



Oifig
Fiontair
Áitiúil

Local
Enterprise
Office

How to Finance the Business

*...Let's talk
business*

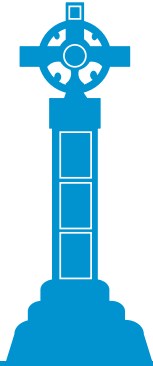


Oifig Fiontair Áitiúil Muineachán

Local Enterprise Office Monaghan

How to Finance the Business

Getting enough of the right funding is one of the more difficult tasks that you will face as a new entrepreneur. Typically, start-ups draw on a number of sources to fund their operations, ranging from owners' and external capital, grant aid and bank debt to credit from suppliers.



Types of Finance

There are basically only two types of finance:

Equity Capital invested in the business, usually not repayable until the business closes down or is sold.

Debt Capital lent to the business, usually repayable at a specified date.

Sometimes, it is possible to obtain grants or subsidies (perhaps from the Local Enterprise Office Monaghan for example), although, increasingly these are repayable, making them more like debt.

Equity

There are **three** types of external equity:

- 1 Seed capital:** Less than €125,000, for start-ups.
- 2 Venture capital:** Between €125,000 and €600,000, for businesses at an early stage of development.
- 3 Development capital:** €600,000+, for companies ready to expand.

Equity

If you are putting equity into your business, you must recognise that this investment will be exposed to the highest risk, because all other creditors rank ahead of you for payment in the event of a financial problem. Nonetheless, it is important for you to raise as much as you can from your own resources, since most financiers work on a "matching funds" basis - they will invest no more than you do.

Debt

Owner's own debt is not a major source of finance for start-ups, since other investors prefer to see the owners' investment in the form of equity [more permanent than loans]. However, it may be appropriate for you to put some part of your investment in the business as a loan [and thus repayable].

The first sources you should try are:

- **Family and friends:** Depending on personal circumstances, this can be a fruitful source. But make sure they understand the risks involved and can afford to lose their investment. Put any agreement in writing.
- **Business contacts:** It's worth checking to see whether someone you know will help you get started with a small investment.
- **Business angels:** Professional investors who may take an active role in managing the business as well as providing finance.

Then it is time to turn to the professionals - the venture capitalists - who provide medium to long-term finance in return for an equity shareholding in unquoted companies. But VCs only invest in 'growth' businesses, capable of showing significant returns on investment over a three to five year period.

While the Revenue Commissioners will not invest directly in a business, effectively they provide a source of equity capital through the Employment Investment Incentive [EII] - which is intended to help small businesses, established as limited companies, to obtain additional capital.

The 'Startup Refunds for Entrepreneurs' [SURE] scheme, which operates on a similar basis, allows founding entrepreneurs to invest in their businesses using refunds of PAYE tax previously paid.



Debt

Debt finance available to start-ups includes:

- **Overdraft:** The simplest form of bank finance. Basically, this is no more than permission to have a minus balance on the business' bank account. However, overdrafts must be cleared (and stay cleared for at least 30 days during the year, though not necessarily consecutive days) on an annual basis and the overdraft is repayable on demand.
- **Term loan:** A loan for a fixed period, usually at a variable rate. Repayments include interest and capital.
- **Long-term loans:** These provide businesses with capital for 7 to 10 years.
- **Mortgages:** Loans to buy business property, secured on the property itself, with fixed or variable rate options.

Fixed debt is a loan that is secured on a specific asset - for example, on premises.

Floating debt is secured on assets that change regularly - for example, debtors.

Secured debt means that, in the event that the loan is not repaid, the lender can appoint a 'receiver' to sell the asset on which the loan is secured in order to recover the amount due. Thus, giving security for a loan is not something to be done lightly.

Sources of debt include:

- **Family and friends:** Depending on circumstances, this can be a fruitful source. But make sure they understand the risks involved and can afford to lose their money. Put any deal in writing, with professional advice on both sides.
- **Business contacts:** It's worth looking to see whether someone you know will help you get started with a small loan.
- **Banks:** The main source of start-up borrowing – all the major banks have special deals for start-ups.
- **Peer to Peer lending networks** eg. Linked Finance.

Leasing allows you to use fixed assets – for example, plant and machinery, cars, office equipment – with the minimum up-front cost. A regular monthly or quarterly payment is made, which is usually allowable for tax purposes. At the end of the lease, depending on the terms, you may have the option to continue using the asset for a modest continuing payment or to buy it outright from the lessor.

Your Initial Investment

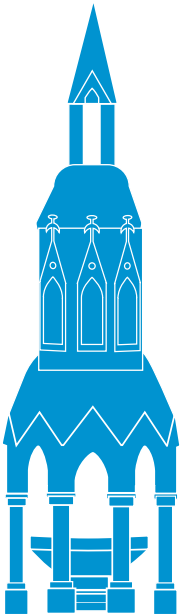
The initial investment includes:

- **Fixed assets:** Property, renovations, fixtures and fittings, transport, machines and equipment, etc.
- **Current assets:** Stocks, debtors, etc.
- **Cash**
- **Start-up expenses:** Expenses paid before the business begins, promotion and opening costs, etc.
- **Margin for unforeseen costs:** There will always be something overlooked or that could not have been expected at the planning stage. Allow for it here.

Initial Investment

Your initial investment must be sufficient to carry the business for a reasonable period before it reaches some kind of balance, when money coming in equals money going out.

In addition to capital investment in plant, equipment and premises, your initial financing may have to supply most of the working capital you need until sales begin to generate sufficient income to give an adequate cash flow.



Budgeting

Budgeting [also called 'projections'] is the process of estimating costs in advance, in order to:

- Ensure adequate finance for the business to achieve what it has planned.
- Provide a control mechanism over subsequent spending.

The Operating Budget forecasts:

- **Turnover**
Total sales
- **Gross profit**
The difference between the turnover and its purchase cost
- **Overheads**
All the expenses incurred in order to keep the business going
- **Net profit**
The gross profit less the overheads

Bear in mind that most businesses have busy times and not so busy times, and so turn-over is not constant throughout the year. Budget for peaks and troughs.

Overheads

These are the expenses that you will incur in running your business, including:

- Staff
- Production overheads
- Premises
- Transport and travel expenses
- Selling and promotion
- General expenses
- Finance costs
- Depreciation

Cash Flow

On paper, you could be the richest person in the world and yet not be able to buy a round of drinks, because you have no cash in your pocket. That is because there is a distinction between cash flow and profits. Cash is the lifeblood of a business and should be monitored rigorously.

More businesses fail because they run out of cash than from almost any other cause. Even profitable businesses can fail because of lack of cash!

Cash flow planning means looking at every item of income and expenditure in a budget and estimating when it will impact the business in cash terms.

Look again at the Operating Budget:

- Which items of expenditure will occur every month?
- Are there any once-off payments such as legal fees, security deposit for rent, new phone lines, insurance, etc.?
- Any advance payments for suppliers, rent, etc?
- Check your marketing plan. Are there seasonal patterns? Will some promotional actions increase sales in particular months? What are the expectations of how sales will develop in the first few months? Does activity in a particular month mean extra expenditure for that month [advertising, direct mail, networking, meeting with mentor, holiday, travel, etc.]? Fill in those extra expenses.
- If clients have paid [or will pay] in advance, put that in the appropriate month.

Your Cash Flow

The income generated by sales must provide sufficient cash flow to enable the business to cover all costs. If money comes in too slowly, the business can choke to death, even as demand booms. Cash flow - collecting money from customers as quickly as possible and getting the longest possible credit period from your suppliers - is often more important in the short term for a small business than profit, although a business must make a profit to stay in business.

Financial Records

You must keep full and accurate records of your business sufficient to enable you to make a proper return of income for tax purposes. This is to allow for inspection of the documentation under the Companies Acts or tax legislation, for example, a VAT or PAYE inspection. It is important for you to be in a position to establish at any time:

- The business' takings.
- All items of expenditure incurred, such as purchases, rent, lighting, heating, telephone, insurance, motor expenses, repairs, wages, etc.
- Any money introduced into the enterprise, and its source.
- Any cash withdrawn from the business or any cheques drawn on the business bank account for the entrepreneur's own or their family's private use [drawings].
- Amounts owed to the business by customers, showing the total amount owed by each debtor.
- Amounts owed by the business to suppliers, showing the total amount owed to each creditor.
- Stocks and raw materials on hand.

Accounting systems provide all this information [see next page], as well as the information for the end-of-year accounts and to help you manage the business.

Financial Statements

The main financial statements included in a set of accounts are:

- Balance sheet
- Profit & loss account
- Cash flow

These statements are important. It is only by collectively analysing the balance sheet, the profit & loss account and the cash flow of a business that an overall impression can be gathered on the financial strength of the business.

Balance Sheet

A balance sheet is a statement of a firm's assets, liabilities and owners' equity at a specific date [it is a **'snapshot'** of the business at a particular moment in time]. When added together, the liabilities and owners' equity represent the sources of capital [where the money came from] and the assets represent the uses of the capital [how the money was spent]; the two sides must always balance.

Profit & Loss Account

The profit and loss account shows the revenue that the business has received over a given period of time, and the corresponding expenses which have been paid.

Balance Sheet for 'Enterprise PLC', as at 31 Dec 20X

| | €(000) | €(000) |
|--------------------------------------|------------|-------------------|
| Fixed Assets | | 250 |
| Current Assets | | |
| Cash | 50 | |
| Debtors | 75 | |
| Stock | 25 | |
| Total Current Assets | <u>150</u> | |
| Less Current Liabilities | | |
| Overdraft | 10 | |
| Creditors | 70 | |
| Total Current Liabilities | <u>80</u> | |
| Net Current Assets | | <u>70</u> |
| [=Working Capital] [150-80] | | |
| Net Assets | | <u>320</u> |
| [=Assets Employed][250+70] | | |
| Represented by | | |
| Long Term Liabilities | 100 | |
| Share Capital | 125 | |
| Reserves | 95 | |
| Capital Employed [100+125+95] | | <u>320</u> |

Profit & Loss Account 1 Jan 20X - 31 Dec 20x

| | €(000) | €(000) |
|---------------------------------------|--------|------------------|
| Sales Revenue | | |
| Cost of sales | | 500 |
| Materials | 150 | |
| Direct labour | 100 | |
| Production overheads | 50 | |
| | | <u>(300)</u> |
| Gross Profit | | 200 |
| Less selling expenses | 50 | |
| Less administrative expenses | 60 | |
| | | <u>(110)</u> |
| Trading [Operating] Profit | | <u>90</u> |
| Add non-operating income | | 5 |
| Profit before interest and tax | | <u>95</u> |
| Less interest expense | | (15) |
| Profit before tax [Net Profit] | | <u>80</u> |
| Less taxation | | (30) |
| Profit after tax | | <u>50</u> |
| Less dividends | | (10) |
| Retained Profit | | <u>40</u> |

Cash Flow

A cash flow statement shows the cash inflows and the cash outflows for a business over the past 12 months.

A cash flow projection (or forecast) predicts the cash inflows and outflows for a business for a future period, usually 12 months.

Cash Flow Projection for 'Enterprise PLC' for 20x

| | Total [€] | Jan | Feb | March | April |
|------------------------------|-------------|-------------|-------------|--------------|--------------|
| Sales revenue | 5700 | 1800 | 1700 | 1500 | 700 |
| Other revenue | 1300 | 400 | 400 | 200 | 300 |
| Total cash inflows | 7000 | 2200 | 2100 | 1700 | 1000 |
| Total Cash outflows | 6800 | 1400 | 1900 | 2400 | 1100 |
| Net monthly cash flow | 200 | 800 | 200 | (700) | (100) |
| Bank balance | 600 | 1200 | 1400 | 700 | 600 |



Oifig Fiontair Áitiúil Local Enterprise Office

Further Information

Local Enterprise Office Monaghan | www.localenterprise.ie/Monaghan

Monaghan County Council | www.monaghancoco.ie

Supporting SMEs | www.supportingsmes.ie

Enterprise Ireland | www.enterprise-ireland.com

Local Enterprise Offices | www.localenterprise.ie

Department of Jobs, Enterprise and Innovation | www.djei.ie

Revenue Commissioners | www.revenue.ie

Companies Registration Office | www.cro.ie

ACCA | www.accaglobal.com/ie

Halo Business Angel Network (HBAN) | www.hban.org

Institute of Chartered Accountants in Ireland | www.icaei.ie

Irish Venture Capital Association | www.ivca.ie

These booklets have been designed as a guide only. Readers are advised to seek professional guidance before making any financial or legal commitment.



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