Financing

LESSON 5

Estimating Start-up Costs

It is important to think and plan carefully before starting the process of opening your business. One of the first things to do is estimate the start-up costs for your planned business. Start-up costs are the costs associated with opening and operating a new business for a period of time, usually one year. Start-up costs vary depending on the size and type of business that is being considered. Some examples of start-up costs are the cost of renting a building for a store, purchasing inventory for a store, signage, employee wages, electricity, telephone and Internet installation, and insurance. Some of the start-up costs will be one-time expenses, such as having permanent signs made and obtaining a license. There will also be ongoing costs such as electricity and employee wages. Remember to include your living expenses in your start-up costs. You will still have to pay for rent, food, your car, and other expenses.

Once a list of all the first-year expenses is projected, a monthly estimate of those expenses should be calculated. The total of the estimated monthly expenses will give you the total start-up costs for the first year. You can find start-up cost worksheets on the U.S. Small Business Administration's website, www.sba.gov. The worksheet will provide a step-by-step guide for estimating your start-up costs.

Where to Get Money

Completing the start-up costs estimations will give you a good idea about the amount of money needed to open and operate your business.

Main Idea

Many people want to own their own business. Before opening a business, there are several steps a potential business owner must take to get started. After coming up with an idea for a new business, one must consider financing for it. In this unit, we will look at financing a business. How do you estimate the amount of money you will need to start a new business? Where can you get the money to start the business? At the end of the unit, we will review some of the mathematical calculations.

After completing this lesson you will be able to:

- Compute business start-up costs and ongoing costs
- Compare the different funding options for starting a business
- Complete a personal financial report, including net worth based on assets and liabilities
- Determine loan payments based on principal, interest, and other terms
- Determine the pros and cons of using trade credit

Key Terms

- Start-up Costs
- Sweat Equity
- Personal Financial Report
- Asset
- Liability
- Net Worth
- Income Statement
- Balance Sheet
- Cash Flow Statement
- Principal
- Interest
- Interest Rate

There are several methods for financing a new business. Often a combination of financing methods is used. Some financing methods include:

- Your own money,
- Loans from family or friends,
- A loan from a bank or other lending agency, and
- Money from a venture capitalist company.

Your Own Money

Prospective business owners need to invest some of their own money in their business. Money can come from a savings account, the sale of stock, or other sources. The use of your own money can be looked upon as an investment in your idea and abilities. Another investment that business owners make is in the form of sweat equity. Sweat equity is the unpaid work—both mental and physical—that a business owner puts into a business, increasing its value.

Loans from Family or Friends

Loans from family and friends represent the largest source of funding for a new business. Often, family or friends will offer to help finance your business. Sometimes you might ask them to invest. Regardless, this source of financing is one that will have to be repaid to the person lending you the money. A positive note about this type of loan is that if your business has unforeseen financial problems, family or friends may be more flexible about payment amounts or the schedule for repayment. Before accepting a loan from family or friends, you should think about what would happen if you were unable to repay the loan. This situation can cause hard feelings, resentment, or even the loss of a friendship.

Loan from a Bank or Other Lending Agency

A bank is a logical place to inquire about a loan. Banks have money to lend to qualified applicants. The loan officer at the bank will examine your business plan and other financial documents discussed later in this unit. After careful study of your documents, the bank will determine whether to make the loan. State and federal governments regulate banks; therefore, the bank will want assurance that you have the ability to repay any loans they make.

Money from a Venture Capitalist Company

Venture capitalist companies specialize in investing in new businesses. They typically invest in businesses they feel have large growth potential and invest cash into the business in exchange for equity in the company. Accepting investment money from a venture capitalist company means that you will probably relinquish some of the control of your business. Venture capital represents one of the smallest sources of new business funding.

Borrowing Money

Most new business owners will have to borrow at least some of the money they need to get their business up and running. In addition to preparing an estimate of start-up costs, you will want to prepare a personal financial report. A personal financial report is a statement of your personal financial status. Your personal financial report lists and compares your total assets and liabilities. An asset is any tangible item of value you own, such as a savings account or land. A liability is any debt you have, such as a car loan or money owed on credit cards. Once all of your assets and liabilities are listed, net worth can be determined. Net worth is the difference between total assets and total liabilities. Potential lenders will want to examine these financial documents. Lenders want to know that you have the ability to repay the loans they make to you.

Forecasting Revenue and Expenses

Calculating start-up costs and completing a personal financial report supports the preparation of an income statement, balance sheet, and cash flow statement for the business. Preparing these documents will be worthwhile once the business is in operation, since they can serve as a guide for the timing of making inventory purchases or other business expenses. These documents will also help you to realistically determine the amount of money you will need to borrow. Remember that the projections you make must be realistic in order to be helpful. A more detailed explanation of the following financial documents will be studied in the Financial Statements unit.

Income Statement

An income statement is a report that outlines projected business revenue and projected business expenses for a period of time. That period of time can vary and might be a month, three months, or a year.

Balance Sheet

The balance sheet is a report that summarizes the business's assets and liabilities, and the owner's equity. The purpose of a balance sheet is to show a clear picture of the business's assets and liabilities at a particular point in time.

Cash Flow Statement

The cash flow statement is a report that provides information about when cash comes into the business and when that cash will be spent. The purpose of the cash flow statement is to let the business owner know if there will be enough cash to cover the business's projected expenses.

How Much to Borrow

Once all of these reports have been completed and carefully studied, the business owner can make an accurate projection about the amount of money to borrow from a lender. The bank or other lending source will study these reports as well as your business plan. (Business plans will be discussed in the Business Plan Analysis unit.) The result of the analysis of this information by the lender will determine how much money they will allow you to borrow. The amount of the loan is known as the principal. Interest is the amount of money you pay to the lender for use of the money you borrow. The interest on a loan is usually expressed in terms of an annual percentage rate, or the interest rate. Both principal and interest will be repaid to the lender according to a schedule that is determined at the time the loan is made. This schedule is called a loan agreement. The loan agreement is a contract between you and the lending agency that specifies the amount of the loan, the interest rate, the amount of the monthly payment, when the payments are due, and the length of time of the loan.

Summary

In this unit we have examined some of the steps a prospective business owner should take to start a new business. We reviewed some methods of financing a new business. We continued with an overview of some of the financial reports that are important for securing financing for a new store. A brief discussion of the components of a loan, the principal and interest, followed the overview, and we concluded with some of the basic mathematics used in financing.

Key Math Concepts

COMPUTE YOUR MONTHLY START-UP COST
To compute your monthly start-up cost, add together the amount of each monthly expense.

COMPUTE YOUR YEARLY START-UP COST
To compute your yearly start-up cost, multiply the monthly start-up cost by 12.

COMPUTE NET WORTH
To compute net worth for your personal financial report, use this formula:
Net Worth = Assets – Liabilities

COMPUTE SIMPLE INTEREST
To compute simple interest on a loan, use this formula:
Simple Interest = Principal x Annual Interest Rate x Length of Time of Loan

Key Terms

Start-up Costs
The costs associated with opening and operating a new business for a period of time, usually one year.

Sweat Equity
Unpaid work, mental and physical, that a business owner puts into a business, increasing its value.

Personal Financial Report
Aa statement of an individual's personal financial status.

Asset
Any tangible item of value an individual owns.

Liability
Any debt an individual owes.

Net Worth
The difference between an individual's total assets and total liabilities.

Income Statement
A report that outlines projected business revenue and business expenses for a period of time.

Balance Sheet
A report that summarizes a business's assets and liabilities, and the owner's equity.

Cash Flow Statement
A report that provides information about when cash comes into a business and when that cash will be spent.

Principal
The amount of a loan.

Interest
The amount of money an individual pays to the lender for use of the money borrowed.

Interest Rate
The interest on a loan expressed as an annual percentage.

Financing

1. A partial listing of monthly start-up costs for a store includes $2,800 for rent, $650 for electricity, $285 for telephone and Internet service, $9,550 for employee salaries, $800 for cleaning service, and $300 for supplies. What is the total of these monthly start-up costs?

2. What is the yearly start-up cost for each item listed in problem #1? What is the total yearly start-up cost for all the items in problem #1?

3. Molly has $500 in her savings account. She owes her parents $100 for a new outfit. She also owes her brother $25. What is her current net worth?

4. A business owner has two loans from the local bank. One of the loans is a three-year loan with a principal of $75,000 and an annual interest rate of 5%. The other is a one-year loan with a principal of $21,000 and an annual interest rate of 4.5%. What is the simple interest for each loan? What is the total amount of simple interest for both loans?

WRITTEN EXERCISES **LESSON 5**

Financing

1. You are planning to open your own store in the near future. As part of your preparation, make a list of your personal expenses for a typical month. Assume that you will be paying typical rent for your area and that you will have a car payment. List and total your other personal expenses. Prepare a brief rationale for each expense that identifies each as a necessary or discretionary expense.

2. Based on what you have learned in this unit, make a list of the critical factors you should consider and analyze before investing in a new business, and state your reasons for listing each factor.

3. List and discuss the major differences between banks and venture capitalist companies.

4. You are planning to open a new store in the near future. You estimate that you will have $150,000 in start-up costs. You have $25,000 of your own money to invest. What steps will you follow to secure the remaining financing necessary? List the steps and be prepared to discuss them and your rationale.

COMPUTER EXERCISE

Financing

GOAL: Your goal is to get your business up and running profitably without running out of cash.

YOUR SITUATION: In this lesson, you control Bank Debt and Trade Credit. All other actions are controlled for you.

1) Run the **Trade Credit** and **Bank Debt** sections of the **Tutorial**.
2) Open the **Financing** lesson.
3) Run the simulation at high speed for several simulated weeks and watch for any messages.

QUESTION 1: What happened to your store? What was the date that it went out of business?

4) Reopen the **Financing** lesson. You will now make it through the start-up phase of your business by getting a bank loan. Click **Actions->Bank Debt->Get Loan**. Get the loan for $25,000. Run the simulation at high speed.

QUESTION 2: What happened to your store? What was the date that it went out of business? Did the business survive longer than without any financing?

5) Reopen the **Financing** lesson. You will now try to make it through the start-up phase of your business simply by using **Trade Credit**, or credit which is extended to you by suppliers. Click **Actions->Trade Credit** and change **Pay In (Days)** to 30 days. Run the simulation at high speed.

QUESTION 3: What happened to your store? What was the date that it went out of business? Did the business survive longer than without any financing?

6) Reopen the **Financing** lesson again. Now use a combination of the bank loans and trade credit (paying suppliers in 30 days) to finance your business. Run the simulation at high speed. Open the Vital Signs screen.

Continued

QUESTION 4: Were you able to get your business through the start-up phase to the point where it was making a consistent profit?

7) Your bank loan interest rate was 18%. If you paid your suppliers 23 days earlier, you could get a 2% discount.

QUESTION 5: Show a calculation of the effective annual interest rate on the loan from suppliers. Compare this interest rate to the rate on the bank loan.