UNIT 13: SOURCES OF FINANCE AND FINANCIAL INFORMATION FOR ENTREPRENEURS

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13.0 OVERVIEW

This Unit on financial decision-making gears the prospective entrepreneur to take advantage of the IT tool in the management of his/her finances. Sources of finance and relative costs are explored as well as the synthesis of financial tables.

13.1 LEARNING OBJECTIVES

By the end of this Unit, you should be able to do the following:

1. Discriminate between various sources of funding, their advantages and disadvantages.
2. Read simple financial tables as sources of financial information.
3. Analyse financial ratios as a tool for control.
4. Assess the importance of the IT tool in facilitating financial management.
13.2 INTRODUCTION

Finance has long been considered by SMEs to be a painstaking and time consuming activity. With the advent of accounting software and easy access to the IT tool, this activity is becoming an easy to implement and to run function, with added convenience provided for financial analysis and decision making.

As vital this function might have appeared for former SME owner-managers, the accounts of SMEs are more and more outsourced or relegated to technical personnel, leaving the entrepreneur to concentrate on his core business and take policy decisions (including financial strategies).

When elaborating a financial plan, the entrepreneur has to make a number of safe hypotheses and realistic forecasts. The first step will be to evaluate the cost of financing the project at its start. Secondly, he/she will have to examine available sources of funding and decide on the structure of the financing plan, that is, how much to fund oneself (and partners) and how much to borrow, either from parents, banks and other instruments like leasing facilities. Thirdly, he/she will have to prepare technical reports like opening balance sheets, profit and loss accounts and cash flows projected for 2-3 years with scenario planning if necessary. He/she may need help from a professional, in addition to an Accounting Software.

13.3 PRESENTING A CASE FOR FINANCE

The business plan is an essential element in presenting a case for finance. However, the business plan is a necessary but not a sufficient condition for obtaining finance for a business proposal. “Potential bankers are looking for motivation, enthusiasm, integrity, but most of all the managerial ability and competence to make the plan actually happen”. (Holt, 2001).

Enthusiasm and drive ought, however, be tempered by realism, for example, by taking a market view of the business and its potential. Quite often, when potential investors discuss funding while being centred on the business plan, the final decision whether or not to fund is the result of a ‘gut feeling’ or a personal ‘chemistry’ between owner manager and funding agent.
Trying to get start up funds, a bridging loan or an overdraft can be compared with a salesperson trying to get an order from a customer. Sales persons work out how the customer can be impressed by the goods and services available. As an analogy, the owner manager needs to display available resources and capabilities to impress the bank manager or other funding agent, as well as present his/her own needs.

Obtaining financial resources in the amount required and when they are needed can be more difficult for entrepreneurial ventures than for established organisations.

The critical issue is to ensure sufficient cash flow for current operations and growth as well as repayment of current liabilities.

13.4 EQUITY FINANCING

13.4.1 Own Finance
Own finance refers to capital invested in a business by its owners/investors. Being permanent, it creates no obligation by entrepreneurs to repay investors, but raising equity dilutes ownership. Entrepreneurs must first look for individual resources for start up capital. These include cash and any personal assets convertible into cash or simply converted to business use, for example, personal vehicles. This also includes cash from family/friends – love money.

13.4.2 Venture Capital
The venture capital industry may consist of:

- Wealthy individuals.
- Foreign investors.
- Private investment funds.
- Pension funds, or
- Major corporations, e.g. Xerox.
The ‘market’ for venture capitalists lies in the ‘vacuum’ existing between many small firms (which get funding from, for instance, micro credit schemes) and ‘larger’ SMEs (which can access bank sources easily). Venture capitalists will therefore target the gap between these two extremes.

Venture capitalists are attracted towards high risk ventures and consequently carefully analyse potential investments. They will fund potentially successful entrepreneurs.

Subsequent evaluation by the venture capitalist entails an assessment of the business plan and an interview of the promoter(s). Because they are undertaking risky business, venture capitalists must expect high returns on their investments. The rule of thumb for profit potential is normally at least ten times return in a period between 5 and 10 years.

### 13.4.2.1 Relationship between Venture Capitalists and Entrepreneurs

Entrepreneurs obviously seek venture capitalists for their money, but both parties may be looking for a sustained relationship. This is illustrated by the services offered by venture capitalists to entrepreneurs.

**Assistance and Involvement by Venture Capitalists:**
- Providing advice on management and board decisions.
- Introducing entrepreneurs to suppliers and distributors.
- Facilitating relationships between entrepreneurs and lenders.
- Introducing entrepreneurs to management consultants.
- Development relationships with securities firms and brokers.
- Facilitating expansion financing.
- Monitoring all investors’ interests through involvement.
- Providing technical assistance on products and innovations.
- Acting as guarantors on loans or leases.
- Developing new customers or new markets through networking.
- Finding key resources, locations, or facilities.
- Motivating entrepreneurs through personal assistance.
- Developing leadership through personal ‘mentoring’.
Venture capitalists are therefore involved in businesses but, being essentially investors, they are neither interested nor capable to be involved in the management of the probably large number of companies they finance. Consequently, entrepreneurs are not likely to lose control of their businesses in such a relationship although exceptionally, venture capitalists may seize control when the enterprise is threatened with failure.

13.4.3 Small Business Investment Organisations

These can be government owned or private owned with debts being government guaranteed. SBIO’s can be regular or specialised, for example, giving loans only to agri-business or manufacturing and so on. Unlike traditional venture capital companies, they use private capital and government funds to provide both debt and equity financing to small businesses.

Activity 1

Investigate existence of such organisations in Mauritius.

13.5 DEBT FINANCING

Funds that the business owner borrows and must repay with interest. Borrowed capital maintains ownership of the business (unlike equity financing, which dilutes ownership) but is carried as a liability on Balance Sheet. In general, small businesses are required to pay more interest than large businesses because of perceived higher risks, that is, few percent above prime rate.
Entrepreneurs seeking debt capital can have access to a range of credit options varying in complexity, availability and flexibility, both from commercial and government sponsored lenders.

### 13.5.1 Commercial Banks

Banks have a very conservative approach and prefer to finance established firms rather than high risk start-ups. Commercial banks have special financing devices for SMEs at specific rates, which may be different from e.g. personal loans or housing loans.

In general, banks will give loans to SMEs on a medium to long-term basis, usually with a reimbursement period of 3-5 years and interest rates ranging from 9 to 14%. However, the main difficulty faced by entrepreneurs is the guarantee/collateral required by banks in order to manage their risks. It should be kept in mind, however, that financial institutions rarely have recourse to the seizure of guaranteed assets and preferably reschedule loan repayments depending on financial status of businesses.

Normally, for a loan amount exceeding a certain limit, the bank will ask for a fixed charge on property. For the lesser sums, a floating charge on personal assets may be required. Commercial banks provide secured and unsecured loans.
Commercial banks, tending to be cautious in their lending practices observe a few rules in financing small businesses:

- They want to see evidence of the company’s successful track record.
- They will scrutinise such records and make a projection in future.
- They need proof of company stability.
- Cash flow generation will have to ensure repayment of the loan.
- Investment from the owner should be significant (e.g. 50% of the project).
- They will prefer to secure the loan against collateral/or guarantee from a government sponsored fund.

13.5.1.1 Short Term Loans

Normally, for less than one year, short term loans are used to replenish the working capital account, for example, to purchase inventory, finance credit sales or take advantage of cash/bulk discounts. This is repaid after converting inventory or receivables into cash.

13.5.1.2 Commercial Loans

A quick loan, repayable in toto within 3 to 6 months, unsecured. Interest may be deducted from amount borrowed before disbursement.

13.5.1.3 Overdraft Facility

Another financial facility is overdraft facility, which banks give to business clients. However, this is a short-term financial facility which is renegotiated every year depending on performance. This is usually covered by personal guarantee of SME owners and carries a higher interest rate than a normal loan. Often this interest rate is higher than profit margin percentages, which makes it a very short-term loan for covering cash flow problems rather than to finance acquisitions or buy stocks.

For example an overdraft can finance a time lag between paying your supplier of raw materials and influx of money following credit facility given to your client (usually 1-2 months or less).
13.5.1.4 Intermediate to Long-term Loans

Banks are primarily lenders of short-term loans to small businesses, although they will make longer term loans, for example, to establish SME clients.

Such loans are in general secured, repaid in instalments (monthly or quarterly) and remunerated by interest. Banks normally finance up to 70-80% of the project and in the case of equipment may take the latter as security.

However, there exist cases of ‘Character loans’ where, instead of evaluation of entrepreneur trustworthiness with financial statements and so on, banks base their decisions on the borrower’s reputation and reliability in the community (character).

Activity 3

How can a business maintain a positive relationship with its banker?

13.5.2 Development Bank

Specialised in providing loans to the business community, they are usually government owned (DBM was privatised in the nineties) but can also be private banks. They will promote given schemes depending on government priorities for economic development. Promotion may take the form of government sponsored loans, for example, 100% funding, lower interest rates, extended repayment periods and reduced need of collateral.

In Mauritius, the Development Bank of Mauritius Ltd (DBM) and the MPCB have specific schemes for different categories of businesses with, from time to time, concessionary rates for certain types of trade whose development are favoured by government. A Microcredit Scheme
for women entrepreneurs is available at the Ministry for Women’s Affairs (Certain loans are
government-sponsored but managed by the DBM).

### 13.5.3 Small Business Lending Organisations/Schemes

These are governmental organisations lending according to specific well-defined schemes for
business research, product research and development, business start-ups and minority/vulnerable
groups.

**Activity 4**

Give suitable local examples

### 13.6 OTHER SOURCES OF FINANCE

#### 13.6.1 Hire Purchase

Used to purchase assets such as plant, machinery and vehicles. An initial deposit may be required
followed by a series of instalments. Remunerated by premium interest rates (e.g. 4 percent above
bank lending rate when regulated by government). Otherwise, Hire Purchase can be an expensive
form of finance. Agreement periods can range from 1 to 3 years depending on useful asset life.

Hire purchase is quick and easy to arrange, the security for agreement being the asset itself. Suited
to short life, guaranteed return assets. The customer also enjoys immediate use of the asset.

The asset legally belongs to the business from the outset so that capital allowances can be claimed
by the business.
13.6.2  Leasing

The leasing instrument is used by SMEs to finance equipment (including vehicles) acquisitions.

A lease is an agreement whereby the owner-manager undertakes to make regular monthly payments to the financial institution (leasing company) in return for the use of equipment belonging legally to the latter. Operating leases function in such a way that the leasing company retains ownership and risks associated with the equipment (although insurance is mandatory). “The lessor is therefore both the financier and the legal owner of the equipment” (Petty et al., Basic Financial Management, 1996). At the end of the lease, the owner-manager can elect to buy the equipment for a sum representing 10% of the cost of the equipment.

- Ownership of the asset does not rest with the business until the asset is sold at residual value at end of contract.
- Capital allowances may be claimed by leasing institution but not by the business.
- Lease payments are tax deductible, that is, passed as expenses in Profit and Loss.
- Leasing does not normally affect borrowing capacity unless financial legislation requires.
- Period of repayment matches expected life of asset.
- Immediate use of asset.

13.6.2.1  Difference between Financial Lease, Operating Lease and ‘Sales and Lease Back’

Financial lease: Leasing of asset only as described above.

Operating lease: Along with the asset, there is an attached maintenance and service contract (common for large items of plant and machinery).

Sale and lease back: The business sells an asset (e.g. a property) to the finance source with an agreement for it to lease back the property over a specified period. The company secures an immediate cash inflow, but removes from its ownership a source of security for future borrowing.
Strictly speaking, leasing is not an alternative form of financing. In fact, it eliminates financing because the entrepreneurs do not own the asset, but only gains access to it. Whether leasing is cost effective or not depends on the equipment, its utilisation and lease terms. Leasing can reduce the risk of owning an obsolete asset.

13.6.3 Credit Factoring
A form of finance whereby cash is provided against an invoice. In case of full credit factoring, the operations of the business’s sales ledger is taken over entirely by the factor, which collects the debts as they fall due. The administrative charge can be of 0.5 to 2.5 percent of invoice value. One variation of full CF is called ‘acceptance credit bill finance’, which is a one off arrangement for a particular transaction.

Activity 5

What are the advantages and disadvantages of credit factoring?

Credit factoring institutions ought to justify that they have expertise in assessing credit worthiness of both new and current customers and that the protection they give against bad debts are more than worth the charge they claim for their services.

It is now time to define precisely the ways and means of financing the project: first of all, to assess his/her own financial contribution, that of relatives/friends and that of associates if any. Secondly, to find alternative sources of finance and to evaluate options.

In order to successfully convince relatives, associates and bankers to fund the business activity, the entrepreneur has to show total control over all aspects of the project, its profitability and long term potential. A prior knowledge of the criteria of bankers to assess project feasibility and profitability is
of strategic importance for the entrepreneur. Realistically though, he/she also should be able to measure the risks incurred and to show how he/she will mitigate them and convince that the potential of the project outweighs the risks.

13.7 FINANCIAL INFORMATION

13.7.1 Purpose of financial information for SMEs

Since accurate and well presented financial information is a pre-requisite for successfully convincing stakeholders, bankers and prospective investors and to reassure shareholders in an ongoing concern, SME owners often have recourse to professional accountants to prepare their finance plan.

Keeping financial information is a statutory requirement for organisations, be they public, private or charitable institutions, that is, it is required by law. Yearly financial statements have to be submitted, for example, SMEs operating as small private companies have to submit accounts to the Registrar of Companies and to Tax authorities yearly (this is currently being changed to twice yearly in Mauritius).

The financial statements of a firm represent an objective document that allows comparisons with previous periods and indicates trends for forecasting performance. However, they may not be the best indicators of business performance.

Banks and other financial institutions invariably wish to get access to the firm’s financial documents before making a decision to lend money or approve a lease. Small enterprises that do not hold such documents often face difficulties when negotiating loans.

When acquiring (or selling) of an ongoing concern, financial information, present and past, is essential for decision making especially in evaluation of assets and pricing.

A large company’s liability is limited to its assets only (and not those of shareholders). A small firm’s owner usually has personal liability for financial risks, whereby it is vital for them to keep
personal control over the finance function even when the book-keeping aspect is delegated or outsourced.

13.7.2 Types of Financial Statements

13.7.2.1 Cash Flow Statement (and Forecast)

The Cash Flow statement depicts the movement of cash into and out of the business over a period. It shows at a moment in time the amount of cash available, for example, for a particular purchase of stocks, or repayment of the loan.

The Cash Flow statement shows how much cash gets in and gets out. It shows negativity when suppliers are paid within one month and clients pay within 2 months (cash flow problem implies use of expensive overdraft facility).

In financial terms, the Cash Flow Statement is more informative than the Profit and Loss Statement because a business can be profitable over a year, but lack enough cash to pay normal monthly debts (thereby putting firm survival at risk).

Small firms often trade with little working capital (banks use this as an indicator of risk!). Adequate working capital, however, bridges the gap of cash flow when revenue lags behind expenses (when debtors and bad debts are at a high level).

Activity 6

How can cash flow be improved in the small firm?
13.7.2.2 Profit and Loss Statement

A Profit and Loss Statement is a one-year summary of trading and operational activities, that is, it shows revenue generated and expenses incurred by activities of the business.

The Profit and Loss Statement is silent on revenue arising from bank loans or owner’s capital, unlike the Cash Flow Statement. However, it accounts for ‘virtual’ non cash expenditures such as depreciation of equipment. Conversely, one off expenses like purchasing heavy equipment does not appear on the Profit and Loss Statement (strictly sales revenue and current expenses appear in Profit and Loss Statement).

Being given these technicalities, it now becomes obvious that an owner-manager may not be capable of personally keeping track of such complex financial matters. Hence, comes into play the usefulness of accounting software, and where possible, employment of an accounting technician.
Example of a Profit and Loss Statement for an SME:

**MNO Trading Company Ltd**

Profit and Loss Statement for period 01/07/08 to 30/06/09

<table>
<thead>
<tr>
<th></th>
<th>Rs</th>
<th>Rs</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Revenues</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Sales</td>
<td>1,500,000</td>
<td></td>
</tr>
<tr>
<td>Less: Cost of goods sold</td>
<td>1,000,000</td>
<td></td>
</tr>
<tr>
<td>Gross Profit</td>
<td>500,000</td>
<td></td>
</tr>
<tr>
<td><strong>Expenses</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Professional fees</td>
<td>5,000</td>
<td></td>
</tr>
<tr>
<td>Advertising</td>
<td>5,000</td>
<td></td>
</tr>
<tr>
<td>Depreciation</td>
<td>4,000</td>
<td></td>
</tr>
<tr>
<td>Insurance</td>
<td>500</td>
<td></td>
</tr>
<tr>
<td>Building rental</td>
<td>60,000</td>
<td></td>
</tr>
<tr>
<td>Stationery</td>
<td>3,000</td>
<td></td>
</tr>
<tr>
<td>Salaries &amp; Wages</td>
<td>350,000</td>
<td></td>
</tr>
<tr>
<td>Electricity, Water, Telephone</td>
<td>15,000</td>
<td></td>
</tr>
<tr>
<td>Total expenses</td>
<td>442,500</td>
<td></td>
</tr>
<tr>
<td>Net Profit</td>
<td>57,500</td>
<td></td>
</tr>
<tr>
<td>Less Tax @ 15%</td>
<td>8,625</td>
<td></td>
</tr>
<tr>
<td>Net Profit after tax</td>
<td>48,875</td>
<td></td>
</tr>
</tbody>
</table>

(Not a very profitable business!)
Activity 7

What differences does it make on a Profit and Loss Statement if equipment is financed by a lease rather than by a loan?

13.7.2.3 Balance Sheet

The Balance Sheet is a yearly document showing the asset value of the business, the debt situation and the resultant net worth.

Assets can be current (easy conversion to cash) or fixed (difficult conversion to cash). Liabilities are the financial obligations of the firm towards financial institutions and others. The difference between assets and liabilities is the net value for the owner, that is, what would theoretically remain if all assets were disposed of and all liabilities effectively paid.

Activity 8

Is it easy to predict the Balance Sheet of a business start up? Why?
13.7.2.4 Financial Forecasts

Using trend analysis and ratios, abovementioned financial statements can be predicted for further periods of time (years). Banks often require SMEs to submit forecasts for a number of years to facilitate loan approval decisions.

13.8 FINANCIAL CONTROL

13.8.1 Financial Ratios

Ratios are indicators of performance and assist financial control.

Examples:

Profitability ratios:

\[
\text{Gross Profit Margin} = \frac{\text{Gross Profit}}{\text{Turnover}}
\]

\[
\text{Return on Assets} = \frac{\text{Net Profit before tax}}{\text{Total Assets}}
\]

When compared with the industry performance, a low gross profit margin shows that costs have to be controlled. In general, the Services Sector carries a higher profit margin than the manufacturing and retail trading sector.

13.8.2 Liquidity Ratios

They assess a firm’s cash flow management.

\[
\text{Current Ratio} = \frac{\text{Current Assets}}{\text{Current Liabilities}}
\]

The current ratio assesses a firm’s capability to repay its short-term debts. Ideally this ratio should hold a value of 2 for a healthy firm. A newly established SME or a steep growth curve firm may have a lower ratio.
13.8.3 Efficiency Ratios

The debt/equity ratio measures the risk status of the firm.

Debt/equity Ratio: External Debts

Owner’s Equity

A ratio of >1 is a cause for concern. Bankers keep an eye on this particular ratio in order to limit loan approval to the firm.

13.8.4 Keeping Track of Financial Transactions

Measures to be taken by the SMEs owner-manager to keep sound records of transactions:

1. Open a separate bank account in the name of the business.
2. Keep separate accounts books for business and self.
3. Pay all business expenses from business account, if possible by cheque for traceability.
4. Keep receipts for expenses.
5. Keep files for different transactions.
6. Ask a professional accounting technician to check book keeping system (according to statutes).

13.9 IT AND THE FINANCE FUNCTION

The finance function has been shown to be very technical and has to take charge of a huge amount of data. It therefore warrants the use of IS/IT right at the beginning of the SME venture. Accounting Software packages range from free web downloadable software for use in small firms to expensive systems which can take care of accounts of larger firms. SMEs can always take advantage of free ware available on the Net.

Accounting Software like Quick Books also takes care of financial statements. SMEs often outsource although this function to a professional accountant, at least once a year to be remunerated on a yearly professional fee basis. Business/Company Law sometimes require signature of a professional accountant on financial statements especially where audited reports are mandatory.
13.10 SUMMARY

After going through this Unit, you will have grasped the technicalities of the finance function, not with the satisfaction of having mastered them but with the confidence of having understood their implications for him/her and other stakeholders. Mastering of all aspects of finance will be achieved with the help of the IS/IT tool which should sooner than later become a strong partner of the SME owner-manager.

The Financial Plan will later be a decisive document in the Business Plan of the owner-manager when meeting his/her financiers.

13.11 REFERENCES