B A 250: Small Business Management

Lesson 7: Sources of Debt and Equity Financing

Where Do I Get Money? Sources of Debt and Equity Financing

Where does a potential business owner go to find money to turn an idea into a real business? Many people just assume a small business owner can walk through the doors of the local bank and have money pour into his or her pocket. This is a tough lesson to learn, but an essential lesson for any small business owner: One of the biggest disadvantages of a small business is the lack of access to capital. For a large corporation, like Amazon or IBM, it is as easy as selling sheets of paper (stocks and bonds), but for a small business, it is not so easy. **Company debt** involves borrowing money that must be paid back through a contractual obligation. You can think of it like a student loan and the signing of the "master promissory note" or a car/home loan.

Equity is the owner's investment in the firm. You can think of this as a person saving up money from being an employee at a job and then infusing that hard-earned money into the creation of their business.

If you want to start a business, it is imperative that you determine how much money you will need as well as where you are going to get the money (capital). This lesson will review several types of financing that are available to you.

Learning Objectives

The readings and questions in the lesson should help you to do the following things:

- Recognize the difference between working capital and fixed capital.
- Differentiate equity sources from debt sources of capital.
- Define an IPO and state its advantages and disadvantages.
- Recognize equity capital sources, such as friends and family, venture capitalists, and angel investors.
- Recognize debt capital sources, such as government financial assistance, SBA loan programs, and commercial banks.
- Examine the debt/equity structure of an existing business.

Key Terms/Concepts

angels

private, usually wealthy investors who finance businesses (usually at start-up) for partial ownership of the business

bond

long-term debt represented by a document or certificate, usually in some preset denomination indicating a specified interest and time for repayment

capital

a form of wealth used to create more wealth. There are three primary types of capital:

- **Fixed capital** is used to purchase the permanent assets necessary to start the business, such as land, buildings, and equipment.
- **Working capital** is needed to support the day-to-day business operations, such as payroll, inventory, and utilities.
- **Growth capital** can be used for the same needs as fixed and working capital, but is specifically needed for expanding or changing the direction of the business.

common stock

the most basic form of stock ownership, providing decision voting rights and a claim to share in company profits, if dividends are declared

debt financing (financial leverage)

funding business needs by borrowing money from lenders with fixed repayment according to specified time frames and rates of interest

equity financing

the financial investment of the owners into the business assets; in a corporation, this ownership is represented by a share of stock

initial public offering (IPO)

the company "goes public" by selling shares of stock in the corporation to investors

intermediate and long-term loans

borrowed funds with repayment set for one year or longer

layered financing

securing financing from multiple sources

line of credit

an unsecured, pre-approved short-term loan extended by a bank, which can be drawn against to fund day-to-day operations as needed up to a pre-determined limit

mortgage loan

a long-term debt secured by real estate property

preferred stock
: a preferential form of stock ownership that has first claim on dividends declared and company assets when a business is sold, but generally has no voting rights

short-term loans
: borrowed funds that must be repaid in one year or less

Small Business Investment Companies (SBICs)
: private investment companies licensed and regulated by the Small Business Administration to lend funds to small businesses

trade credit
: the extension of credit by supply vendors in the form of delayed payments for purchases

venture capitalists
: individuals or organizations that invest in small businesses demonstrating fast growth potential for partial ownership of the business; usually provide funding for expansion rather than start-up

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Road Map (3 of 9)

Road Map

Readings:	• Complete the readings for Lesson 7 listed in the course syllabus. • Read the online commentary for Lesson 7.
Assignments:	1. View the video linked in the Lesson 7 assignments. 2. Complete your case analysis.

Importance of Financial Management (4 of 9)

Importance of Financial Management

Source: selensergen/iStock/Thinkstock

One of the main reasons for small business failure is inadequate financial management. In fact, it is common knowledge that the largest portion of small business failure is caused by either inexperienced management or inadequate financing.

Sound financial management incorporates the following financial functions:

- **capitalization**, or the acquisition of funds for starting and growing the business;
- **cash management** to ensure the continued and ongoing day-to-day operation of the business; and
- **financial control**, or the monitoring and comparing of finances to projections.

In this lesson, we look at capitalization activities and some aspects of operational funding methods, as well as explore the complexities of an initial public offering (IPO).

To finance a new business or the expansion of an existing business, entrepreneurs typically first look to their own funds. This is one of the major risks an entrepreneur and his or her family must face when the decision is made to start a business. It is critical that financial arrangements with family members be formalized and structured to clearly spell out all pertinent details. A business may seem at times to be a black hole that gorges itself on family funds.

There are a variety of reasons an entrepreneur might use up initial funding sooner than expected. He or she may not have properly planned from a financial standpoint, or there may have been unexpected growth and expansion. For this reason, an entrepreneur must realize up front that the process of fundraising is going to be a major requirement of the venture, drawing a lot of time away from operating the business.

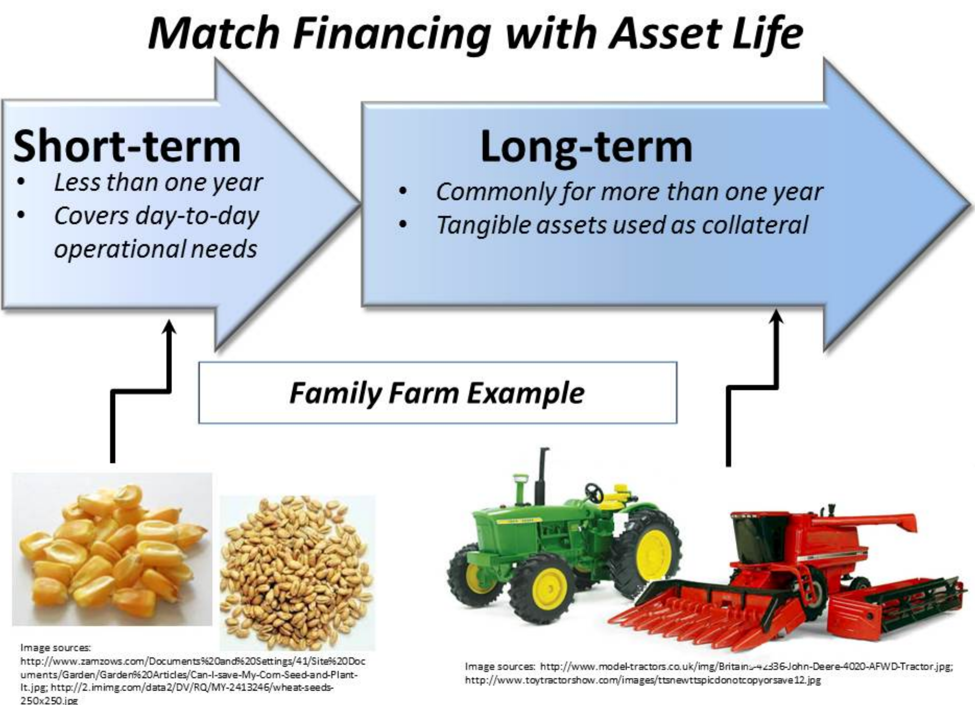
The other challenge is understanding the strategic impact of financing decisions. Minor details that have little short-term impact can become nightmares as businesses grow.

Obtaining Outside Funding

Recognizing the need for more finances than anticipated is just part of the financing issue. Entrepreneurs must become polished at selling themselves and their business concepts. The enthusiasm that spurred the business idea in the first place has to be presented in an organized, well-thought-out manner to encourage potential investors and lenders to buy into the concept and trust the entrepreneur to deliver. This is one of the primary reasons that a well-developed business plan is so critical to the success of the business.

Investors and lenders are very wary of new businesses and are well aware of the risks they face with their investment funds. As a result, the entrepreneur may find it difficult to obtain all of the funds needed from one source. This is where searching, researching, and creativity come into play. You may find that you have exhausted the obvious funding sources. At that point, you need to explore areas and sources that are not familiar, such as factoring, micro-lending, and peer-to-peer lending. An entrepreneur cannot be shy or timid in searching for funds. This must be a foregone understanding when you first consider owning your own business.

When looking for funding, the entrepreneur should attempt to match the financing need to the type of funding. For example, long-term financing is easier to obtain when it is being used to purchase tangible assets, such as buildings and equipment that can be secured as collateral for the loan. Similarly, funding for the day-to-day operational needs caused by cyclical or seasonal business fluctuations is more typically from a short-term source.



Source: The Pennsylvania State University

Match Financing with Asset Life: Family Farm Example

Short-Term:

- *Less than one year*
- *Covers day-to-day operational needs*

Long-Term

- Commonly for more than one year
- Tangible assets used as collateral

A good example for this matching concept is the family farm. Financing the equipment is totally different than financing the seed for this season's crop. Entrepreneurs must understand the importance of working with multiple sources of funding to create a layered approach.

Debt Versus Equity Financing

A second factor to consider when financing your business is the need for balance between debt and equity financing. The entrepreneur must evaluate the pros and cons of each. A business can get itself into difficulties—even failure—if the proper funding balance is not maintained.

There are a variety of non-bank sources of capital, such as asset-based lenders, federally sponsored programs, or internal financing, in which entrepreneurs use their own credit cards to cover debt. The exclusive use of **debt financing**, or loans and bonds, can put a drain on the business's cash flow. The repayment of principal and interest can limit the availability of cash for other operational expenditures. For example, if the business is cyclical or seasonal, or if proper financial planning has not been conducted, heavy debt financing can cause critical cash shortages just when payrolls and payments for supplies and materials must be met. This puts the business and the entrepreneur into stressful credit situations, which, if not properly managed, can result in business failure.

If the business is funded exclusively using equity financing, the entrepreneur may find that the majority of the business is owned and controlled by others. By taking on new partners or selling shares of stock, the entrepreneur dilutes his or her control and influence.

In order for a company to sell shares publicly, the owners must register with the U.S. Securities and Exchange Commission (SEC). The SEC registration process for small businesses has been simplified; however, understanding a public offering's financial and organizational impact remains complex. It can add unanticipated stress, especially if the partners do not agree on where the business is headed.

The critical nature of business financing cannot be overemphasized. Business operators must be willing to concentrate on the needs of the business in this area and to understand their importance —or they cannot expect to be in business for long.

Case Analysis: Financial Statements

This lesson contains a case analysis where you will be asked to apply many of the methods of analysis you have learned so far and to make recommendations based on your analysis. Therefore, you may need to review previous chapters of the textbook in preparation to create *an income statement, a statement of retained earnings, a balance sheet,* and *a ratio analysis*.

Resources

The expectation is that you will complete this assignment using Microsoft Excel, which is software commonly used to prepare spreadsheets. As a Penn State student, you have access to many free resources that can help you. If you do not have access to Excel, you access can it for free at WebApps (http://clc.its.psu.edu/RemoteAccess/WebApps) (Office 2010 or Office 2013 will contain Excel). Should you need training to use Excel, you can access free training at Lynda (http://lynda.psu.edu/) or Microsoft Academy (http://msitacademy.psu.edu/) .

Examples

Examples of most of these statements can be found in the textbook, with the exception of the statement of retained earnings.

Income Statement and Pro Forma

Prepare the income statement and pro forma using the simple percent-of-sales method:

Table 7.1. Example of Income Statement and Pro Forma Using Simple Percent-of-Sales Method

	A	B	C	D
	Account names (current year)	**Account balances (current year)**	**% of sales (current year)**	**Pro forma (upcoming year)**
1	Sales	$500		$575*
2	Cost of goods sold (CGS)	$200	= B2/B1 (40%)	$230 (= C2 x D1)
3	Gross profit	**= B1 - B2**		**= D1 - D2**
4	Operating expense	$100	= B4/B1 (20%)	$115
5	Net income before tax	**= B3 - B4**		**= D3 - D4**

When creating your spreadsheet, be sure to include a column for account names (see above, Column A) and a column for account balances (Column B). Be sure to look at previous lessons for content on how to prepare financial statements.

The percent-of-sales method is a very simple method that can be used to develop the pro forma income statement for an existing business:

- An upcoming sales forecast is needed (for the above example, let's say an increase of 15%* of the current year sales is $500 x 1.15 = $575).
- Then, express the various income statement items (CGS and all other expenses) as a percentage of sales from the most current year.
- Looking at the above example, you would create a new column (Column C) showing what percent of sales CGS is; continue doing that with all the expenses on the current income statement.
- Once that is completed, you will create a new column to create your pro forma income statement for 2013, starting with the new sales forecast and applying the percentages you just calculated to the new sales forecast. For example, the 2014 CGS would be 40% of $575, and the 2014 operating expenses would be 20% of $575.

Statement of Retained Earnings

When a business determines its net income through the creation of an income statement, the owner must decide what will happen with the company's profit. The owner can choose to keep the profit in the company and purchase more assets (this is called keeping or "retaining" the earnings) or take the profit out of the business. When that happens, it is called a **dividend**.

A business may want to retain profits because that will lessen the need for external financing.

If a business has, for example, $55,000 in profit, the owner can

- retain all $55,000 and put it back into the company,
- take the entire $55,000 out of the company for personal use, or

- retain some and take some out (a dividend).

The **statement of retained earnings** shows what the owner does with the current period's profits. If you look at the example below, you will see that the business made $55,000 in profit, and the owner took $10,000 out of the business. That means the owner is retaining $45,000 (the **retained earnings**).

In the example below, the owner had retained $300,000 since the inception of the business. For this current period, he decides to retain $45,000. Therefore, the new retained earnings at the end of the period is $345,000 ($300,000 from past periods and $45,000 for this period).

Table 7.2. Format for the Statement of Retained Earnings

Beginning retained earnings: September 30, 2011	$300,000
(add) **Net income for current year**	$55,000
Subtotal	$355,000
(subtract) **Dividends paid on common shares**	$10,000
Ending retained earnings: September 30, 2012	$345,000

References (8 of 9)

References

eHow. (2008, October 31). How to finance a business: How to get start-up business financing [Video file]. Retrieved from https://www.youtube.com/watch?v=Jsek3PQypzw

The Capital MarketPoint. (2010, January 24). Find investors: Which is best: Debt or equity funding? [Video file]. Retrieved from https://www.youtube.com/watch?v=Mg5jb1z2P8c

Lesson Assignments (9 of 9)

Lesson 7 Assignments

Complete all the following tasks and readings by the due dates listed in the course syllabus.

Online Videos

Watch the following online videos (eHow, 2008; The Capital MatchPoint, 2010). They will provide background for this lesson.

Video 7.1. How to Finance a Business

Time: 00:02:33

No transcript available.

Video 7.2. Find Investors: Which Is Best: Debt or Equity Funding?

Time: 00:02:18

No transcript available.

Case Analysis: ABC Company

Complete the following steps after reading the lesson materials and the case analysis (https://cms.psu.edu/section/content/default.asp?WCI=Goto&WCU=CRSCNT&MATCH=ABC+Co+case+analysis) (found in Activities > Lesson 7 folder).

1. In an Excel spreadsheet, prepare the following financial statements for ABC Company. **Be sure to use formulas whenever there is a calculation** and clearly identify (rename) each worksheet so the sheet corresponds to the statements. Show each financial statement in a separate tab within your Excel workbook.

   Specifically, you will need to create
   1. an income statement,
   2. a statement of retained earnings, and
   3. a balance sheet.
2. Perform a ratio analysis on ABC Company by calculating the following ratios (reviewing Lesson 4 for content on how to calculate ratios, if needed):
   1. current ratio,
   2. quick ratio,
   3. debt ratio,
   4. debt to net worth ratio,
   5. times interest earned,
   6. average inventory turnover ratio,
   7. average age of inventory,
   8. receivables turnover ratio,
   9. average collection period ratio,
   10. payables turnover ratio,
   11. average payable period ratio,
   12. net sales to total assets ratio (total asset turnover ratio),
   13. gross profit on sales ratio (gross profit margin or GPM),
   14. operating profit on sales ratio (operating profit margin or OPM),
   15. net profit on sales ratio (net profit margin or NPM),
   16. net profit to assets ratio (return on assets or ROA), and
   17. net profit to equity ratio (return on equity or ROE).

Once you have your statements and ratios prepared, open the case study quiz (https://cms.psu.edu/section/content/default.asp?WCI=Goto&WCU=CRSCNT&MATCH=case+study+quiz) to answer questions based on your results in Excel. The quiz consists of 17 questions—15 questions based on your prepared financial statements and ratio analyses, plus two short essay questions. You will have one hour to complete the quiz. Submit your completed Excel workbook to the ABC Company Case Study drop box (https://cms.psu.edu/section/content/default.asp?WCI=Goto&WCU=CRSCNT&MATCH=ABC+Company+case+study) .

Please direct questions to the World Campus HelpDesk (http://student.worldcampus.psu.edu/student-services/helpdesk) |

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