Building your knowledge

Business finance
a practical guide

GOVERNMENT OF WESTERN AUSTRALIA

Small Business Development Corporation

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A practical guide to **business finance**

An essential part of being a small business owner is knowing how to set up and manage your business finances. Finance is more than just money; it's the foundation of your business. Understanding your finances will help you manage your money, improve cash flow, plan future growth, meet legal obligations, identify your break-even point, maximise profits and better understand the strengths and weaknesses of your business.

Funding your business

When applying for business finance it's essential to be prepared. Most lenders want to check the viability of your business to ensure they will get their money back, and to provide you with the right type of finance and advice. Every financial institution has its own criteria for assessing applications; however most will make an initial assessment based on the three Cs:

- character - your past business performance, skills and credit history
- cash flow - the expected cash in and out of the business (it should be realistic and show sufficient funds can be generated to cover any loan repayments)
- collateral - what you're offering as security against any potential loss by the lender (most often your home or investment property)

The following steps outline the information needed to help you secure finance.

1. Develop a comprehensive business plan

A detailed plan will help you prove the feasibility of your business idea to potential lenders. It should provide an overview of the products or services you will be offering, your operations, realistic financial projections and how you will differ from your competition.

It is important to state whether you are planning to buy a business or start from scratch. The information provided must be realistic and logical. Consider these five key questions before borrowing money:

1. How much will you need?
2. What do you need the money for?
3. Are you able to repay the loan?
4. What timeframe will you need to repay the loan?
5. What can you offer as security?

Seek professional advice from your accountant and financial adviser to help you make sound financial decisions.

To help you draft a business plan attend our 'How to Write a Business Plan' workshop or download a business plan template from our website.

2. Calculate how much you need to borrow

When applying for business finance it's important to apply for sufficient funds. These funds should cover your business operations (and personal expenses) for the first six to 12 months of trading.

Use the table below to work out how much money you need to start or buy a business.

How much money do I have to invest in this business?	
Owner's savings	$
Loans from family/friends	$
Other finance	$
Total investment	**$**

How much money do I need to start or buy this business?	
Business purchase price (if applicable)	$
Professional advisory cost (eg. lawyer, accountant)	$
Expenses related to leased premises (eg. bond, deposit)	$
Licences, permits and registrations (eg. business name, domain name registration)	$
Fit-out costs and signage	$
Initial stock	$
Advertising and promotion (eg. business cards, letterheads)	$
Computer equipment	$
Website development	$
Graphic design fees	$
Plant, equipment and tools	$
Utility connections	$
Working capital (two months)	$
Subtotal	**$**
Contingency (add 20% to subtotal)	$
Total start-up costs	**$**
Minus total investment	$
Additional finance required	**$**

If the money you need does not match the money you have available, you will need additional finance to cover the difference.

Funding your business

3. Calculate how much you need to borrow

There are two main types of finance; debt and equity.

Type	Advantages	Disadvantages
Debt finance - money borrowed from external lenders, such as a bank.	• You'll retain full control of your business. • The interest on the loan is tax deductable. • The loan can be short or long-term.	• The loan must be paid back within a fixed time period. • Loan repayments will commence shortly after the loan is approved. • The loan is often secured against collateral which may include assets of the business or the owner's personal property. • It can be difficult to grow the business because of the cash drain of repaying the loan.
Equity finance - investing your own money, or funds from other stakeholders, in exchange for partial ownership.	• Less risky than a loan as the investment doesn't need to be paid back immediately. • You'll have more cash on hand as profits don't have to be used to repay the loan. • Investor(s) may provide additional credibility and skills to your business.	• Investor(s) will want some ownership or controlling interest of your business and will have a say in business decisions. • It takes time and effort to find the right investors for your business.

4. Sources of finance

Shop around and compare the many options for securing finance. These include financial institutions, retailers, finance companies, suppliers, factor companies, invoice finance, family and friends, crowd funding, and peer-to-peer financing.

The main sources of debt finance are:

Financial institutions

Finance can be provided by banks, credit unions and building societies as loans, overdrafts and lines of credit.

Be realistic about how much money you need to start your business, especially if you are seeking finance. Lending institutions may lose confidence in your business if you come back for more money too quickly.

Borrowing funds from a financial institution will incur costs and charges which will vary but are likely to include:

- interest rates
- application fees
- ongoing fees and charges
- insurance costs

Many banks and financial institutions have specialised and comprehensive services for small business. There are many financial comparison websites, including Canstar, to help you compare financial products based on your business requirements.

canstar.com.au

Retailers

Purchasing goods for your business using store credit through a finance company.

Store cards are also an option. However, they can attract high interest rates (some retailers offer an interest free period).

Finance companies

To engage in credit activities, a business must have a credit licence or authorisation from a credit licensee. Financial companies must be registered with the Australian Securities and Investments Commission (ASIC).

Suppliers

Arranging credit with suppliers will allow you to delay payment for goods.

Factoring companies

Also referred to as debtors finance. Factoring is when a business sells its accounts receivable (invoices) to a third party (called a factor) so that it can receive cash without waiting for customers to pay. Customers then pay their invoice directly to the factoring company. The cost of providing this service will vary between companies and it is important for you to research these costs before entering into an agreement.

Invoice finance

Essentially the same as factoring, however invoices are paid to your business and customers are not aware of your arrangements with the financier. Acting as collateral, your accounts receivables (unpaid invoices) are used to secure finance and loans.

Peer-to-peer lenders

Matches people who have money to invest with people looking for a loan. Loans may need to be repaid within a certain time period and interest rates may vary according to the level of risk.

Family and friends

If you are sourcing money from friends or family, be clear from the start whether it's a loan that they expect to be repaid, if it is a gift, or whether it is an investment and they expect an ownership share in your business. Put your agreement in writing and have it witnessed by an independent third party.

Review the relationship with your lender annually to ensure you are getting the best finance terms.

Funding your business (continued)

The main sources of equity finance are:

Personal finances

Self-funding your business from personal savings or the sale of personal assets.

Venture capitalists

Professional investors who invest large funds into businesses (as equity) that have potential for high growth and profit.

Family and friends

If you have limited equity and minimal business management experience, then family and friends may provide finance to get your business up and running. It is wise to sign a professionally drafted agreement which details the terms of the loan including rate of interest, and how and when repayments will be made.

Private investors

Also known as 'business angels', private investors are generally wealthy individuals who invest large sums of money in a business in return for equity and a share of the profits.

Crowd funding and crowd-sourced funding (CSEF)

These methods of raising finance involve using online platforms to bring investors together to generate project funding in exchange for goods, services or equity. These options allow investors to provide large or small sums of money in exchange for equity, first-run products or other rewards.

Govermment grants

While there may occasionally be financial support for particular industries or projects, competition is fierce and all money must be accounted for. Search for 'Grants and Assistance' at business.gov.au for more information. You may be approached by organisations claiming to offer exclusive access to government grant information for a fee. Be aware, information about government grants is free of charge and available to all businesses. You do not need to repay the money you receive as a grant.

Setting up business banking

It is recommended to always keep business accounts separate from your personal accounts. Setting up a business bank account is relatively quick and easy, but be clear about your needs, for example:

- Do you need merchant facilities (EFTPOS) or online payment options?
- Are you likely to need an overdraft facility?
- Will you need to physically deposit cash takings at the end of the work day?

Merchant facilities

These give customers the option of paying by credit or debit card. However, take the time to research the associated costs. For some online businesses it may be more beneficial to use an online third party payment system rather than set up merchant facilities. There are also additional costs associated with having a physical terminal (EFTPOS).

Businesses can only charge customers what it actually costs them to process credit card payments.

Establishing your payment terms

It's in your best interest to create payment terms with suppliers and customers to ensure you have adequate cash flow to meet your financial obligations.

- Make sure your payment terms are clearly displayed on all invoices.
- Set up long payment terms with your suppliers, for example 30 days and short payment terms with your customers of seven to 14 days.
- If offering a significant level of credit to customers, check their credit history first using one of the many online tools available (and consider taking a deposit to cover your costs).

You can improve your cash flow by preparing regular cash flow forecasts to anticipate payments and then put aside sufficient money to meet these commitments.

With your suppliers

Negotiate payment terms which will help you manage your cash flow.

Ask suppliers to:

- extend their payment terms
- allow you to pay quarterly (particularly utility companies)
- start the payment term from the date of complete delivery, not partial delivery

Establish an accounts control system and weekly cash flow forecast so your suppliers are not:

- paid earlier than necessary
- overpaid - check whether the goods you receive match your original purchase order and the total on the invoice
- paid twice - pay only on a supplier's invoice, not the statement

With your customers

Set up clearly defined payment terms which favour your financial needs, for example immediate payment, or within seven to 14 days of the invoice date. When setting your payment terms make sure they are clear and consider:

- methods of payment
- credit limits
- early payments and incentives

If you intend to offer credit to your customers, reduce your exposure to risk by conducting credit checks and asking customers for a deposit to cover the cost of labour and materials. Many businesses ask for cash on delivery until a firm relationship has been developed with customers.

Keeping good records of your transactions and tax invoices will help you monitor the financial performance of your business and comply with your tax obligations.

Pricing your goods and services

It is important to correctly price your product or service to ensure you cover all your costs, make a profit and stay competitive. This is a key step in determining the overall financial viability of your business. There are four key elements to consider when pricing:

1. Cost of goods sold (COGS)

If you sell physical products you will need to forecast how much it costs to produce and sell them. The COGS forecast relates to your sales forecast. If you are forecasting an increase in sales, the cost of producing the goods will also increase.

To forecast COGS you will need to include all the direct costs associated with production and preparation for sale. These may include:

- the wholesale cost of buying completed goods, raw materials or parts
- packaging
- freight and freight insurance
- commission paid on sales
- direct labour costs used to manufacture the product

Visit smallbusiness.wa.gov.au and download the 'Cost of goods sold' calculator to help you.

2. Expenses

Your expenses (overheads) are all the other costs you incur in running a business. These may include marketing, bank fees, electricity, rent, insurance, vehicle cost, wages and salaries, accounting, utilities, interest paid on loans, and legal fees.

If you are starting a new business, base your forecast on market research and industry benchmarks. If you are operating an existing business, use records from previous years to assist you.

Make sure you allow for any likely changes, such as an increase in costs or employing additional staff. Remember you have to price your products or services to cover COGS and ongoing expenses.

3. Profit

In addition to covering your COGS and expenses you also need to make a profit. Determine what level of profit you want to make and mark-up your products or services accordingly.

4. Competition

The final element to consider is competition. Your prices must be comparable with your competitors and in line with what customers are willing to pay.

Never assume your competition has their pricing right. Research why they are charging these prices. You can compare how your business would perform against the Australian average by searching for 'small business expected income benchmarks' at ato.gov.au

If your prices are more expensive than your competitors, it's important to communicate the reasons to your customers (eg. quality, cost savings, after sales service or experience). It must relate to something customers are willing to actually pay more for.

Review your accounts regularly

The easiest way to monitor the financial health of your business is to regularly review your profit and loss (P&L) statement. A P&L statement shows your income and expenses over a specific period of time and whether you have made or lost money.

There are five key figures in a P&L statement:

1. Revenue (sales/turnover)

This includes the total income from your core business activities, such as the sale of your goods and services, grants and rebates and other income received.

2. Cost of goods sold (COGS)

These costs are directly incurred as a result of buying or making your product. COGS are often referred to as variable costs as they are tied to the level of production or service.

3. Gross profit

This is the real income of your business as opposed to the sales income (sales minus your variable costs).

4. Expenses

Expenses (overheads) are often called fixed costs because they are incurred regardless of the volume of business activity. Expenses may include wages, rent, utilities, and interest paid on loans.

5. Net profit

Net profit (before tax) shows what the business has earned (or lost) in a given period of time (usually monthly, quarterly, or annually) after the cost of goods sold and operating expenses have been subtracted from your revenue.

This final figure is what matters to financial institutions and business buyers. Having good sales doesn't necessarily mean your business is doing well; it's the net profit that puts money in your pocket.

Formula to calculate net profit:

Sales − COGS = gross profit – expenses = net profit

Creating good record keeping habits

There are two types of record keeping; financial and business.

Financial record keeping

For any transaction with a financial element keep:

- purchase invoices for goods or services, or bills you pay for rent, rates and utilities
- sales related invoices, receipts, cash register tapes etc. related to sales
- financial statements, including profit and loss statements and balance sheets
- bank account and credit card statements
- year-end inventory records of stock and assets
- tax return information
- employee payslips, summaries and super payments

Invoices that are laid out in a clear and consistent way and include all the essential details make it easier for customers to pay. This will likely reduce the amount of time you spend chasing payment. For a guide on what to include in your invoices, visit ato.gov.au and search for 'how to set out tax invoices'.

Creating good record keeping habits (continued)

Business record keeping

It is essential to keep business records and documents to help you to monitor the financial performance of your business, as well as comply with your tax obligations. In addition to the requirements of the Australian Taxation Office (ATO), other government agencies also require you to keep records relating to your business and employees.

Staff or employee records including:

- tax file numbers (TFN) and withholding declarations
- records of wages, timesheets, allowances and
  other payments
- superannuation records and Pay As You Go (PAYG) withholding
- fringe benefit tax (FBT)
- safety records (eg. risk assessment for occupational health and safety compliance)

Other business records including:

- contracts, insurance agreements and other legal documents (eg. trust deed, companyregister, minutes of meetings etc)
- your commercial lease
- licences and permits

Good financial records management should include preparing a profit and loss budget and cash flow forecast, and using them for future business planning.

Download our easy-to-use business templates from the 'templates and tools' section of our website at **smallbusiness.wa.gov.au**

Tax law requires you to keep records, in English, for a period of at least five years.

The ATO has developed a record keeping tool to help you understand which records you need to keep for your business. Visit **ato.gov.au** for more information.

Balance sheet

A balance sheet is a snapshot of what your business owns (assets) and owes (liabilities), at a specific point in time, often produced at the end of the financial year.

The balance sheet provides a good picture of the financial health of your business and helps you understand the financial strength and capabilities of your business.

Assets – liabilities = owner's equity

Cash flow statement

The cash flow statement shows the movement of cash in your business. The more cash available for business operations the better. It projects the net increase or decrease in cash. If the cash flow is negative, the business will have a problem paying its short-term debts and difficulty continuing to operate.

The cash flow statement consists of three components:

1. Cash inflows (receipts)
2. Cash outflows (payments)
3. Net cash position (receipts minus payments)

Cash flow forecast

A cash flow forecast indicates the anticipated movement of cash coming in (receipts) and going out (payments) of your business and includes all your projected income and expected expenses. A forecast is usually conducted on a monthly or fortnightly basis.

Cash flow forecasts can help you identify when you may have extra cash available or experience shortages, so you can make the right decisions for your business.

It is important to regularly review your cash flow forecast against actual results. Differences between projected and actual figures can provide warning signs that may help you avoid future financial problems. Such warning signs include:

- cash payments being more than cash receipts - you will soon run out of money
- net operating cash flow being less than profit after tax - you are spending more than
  you earn

Download our free 'cash flow forecast' business template from our website.

Running a business means having the confidence to make important financial decisions. Our practical 'Understanding Business Financials' workshop will help you understand key financial information so that you can gauge how your business is performing, make better financial decisions and spot problems before they get out of hand.

Visit smallbusiness.wa.gov.au for more information or contact one of our business advisers on 13 12 49.

Sign up for our monthly e-news via our website homepage and follow us on facebook.com/smallbusinesswa to receive handy hints and tips on running your business.

We also encourage you to join thousands of WA small business owners in our Facebook group 'I'm a small business owner in Western Australia' – the perfect place to ask questions and share ideas with your peers.

Note: This information is not a substitute for legal advice.

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