

# PACE

## Fourth Edition

Program for Acquiring  
Competence in  
Entrepreneurship



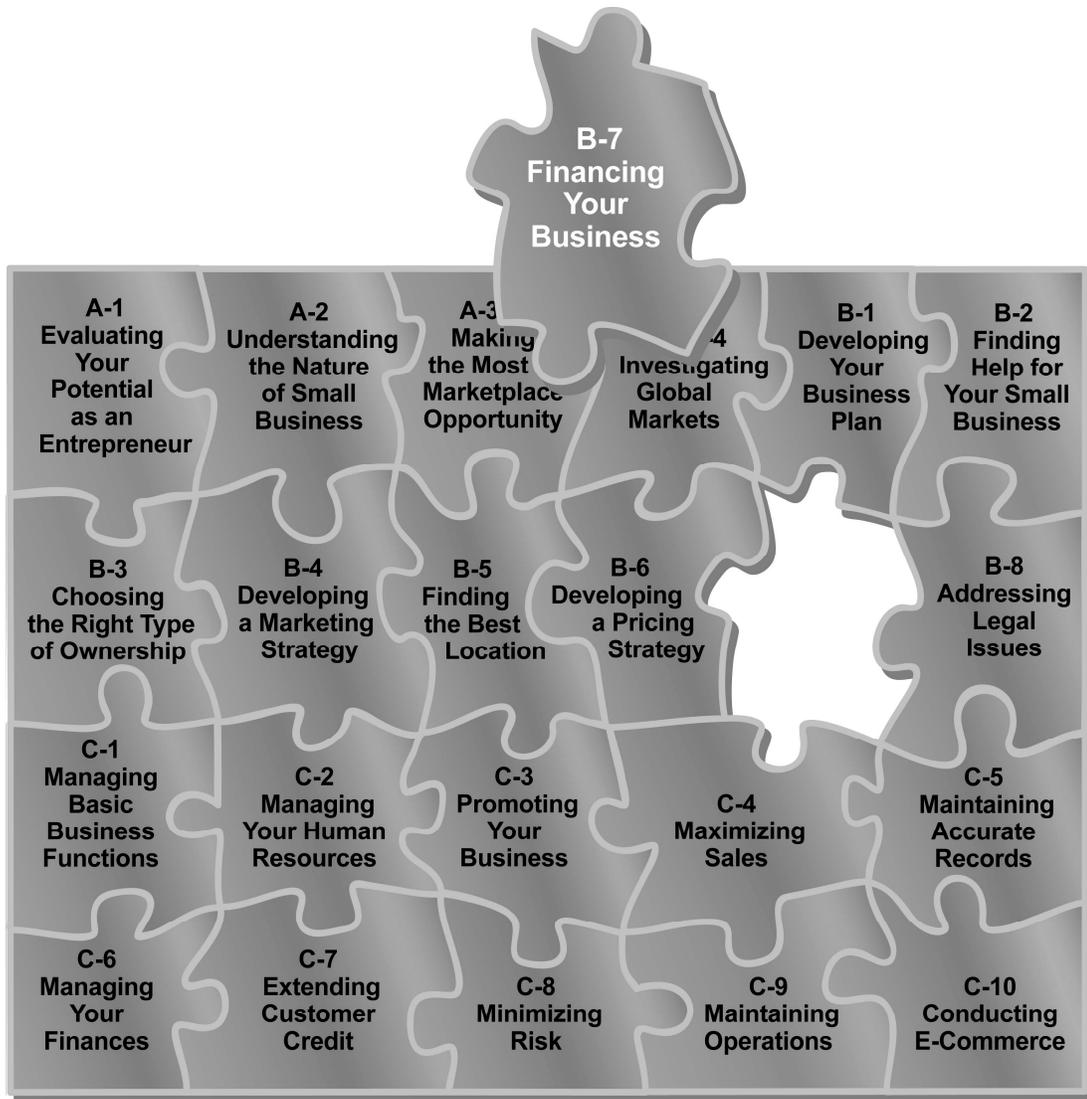
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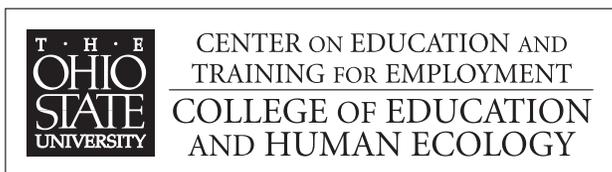
# PACE

## Fourth Edition

## Program for Acquiring Competence in Entrepreneurship



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## Foreword

I am pleased to introduce you to the Fourth Edition of the Program for Acquiring Competence in Entrepreneurship (PACE). PACE represents our continuing effort to respond to the needs of the education and business communities. At no other time in history has understanding entrepreneurship been as important. For one thing, promoting entrepreneurship carries the societal imperative as small businesses as a whole contribute much to the growth and renewal of regional and national economies.

When first published in the late 1980s, PACE properly emphasized that entrepreneurship was based as much on sound planning as having products and services that were responsive to the marketplace. Through its various revisions, PACE continued to focus on the general importance of planning and managing the startup of a small business.

The current PACE edition represents a necessary break from past versions in both its format and some content. For one thing, the text format has been substantially changed from paragraphs to a series of related sections with subheadings. This change allows readers to have greater accessibility to the information, whether it is delivered via a printed booklet or a technology-based approach. And the format allows the instructor/facilitator to have greater flexibility in selecting content to accommodate the needs of various audiences and settings.

In terms of the content, PACE continues to emphasize the importance of planning and managing of a small business. But it now includes a renewed emphasis on meeting customer expectations. Any business cannot exist without a comprehensive understanding of who receives its products or services. In this sense, PACE introduces the topic of conducting e-commerce. Until recently, the entrepreneurial horizon may have been limited to serving local customers only. The advent of the Internet offers the promise of serving many more customers, but not without the accompanying challenges.

This edition was supported in part by a grant from OSU Extension and in partnership with OSU South Centers – Piketon. We hope that PACE will provide you with the understandings necessary to help you to achieve your entrepreneurship goals.

Ronald L. Jacobs  
Director  
Center on Education and Training for Employment



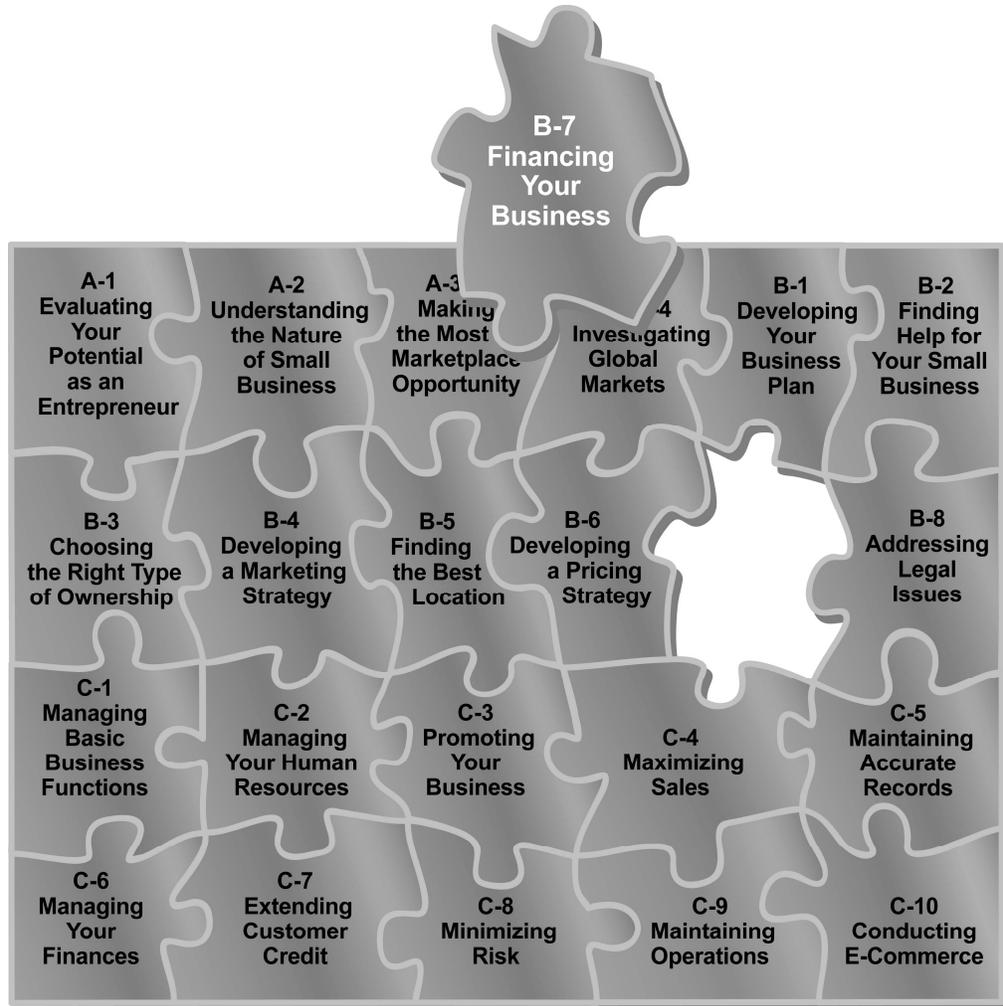
# Overview

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## Introduction

Finding adequate financing to start and sustain your small business is a major challenge that you will face as an entrepreneur. Although the financing barrier may seem insurmountable, you can overcome it with careful planning to identify your money needs and potential sources of funding.

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## Overview, Continued

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**Rationale** Financing is a crucial piece in the small business puzzle. Without sufficient funding, you cannot start your enterprise, achieve profitability, and then sustain it for a significant period of time.

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**Objectives** By the conclusion of this module, you will be able to:

- Describe the cost factors in starting a new business including:
  - the nature of your business
  - size
  - location
  - economic conditions
  - trade assistance
  - the nature of the inventory required
  - credit policies.
- Explain how to estimate cash needs for:
  - start-up costs
  - operating costs
  - personal expenses.
- Describe the sources for equity and debt financing.
- Compare and contrast the different types of loans:
  - short-term
  - intermediate-term
  - long-term.
- Explain the two kinds of lenders, commercial and governmental.
- Describe the contents of a loan application package and the checklist items to address.

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**Relevant NCSEE standards** This module aligns with the following National Contents Standards for Entrepreneurship Education (NCSEE):

- I.14 Determine financing needed to start a business.
- I.15 Determine risks associated with obtaining business credit.
- I.16 Explain sources of financial assistance.
- I.20 Complete loan application process.

More information on the NCSEE is available at: [http://www.entre-ed.org/Standards\\_Toolkit](http://www.entre-ed.org/Standards_Toolkit).

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## Overview, Continued

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### Topics

The topics in this module are:

<b>Topic</b>	<b>See Page</b>
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Loan Application Package	24

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### Exhibits

The exhibits in this module are:

<b>Exhibit</b>	<b>See Page</b>
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Sample Personal Expense Worksheet	11
Sample Loan Application Package Format	25
Sample Financing Checklist	26

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### Before you begin

After reviewing the above objectives for this module, determine whether you can already meet those objectives and consult your instructor if you can.

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# Cost Factors in Start-Up

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**Introduction** Prospective entrepreneurs often underestimate the amount of money it takes to start a business. It may be because they are swept away by their dream of owning a business, or they may not realize how much money it actually takes.

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**Potential trouble spots** Both overestimating and underestimating the amount of financing necessary to start a business are impediments to success.

**Underestimating** – If you underestimate the money required for start-up, you will not be able to meet your financial obligations and the endeavor will fail.

**Overestimating** – If you overestimate the money required, you will carry a heavy load of debt that may prevent your business from realizing a profit.

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**Factors in finding the right amount** The crucial question is, “Exactly how much money do I need to start my business?” The answer depends on the following factors:

- the nature of your business
  - its size
  - the location
  - current economic conditions
  - available trade assistance
  - the nature of the inventory required
  - credit policies
  - timing.
- 

**Nature of your business** The nature of your business impacts the money needed as follows:

Ranking	Explanation
1. Manufacturing	Start-up costs include: <ul style="list-style-type: none"> <li>• expensive machinery and technology</li> <li>• large facilities in which to house equipment</li> <li>• large number of employees.</li> </ul>
2. Retail/wholesale	Requires financing for inventory of the merchandise you will sell.
3. Service	Requires no inventory and less equipment to operate.

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## Cost Factors in Start-Up, Continued

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### Size

The size of your business at start-up plays a major role in determining how much financing you need to acquire. The amount of money required is in direct proportion to how large the business will be.

Key point: Large businesses require more money than small ones. Therefore, it may be wise to start small and finance your growth through self-generated profits in order to avoid accumulating debt.

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### Location

A good location in which to situate your business is vital to success. The following guidelines apply to finding the best spot for a start-up business:

- For retail businesses, it's important to choose a convenient location with ample parking along a heavily traveled street. Such locations are very desirable and might be very expensive.
  - For manufacturing businesses, the location may not be as expensive but it still has to be carefully selected. It's desirable for manufacturers to locate near access to transportation such as highways and railways and other needed infrastructure such as electricity and water.
  - For service businesses, location may depend less on convenience if the service is provided at the consumer's location. Consider how to best serve the customer, and then find the most suitable and least expensive place from which to operate.
  - In every type of business, cost is not the only consideration. Also think about the role that location will play in your success over the long term. The location should be able to support growth of the business. The location should allow you to meet consumer demand while conserving your financial resources.
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## Cost Factors in Start-Up, Continued

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### Economic conditions

Remember that your business is a small part of a very large economic system based on the interaction of consumers and businesses. You are dependent on these other participants to set the stage for your success. Economic conditions play the following role in financing your business:

If the economy is...	Then you...
bad	will face financing problems like high interest rates, lower demand, more time needed to make a profit, and higher start-up costs.
good	may be able to borrow money at a lower interest rate, which could accelerate your return on investment.

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### Favorable terms

Favorable terms may be available from suppliers and equipment manufacturers willing to help you finance some of the start-up costs.

Example A: You're starting a retail shop. Some of your suppliers grant you favorable credit terms, such as payment in 10, 30, or 60 days, instead of requiring cash upon receipt of the inventory. With the delay in payment, you have time to generate funds by selling the merchandise.

Example B: You're opening a one-stop printing business. Some of the printing equipment manufacturers allow you to lease the equipment or pay for it over several months. This allows you to open your shop with less start-up money than if you had to pay for the equipment in full when delivered.

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## Cost Factors in Start-Up, Continued

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### Nature of the inventory

The nature of the inventory you carry affects start-up costs. Both the type and selection of merchandise impact your financial requirements.

**Type** – If your inventory consists of more expensive items, you need more money to stock this type of merchandise.

Example: Furniture costs more to stock as inventory than clothing.

**Selection** – If you sell a wide variety of merchandise, it's more expensive than if you carry a narrow selection. Consider starting with limited inventory and then expanding as your business becomes profitable.

Example: Offering several kinds of clothing – men's, women's and children's – is more expensive than carrying only women's items.

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### Credit policy

Whether to offer credit and the terms of the credit if you decide to offer it impacts the financing you need to get your business off the ground. It requires more money to start a business that provides customer credit because it takes longer for you to receive payment. Thus the flow of cash into the business is slower.

**Bad debts** – You will likely experience some bad debts when you don't receive all payments for credit as promised by the customer. You will have to absorb these losses and factor them into your financial plan. You should develop a policy for managing bad debts.

**Long-term benefit** – In the beginning, if you offer credit, you will have to withstand a cash drain when you are required to pay for inventory from suppliers before you receive payment from customers using credit. However, providing credit to customers will increase sales in the long-term, but you must be able to properly manage cash flow.

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# Estimating Cash Needs

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## Introduction

Consider the categories of expenses that you have to address when estimating the cost of running your business. There are basically three types of costs to take into account when starting a business:

- Start-up costs
  - Operating costs
  - Personal expenses.
- 

## Start-up costs

These are one-time expenses for items necessary to open your doors for business.

Examples: licenses, starting inventory, advertising, attorney fees, utility deposit

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## Operating costs

Once you've started doing business, you incur some expenses on a monthly basis. Since you won't be profitable immediately, it's wise to plan ahead and have operating expenses for at least the first three months on hand when you open.

Examples: rent, utilities, payroll, inventory, debt repayment

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## Personal expenses

Include personal expenses in your financial plan. While starting your business, you still have to pay for your own house, food, clothing, and other expenses of daily living. Make sure your cash flow projections include a salary or wages for yourself, and write yourself a paycheck. Do not mix the business finances with personal finances.

Note: If you depend solely on business profits to pay your personal bills, make sure you have enough funds on hand to cover both business and personal expenses.

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## Estimating Cash Needs, Continued

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### **Determining business costs**

Determining the amount needed to start and operate your business for the first three to nine months without a profit is a monumental task. Take the factors below into account in order to ensure that you're capable of financing the business through start-up.

**Your own experience** – Rely on your own experience to help determine early costs. The knowledge you've gained through previous experiences and the market research you have conducted will support your investigation into future needs and how to meet them.

**Input from others** – Gather as much information as possible from other business owners and trade association members. You can learn from people who've run both successful and unsuccessful ventures.

**Start-up cost worksheet** – Use a checklist or worksheet to list the expenses you're likely to incur to systematically calculate the required funds. This document is a guide for estimating the cash you will need for start-up costs only.

Exhibit: The next page is a sample start-up cost worksheet.

**Personal expense worksheet** – Since personal expenses aren't included on the business worksheet, make sure to estimate personal expenses and include them in your financial plan as well.

Exhibit: The page after next is a sample personal expense worksheet.

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### **Rules of thumb**

From what you learn, develop some rules of thumb to apply. These guidelines will enable you to uncover the ratios of various expenses to sales. Once you can forecast expected sales, it's relatively easy to calculate other expenses using these ratios as a guide.

Note: Since ratios are based on historical data, don't rely on them exclusively. The more you investigate the ways to finance your new business, the more practical knowledge you'll have to apply to your own situation and the more accurate your estimate will be.

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## Estimating Cash Needs, Continued

### Cushion for meeting costs

Financial advisors recommend that you have savings as a cushion to cover at least three months of living expenses. On the average, it takes three to nine months before a new business shows enough profit to support the personal living expenses of the owner.

## Sample Start-Up Cost Worksheet

<b>A. Cash Available Now</b>	
<b>Costs</b>	
1. Purchase fixed assets (land, equip, building, vehicles)	
2. Remodeling costs (fixtures, signs, paint, cleaning)	
3. Installation fees	
4. Deposits (utilities, lease, phone, leased equipment)	
5. Fees and Licenses	
6. Legal Fees	
7. Accounting and other professional fees	
8. Insurance	
9. Pre-opening labor expense	
10. Pre-opening training costs	
11. Beginning inventory of merchandise or materials	
12. Supplies (letterhead, forms, price tags, etc.)	
13. Promotional efforts (grand opening, prizes, giveaways)	
14. Advertising (initial media, direct mailings, coupons)	
15. Other Expenses	
16.	
17.	
18.	
<b>B. Total Start-Up Costs</b>	
<b>C. Beginning Cash Balance Or Additional Cash Required</b>	
<b>To calculate:</b> $A - B = C$ If C is a positive number, the amount is your beginning cash balance. If C is a negative number, the amount is the additional cash required.	

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## Estimating Cash Needs, Continued

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### Sample Personal Expense Worksheet

Expenses	Amount
<b>Housing</b>	
Rent/Mortgage	
Electricity	
Gas	
Water/Sewer	
Telephones	
<b>Food</b>	
Home	
Lunches	
Household Supplies	
<b>Transportation</b>	
Car Payment	
Gasoline	
Parking	
Repairs	
Insurance	
License Plates/Registration	
Public Transportation	
<b>Clothing</b>	
Children	
Self/Spouse	
Cleaning/Laundry	
<b>Medical</b>	
Doctor	
Dentist	
Medications	
Medical & Life Insurance	
<b>Entertainment</b>	
Children	
Dining Out	
Hobbies	
Cable TV	
<b>Education</b>	
Tuition	
Books/Newspapers/Magazines	

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## Estimating Cash Needs, Continued

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### Sample Personal Expense Worksheet, Continued

Expenses	Amount
<b>Credit Payments</b>	
Loans	
Credit Card Charges	
<b>Miscellaneous</b>	
Bank Charges	
Taxes	
Household Repairs	
Alimony/Child Support/Daycare	
Pet Care	
Donations (Church and Non-profit)	
Allowances (Children/personal)	
Vacations	
<b>Total Expenses</b>	
<b>Monthly Household Income</b>	
Salary & Wages	
Interest & Dividends	
Rental Property Income	
Income from Business/Professions	
Child Support/Alimony	
Other	
<b>Total Income</b>	
<b>Net Income</b> (Total income minus total expenses)	

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# Sources for Financing

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## Introduction

After determining how much money you need to start your business, the next issue is where to obtain funding. When you systematically calculate the amount of money needed, you will see how large that amount actually is.

Caution: Don't underestimate the amount of money you'll need to both start up and then sustain your business for three to nine months without making a profit. This revelation may be discouraging; however, being realistic is the only way to achieve your business goals.

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## Types of financing

A combination of financial sources may be the answer to where you can obtain funding. The two major types of financing are equity and debt.

- Equity financing consists of money that you, as the owner, and others invest in the business.
  - Debt financing involves borrowing money to get the business started.
- 

## Equity financing

According to the online Dictionary of Small Business, equity financing in a corporation is “raising money by issuing and selling shares of common or preferred stock or taking on a partner in a partnership, as opposed to incurring debt or borrowing. Obtaining needed additional money to operate or expand a business by surrendering part of the ownership of the business in exchange for the invested capital. Small businesses must exercise care in obtaining money in this manner because control of the business could be lost, or earnings may be reduced (diluted) by payments to the other owners.”

([www.small-business-dictionary.org/default.asp?term=EQUITY+FINANCING](http://www.small-business-dictionary.org/default.asp?term=EQUITY+FINANCING))

**Sole proprietorships** – Frequently, a small business is started by a single individual. This entrepreneur provides equity financing by investing his or her personal savings in the start-up company. The lists below present the advantages and disadvantages of starting a business as a sole proprietor.

### Advantages

- Total ownership of profits
- Amount of debt reduced
- Complete control over decisions
- High degree of motivation
- Sense of personal achievement

### Disadvantages

- Total liability for the risk
  - Potential to lose personal savings or collateral (e.g., your home)
  - Initial lower standard of living
  - Sacrifice of personal comfort
  - Loss of future returns on savings
- 

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## Sources for Financing, Continued

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### Equity financing (continued)

Note: If you choose to borrow money from family or friends, it may be more informal and based on good faith. But you risk damaging personal relationships if you cannot pay them back as expected. It is very important to properly communicate the potential risks and returns. What happens if the business fails and you cannot pay back the loan? What does the investor get in return? Percentage of profits, partial ownership?

**Partnerships** – If two or more people go into business together, they form a partnership, general or limited, and each shares in the ownership of the business. Partners don't have to contribute equity capital, but again communication is critical. The two types of partners are characterized as follows:

- General partners are involved in the day-to-day operations. They assume liability for the debts that the business accumulates.
- Limited partners are not directly involved in daily activities. Their liability is limited to just their investment in the business, not its debts.

Note: Not all states require a written partnership agreement, but it is strongly recommended.

The lists below present the advantages and disadvantages of starting a business with a partner.

#### Advantages

- Possible source of shared financing
- Some degree of shared liability
- Increased skill set for operations

#### Disadvantages

- Less control over decisions
- Problems when one partner wants or needs to leave the business

**Corporations** – When you need a large amount of financing, you could incorporate and sell shares of ownership in the business to many people. The lists below present the advantages and disadvantages of incorporating.

#### Advantages

- More funding available
- Limited legal liability
- Tax advantages

#### Disadvantages

- Less control over decisions
- Decreased authority
- Complex and costly to form

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## Sources for Financing, Continued

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### Equity financing (continued)

**Venture capital** – You can seek financing from a private company that buys partial ownership in new businesses and assumes the risk in return for the promise of large returns on the investment. Venture capitalists are characterized as follows:

- They are very selective about where they invest; they generally invest in businesses with high growth potential.
- Although they might not have limits on the amount they invest, they may have minimums because they want to meet certain investment return goals, usually 20 percent. Small investments may not return enough to make it worthwhile.
- Venture capitalists exchange their money for common or preferred stock.
- As partial owners, they may contribute to major decisions, but normally they don't participate in daily operations.

#### Advantages

- Large amount of funding offered
- Shared risk
- Expertise from venture capitalists

#### Disadvantage

- Difficult to qualify for funding by venture capitalists if your business doesn't promise high enough returns

**Small business investment companies** – Since venture capitalists often don't meet the financing needs of small business owners, the federal government intervened by starting a program in 1958 that authorized small business investment companies (SBICs). SBICs are characterized as follows:

- The Small Business Administration (SBA) grants loans to SBICs. SBICs act as private venture capital operations and, in turn, invest this money in small businesses that might not qualify for regular venture capital.
- These organizations are licensed and regulated by the SBA.
- SBICs must have at least \$500,000 of private capital. Then for every dollar of their own money, they may borrow \$3 to \$4 from the SBA.
- They may also make loans to small businesses.
- SBICs exchange their money for some type of ownership in the small business, frequently in the form of common or preferred stock.

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## Sources for Financing, Continued

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### Equity financing (continued)

The lists below present the advantages and disadvantages of SBICs.

#### Advantages

- Designed to meet the need of small businesses overlooked by venture capitalists
- Same as for venture capitalists

#### Disadvantages

- Favor given to expanding businesses rather than start-ups

**Minority enterprise small business investment companies (MESBICs)** – MESBICs, spun off from SBIC in 1969, specialize in investing in small businesses with at least 51 percent ownership by ethnic minority entrepreneurs. Otherwise, MESBICs have the same characteristics as SBICs.

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### Debt financing

Debt financing is borrowing the money you need to start your business. Like equity financing, there are several available sources, each with advantages and disadvantages, which are shown in the lists below.

#### Advantages

- It's easier and quicker than equity financing.
- Repayment may be delayed.
- The cost of borrowing to buy inventory or equipment may save money in the long-run (such as replacing old, outdated stock with new stock in demand, causing profits to grow).
- Interest and other costs are tax deductible as business expenses.
- Loans can be paid back with "cheaper" dollars during inflation.

#### Disadvantages

- You may pay higher interest rates; it's difficult to qualify for prime rate when starting up.
- It's easy to adopt as a habitual remedy for cash management problems.
- You risk borrowing more money than you can realistically repay.
- It may require sharing private and confidential information.
- You may have to sign a personal guarantee pledging personal assets to back up the loan.
- The arrangement may be subject to covenants (limitations and restrictions) by the lender as follows:

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## Sources for Financing, Continued

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### Debt financing (continued)

Type	Description
Negative covenant	Defines what the borrower cannot do without prior approval of the lender (such as borrow more money).
Positive covenant	States what the borrower must do (such as maintain insurance coverage and provide periodic financial statements to lender).

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### Other sources

Other sources for financing each have specific advantages and disadvantages.

**Franchising** – When you become a franchisee, you may receive considerable financial assistance. In exchange, you must pay back the money borrowed with interest and operate the business within the franchiser’s set restrictions.

**Trade credit** – Suppliers often allow their customers to purchase inventory or equipment on trade credit, which allows you to generate sales without paying for the purchase right away. However, trade credit usually requires paying interest or foregoing the cash discount on purchases.

**Selling accounts receivable** – Once you’ve opened your doors, you can raise cash by selling your accounts receivable to another company, a *factor*. The factor pays less than the face value of your accounts but you get cash now instead of waiting.

**Cost reduction** – Every dollar you save by reducing start-up and operating costs decreases the amount of financing required. Some methods of cost reduction are:

- buying used equipment and furnishings
- bargaining for the most favorable lease and supplier terms
- maintaining rigorous control of direct expenses (travel, postage, supplies)
- pursuing accounts receivable with much vigor
- managing accounts payable effectively to maintain a solid credit rating and take advantage of available discounts.

Key point: Cost reduction also gives you cost-effective financial controls.

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# Loans

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## Introduction

When researching the different types of loans available, evaluate financing in terms of what best meets your specific need. Consider these factors when assessing financing options:

- your intended purpose
  - the characteristics of each type of loan
  - your ability to repay it according to stated terms.
- 

## Loans

There are three basic types of loans:

- short-term
- intermediate-term
- long-term.

The table below describes the different types of loans.

Type	Repayment Period	Purpose	Cost
Short-term	Within 1 year	To satisfy an immediate, temporary, or seasonal need.	<ul style="list-style-type: none"><li>• Because the length of the loan is short, the amount of interest paid is small.</li><li>• Since the risk to the lender is slight, this loan is usually less expensive.</li></ul>
Intermediate-term	1 to 5 years	<ul style="list-style-type: none"><li>• To buy items like equipment during the normal course of operations.</li><li>• To expand the business.</li><li>• To replace long-term indebtedness.</li></ul>	More costly than short-term loans.
Long-term	5 years or more	<ul style="list-style-type: none"><li>• To start your business (such as to purchase real estate or build a facility).</li><li>• To buy expensive assets.</li></ul>	More costly than other types of loan but different lenders offer a variety of terms, so shop around.

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# Lenders

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## Introduction

Lenders are either commercial or governmental. There are more sources of commercial money than governmental, but government sources usually require the participation of a commercial lender. The lists below present the various types of commercial and governmental lenders.

### Commercial

- Banks
- Credit unions
- Commercial finance companies
- Consumer finance companies
- Life insurance companies
- Savings and loan associations

### Governmental (Federal, State, Local)

- Small Business Administration
- Economic Development Administration
- Farmers Home Administration
- Local Economic Development Agencies (both State and County agencies)

**Other financial assistance** – Other types of financing to consider include free professional business counseling services, Small Business Development Centers (SBDCs), and business incubator services offering discounted space, shared resources and equipment, and clerical services.

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## Banks

Conservative by nature, banks make a large number of assorted loans to entrepreneurs whom they've carefully screened.

**Criteria** – Bankers are very interested in your personal credit history and ability to repay the loan. They also examine:

- experience in the proposed industry
- your management skills
- the financial position of your business
- expected business profits
- the likelihood for growth and success.

**Interest rates** – The interest rates charged by banks for small business loans are based on several factors including:

- Since banks use the money of depositors and the funds they borrow in the marketplace, the cost of the money they use affects the rate they charge.
  - Short-term loans tend to fluctuate according to supply and demand in the marketplace.
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## Lenders, Continued

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### Banks (continued)

**Interest rates** – The interest rates charged by banks for small business loans are based on several factors including:

- A fairly accurate gauge for short-term borrowing is the prime rate, or the level of interest charged to the most reliable and trustworthy large businesses. Although most small businesses don't qualify for this rate, its increase or decrease parallels the interest rates charged for the more expensive small business loans.
- The length of time allowed for repayment to the lender increases the possibility of nonpayment and affects interest rates. The risk is greater when the repayment period is long.
- The stability and strength of the small business is another variable. Established businesses with proven credit-worthiness are better risks than new and untested start-ups, and interest rates reflect that factor.
- Be aware that rate fluctuations may affect your plans. The rate you use in your initial plan may not be available when you actually use the money.

**Secured vs. unsecured** – Small business loans may be either secured or unsecured.

- With a secured loan, the borrower pledges an asset as collateral to be forfeited if he or she doesn't repay the money.

Examples: Common forms of collateral include personal savings, accounts receivable, life insurance, real estate, and chattel mortgages.

- With an unsecured or signature loan, the lender doesn't require any collateral. The borrower's excellent credit rating induces the lender to grant the loan without collateral. The amount borrowed depends on the borrower's credit worthiness.

Note: These loans are usually relatively small.

**Credit line** – When a small business earns a good credit rating and has a positive working relationship with the bank, it may receive a line of credit. This arrangement is an ongoing loan to be used, repaid, used, and repaid on a continual basis. The entrepreneur doesn't reapply each time he or she needs more money as long as the credit limit hasn't been reached.

Note: Credit lines are often used for inventory financing.

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## Lenders, Continued

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### Credit unions

Although credit unions operate for the personal savings and loan needs of individual members, they do make loans for starting a business.

**Types of loans** – Personal loans may be either secured or unsecured, but they are usually short or intermediate term.

**Qualifications** – To obtain a loan, you have to belong to the credit union.

**Limited financing** – Consider credit unions as a limited source of business financing. They can be advantageous for a small loan with a reasonable interest rate that you can use with other financing arrangements to get started.

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### Commercial finance companies

Because of their conservative nature, banks turn down a high percentage of loan requests from small businesses trying to start up. Commercial finance companies are usually willing to accept some of the risks that conventional banks reject, since they charge higher interest rates and are willing to take a chance to earn a larger profit.

**Collateral** – As a business specializing in making commercial loans, these companies are keenly interested in the borrower's collateral. The three forms of collateral most often accepted are:

- real estate
- equipment
- inventory.

**Types of loans** – The most common types of loans provided by commercial finance companies are short-term accounts receivables financing and intermediate 2- to 5-year loans with equipment as collateral. However, they also write long-term mortgages for commercial and industrial real estate.

**Competing with banks** – To compete with banks, commercial finance companies may make partially unsecured long-term loans of up to 10 years. This type of loan arrangement would probably not be available to the entrepreneur looking for money to start a business.

**Convenience** – Commercial finance companies don't usually require as much financial information about the business and they usually don't take as much time as bank loans to process.

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## Lenders, Continued

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### Consumer finance companies

If you have personal property (such as a car, camper, or boat) or real estate to pledge as collateral, you might be able to borrow money for start-up from a consumer finance company.

**Types of loans** – Consumer finance companies may lend you from \$30,000 to \$50,000 for up to 15 years if your security warrants it.

**Interest rates** – Since these organizations are willing to take risks that banks and commercial finance companies will not, they charge higher interest rates.

**Your own risk** – When considering a loan from a consumer finance company, remember that you are risking the loss of your collateral if you default on the loan. If you mortgage your home as collateral and the business fails, you might be forced to sell your home or lose it through foreclosure in order to pay back the loan.

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### Life insurance companies

You may use life insurance policies that build cash value for borrowing money. This component is often a standard part of the life insurance contract. This money is available for either personal or business use.

**Slight risk** – Because the policy's cash value is based on cash that the policyholder has already paid in, the insurance company assumes a very slight risk when making this type of loan.

**Cost and convenience** – Loans against your life insurance policy are relatively easy to obtain and interest rates are substantially below the prime rate.

**Mortgage loans** – Life insurance companies also make mortgage loans for commercial or industrial real estate. However, these mortgages are for very substantial projects that only large businesses would undertake. Most small businesses would not qualify for such a loan.

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## Lenders, Continued

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### **Savings and loan associations**

Besides making loans so people can buy homes, savings and loans associations also make commercial and industrial property loans. These organizations tend to be as conservative as banks.

**Types of loans** – Savings and loans also make personal loans that you can use for business purposes, like home equity loans at very low interest rates for long terms.

**Qualifications** – Savings and loans analyze the entrepreneur's personal and business financial situation. They usually don't make a loan unless they ascertain that your business profits will be adequate to repay the money.

**Your own risk** – When making personal loans, the savings and loan doesn't invest the time to review the repayment ability of the underlying business venture. Your personal credit history and equity in a house may lead you into dangerous territory without a second opinion from a conservative loan officer.

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### **Government sources of loans**

Governmental loan programs change periodically. The annual budgeting process may add to or take away from these financial assistance programs. For current information, contact your SBA district or branch office.

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# Loan Application Package

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## Introduction

To determine whether a small business venture is a good risk, potential lenders require detailed information about your plans in order to assess your potential for success. The presentation of this data is organized in a loan application package.

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## Contents

The SBA suggests including the following information in a loan application package to present when obtaining financing to start a small business:

- Identify the type of business you plan on operating.
- Describe your experience and managerial capabilities.
- Prepare an estimate of how much you or others have to invest in the business and how much you need to borrow.
- Develop a financial statement that details your net worth.
- Prepare a detailed monthly income statement for the first year of business with less detailed projections for the following two years.
- Prepare a detailed monthly cashflow forecast for the first year of business.
- List the collateral you have to offer to secure the loan. Indicate your estimate of the current market value of each item. This is not necessarily the same thing as the personal financial statement listed above.

Example: If you have a home with a mortgage and no equity, you cannot use the home as collateral.

Note: The lender may designate additional items for the loan application and may want to see leases, income tax statements, life and casualty insurance policies, ownership papers, and other contracts.

Exhibit: The next page is a sample format for your loan application package.

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## Financing checklist

To help devise a sound financial plan, follow a financing checklist.

Exhibit: The page after next is a sample checklist for obtaining financing. Address each relevant activity, and mark N/A beside the ones that aren't applicable. Upon completion of the checklist, your financial plan will be ready to present to potential lenders.

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**Sample Loan Application Package Format**

**1. Basic Application Information**

- a. Applicant's name, address, phone numbers, and e-mail address
- b. Business name, address, phone numbers, and e-mail address
- c. Type of business
- d. Size of business
- e. Type of ownership
- f. Applicant's financial contribution to the business

**2. Loan Request**

- a. Purpose of the loan
- b. Amount needed
- c. Terms including desired interest rate
- d. Debt/equity ratio
- e. Collateral offered
- f. Specific use of funds borrowed

**3. Applicant's Personal Information**

- a. Resume including education, work experience, and business background
- b. Credit references
- c. Personal balance sheet
- d. Past two to three years income tax statements

**4. Business Information**

- a. Business plan
- b. Life and casualty insurance coverage
- c. Business licenses or permits
- d. Lease/facilities agreement
- e. Other supporting information

**5. Financial Projections**

- a. Projected monthly income statement for at least one year
- b. Projected monthly cash flow statement for at least one year
- c. Projected balance sheet for the first year

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## Loan Application Package, Continued

### Sample Financing Checklist

<b>Step 1. When investigating your financial needs, did you...</b>			
<b>ACTIVITY</b>	<b>DONE</b>		<b>NOTES</b>
	<b>Yes</b>	<b>No</b>	
a. Obtain specific information on operating ratios?			
b. Identify start-up costs?			
c. Talk with others in your field?			
d. Talk with your banker?			
e. Talk with potential suppliers?			
f. Determine what is unique about financing your specific venture?			

<b>Step 2. When determining the type and amount of financing needed, did you...</b>			
<b>ACTIVITY</b>	<b>DONE</b>		<b>NOTES</b>
	<b>Yes</b>	<b>No</b>	
a. Use the information gathered in the step above?			
b. Apply operating ratios to estimate your financial needs?			
c. Include actual quotes for pricing of inventory and equipment?			
d. Estimate your sales volume for the first year?			
e. Determine the type of start-up costs and monthly operating expenses that you'll incur?			
f. Identify where the money will come from to cover your personal living expenses for the first few months?			

<b>Step 3. When preparing to arrange the financing needed, did you...</b>			
<b>ACTIVITY</b>	<b>DONE</b>		<b>NOTES</b>
	<b>Yes</b>	<b>No</b>	
a. Decide how much you are personally going to invest?			
b. Determine how much additional financing will be needed?			
c. Prepare a projected income statement?			
d. Prepare a cash flow statement?			
e. Prepare a personal balance sheet?			
f. Obtain a second opinion from an objective professional business advisor?			

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## Loan Application Package, Continued

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### Sample Financing Checklist, Continued

<b>Step 4. When determining which financing source to use, did you...</b>			
<b>ACTIVITY</b>	<b>DONE</b>		<b>NOTES</b>
	<b>Yes</b>	<b>No</b>	
a. Consider the advantages and disadvantages of the equity financing alternatives?			
b. Consider the advantages and disadvantages of the debt financing alternatives?			
c. Identify which sources of financing you qualify for?			
d. Determine the type and form of financing that best suits the needs of your business?			
e. Prioritize the financing sources that you'll approach?			
<b>Step 5. When preparing the loan application package, did you...</b>			
<b>ACTIVITY</b>	<b>DONE</b>		<b>NOTES</b>
	<b>Yes</b>	<b>No</b>	
a. Discuss the loan application procedures with potential lenders?			
b. Determine the information required for the loan application package?			
c. Identify the collateral you will offer?			
d. Organize the information needed to complete the loan application package?			
e. Complete the loan application package?			
f. Have the package reviewed by another qualified party?			

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# **PACE**

## **Program for Acquiring Competence in Entrepreneurship**

### **Fourth Edition**

#### **Cluster A – Exploring Entrepreneurship**

Module A-1 Evaluating Your Potential as an Entrepreneur  
Module A-2 Understanding the Nature of Small Business  
Module A-3 Making the Most of Marketplace Opportunity  
Module A-4 Investigating Global Markets

#### **Cluster B – Planning for Business Success**

Module B-1 Developing Your Business Plan  
Module B-2 Finding Help for Your Small Business  
Module B-3 Choosing the Right Type of Ownership  
Module B-4 Developing a Marketing Strategy  
Module B-5 Finding the Best Location  
Module B-6 Developing a Pricing Strategy  
Module B-7 Financing Your Business  
Module B-8 Addressing Legal Issues

#### **Cluster C – Business Management for the Entrepreneur**

Module C-1 Managing Basic Business Functions  
Module C-2 Managing Your Human Resources  
Module C-3 Promoting Your Business  
Module C-4 Maximizing Sales  
Module C-5 Maintaining Accurate Records  
Module C-6 Managing Your Finances  
Module C-7 Extending Customer Credit  
Module C-8 Minimizing Risk  
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