have done your homework and thought through your financial plan, the actual plan allows them to quickly evaluate the following:

- The short and long term prospects for your business
- Your company's profit potential
- Your company's strengths and weaknesses
- Future opportunities and challenges
- The amount and type of financing your business will need to be successful

This publication will help you understand the basics of financial planning. Chapter *One* describes and provides examples of the key elements of your financial plan. Chapter *Two* deals with the two main sources of financing for your business: equity and debt. Chapter *Three* covers internal sources and other methods of financing. Chapter *Four* describes how to approach lenders and investors.



One: Financial Planning

Your business will only be as strong as its financial plan. For your financial plan to attract investors and be valuable as a business planning tool, it must be based on reliable numbers and careful calculations.

Your financial plan should include:

- Start-up costs, if you are starting a new business
- Cash flow projections
- Projected (pro forma) balance sheets and income statements
- Balance sheets and income statements for at least the previous year (if your business is already in operation)
- A break-even analysis
- A ratio analysis (if your business is already in operation)

Remember that current financial statements are based on the actual numbers which describe your company's financial performance over the past year or years. Financial projections look into the future and estimate, as realistically as possible, the future performance of your company. When completing financial projections, it is advisable to use best, worst, and most likely scenarios.

If your business is already in operation, your accountant can easily prepare your financial statements, provided your bookkeeping records are accurate and up-to-date. For more information on bookkeeping and overall recordkeeping, refer to ED&T's *Recordkeeping for Small Business.*

Your accountant or a business consultant can help you prepare your financial projections. The business sections of libraries and bookstores also provide guidance materials for completing your financial statements and projections.

Start-up Costs

If you are starting a new business, first determine start-up costs. These are one-time expenditures that your company must make before it opens its doors for business. Included are such costs as equipment, furniture, fixtures, supplies and materials, inventory, renovations (leasehold improvements), licences, permits, and incorporation fees (if applicable).

Expenses incurred after the opening date are called operating expenses and will appear in your company's income statements and cash flow projections. Once your business is in operation, you will require adequate funds to finance your new business from start-up until monthly cash flows are positive. (See *Cash Flow Projections* below.)

In *Appendix A*, you will find a start-up costs worksheet. Use it to complete your own start-up cost projections.

Cash Flow Projections

A cash flow projection or forecast is an estimate of when you expect to receive cash from your sales and, therefore, when you expect to pay bills. It is a critical part of your financial planning and business plan because it shows how much money will flow into and out of your business each month. Cash flow projections are usually done for each month and at least one year into the future.

A cash flow projection is an important management tool because it does the following:

1. Estimates the amount of money necessary to finance month-to-month business operations.
2. Enables you to plan for the times when revenue will not be sufficient to cover expenses.
3. Demonstrates to potential lenders that you expect to have sufficient revenue to repay loans on a regularly-scheduled basis.
4. Can be used to compare estimated and actual cash flows on a monthly basis. This will allow you to constantly adjust your cash flow projections and identify potential problem areas.

Preparing a Cash Flow Projection

The first step in preparing a cash flow projection is to estimate how much revenue you expect to generate from sales on a monthly basis. When estimating your monthly sales revenue

- Consider sales from previous years (if applicable)
- Consider best and worst case projections, but use the most likely scenario for your business planning
- Decide on a credit policy (example, cash on delivery or 30 days credit) and then estimate what percentage of your sales will be on credit

Once you've estimated your monthly revenue, next decide how you will pay expenses and debts. Consider the following:

- Which bills must be paid promptly, and which payments can be delayed when necessary
- How promptly you must pay your own suppliers (for example, cash on delivery or 30 days)
- The amount and how often you pay your employees
- The amount of your monthly loan payments and when these payments are due
- Your plans to purchase assets and capital assets, such as equipment and vehicles

It is important that cash flow projections are completed on an ongoing basis, are compared to actual cash flow results, and are revised when necessary.

If necessary, work with your accountant to set up realistic cash flow projections. If you have a personal computer, several cash flow software packages are available. Check with your local software distributor for one which meets your needs.

In *Appendix A*, you will find a cash flow projections worksheet. Use it to complete your own cash flow projections. A sample cash flow projection is also provided.

Income Statements

An income statement presents your actual business revenues and expenses, the difference between which is your company's net profit (or loss) over a specified period of time. An income statement is sometimes referred to as a profit and loss statement, an income and expenses statement, or an operating statement. According to Canadian tax law, it must be completed at least once a year.

A budget projection (pro forma) income statement compares estimated revenue and expenses and then calculates your estimated net profit (or loss) over a specific period of time. For existing businesses, this is usually the next year of operation. For new businesses, this is usually the first year of operation. Potential investors and lenders will want to see a projected income statement for at least one, and possibly three, years. Be sure to include best and worst case projections, as well as most-likely scenarios.

Check your projected income statement at least every three months. If your projections prove to be significantly inaccurate, find out why. This may help you identify an emerging problem for your business.

In *Appendix A*, you will find a sample income statement. Use it as a model to complete your own current and projected income statements for financial planning and your business plan.

Balance Sheets

A balance sheet provides a snapshot record, at a specific point in time, of everything your business owns (assets), as well as what it owes (liabilities) and the owner's equity. Assets include cash, inventory, accounts receivable, and fixed assets, such as property, equipment, and vehicles. Liabilities include taxes owed, accounts payable, mortgages, leases, bank loans, and loans from shareholders. According to Canadian tax law, Canadian corporations must complete and file a balance sheet at least once a year.

On the balance sheet, total assets will equal the total of liabilities plus the owner's equity. For example, suppose assets are $20,000 and liabilities are $10,000. Your equity, as owner, would be $10,000. Owner's equity can also be described as the net worth of the business (assets minus liabilities).

A projected (pro forma) balance sheet is an estimate or prediction of your business' net worth at a specific time in the future. Potential investors and lenders will want to see a balance sheet projected at least one and possibly three years into the future.

In *Appendix A*, you will find a sample balance sheet. Use it as a model to complete your own balance sheet.

Break-even Analysis

Your break-even analysis allows you to calculate the amount of sales your business needs to not lose money. Your business' break-even point is where total costs equal total revenues, and it is an important calculation in order to determine the viability and profitability of your business.

A break-even analysis is based on three main factors:

Selling price: for information on how to determine selling price, refer to ED&T's *Managing a Small Business*

Fixed costs: these costs, such as rent, mortgages, equipment leases, loan repayments, insurance, and core staff, do not change as sales increase or decrease

Variable costs: these costs, such as additional staff salaries, the costs of goods sold, supplies and materials, increase or decrease in direct proportion to sales

Here is an example of a simple break-even calculation:

Barbara's Bowls:
Barbara produces and sells clay bowls for $40 dollars each. She calculates that the actual (variable) cost to produce each bowl in labour, supplies, and materials is $30. This means her gross profit on each bowl is $10 ($40 minus $30).

She has calculated that her fixed monthly costs, such as rent, utilities, and equipment are $1,000. This $1,000 must be paid whether or not she produces any clay bowls.

To calculate how many bowls she must sell each month to break even, she divides her fixed costs ($1,000) by her gross profit ($10) or 100 bowls to break even.

Work with your accountant or business advisor to determine your business' break-even point. In *Appendix A*, you will find a sample break-even chart you can use for more complex calculations. You may wish to include a break-even analysis in your business plan.

Business Ratio Analysis

There are a number of business ratios which potential lenders and investors will use in order to assess the relative health of your business. Ratio analysis is a useful management tool because it helps identify positive and negative trends in your business performance.

The data for your ratio analysis comes from your balance sheet and income statement. Your ratios should be compared to the ratios of similar businesses, which can be obtained from industry associations, business libraries, or your lender.

Ask your accountant or business advisor to help you calculate ratios relevant to your business. Useful ratios include the following:

Current Ratio: Comparing current assets to current liabilities is an indicator of your business' ability to pay its bills. For example, a ratio of 2:1 means that you have twice as many current assets, such as cash-on-hand, accounts receivable, and inventory, as you do current liabilities. Lenders and investors look more favorably at companies with high current ratios (generally above 2:1).

Formula: $$\frac{\text{Cash + Accounts receivable + Inventory}}{\text{Current liabilities}} = \frac{?}{1}$$

Quick Ratio (Acid Test Ratio): This ratio is the same as the current ratio without including inventory. Some inventory is not easy to sell, so the Quick Ratio is seen as a better measure of relative "liquidity".

Formula: $$\frac{\text{Cash + Accounts receivable + Marketable securities}}{\text{Current liabilities}} = \frac{?}{1}$$

Debt to Equity Ratio: This ratio compares what the business owes (debt) to what it owns (equity), giving a picture of what proportion of the business's financial commitments are covered by the owners' investment. Total debt is divided by equity (assets minus liabilities). Lenders and investors will compare your debt to equity ratio against other similar businesses. A ratio below 2:1 is desirable.

Formula: $$\frac{\text{Total debt}}{\text{Assets - liabilities}} = \frac{?}{1}$$

Return on Investment Ratio: Net profits are compared to investment (equity), and the result is shown as a percentage (e.g. 7% ROI). Return on investment is considered one of the best criteria for determining a business' profitability. If the return on investment is low, it might be better invested elsewhere.

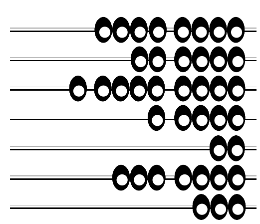
Formula: $\dfrac{\text{Net profit}}{\text{Equity}} \times 100 = ?\%$

Inventory Turnover Ratio (Stock Turns): In retail operations, sales are compared to inventory to indicate the average turnover of inventory in a given year. This number (e.g. inventory turned over 6 times last year) is compared with industry norms. Remember that the turnover figure is only an average and does not include information on specific items within the inventory. See Chapter IV of *Managing a Small Business* for sample industry norms.

Formula: $\dfrac{\text{Cost of goods sold}}{\text{Average value of inventory}} = ?$

Working Capital: While not a true ratio, working capital represents assets available to protect the ability of the business to repay short-term obligations. This number alone, however, is not useful without knowing how the working capital is being utilized. The other ratios, above, provide this analysis.

Formula: Current assets - Current liabilities = $?



Two: Methods of Financing Your Business

Once you've completed your financial calculations, statements, and projections, you will have a clearer idea of how much money you need to raise in order to finance your business. The two main ways of financing a business, equity financing and debt financing, will be discussed in this chapter.

Equity Financing

Equity capital is the amount of money that you and/or your partners put into the business or raise from other investors. Equity is not debt. While investors share in the profits (or losses) of the business, their investment is not a loan.

Remember that to attract investors (shareholders) or partners, you must be able to demonstrate both the profitability and the reasonable risk of your business venture. The best way of doing this is through solid financial planning. Financial planning is discussed in chapter *One* of this publication. For information on preparing a business plan, refer to ED&T's *Starting a Small Business.*

Consult your lawyer and your accountant before you enter into any equity agreement for your small business.

Personal Investment from Self, Friends, and Relatives

Personal savings, securities, real estate, and other personal assets are the most obvious source of cash for equity financing. Friends and relatives may provide additional sources of funds. In most cases, the small business owner must assume the largest share of the risk— this means making the largest investment in the business.

Personal investment in the business by you, your family, and your friends demonstrates a faith in, and a commitment to, your business. This is important to other potential investors and lenders. In fact, banks and other lending institutions have established guidelines for the amount of investment that is required before they will lend money to a business. This is sometimes called the debt-to-equity ratio (see chapter *One*), and it varies depending on the type and nature of your business.

Partner Investment

If you cannot supply all the equity capital needed to finance your small business, you may have to find one or more partners willing to put money into the venture. Obtaining a partner means that ownership of the business, including its profits and liabilities, is normally shared.

In most cases, partners want a say about how the business is run. Limited partners, sometimes called silent partners, can contribute financially to your business without participating in its management. Limited partners are normally only responsible to the business or its creditors in proportion to the amount they have invested in the partnership; however, parties considering a partnership agreement should seek legal advice on this and related issues.

Shareholder Investment

A business may be incorporated as a private or public corporation. A private corporation can have up to 50 shareholders, but it cannot sell shares to the general public. The vast majority of new small business corporations are private. For more information on incorporating, refer to ED&T's *Starting a Small Business.*

Ownership is shared in a private corporation, generally in proportion to the amount of investment of each shareholder (which may be translated into the number of voting shares each person owns). You must be able to demonstrate the viability and profitability of your business venture to attract potential shareholders.

Because public corporations can sell their shares to anyone, they provide the greatest opportunity for raising equity capital. However, offering shares to the public can be a long, complicated and expensive procedure. A detailed prospectus of the business' operations must be filed with the Alberta Securities Commission.

Nevertheless, when your business becomes sufficiently large and prosperous, a public share offering can be an attractive method of obtaining financing.

Employee Investment

Another way of raising funds is to ask employees to invest in the business. You might consider making your most talented and dedicated employees a partnership offer, or, if your business is incorporated, you could sell stock to employees to provide a form of profit sharing.

Employees may be willing to invest in your business because they understand its products or services, trust the management, and are able to closely monitor their investment. Having a stake in the business can positively influence employees' working habits since they will benefit from its success. On the other hand, when employees have a share in the business, it could prove difficult to remove, retire, or replace them if they become unproductive or uncooperative.

Venture Capital

In Canada, a number of venture capital firms provide equity financing, usually for high risk enterprises with potential. Most venture capital investment is directed to the expansion of existing businesses. As a general rule, venture capitalists plan to liquidate all or part of their investment in your business at a substantial profit within five to ten years.

Venture capitalists are in a high-stakes, high-risk business. In negotiations, they will aggressively try to make the best deal they possibly can with you. Besides fast-growth prospects, they look for sound management and a high degree of financial commitment on the part of the small business owner/operator.

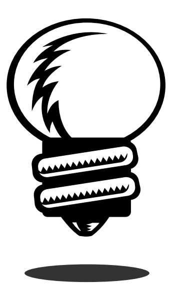
While most venture capitalists do not wish to become involved in your day-to-day operations, they will require representation on your board of directors. Some venture capital sources may consider equity participation if your venture meets their criteria.

Debt Financing

With your equity capital in place, you are now in a position to approach lenders for a business loan. Debt capital is the money your business borrows. It must be fully repaid with interest, over a specific time period. While lenders do not share in business profits as investors do, they must be repaid with interest whether the business is showing a profit or not.

Potential lenders include the following:

- Banks and Trust Companies
- Alberta Treasury Branches
- Credit Unions
- Private Investors
- Commercial Finance Companies
- Alberta Opportunity Company
- Business Development Bank of Canada



As a small business owner/operator, you should familiarize yourself with the lenders' requirements before determining the type and the source of your debt financing.

When determining the type of debt financing that is right for your business, remember this basic rule:

- Finance day-to-day operations (working capital) with short-term operating loans
- Finance long-term fixed assets with longer-term loans or mortgages

Business Term Loans (Financing Fixed Assets)

Major purchases require foresight and careful planning. The fixed assets of a business, such as land, buildings, and equipment, are usually financed through a combination of equity capital contributed by the owner(s) and business term loans.

A business term loan has a maturity of not less than one year and usually not more than 15 years. The security offered for repayment is usually the assets being financed. The repayment schedule is generally based on the useful life of the asset. This type of debt financing is frequently referred to as fixed-asset financing.

Lenders will finance only a percentage of the value of the asset being purchased. For example, a bank may lend up to 75% of the value of a truck, to be repaid within five years, and up to 80% for a building, to be repaid within 12 years.

The benefits of a business term loan are the following:

- The loan agreement is based on the borrower's ability to repay the loan out of earnings
- As long as the borrower meets the terms of the loan agreement, no payments other than the regular installments will be required before the due date of the loan
- A long-term working relationship is established between lender and borrower

When lending on a medium to long-term basis, credit institutions tend to focus on the earning power of your business over a period of years. Therefore, to obtain long-term loans, your business plan must convince lenders of the viability and profitability of your business venture over time. If the loan is given to a limited business (corporation), the lender may require your personal guarantee so, if the business cannot repay the loan, you will be personally liable.

Small Business Loans Act

This federal government program supports term debt financing to small businesses. The program is administered by many lending institutions to which you can apply. Talk to your lending institution to see if you qualify for a business loan under the terms and conditions of this program.

Operating Loans (Financing Working Capital)

Obtaining sufficient working capital is frequently cited as one of the most difficult challenges facing small businesses. Obtaining an operating loan allows you to meet day-to-day operating costs. Working capital secured through operating loans should not be used to finance long-term fixed assets.

Line of Credit (Demand Loans)
A line of credit is provided by financial institutions to assure the working capital required by your business. The financial institution will negotiate and lend up to a fixed amount of money under certain terms and conditions. It can cancel the line of credit at any time (hence the name demand loan). However, it will generally not cancel without cause. Demand loans are usually secured by current assets, such as accounts receivable or inventory, and, for most small businesses, a personal guarantee. Be sure to read and understand the terms and conditions before committing to a line of credit.

Lines of credit are extremely useful and flexible. The amount owing on the loan goes up (to the credit limit) and down as your business needs the money. Interest is paid only on the amount outstanding at the end of each month. However, advances are provided in fixed amounts so, again, understand the terms of your line of credit.

Accounts Receivable Financing
In this method of financing, lenders will make cash available to your business using accounts receivable as security. With accounts receivable financing, you are able to secure a continuous source of operating funds without entering into long-term financing arrangements.

There are two methods by which this is accomplished. In the first method, your customers are asked to pay the lender directly. This is generally not desirable because it may upset the relationship you have with your customers. Using the second method, you receive payment from your customers and send the total payment intact to the lender. The lender will return any excess payments after deducting finance charges.

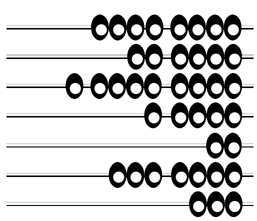
Inventory Financing
For some established firms, inventory will be financed by banks or commercial finance companies for up to 50% of the value of the raw materials, work in progress, and finished goods.

New businesses that require large amounts of unsold inventory, such as retail stores, often experience difficulty obtaining inventory financing. In most cases when inventory financing takes place, there must be a ready market for the products, and they should not be perishable or subject to early obsolescence.

Comparing Equity and Debt Financing

Before deciding on what combination of equity and debt financing you will use to fund your business, consider the relative advantages of each:

Advantages of Equity Financing	Advantages of Debt Financing
Equity financing is not a loan and doesn't have to be quickly repaid (with interest)	If your business succeeds, you won't have to share the profits with partners or investors
You can increase your business' debt financing ability by increasing its equity	You will maintain independence and control over how your business is run
Increased equity may improve your business' credit rating with suppliers	
It provides greater flexibility if the business experiences difficult times	



Three: Internal and Other Types of Financing

Internal Sources of Financing

Another source of money you can use to finance your business, and one that may be overlooked by many small business owners, comes from internal resources of the business itself. Tighter management controls can reduce the need for external capital.

Collecting Accounts Receivable

Accounts receivable are a particular problem for new or expanding businesses with growing sales. In these cases, receivables tend to increase at the expense of cash, inventory, and fixed assets. Unless receivables can be converted into cash in a short period of time, the business will lose its liquidity, exhaust its credit, and find its growth potential limited.

Receivables can be reduced by better credit policies, better monitoring of credit accounts, and more diligent collection policies.

Many businesses would have fewer bad debts and overdue accounts if more attention was paid to the initial granting of credit. The prospect of a good sale shouldn't influence you to ignore the customer's realistic ability to pay for your product or service. Make sure you develop a credit policy before you extend credit privileges to your customers.

A good recordkeeping system is critical to controlling accounts receivable. Overdue accounts should be immediately identified for attention and action. Determine what steps you will take and when you will take them. For more information on accounts receivable ledgers and the "aging" of accounts receivable, refer to ED&T's *Recordkeeping for Small Business.*

Some businesses rely on service bureaus for collection, but this can prove costly to new and expanding businesses that need all the working capital from their accounts receivable to finance current operations. Whatever your collection policy, remember that the sooner receivables are turned into cash, the more operating capital your business will have to work with.

Reducing Inventory

Your business may have considerable amounts of money invested in inventory. This could be in the form of raw materials, work in progress, or finished goods. It is costly to maintain inventory for sales expected months in the future.

Manufacturers, for example, want to keep inventories to a minimum to avoid tying up too much capital. Many businesses now use a "just in time" method of inventory; materials are ordered to arrive only as they are needed for production. Good coordination is required between sales and production.

All retail and most service businesses depend on continuous inventory turnover to make a profit. Keeping control of your inventory involves knowing how much and what kind of stock you have on hand, past sales trends and patterns, and anticipated sales. For more information on inventory management, refer to ED&T's *Managing a Small Business.*

If you have an excessive amount of inventory on hand, you can turn it into operating capital for your business by offering cash discounts, by selling on credit terms, or by advertising aggressively. When reducing prices, care should be taken to avoid offending customers who paid full price. Also, customers can become accustomed to sale prices and not buy when normal price levels are restored.

Prepayment Agreements

In some cases, a business can encourage its customers to make payments prior to the production and/or delivery of the goods or services. For example, mail-order businesses generally ask for payment prior to delivery. Custom manufacturers often ask for prepayment of goods. These prepayments may form a significant and permanent source of working capital. Sometimes special pricing or special terms may be necessary to attract prepayment customers.

Other Sources of Financing

Leasing Fixed Assets

More and more small businesses are leasing rather than buying their fixed assets, such as land, buildings, and equipment. By leasing, your business can acquire the fixed assets it needs by merely committing itself to rental payments, without making a substantial cash payment or incurring a large financial obligation. Although this policy may appear more expensive over the long run, it means the business will have more operating (working) capital available for current expenses and growth.

Leasing Equipment

Equipment leases are usually written on the total selling price of the equipment and are drawn up for a period of three to five years. The total amount paid includes the selling price plus finance charges. It is generally to your advantage to lease equipment in the following situations:

- You are rapidly expanding and need all available working capital to increase inventory, hire more staff, or expand plant facilities
- The cost of new equipment is high and you do not have the cash available
- The equipment needs to be replaced frequently, often because of technological advances
- The equipment is used infrequently or temporarily

Before deciding whether to lease or to buy equipment, develop a cash flow forecast for each option and consult with your accountant. Consider each lease or purchase separately, look at the alternatives, and pick the one that best suits your needs. For more information on leasing equipment, refer to ED&T's *Managing a Small Business.*

Conditional Sales Purchases

In many cases, manufacturers of new equipment will assist in financing your purchase of this new equipment. After a downpayment of one-quarter to one-third of the purchase price has been made, the manufacturer and the purchaser enter into a payment agreement. Under this agreement, the manufacturer retains ownership of the equipment until all payments required under the terms of the purchasing agreement are made.

Sale-Leaseback Arrangements

By this method of financing, your business sells an asset to an insurance business or other institution and then immediately leases it back. In this fashion, the business obtains working capital and can record lease payments for tax purposes.

Factoring

Factoring companies purchase existing accounts receivable from your business and may become your entire credit department. Usually the factor is responsible for granting credit to your customers, performing the accounts receivable recordkeeping, and collecting the accounts. The factor assumes all risks in regard to granting credit and collections. In return for assuming these risks, the factor charges you a commission.

Factoring companies offer an important service, particularly to manufacturers and wholesalers who produce items for which there is a continuing demand. Examples include shoes, textiles, and building supplies. Canadian companies in the export business are increasingly using the services of factoring companies.

Supplier (Trade) Credit

Under competitive pressure, suppliers may be prepared to provide financing, usually by extending credit terms to your business.

A new small business, however, can expect suppliers to be reluctant to grant trade credit. Your best approach is to have a frank discussion with suppliers about your financial plans and about the credit terms they are willing to extend. As your credibility with suppliers grows, extended terms can be negotiated.

You must be careful that your business doesn't lose some of its independence and flexibility by becoming too firmly attached to a particular supplier because of significant credit assistance.

Some businesses simply extend their credit terms by delaying payment of their bills. Used in moderation, this is an accepted business tactic used by some of the world's most respected companies. If abused, this tactic could cost your business the goodwill of suppliers, who might impose strict credit conditions or ask for prepayment of goods and services.

Four: How To Approach Lenders

Most people are apprehensive about approaching a financial institution for a loan. To help you feel more comfortable about approaching your lender, it is useful to remember the following:

- In order to make money, the lender needs your business
- It is in the lender's interest to see your business succeed and grow
- Your lender is in business to extend credit provided your business venture is sound and profitable and represents no more than a reasonable risk to the financial institution

Some Key Questions Before You Borrow

Before approaching your financial institution, you should identify your actual loan requirements by answering some key questions.

Does Your Business Really Need to Borrow Money?

Some small businesses, particularly small service businesses with low start-up and operating costs, do not need to borrow money because of the following reasons:

- On a monthly basis, they take in enough money to cover expenses, or
- The money they (and others) have invested in the business provides the necessary financing

However, most small businesses, at some point in time, need to borrow money to do the following:

- Finance start-up costs and negative cash flows until the business is well established
- Finance business growth and expansion until customer demand for the business' product or service increases
- Fill a need for working capital to cover operating expenses, such as rent, wages, and inventory purchases
- Finance major capital expenditures, such as buildings, land, and equipment

How Much Does Your Business Need to Borrow?

It is important that your business borrow just the right amount of money to meet its needs. Borrowing too much will result in paying unnecessary financing (interest) charges. Too large a loan may also cause you to be careless about controlling expenses. This makes your business less efficient and could result in a larger debt to be repaid in the future. On the other hand, borrowing too little may mean you will be unable to meet operating expenses and respond to challenges and opportunities as they arise.

A comprehensive business plan, complete with cash flow projections (see chapter *One*) will help identify your financing needs. It will also show what percentage of those needs will be met through debt, equity, and other types of financing.

How Fast Should You Repay Your Loans?

Borrowed capital in a business should be used in the same way that you use materials, equipment, and other assets. As described in the previous chapters of this guide, short-term loans and supplier credit should be used to finance operating capital. Longer business term loans should be used to finance major fixed assets, such as property and equipment. The length of a term loan is usually tied to the useful life of the asset it is financing.

In general, it is not advisable to repay loans faster than the terms of the loan agreement. Quite often there are financial penalties for paying off loans early. In addition, paying off loans early reduces the working challenges, and opportunities in the marketplace.

Obtaining and maintaining a loan, however, should be profitable for your business. For example, if borrowed capital costs 15% per year and can be used to earn 20% per year, then it is to your business benefit to borrow and not pay off the loan early. On the other hand, if the borrowed money costs 15% but is only earning your business 10%, it may be to your advantage to use surplus cash to pay off the loan early.

Understanding the Loan Approval Process

When you borrow money, you enter into a contractual obligation. Many of the major commercial lenders have streamlined their loan approval process to provide faster service for their clients. In order to help speed the process, you must provide your financial institution with sufficient information to prepare and assess your credit application in detail.

There are essentially three steps to the loan approval process:

Step 1: The Interview

When applying for a business loan, the first step — the initial presentation to your account manager at the financial institution — is crucial. Make an appointment so that your account manager is ready to see you. Make sure you bring your business plan, and be prepared to discuss it in detail. Make sure you understand and can explain the financial statements and projections. For complete information on preparing a business plan, refer to ED&T's *Starting a Small Business.*

Be prepared to explain:

- How much money you need and how you plan to spend it
- How the money will help your business grow and prosper
- How much money you can afford to pay back on a regular basis (based on your cash flow projections)
- What you plan to use as collateral, including personal guarantees you are willing to make
- How you are prepared for a worst case scenario (for example, sales volumes do not materialize or clients delay payments)

In the interview, your account manager will be assessing the elements of your business plan and your management strengths and weaknesses, including the following:

- Your level of expertise and experience
- Your professionalism and presentation skills
- Your level of commitment and enthusiasm

To create a good impression, you should be well-prepared, enthusiastic, and professional.

Step 2 - Assessment and Decision

If the information in your business plan is complete, it generally takes one or two working days for your account manager to decide if your loan application is acceptable. Account managers can usually approve loans up to a certain limit. Loans above this limit must be approved by a supervisor. It is unusual for small business loans to be sent outside the local region for approval. In any case, you can expect an answer within several days. You may be asked to pay an application fee.

Step 3 - The Paperwork

If your loan is approved, the appropriate paperwork setting out the terms of the loan agreement must be signed by you, the lender and any other involved parties such as guarantors. This could take several business days, depending on the complexity of your application. Before signing any loan agreement, always review the paperwork with your accountant or lawyer.

What Lenders Are Looking For

There are no hard and fast rules that determine which loan applications are approved and which ones are rejected. Part of a lender's decision is based on the impression you make in the interview process. Nevertheless, there are some facts your financial institution will look at when evaluating your application. These include the following:

- The managerial skills, background and experience of you and your management team
- Your current assets, such as inventory and receivables, for security for short-term loans
- Your fixed assets for security for long-term loans
- Any personal financial guarantees you are willing to make
- How much money you have invested in the business
- The business' overall debt to equity ratio
- Your ability to repay your loan based on cash flow projections
- Your business' past financial performance and current reputation
- An assessment of the long-term feasibility and profitability of your business
- The long-term prospects for the industry you are in
- You and your business' track record in repaying loans (your credit record or credit rating)

Be prepared to provide your personal net worth statement.

If Your Application is Rejected

If you are turned down for a business loan, it is likely for one of the following reasons:

- Your business plan was incomplete
- Your presentation was unprofessional
- There is not enough equity in your business
- Your cash flow is insufficient to ensure regular repayment of the loan
- Your business, or the industry your business is in, appears too risky or unpredictable
- Your management team lacks the necessary abilities
- You cannot supply enough security for the loan

If your application is rejected, try to find out why. What areas of the application were weak? What information was missing or required further clarification?

You now have several options:

- You can rethink your proposal and try again
- You can consider other forms of financing (see chapters *Two and Three*)
- You can wait until your business' financial performance improves before reapplying

Try not to get discouraged. A majority of small business clients who are turned down by their banks are able to obtain funding elsewhere.

Establishing a Positive Relationship With Your Lender

The first step in establishing and maintaining a positive working relationship with your financial institution is to choose one you are comfortable with and which meets the needs of your business.

Find out which financial institutions are knowledgeable about your type of business, and ask the owners of other small businesses who they would recommend. If possible, try to arrange a brief meeting with the managers of the financial institutions you think would be the best fit for your business.

Once you've chosen a financial institution, it's important to work at developing a positive, long-term working relationship. Your lender can be an excellent source of expert advice, offering you guidance and insight into how to structure and run your business to ensure the greatest return on your investment. It is also in the best interest of your financial institution to make sure that your business grows and prospers.

Here are some tips on establishing and maintaining a positive and mutually-beneficial working relationship with your financial institution:

1. Have a business plan and discuss it regularly with your account manager.
2. Keep your account manager informed about what is happening in your business, both good and bad. When a problem occurs, discuss it openly with your account manger.
3. Never surprise your financial institution. Plan ahead. Let them know in advance if you're going to miss a loan payment, or if, for example, you need a short-term loan to cover payroll while you're waiting for a major payment from one of your customers.
4. Evaluate your financial relationship yearly or if your financial situation changes unexpectedly.
5. Have regular meetings with your lender, and, if appropriate, invite their representative to your business premises.
6. If your lender is transferred, make an appointment with the new manager to establish a personal relationship.
7. Observe your financial institution's policies, and make loan payments on time.

8. Keep your financial records clear, accurate, and up-to-date and submit them regularly and on time to your financial institution.
9. Be honest, frank, and realistic when discussing your cash flow projections and update them on a monthly basis.

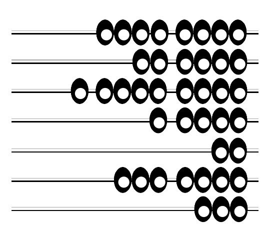
Why Business Loans Sometimes Become Problem Loans

Despite the best of intentions, some small businesses run into serious financial difficulties and are unable to repay their loans as scheduled.

If a business has run into financial problems, it could be for any combination of the following reasons:

- Poor or non-existent business planning, budgeting, and recordkeeping
- Too large a debt load
- An increase in sales has caused you to lose contact with your most important customers or has caused product quality and service to deteriorate
- Increased competition or decreased consumer demand for your product or service
- Unrealistic cash flow projections, decreasing cash flow, or poor planning around cash flow projections has resulted in a decrease or disappearance of working capital
- A person essential to the success of the business dies, retires, or moves on
- Poor management of inventory and/or accounts receivable has resulted in too much capital being tied up in these assets
- An inability to delegate responsibility results in one person trying and failing to do it all
- The business loses one of its major customers

If you have a close working relationship with your lender, renegotiating the terms of the loan repayment will likely go more smoothly.



Appendix A: Financial Planning Workbook

The exercises which follow allow you to apply the concepts described in chapter *One* of this guide to your own venture.

1. Start-up Costs Worksheet

	$
1. Licences	________
2. Security deposits:	
a. rent or lease	________
b. utilities, telephone	________
3. Leasehold improvements	________
4. Furniture, fixtures, equipment, signage	________
5. Legal, accounting, consulting	________
6. Insurance	________
7. Vehicles (if required)	________
8. Pre-opening costs:	
advertising	________
wages	________
supplies, stationery	________
training, travel	________
9. Opening inventory	________
10. Operating loan *	________
TOTAL	________

* *from cashflow projections*

2. Cash Flow Projections Worksheet

	January		February		March	
	Budget	Actual	Budget	Actual	Budget	Actual
CASH IN						
Cash sales						
Accounts Receivable collected						
Other cash received *						
Total cash in						
CASH OUT						
Inventory purchases **						
Wages & benefits						
Owner Advances (proprietors only)						
Rent						
Advertising, Promotion						
Administration, Office						
Utilities/ Telephone						
Insurance **						
Accounting, legal fees						
Loan payments (principal & interest)***						
Maintenance, Repairs, leasehold improvements						
Travel, Auto, Delivery						
Licences & taxes **						
Assets purchased **						
Other						
Total cash out						
Surplus or Deficit						
OPENING CASH						
CLOSING CASH						

* Include loans & line of credit received
** Record only in the month actually paid out
*** Can record principal and interest separately (helps do taxes later)

Remember to complete a cashflow projection for a full year. Not all categories will apply to every type of small business and your business may require additional lines. Adapt the above format to meet the specific needs of your business.

3. Sample Cashflow

Best Men's Clothes Ltd.

Pro-forma Cashflow Statement
Period: September 1, 1995 to August 31, 1996
Date: September 1, 1995

	SEPT	OCT	NOV	DEC	JAN	FEB	MAR	APR	MAY	JUN	JUL	AUG	TOTAL	% of SALES
TOTAL SALES	35550	39150	46800	79650	28800	22950	26550	32850	37800	37350	31050	31500	450000	
CASH IN														
Cash Sales	34057	37506	44834	76305	27590	21986	25435	31470	36212	35781	29746	30177	431100	95.8
Accts Rec. Collected	0	1300	3450	2000	1200	1000	900	800	700	600	890	1400	14240	3.2
Other Cash	0	0	0	0	0	0	0	0	0	0	0	0	0	
TOTAL CASH	34057	38806	48284	78305	28790	22986	26335	32270	36912	36381	30636	31577	445340	99.0
CASH OUT														
Inventory Purchased	20512	22590	27004	45958	16618	13242	15319	18954	21811	21551	17916	18176	259650	57.7
Wages, benefits	9375	9375	9375	9375	9375	9375	9375	9375	9375	9375	9375	9375	112500	25.0
Rent	2438	2438	2438	2438	2438	2438	2438	2438	2438	2438	2438	2438	29256	6.5
Advertising, Promotion	3000	200	2000	460	0	0	500	0	500	0	0	1500	8160	1.8
Admin., Office	779	779	779	779	779	779	779	779	779	779	779	779	9348	2.1
Utilities, Telephone	145	145	145	145	145	145	145	145	145	145	145	145	1740	0.4
Insurance	2220	0	0	0	0	0	0	0	0	0	0	0	2220	0.5
Accounting, Legal	700	100	100	100	100	100	100	100	100	100	100	100	1800	0.4
Loan: principal	488	492	496	500	505	509	513	517	522	526	530	535	6133	1.4
Loan: Interest	415	410	405	400	395	390	387	385	383	380	377	375	4702	1.0
Maintenance	0	0	0	0	0	0	0	0	0	0	0	0	0	
Travel, Auto	1350	150	150	150	1350	150	150	1350	150	150	150	1150	6400	1.4
Licences, Taxes	100	0	0	0	0	0	0	0	0	0	0	0	100	
Assets Purch.	0	0	0	0	0	0	0	0	0	0	0	0	0	
Other	0	0	0	0	0	0	0	0	0	0	0	1290	1290	
TOTAL CASH OUT	41522	36679	42892	60305	31705	27128	29706	34043	36203	35444	31810	35863	443299	
Surplus/ Deficit	-7465	2127	5393	18000	-2914	-4142	-3371	-1773	710	937	-1174	-4286	2041	
Opening Cash	10500	3035	5162	10555	28554	25640	21498	18126	16353	17063	18000	16827		
Closing Cash	3035	5162	10555	28554	25640	21498	18126	16353	17063	18000	16827	12541		

4. Sample Income Statement

Best Men's Clothes Ltd.

Pro-forma Income Statement
Period: October 1, 1995 to September 30, 1998
Date: September 1, 1995

	Year 1: 1996	% of Sales	Year 2: 1997	Year 3: 1998
Total Sales	$450000		$525100	$620400
Cost of Sales	264600	58.8	308759	364795
Gross Margin	185400	41	216341	255605
Expenses				
Wages & benefits	112500	25	131275	155100
Rent	29250	6.5	29250	29250
Advertising, Promotion	8160	2.0	6530	6770
Administration, Office	9345		10055	11640
Utilities, Telephone	1740		1740	2140
Insurance	2220		2400	2400
Accounting, Legal	1800		2100	2400
Loan interest	4702		4252	3886
Travel, Auto	6395		8102	9490
Maintenance, Repairs	0		0	0
Depreciation	7380		7380	7380
Licences, Business Taxes	100		100	100
Assets purchased	0		0	0
Other	1290		1800	2100
Total Expenses	184882		205284	232656
Net Income before tax	518		11057	23049
Tax (17%)	88		1880	3918
Net income	430		9177	19131

5. Sample Balance Sheet

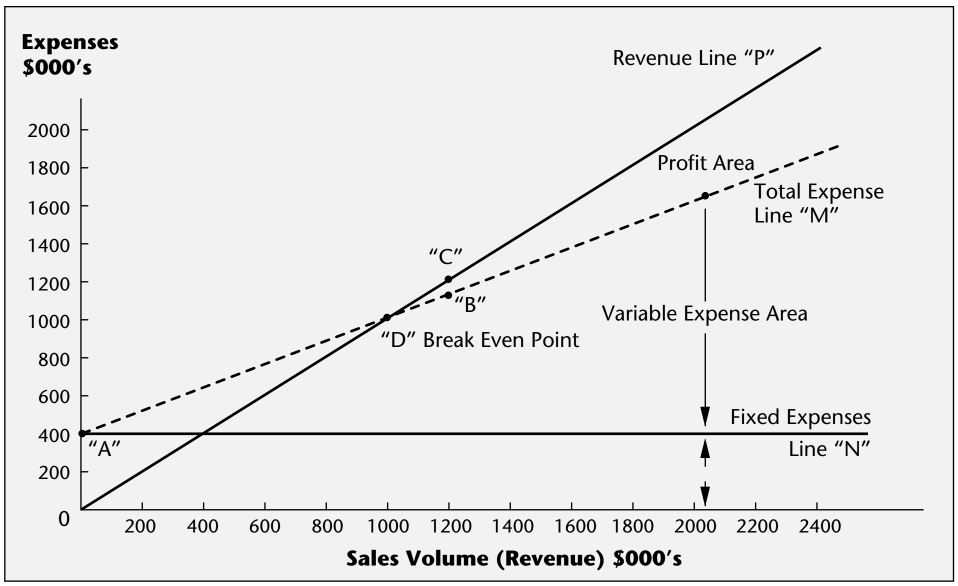
Best Men's Clothes Ltd. Pro-forma Balance Sheet
Period: October 1, 1995 - September 30, 1998
Date: September 1, 1995

	Opening	Year 1	Year 2	Year 3
ASSETS **Current**				
Cash	10500	12541	22634	20575
Accounts Receivable	0	4660	3893	3144
Inventory	120000	120000	120000	120000
Prepaid Expenses	0	1537	1200	1200
Total Current	130500	138738	147727	144919
Fixed				
Leasehold Improvements	30000	30000	30000	30000
Equipment & Furniture	14500	14500	14500	14500
Accumulated Depreciation	0	-7380	-14760	-22140
Total Fixed Assets	44500	37120	29740	22360
TOTAL ASSETS	175000	175858	177467	167279
LIABILITIES				
Current				
Accounts Payable	0	4950	3305	2663
Current portion of long-term loan	6133	6776	7487	8270
Total Current Liabilities	6133	11726	10792	10933
Long-term Debt				
Loan	100000	93867	87091	79604
Minus current portion	-6133	-6776	-7487	-8270
Shareholder's Loans	0	0	0	0
Total Long-term Debt	93867	87091	79604	71334
TOTAL LIABILITIES	100000	98817	90396	82267
EQUITY				
Opening Equity	75000	75000	77041	87071
Retained Earnings — current year	0	2041	10030	18941
Minus Dividends	0	0	0	-21000
TOTAL EQUITY	75000	77041	87071	85012
TOTAL LIABILITIES & EQUITY	175000	175858	177467	167279

6. Break-even Chart

The Small Retail Company

Net Sales			$1,200,000
Expenses:	<u>Variable</u>	<u>Fixed</u>	
Cost of goods sold	$600,000		
Labour	100,000	$230,000	
Rent		100,000	
General expenses	20,000	70,000	
Total Expenses	$720,000	400,000	=$1,120,000
Net profit before taxes			80,000



Step One: The horizontal axis represents sales volume (revenue). The vertical axis represents expenses. Line "N" represents total fixed expenses ($400,000 from *The Small Retail Company* data above). Notice that the line is flat because fixed expenses do not change as sales revenue increases or decreases.

Step Two: Point "A" on the chart represents sales revenue of $0 but fixed costs are still $400,000. Point "B" represents total expenses on the vertical axis ($1,120,000) and total sales on the horizontal axis ($1,200,000 from the data above). Line "M", starting at point "A" and extending through and beyond point "B", shows variable costs and total costs at any level of sales.

Step Three: Point "C" on the chart represents the point where expenses equal total sales ($1,200,000 on both scales). Revenue line "P" is drawn starting at zero through point "C". The break-even point is point "D", where the total expense line "M" intersects with revenue line "P". The break-even point on this chart is where sales are $1,000,000, covering total expenses of $1,000,000. Sales greater than this number reflect a profit for *The Small Retail Company.*