Chapter : 11

Financing Small Business

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The key to small business success rests mostly on the ability of the entrepreneur to raise adequate amount of funds for infrastructural developments as well as meeting day-to-day working capital needs. One of the first questions a potential entrepreneur must ask is, "Where do I get the money?" The type of business may have been decided, the plans made, the legal steps taken, and the financial projections carefully worked out. But without the necessary fuel (money), the ship 'enterprise', will not get off the ground. Plant, or fixed asset, financial needs include purchasing land and buildings (if a new business is to build rather than rent), machinery and equipment, furniture and fixtures, and business vehicles. Financial information pulls together all the information presented in the other segments of the business: marketing, distribution, manufacturing, and management. It quantifies all the assumptions and historical information concerning business operations.

11.1 Planning Financial Needs

Before an individual leaves on a date or takes the family out to a local restaurant, he or she will usually check his or her financial resources to make sure that he or she can pay for the evening. Planning the financial needs of a business is very important. While estimating how much money they need, entrepreneurs must know what they plan to do. Unfortunately, many entrepreneurs do not, often because they have failed to work out a business plan. Yet the very act of preparing such a plan enables entrepreneurs to crystallize their thinking on how best to launch their ventures. It forces them to move logically and systematically from the stage of dreams and ideas to that of concrete action. It is the concretization of business plans that helps entrepreneurs determine their financial needs.

The owner or the manager of a small business needs to be able to ask the following questions:

1. **Why does he need the money?** Expansion is the answer one individual will give. Another will give remodeling as an answer. A third person will state that they need the money to start a new business. There are many reasons why money and capital are needed in small business. However, it is important to be very specific about the amounts and the kinds of money that are necessary. The general areas of need for money are: (a) starting a new business, (b) inventory, (c) expansion, (d) remodeling, and (e) improving cash flow or working capital.
2. **How much money will he need?** It is important to be able to specify how much money the entrepreneur will need. It is advisable when doing any financing to be able to stipulate the amount of taka that the entrepreneur will be using and to specify if it is to be used to buy a new car, purchase inventory, pay salaries and wages, or event to be used to purchase new equipment.

3. **When will he be able to repay the money?** A major criterion for any financial position is an understanding of repayment ability. Friends, bankers, are business associates are always interested in knowing when and how you anticipate repaying loan. The majority of loan repayments come from sales of merchandise and inventory.
4. **Where will he obtain the money?** The most small business owners will obtain additional money from banks, friends, or relatives. There are many times when it is preferable to use banks. However, it is often advisable to use own personal saving or to encourage friends or relatives to invest in small business.

11.2 Using Capital in the Business

Financing a firm properly is a critical element for business success. Many potentially successful firms have failed because they were undercapitalized. Few things are as difficult to accept as having to close the doors because the entrepreneur lacks a few thousand Taka and can't find the money anywhere.
If follows, then, that every firm should be planned with a clear and positive understanding of two items:

1. What the source of the funds will be?
2. What funds will be needed?

The amount needed can be determined by developing a statement of assets to be used. While this document is being prepared, the entrepreneur will need to plan carefully to be able to provide for three things:

1. Enough capital to support one to three months of operation
2. Enough capital to pay the purchase or start-up costs,
3. Some extra capital to cover unplanned expenses (perhaps as much as 10 to 15 percent of the purchase price)

When the amount of the net ownership capital needed has been determined the proprietors turn to the problem of making sure the entire amount is available. The total sum should preferably be deposited in the company's bank account before any commitments are made by the new owners.
When several sources of capital are available, the planners must still bear in mind that all sources may not be equally desirable. Borrowed capital is shown on the balance sheet as a liability. It must be paid back at specific periods. These payments are not operating expenses, which are deducted on the income statement before planned profits are produced. They are payments for the provision of investment capital and are to be paid out of the profits shown on the income statement. Failure to recognize this basic fact is the most common cause for financial strain among small firms. It is important, therefore, to consider the repayment schedules in choosing among sources of financing.
The various types of financing available to business firms are usually classified as:

1. Short-term capital: This is borrowed capital that is to be repaid within 1 year.
2. Intermediate capital: This is borrowed capital that is to be repaid in 1 to 5.
3. Long-term capital: This is capital whose repayment is arranged for more than 5 years in the future.

As new firm planners review the sources of financial assistance that follow, they may find that some of the sources fall into different categories of the above list. For example, a note payable to a commercial bank is generally considered short-term financing, but a 3 year note payable to a finance company would be considered intermediate capital. There are various sources of raising capital for the owners of the small businesses.

11.3 Sources of Finances for the Small Business Firms

Many entrepreneurs often try to manage the initial capital from their past savings. But as the size and the magnitude of the business spreads, own source most likely to be inadequate, hence, the need for outside funds arises. Such suppliers may be individuals or groups of individuals, agencies or even banks & financial institutions.

Two things should be recognized when one is faced with the problem of obtaining outside capital assistance.

1. An established concern with a good record of operations usually has better access to available sources of capital than does a new firm.
2. Some personal capital available for investment in the firm by the new owner is almost always a requisite to obtaining any type of outside assistance.

An exhaustive list of the sources of outside capital available for the small business persons is provided in the following table:

Sources of Small Business Finances

Sources of Long-term Finance	Sources of Short-term Finance
I. Borrowing from issue of corporate securities,	IV. Borrowings from Agencies & Companies
a. Ownership Securities	i. Equipment Suppliers
i. Equity Shares	ii. Family Investment Firms
ii. Preference Shares	iii. Financial Consultancy Firms
b. Creditorship securities	iv. Micro-finance NGOs
i. Debentures	v. Industrial Foundations
ii Bonds	vi. Tax Exempt Foundations
II. Institutional Borrowings:	vii. Charitable Foundations
i. Industrial Development Banks	viii. Veteran Administration
ii . Small Business Finance Banks	ix. Industrial Development Corporations
iii. Commercial Banks	V. Borrowings from Individuals:
iv. Trust Companies	i. Inherited Funds
v. Insurance Companies	ii. Friends & Relatives
vi. Factoring Companies	iii. Customers
vii. National or State Corporations	iv. Employees
viii. Commercial Finance Companies	v. Competitors
ix. Venture Capitalists	vi. Neighbors & Acquaintances
x. Leasing Finance Companies	vii. Partners
xi. Investment Bankers	viii. Public Deposits
III. Borrowings from Funds & Association:	VI. Inter- Corporate Deposits
i. Mutual Funds	i. Call Deposits
ii. Pension Funds	ii. Three-month Deposits
iii. Savings & Loan Associations	iii. Six-month Deposits
iv. Investment Clubs	
v. Credit Unions	

A very short indicative introductions of some the aforesaid sources may be seen as under:

A: Sources of Short-term Finance

Working capital consists of two components viz., fixed component and variable component. While the fixed or permanent component is to be financed through long and medium term sources of finance, the variable portion of working capital is financed through short-term sources, that is, sources that require repayment in a year or less. Some of the important sources are trade credit, bank credit, public deposits, customers' advances, factoring, etc. Certain internal sources like depreciation, reserves and provision, etc., are also used for short-term financing purposes.

Bank Credit: Bank credit is the major source of finance for working capital. Banks offer both secured as well as unsecured loans to business firms such as cash credit, overdrafts, loans and advances and purchase and discounting of bills. They provide credit against security. A loan may be secured by tangible assets or by personal security either by lien, pledge, hypothecation, mortgage or charge, etc. Bank loans are an important source of business financing such as seasonal build ups in accounts receivable and inventories. Banks do not provide 100% finance. They insist that the customers should bring a portion of finance from other sources.

Public Deposits: Another source of short-term finance are unsecured public deposits. In some countries a company can borrow only up to 25 percent of its share capital and free reserves. The maturity period varies from 6 months to 5 years. Maximum interest rate payable is 15 percent. A minimum maturity period of only 3 months is permitted for deposits amounting to 10 percent of share capital and free reserves. The rules relating to public deposits have been made very strict in order to protect the interest of investors.

Accounts Payable: They are created when the firm purchases raw materials, suppliers goods for resale on credit terms on open account. They are interest free and securities free. However, accounts payable is a legally binding obligation of a firm. They also include bills payable.

Accruals: They are shout-term liabilities that arise when securities are received but payment has not yet been made. Examples are wages and salaries payable, taxes payable, expenses payable, etc.

Unsecured Non-Bank Short Term Sources: The following non-bank short-term sources are used though they are not available to every business.

Private Loans: A short-term unsecured loan may be obtained from a wealthy shareholder, a major supplier, or other party interested in assisting the firm through a short-term difficulty.

Cash Advances from Customers: A customer may pay for all or a portion of future purchases before receiving the goods. This form of unsecured financing provides funds to purchase raw material and produce the final products.

Commercial Paper: These consist of promissory notes with maturities of various periods ranging from 3days to even a year is usually issued in higher denomination and can be used only by large well known companies which enjoy a fairly high credit rating. It is purchased by other firms wanting to invest funds in marketable securities temporarily. Individuals, insurance companies and other institutions also purchase commercial paper.

Pledging and Factoring Receivables: These are two techniques of secured short-term financing employed with accounts receivable as the collateral.

By pledging or assigning accounts receivable, a firm gives up the right to the cash collected on those accounts. Because receivables are normally most liquid, they are attractive as collateral to commercial banks and finance companies.

Factoring receivables is the outright sale of the account receivable to a factor that generally accepts all the credit risks associates with the collection of accounts. A factor is a financial institution that purchases accounts receivable from business firms. Since the accounts are sold, a factoring does not involve a loan.

B: Sources of Long -Term Finance

Equity Shares. The equity shares are the main source of finance and it is contributed by the owners of the companies.

Retained Earnings: Reserves and surplus build over the past are called retained earnings. These earnings can be interested in business for modernization and expansion.

Deferred Credits: Many times the suppliers of machinery provide deferred credit facility under which payment for the machinery may be made over a period of time.

Preference Shares. Preference shares confer on preference shareholders two rights viz., to receive the preference dividend and get back their capital on priority basis. Investors, who like to earn a limited but steady return on their capital, prefer preference share investment.

Institutional Term Loans: Term loans are presently the most important source of finance. Loans obtained from banks and financial institutions are generally secured loans. They carry a fixed rate of interest and are repayable in installments.

Debentures: Debentures are very commonly used creditorship securities. Different types of debentures are issued to mobilize the debt capital from the public. They are generally secured and carry fixed percentage of interest. Registered debentures, redeemable debentures, convertible debentures, mortgage or secured debentures, ordinary debentures, etc. are a few types of debentures.

Capital Subsidy and Development Loans: Central Government provides capital subsidy to industries set up in notified backward area.

Unsecured Loans and Deposits: Unsecured loans are normally provided by the promoters to fill the gap between the promoters' contribution required by financial institutions and the equity capital subscribed by the promoters.

Inter-Corporate Deposits

It is a deposit made by one company with another, normally for a period up-to six months. They are usually of three types:

Three-month Deposits: These deposits are more popular in practice. They are taken up by the borrowers to tide over a short-term cash inadequacy. The rate of interest is around 16 percent p.a.

Six-month deposits: Normally lending companies do not extend deposits beyond this time limit. They are made only to first class borrowers. The rate of interest is around 15 percent per annum

Call Deposits: In theory, a cal deposit is withdrawal by the lender on giving day's notice. But in practice, at least three day notice is to be given. The interest rate is around 14 percent p.a.

11.4 Equity Vs Debt Financing

Most small businesses try to finance expansions at least in part by reinvesting profits from ongoing operations. This is a sound, stable method of growth for established small businesses. All small businesses, however, must have financing from outside sources when they first begin operation, and most businesses need additional financing at certain points in their growth. These outside funds may come from equity financing or from debt financing. Financial management must decide what

contribution each type will make to the total funds available to the small business. Both equity financing and debt financing have favorable and unfavorable factors. These may be seen as under:

Equity Financing	Debt Financing
A. Advantages: The major advantages of equity finance are: ❖ No interest charges are required to be paid. ❖ Solvency is less likely to be threatened. ❖ Profit are not reduced by loan repayments. **B. Disadvantages :** The major disadvantages of equity finance are: ❖ If requirements decreased invested money may remain idle ❖ A greater total investment reduces the return on investment.	**A. Advantages:** The major advantages of debt finance are: ❖ Interest payment reduces the cost of fund. ❖ It is unnecessary to set a side large amount of cash for peak needs. ❖ No sharing of ownership of control is required by others. ❖ Better leverage and higher rate of profit. **B. Disadvantages :** The major disadvantages of debt finance are: ❖ May not be always available. ❖ May call for higher rate of interest. ❖ May encounter unfavorable terms and conditions. ❖ Profit is reduced by payment of interests and loan installments.

Most small businesses try to strike a balance between equity and debt financing. The ratio of borrowed assets to owned assets., or debt ratio, is another meaning of leverage. Small businesses with high leverage are often believed to have good profit potential-especially when interest rates are low. However, they are also believed to be more susceptible to failure in an economic slump.

11.5 Working Capital

Working Capital is the amount of capital that is required by an enterprise to carry out its day-to-day operations. In other words, it is defined as all the short-term assets used in daily operations. Technically, working capital management is an integral part of the over-all financial management. The problems involved in the management of working capital differ from those of the fixed capital. They consist of primarily cash, marketable securities, accounts receivable and inventory.

The components of working capital are :

(a) Inventories such as (i) Raw material (ii) Work in progress, (iii) Finished goods, and (iv) Stores and Spares;
(b) Accounts receivable which include sundry debtors and bills receivable;
(c) Cash and bank balances; and
(d) Advances paid for expense and to suppliers.

Estimation of Working Capital

A typical segments to be considered in the management of working capital are : estimated income for the first year, estimated monthly income for the first year, monthly cash flow during the first year. personal monthly financial needs of the owner / entrepreneur and required sales volume to earn the profit target. The estimation of correct of working capital is very important from the points of view of both the needy concern as well as the financing institution (say, banks). Any overestimation of the requirement might result in blockage of scarce funds in idle assets. On the other hand, the underestimation may cripple the unit and deprive it of many profitable opportunities. It is, therefore, of prime importance that the working capital estimation is very carefully done.

Working Capital Forecast: It involves careful study of every aspect of business activity as well as complicated calculations. The following items are usually taken into consideration while preparing a working capital forecast:

(i) Costs to be incurred on material, wages and overheads during the year.
(ii) Length of time during which the raw materials and incomplete products are to remain in stock in the production process.
(iii) Length of production cycle.
(iv) Length of them during which the finished products are to remain in stock before sales.
(v) Period of credit allowed to debtors.
(vi) Period of credit availed of from creditors.
(vii) Tie-lag involved in the payment of wages and overheads.

After calculating the amount of working capital by considering the above factors, a certain percentage would be added to this amount for contingencies.

Any small business depending on its size, nature of activity involved, depreciation policy, efficiency and reputation of the business management besides skill in handling risk may make a realistic estimation of the required working capital. Care must be exercised neither to have idle money in the name of estimating excess working capital not to suffer from drought of funds for wrongly underestimating the same.

Appropriate Quantum of Working Capital

Working capital is like blood circulation – neither too high nor too low flow is desirable & helpful. The volume of working capital should be just adequate, may be a little more- not too much. There are dangers from both too little & too high. This may be seen as under:

Dangers from too little working capital	Dangers from too much working capital
1. Increases costs of funds	1. Leads to shaky investments
2. Contributing factor to business failure	2. Leads to management inefficiency
3. Faces chronic liquidity crises	3. Speculation may be encouraged
4. Reduction of ROI	4. Unwise expansion may be stimulated
5. Adversely affects dividend policy	5. Owners withdrawals/ dividends may be liberal
6. Deprive from availing attractive opportunity	6. Unnecessary business expenses may be encouraged

Financing Working Capital: An established small business as a first step uses unorganized sources. If and when unorganized sources are proved to inadequate commercial banks are approached for the purpose. An exhaustive sources are shown in the table presented in 11.3 in the current Chapter of the book. These sources usually extend funds for fixed investments as well as to meet the working capital needs of the small business.

11.5 Request for Bank Loan

In this age of market economy and institutional arrangements, small business entrepreneurs in the developed countries often resort to bank loans. And even in the developing countries like Bangladesh small entrepreneurs sometimes get contacted with banks from whom some of them succeed in obtaining bank finances. Banks after getting loans proposals analyze the same to be sure about the recovery if and when they due. For this purpose banks require many relevant information in order to appropriately conduct appraisal study of creditworthiness of potential bank loanees.

Selecting the Right Banker

A banker is a friend in need. It is not good to change bank as and when you like. Alternatively, the bank should not be such that you are rather forced to change it. Hence, before selecting a bank a small business person should look for:

1. Find the legal standing of the bank as a financial institution;
2. Find the relationship of the bank with the central bank;
3. Find the position & strength of the bank with reference to money market;
4. Conservative character of the bank;
5. One with helping attitude;
6. Have adequate experience in financing small businesses;
7. Location of the bank;
8. One who has the ability to appreciate good business plan and can help to improve the same;
9. One who appreciates honest deal & transparency;
10. Have adequate funds;
11. Offers flexible terms & repayment schedule;
12. Offers loan renewable facilities if and when needed;
13. Loan pricing reasonable, fees & charges not very high;
14. Efficiency & customer-relation records of the bank;
15. Technology use to ensure speed & accuracy of the asked for services;
16. Goodwill of the bank.

Information Required for Creditworthiness Analysis:

Small business owners may apply to banks or other relevant institutions for financial accommodation. Banks or the institutions in which the request is made make the creditworthiness analysis. For this purpose, they require the following:

1. Statement of business history
2. Initial source and application of funds (where money to be used in the business is coming from and how it will be applied).
3. Balance sheet and income statements from the past three years and for the current period for existing businesses.
4. Personal references.
5. List of security to be offered as collateral.
6. Pro forma balance sheet if and when the asked loan is granted.
7. Projected monthly profit and loss statement for the business for at least two years, assuming loan has been granted and proceeds disbursed.
8. Projected cash flow for the business –three years.
9. Resume(s) of individual(s) purchasing the business, showing work experience.
10. Personal financial statement of purchaser, not more than 90 days old.
11. Personal tax returns of purchaser for the past three years.
12. For existing business, listing of receivables and payables with amount of age-dating.
13. Schedule of repayment terms on existing obligations (include secured or unsecured).
14. Copies of existing or proposed leases or agreements.

Sustaining Reasonably Long Relations with a Bank

A successful small businessperson should aim at keeping healthy relations with his banker for a reasonably long time. For this purpose the small business person should remain careful not to do anything that may strain their relationship. He should remain careful:

- ***Treat bankers like partners*:** Honor the banker's view points and make repayments as and when due. Make the deal a two way traffic.
- ***Do as per their directions that the reasonable & natural:*** Banker usually want repeat customers like any other business. They issue directions to clients for better use of the funds provided. These directions should be cared and acted upon.
- ***Understanding the banker's needs:*** Although bankers are interested in all the aspects of the business, they have a special admiration for hard assets, because that's their last line of insurance when all else fails. The small business person understand this fact, shouldn't fight it, and keep impeccable records on all hard asset items, such as receivables, inventory, equipment, and real estate. One should remember that the bankers are creditors, not shareholders, As such, they look first to the balance sheet, not to profit and loss statement alone.
- ***Involve bankers in key decisions:*** Especially those decisions that are likely to result in a need for more cash. participative investment decisions will make the banker feel easy with the sense to keep funds the time the bank already knew.
- ***Minimize surprises:*** Bankers hate surprises, especially bad ones. The small business person should keep the bank informed of potential problems and must not let the bad news pile up to be leaked out all on a sudden resulting which the bank also may suffer a lot..
- ***Communicate:*** The small businessperson need not tell all his business secrets to the banker. But he can tell them too little. Invite them to visit his business at least once in a month, give them a royal tour, and have an outline ready for every meeting. Most importantly, the entrepreneur should call his banker whenever the news is big, whether it is good or bad. Bankers want to hear it from him, not from someone else.
- ***Follow-up:*** *Send* to the banker a letter after every meeting, recapping everything the small businessperson discussed. He is thus helping the banker to do the job.
- ***Treat bankers like customers:*** Like it or not, the small businessperson need his banker a lot more than his banker needs him. There are many more small business looking for cash that there is cash looking for small business. The small businessperson should make his banker feel wanted.

The small businesspersons should remember that bankers are like their employees, customers and their kids. The better they are treated, the more likely they will return the favor.

11.7 Summing Up

Financial information pulls together all the information presented in the other segments of the business: marketing, distribution, manufacturing, and management. It quantifies all the assumptions and historical information concerning business operations. Small business firms should be plan with a clear and positive understanding of the items: what amount of funds will be needed for a definite period, for what purposes and from what the sources, these may be procured at what costs. The amount needed can be determined by developing a statement of assets to be used. While this document is being prepared, the entrepreneur will need to plan carefully to be able to provide for three things: enough capital to pay the purchase or start-up costs, enough capital to support one to three months of working capital and some extra capital to cover unplanned expenses may be as much as 10 to 15 percent of the sum of the two stated.

When several sources of capital are available, the planners must still bear in mind that all sources may not be equally desirable. Borrowed capital is shown on the balance sheet as a liability. It must be paid back at specific periods. Failure to recognize this basic fact is the most common cause for financial strain among small firms. The various types of financing available to small business firms are usually classified as: short-term capital to be repaid within 1 year, intermediate capital to be repaid in 1 to 5 and long-term capital to be repaid after 5 years in the future.

Adequate provision of working capital arrangement in time is essential for efficient operation of a small firm. It is possible with prior forecast. The following items are usually taken into consideration while preparing a working capital forecast: costs to be incurred on material, wages and overheads during the production cycle, length of production cycle, period of credit allowed to debtors, Period of credit availed of from creditors and time-lag involved in the payment of wages and overheads. After calculating the amount of working capital by considering the above factors, a certain percentage would be added to this amount for contingencies.

Model Questions

Broad Questions

1. What questions should be assessed by the manager of a small business while making financial plan? Mention the steps of financial plan.
2. "Using Capital in the business is a critical element for business success" – Explain. What are the generally used sources of funds for small business firms?
3. Differentiate between the sources of long-term and short-term financing.
4. What are the components of working capital?
5. "The estimation of correct working capital is very important for financing institution & needy concern" – Explain.
6. Which sources of funds account for the largest proportion of initial capital for small businesses?
7. Compare commercial bank loans and trade credit as capital sources for the new firms.
8. How are the financial needs and available resources of a firm relate to the state of its development?
9. Explain why a financial plan is so important in estimating money needs for a new venture.
10. How would you, as an entrepreneur, go about estimating how much money is needed to launch your venture?
11. Do banks generally show interest in financing an entrepreneur who is just starting out? Explain your answer.

Short Questions

1. Do you think that planning is essential for financial need? If yes, Justify
2. Mention thirty financial resources of small business.
3. Describe the various types of financing available to business firms.
4. Delineate the long-term source of financing.
5. "Financial information quantifies all the assumptions and historical information concerning to business operations" – Explain.
6. What three things should be planned carefully by an entrepreneur at the time of preparing documents?
7. What do you mean be inter-corporate deposits?
8. What is the chief difference between a balance sheet and an income statement? Explain.
9. Explain the difference between equity capital and debt capital.

Never spend your money before you have it.
- Tomas Jefferson

Expenditure always rises to met income.
- Cyril Northcote Parkinson