

SMALL BUSINESS OWNER'S HANDBOOK

PART II: FINANCIAL PLANNING FOR SMALL BUSINESSES

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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 *Small Business Owner's Handbook Part I: Managing 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

Remember!

This is the most important part of business planning and it is recommended that you seek the services of a qualified Business Consultant.

Financial Planning

Your business plan 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:

1. Project or Start-up costs (for new business and expansion of existing businesses);
2. Projected Income Statement;
3. Projected Balance Sheet;
4. Statement of Financial Activities;
5. Cash flow projections;
6. A break-even analysis;
7. A ratio analysis;
8. Historical financial statements (for existing businesses).

Project Costs

If you are starting a new business, first determine **start-up costs**. These costs include the one-time expenditures that your company must make before it opens its doors for business. These costs are typically financed by personal or investor equity (having 10% of your own cash is a rule-of-thumb), grants, and a small business loan.

Funding needed to run a business (to keep it going once started) and pay for its operational expenses (rent, utilities, suppliers, wages, interest, etc) is called operating funding or working capital. Working capital is usually financed through: the revenues the business generates or an established line of credit through a commercial bank. However, if the business is unable to generate sufficient revenues in the initial months of business, some of the operating costs can be included with the project costs.

Project or start-up costs include (not all costs may apply):

- Fixed assets (land, building, equipment, furniture, fixtures, signage, etc.)
- Inventory (enough for opening—not a year's supply)
- Business fees (loan, business planning, legal)
- Insurance costs
- Licenses, permits, and registration
- Deposits for public utilities and telephone
- Leasehold improvements or renovations
- Franchise fee
- First month's rent
- Labour costs for the first month
- Marketing/advertising costs (grand opening, flyers, etc.)
- Other (appraisal, environmental assessments, etc.)

Remember, total financing must equal total project costs.

Income Statement

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. 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 projected income statement compares estimated revenue and expenses and then calculates your estimated net profit (or loss) over a specific period. Potential investors and lenders will want to see a projected income statement for at least one, and possibly three years.

Revenues (Sales) - Cost of Goods Sold = Gross Margin

Gross Margin - Operating Expenses - Depreciation = Net Income (before tax)

Sales Forecasting

Forecasting sales is the starting point for financial projections, and the basis of budgeting.

1. List all the products and/or services your business plans to sell in separate units.
2. Determine how many of each unit will sell (monthly and yearly). This requires methodology (a logical tactic) by using historical information, a marketing plan, traffic flow, and/or an estimation of your market share (by assessing total demand to current supply).
3. Multiply the number of units that your business is forecasted to sell (calculated in #1 above) with the price of each unit.

Cost of Goods Sold

These are the direct costs associated with the products that your business sells. For retail, this includes cost of the product; for manufacturing, it includes the raw materials purchased, the direct labour required to assemble the product, and the direct overhead expenses. For service related businesses it includes the materials required to properly deliver the service (fuel for truck drivers, hair solutions for hairdressers, etc.).

Operating Expenses

Operating expenses can be divided into two categories (fixed and variable). However, over the longrun most costs can be controlled and therefore variable.

Fixed Expenses are expenses that have to be paid regardless of sales levels and include:

- Rent
- Utilities
- Maintenance agreements (photocopier, internet access, fax, phone rental)
- Insurance
- Interest and bank charges
- Professional fees
- Property taxes

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- Business licenses and memberships
- Office supplies (vary depending on nature of the business)
- Advertising and promotion (fixed if contracts are signed)

Variable Expenses are those that increase as sales increase or those costs that management has control over and include:

- Wages (for long-term sales trends)
- Office supplies
- Repairs and Maintenance
- Fuel and vehicle expenses
- Shop supplies
- Telephone

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 are things of value that the business owns:

Current Assets include cash, inventory, accounts receivable, and pre-paid expenses.

Fixed assets include items with a useful life over one year, such as property, equipment, and vehicles.

Liabilities are debts incurred by the company:

Current liabilities include the financial obligations for the upcoming year, such as GST, PST, payroll and business income tax, accounts payable, the principal (one-year) portion of mortgages and/or bank loans.

Long-term liabilities include the principal portion of mortgages and bank loans beyond the next fiscal year, loans from shareholders, and equipment leases.

According to Canadian tax law, Canadian corporations must complete and file a balance sheet at least once a year.

Net Worth or Retained Earnings is the balancing mechanism between assets and liabilities and is the equity or worth of the business:

$$\text{Assets} - \text{Liabilities} = \text{Net Worth}$$

Break-even Analysis

Break-even analysis allows you to calculate the amount of sales your business needs to pay its fixed expenses. 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 *Small Business Owner's Handbook Part III: 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.

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.

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. One example is the current ratio, others include return on sales, return on assets, and debt to equity.

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 to finance your business. The two main ways of financing a business are equity financing and debt financing.

Equity Financing

Equity capital is the amount of money that you and/or your partners put into the business. Equity is not debt (loans). While investors share in the profits (or losses) of the business, their investment is not a loan. The following are a few suggestions on how to raise equity:

- Selling personal assets
- Reducing personal spending to make money available
- Savings or selling investments, bonds, RRSPs
- Investors
- Friends or family

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 *Small Business Owner's Handbook Part I: Starting a Small Business*.

Consult a lawyer and your accountant before you enter into any shareholders agreement with other investors.

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:

- Equity financing is not a loan and doesn't have to be quickly repaid (with interest)
- You can increase your business' debt financing ability by increasing its equity
- Reducing debt obligations lowers cash flow risk (lower loan payments are easier to pay)

Advantages of Debt Financing:

- If your business succeeds, you won't have to share the profits with partners or investors
- You will maintain independence and control over how your business is run

Small Business Loans

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. 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. Available to Métis individuals:

- SaskMétis Economic Development Corporation: www.smedco.ca
- Business Development Bank of Canada: www.bdc.ca
- Commercial banks (call your local branch office)
- Credit Unions (call your local branch office)
- Women Entrepreneurs (Regina and Saskatoon): www.womenentrepreneurs.sk.ca
- Community Futures (call your local branch office)
- Northern Enterprise Fund (for northerners): www.nefi.ca
- Northern Development Fund (for northerners): www.fnmr.gov.sk.ca/northern
- Canadian Youth Business Foundation: www.cybf.ca
- Farm Credit Canada: www.fcc-fac.ca

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.

Other Types of Funding and Financing

Government Programs

The following are applicable to Métis individuals:

- Clarence Campeau Development Fund: www.clarencecampeau.com
- Northern Development Fund (Northerners): www.fnmr.gov.sk.ca/northern
- Aboriginal Media Arts Grant Program: www.canadacouncil.ca/aboriginal
- Aboriginal Peoples Music Program: www.canadacouncil.ca/aboriginal
- Canadian Youth Business Foundation: www.cybf.ca

Internal Source Comparing

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.

Other Sources of Financing

Leasing Fixed Assets

Many 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 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:

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- 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.

Vendor Financing

At times, the selling person or party will lend the buyer the money. This method is treated just a small business loan with interest and scheduled payments.

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:

1. In order to make money, the lender needs your business.
2. It is in the lender's interest to see your business succeed and grow.
3. Your lender is in business to extend credit provided your business is profitable and produces sufficient cash flows to repay its debt obligations.
4. 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:

- A monthly basis, they take in enough money to cover expenses, or
- 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.

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 all of the following:

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

Be prepared to provide your personal net worth statement.

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:

- Have a business plan and discuss it regularly with your account manager
- 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 manager
- 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
- Evaluate your financial relationship yearly or if your financial situation changes unexpectedly
- Have regular meetings with your lender and if appropriate, invite their representative to your business premises
- If your lender is transferred, make an appointment with the new manager to establish a personal relationship
- Observe your financial institution's policies, and make loan payments on time

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

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.

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 *Small Business Owner's Handbook Part I: Starting a Small Business*.

Be prepared to explain:

1. How much money you need and how you plan to spend it;
2. How the money will help your business grow and prosper;
3. How much money you can afford to pay back on a regular basis (based on your cash flow projections);
4. What you plan to use as collateral, including personal guarantees you are willing to make;
5. 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:

1. Your level of expertise and experience;

2. Your professionalism and presentation skills;
3. Your level of commitment and enthusiasm.

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

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 and/or experience
- 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:

1. You can rethink your proposal and try again;
2. You can consider other forms of financing;
3. 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 other sources of funding.

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 record keeping
- 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.