Part III

Getting Intimate with Your Company's Cash Flow Needs

"Hi, I'm Bob Darrel. I'm here to perform the audit of your books. Don't mind the vultures. They follow me everywhere."

In this part . . .

This part of the book gets down to the nitty-gritty of managing cash flow in the present "real world" of business — which is characterized by capital sources applying tighter and tighter scrutiny and tougher and tougher standards to businesses. If a business comes across as inexperienced or superficial about its cash-flow management skills, its chances of getting a loan or equity capital quickly drop to zero.

The four chapters in this part follow a logical path along the road to business success, starting with formulating a realistic and convincing business plan (Chapter 8), using proven practices for forecasting and planning cash needs (Chapter 9), raising cash from equity (ownership) sources (Chapter 10), and persuading lenders to loan money to your business (Chapter 11).

Chapter 8

Creating a Business Plan to Secure Cash

In This Chapter

- Examining the four basic parts of a business plan
- Creating a business plan, from idea through development
- Including reliable third-party info in your business plan
- Remembering to use data that is complete, accurate, reliable, and timely

To start this chapter, we make a statement that should resonate loud and clear: No Plan = No Cash. Looking at the point from a different perspective, if you were a potential investor or lending source, would you provide cash (in the form of a purchase of stock or by providing a loan) to a company without having a clear understanding of the amount and when and in what structure or form the cash is required? Or would you, as a CEO or division president, commit cash to support a growing business segment without knowing how much is required and how the cash will be deployed? The answer to these questions (hopefully) is no. Whether a business is a start-up or a mature operation, developing a clear and concise business plan represents an essential tool to assist businesses with securing cash, managing their operations, and protecting their business interests.

This chapter provides the basic understanding and tools needed to develop a viable business plan, which is translated into economic value via the production of financial forecasts and projections. The planning process described in this chapter includes numerous elements ranging from obtaining current market information (on the potential demand for a new product and what price the market will support) to evaluating personnel resources (to ensure that proper professionals are available to support a business) to determining how great operational constraints (like manufacturing space availability or environmental regulations) may be in terms of expanding into a new geographical location.

The overall planning process, including the production of projections or forecasts, does not represent a "chicken or the egg" riddle. From a financial perspective, the preparation of budgets, forecasts, and projections (all terms that are used interchangeably throughout this chapter) represent the *end result* of the entire planning process. Hence, you must first accumulate the necessary data and information on which to build a forecasting model prior to producing projected financial information. Trying to create a forecast before looking at past performance, present conditions, and future expectations will result in a budget that doesn't capture your company's true economic structure.

Outlining the Basic Business Plan

Before aspiring entrepreneurs and corporate-ladder climbers can effectively pursue their business interests, they must develop a business plan. All too often, companies proceed with strategies of "We've always done it like that" or "This is how the industry has operated for the past umpteen years" instead of really evaluating and investigating the economic markets in which they operate. The business plan represents management's foundation and justification for birthing, growing, operating, and/or selling a business based on the economic environment present. Without it, management is left to operate a business in the dark, attempting to guess or use their intuition about the best course of action to pursue.

Business plans come in a variety of shapes, sizes, forms, and structures and often take on the characteristics of the business founder(s). No, the business plan won't be brunette or enjoy hiking, but it can resemble its creators by emphasizing certain traits or areas of expertise the founders may have. For instance, a type-A personality may use a number of bold adjectives to describe the massive, huge, unlimited, exceptional (you get the point) potential of the market opportunity present. As for unique areas of expertise, different sections of the business plan may be developed in depth, whereas other sections may be presented in quasi-summary format because the needed information isn't readily available (for presentation).

Herein lies the first lesson of developing a business plan: The business plan should be built from the outside looking in so that any reasonable party can clearly and quickly understand the business concept.

The business plan can come in a multitude of formats and include all types of information, data, graphs, charts, analyses, and more. The basis of every business plan, however, is in four main sections, which we cover in the following sections.

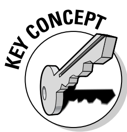
The executive summary

First and foremost in a typical business plan is the presentation of the executive summary. The *executive summary* is a brief overview of the business concept in terms of the market opportunity present, the operational logistics required to bring a product and/or service to market, the management team that's going to make it happen, and the eventual potential economic return available, including the amount of capital needed to execute the plan. This section of the business plan is really nothing more than a condensed summary of the entire business concept, presented in a neat and tidy overview of usually not more than five pages (and hopefully fewer). The general idea is that the executive summary should capture the critical content of each of the three primary areas of the business plan in a very efficient and easy to digest manner.

Although the meat of the business plan resides in the remainder of the document, this section is the most critical in terms of attracting interest from capital sources and/or management. Basically, the reader of the business plan must be able to conceptualize, understand, and justify the business concept from the information presented in the executive summary. This section must gain the reader's interest, generate some type of excitement, and move him with a sense of urgency to pursue the business opportunity at hand.

The market assessment

The second section of the business plan is generally dedicated to the market for the product or service being offered. Yes, we know that you may have trouble believing that the authors of this book, being accountants, would place marketing above finance and accounting issues. But the fact of the matter is that without a viable market, the only thing to account for is losses (and you know how much capital/financing sources and management love these). The marketing assessment segment of the business plan is often the most important because it substantiates the need for a product and/or service that's not being filled in the current economic environment.



You support the business concept by quantifying the size of the market in coordination with qualifying the market need, but that step is only half the battle (and often the easier of the two halves). Beyond providing information and supporting data on the market size, characteristics, and trends, the market assessment must also present a clear understanding of the business's competitive niche, target market, and specific marketing strategies. Identifying the specific niche and target market and developing an effective marketing strategy to capitalize on the opportunity present is often more challenging and critical to the future success of the business. And to top it all off, locating reliable and meaningful data essential to supporting your conclusions on the market opportunity can often be difficult.

All marketing sections should include a summary of the competition that savvy entrepreneurs or business managers can use to their advantage in several ways:

- By including an overview of the competition, the business establishes credibility with the readers (because it indicates that you've done your homework).
- By reading in-depth competitor assessments, managers may identify weaknesses in competitors' plans that can be exploited.
- By evaluating competitors' strengths and weaknesses, managers can better understand business risks.

The operational overview

Following the market segment of the business plan is a well-developed company operating overview. This segment of the business plan addresses a number of operational issues, including personnel requirements, technological needs, locations (for offices, production/manufacturing, warehouses/distribution centers, and so on), company infrastructure requirements, international considerations, professional/expert counsel resources, and the like. This segment drives various business-operating elements in terms of the resources needed to implement and execute the business plan. For example, if a company is planning on expanding into new foreign markets where the local government still "influences" the distribution channels, then the operating segment needs to address how the product will be distributed and what international partners will be essential to the process.

Business plans often dedicate a large portion of the operational overview to providing an overview of the management team in terms of the members' past credentials as well as their responsibilities with the new business concept moving forward. The market may be ripe and capital plentiful, but without a qualified management team, the business concept will, more times than not, sink. In today's challenging economic environment, management qualifications and credibility have taken on an entirely new level of importance, given the heightened sensitivity to management accountability and transparency.

The management team responsible for executing the business plan *is,* in effect, the business plan. Initially, financing and capital sources are lured in by business plans and may turn over any concept in the plan to a slew of professionals for further due diligence, reviews, evaluations, and critique. For example, if a capital source has concerns over the technological basis within a biomedical company, then medical- or technology-based professionals can be brought in to complete additional due diligence and either approve or can the idea. However, the management team standing behind the business plan and its execution is really what the capital and financing sources invest in. The integrity, qualifications, experience, determination, passion, and commitment displayed by the management team are of utmost importance. Any concerns in this area, and the capital and financing sources have their out.

The financial summary: Performance and required capital (Cash)

Finally, the financial segment of the business plan is developed. In a sense, the financial summary brings all the elements of the business plan together from an accounting and/or financing perspective. In the financial summary, financial forecasts are prepared to project the anticipated economic performance of the business concept based on the information and data presented earlier in the business plan:

- The market segment tends to drive the revenue portion of the forecasts, because the information accumulated and presented there substantiates items such as potential unit sales growth (in relation to the size of the market), pricing, and revenue sources by product and service.
- The operational overview drives the expense element of the forecast because it addresses the business cost structure in terms of personnel, assets, company infrastructure, and so on.

When all the elements of the business plan are put together in this segment, not only is the forecast profit and loss or income statement produced but, just as importantly, the projected balance sheet and cash-flow statement are generated as well. And you guessed it: With all this information now in hand, the capital (or cash) required to execute the business plan should be readily quantifiable.

Developing a Business Plan

As coauthor John has pointed out on many occasions (and in numerous books he has published), accounting represents more of an art than a science. This concept also holds true with the planning process, and more than a few accounting Picassos and Rembrandts have been created during the preparation of a business plan. We dive into some more-complex forecasting concepts in Chapter 9, but for now we stick to planning basics. We start by determining where you begin the process of creating a business plan.

The preparation of business plans should not be reserved for new companies just starting out or an existing business looking at launching new products. All companies should implement formal business-planning processes to ensure that their business interests are properly managed and protected.

Outlining your plan by using BOTE, WAG, and SWAG

The real start of developing any business plan is coming up with the initial concept, idea, or thought. This starting point applies equally to a long-standing business evaluating the costs and benefits of outsourcing a product manufacturing process and to a newly launched social-media company targeting the aging Baby Boomer population.

Okay, so what do the acronyms in the preceding heading stand for?

- BOTE: Back of the envelope
- WAG: Wild-ass guess
- SWAG: Scientific wild-ass guess

These terms represent the progression many business plans go through as they are developed. We offer these acronyms on developing business plans and projections somewhat in jest, but at the same time, they do help you understand the evolution of a business plan and projection model from how an idea is born to how the idea is communicated in an economic format/fashion to various parties.

Whether you apply these acronyms and follow this logic or rely on another creation and development cycle, the same key concept holds. Business plans and projection models should continue to evolve, improve, and strengthen over time as more and more effort is invested to bring the idea to life.

BOTE

BOTE usually represents the very first financial projection developed for a business plan: back of the envelope (or maybe in this day and age of advanced technology a more appropriate acronym would be 4GSS, or fourth-generation screen shot). Yes, even the majority of the most astute and experienced business professionals and entrepreneurs can attest to jotting down the basic concepts, needs, potential sales, costs, and profits of a business idea or concept on a random piece of paper (or with a simple mobile communication device application). Sometimes you need to get it out of your head and down in writing just to see if it makes any sense to begin with. You would be amazed at how often BOTE estimates are used.

WAG

If the idea passes the BOTE test, the next step in the evolution of the planning process is the ever-present *WAG* (or wild-ass guess). The WAG is somewhat more sophisticated than the BOTE in that it tends to incorporate more thought and some basic research. WAGs are usually produced using software tools such as Excel and incorporate the basic economic structure of the business, starting with sales and then moving through the remainder of the income statement by capturing costs of sales, operating expenses, and overhead or general and administrative costs. You can then draw two simple conclusions:

- How profitable the idea will be
- More importantly, how much capital or cash the idea needs in order to achieve success

These conclusions aren't overly sophisticated, but they're a very early attempt to put some financial logic behind the idea.

SWAG

If your idea has passed both the BOTE and WAG stages, congratulations are in order because you now can use the much more powerful tool, *SWAG* (scientific wild-ass guess) to further the development of your business plan. In other words, the business plan and supporting projection model are actually getting some serious attention and logical consideration. The idea can actually start to be substantiated and corroborated by external sources (or from third-party data/information). The first real form to the business plan and projection models are taking shape. You may be incorporating the use of technology tools to draft the business plan (for example, Microsoft Word), to build version 1.0 of the projection model (perhaps with Microsoft Excel), and to begin to prepare a presentation to summarize the plan (for example, with Microsoft PowerPoint).

Getting the process going

After the business's executive management teams or new company founders have decided that the concept for the new business endeavor has merit (which is by no means a small task), drafting of the business plan can begin. You can prepare a draft by following four simple steps:

- **Delve into historical business information.** In order to start the budgeting process, you should have a very good understanding of your company's prior financial and operating results. Review as much history as is available and relevant to the current idea, whether it stretches back three months, one year, five years, or longer. Of course for newly formed businesses, the availability of internal historical information is limited, but plenty of external information is usually available from like businesses and competitors and can be utilized to develop a business plan.

TIP

Remember that although the history of a company may provide a basic foundation on which to develop a budget, it by no means is an accurate predictor of the future.

- **Involve key management.** You must ensure that all key management team members are involved in the planning process, covering all critical business functions, to produce a projection that can be relied upon. The accounting and financial departments actively participate in the planning (and rightfully so, as these are the people who understand the numbers the best) and they produce the final forecast. But the data on which the projection model is based comes from numerous parties, sources, and business functions. Just like you wouldn't have a regional sales manager prepare a fixed asset schedule (tracking all asset additions, disposals, and depreciation expense), you wouldn't have your accountant estimate sales volumes by product line during the holiday season (and what prices the products may fetch). Critical business data comes from numerous parties, all of whom must be included in the planning process to produce the most reliable information possible.
- **Gather reliable data.** The availability of quality market, operational, and accounting data represents the basis of the budget. A good deal of this data often comes from internal sources. For example, when a sales region is preparing a budget for the upcoming year, the sales manager may survey the direct sales representatives on what they feel their customers' demand for products and services will be in the coming year (after all, who better to accumulate this information than the people in the field with the direct relationships?). With this information, sales volumes, personnel levels, wages rates, commission plans, and so on can all be determined.

  The internal information will certainly be of value, but it represents only half the battle because external information and data are just as critical to accumulate. Having access to quality and reliable external third-party-produced information is absolutely essential to the overall business planning process and the production of reliable forecasts. Market forces and trends that aren't apparent in internal data may be occurring and set to impact your business over the next 24 months.
- **Coordinate the planning timing.** Most companies tend to start the planning process for the next year in the fourth quarter of their current calendar year. This way, they have access to recent financial results on which to support the budgeting process moving forward.

  The nearer-term the projection, the more detailed the information and results being produced. If you prepare a budget for the coming fiscal year, then you can reasonably include monthly financial statement forecasts (with more detailed support available). Looking two or three years out, you can produce quarterly financial statement projections (with more summarized assumptions used), and so on.

JARGON ALERT

GIGO, or *garbage in, garbage out,* definitely applies to the planning process. If you don't have sound data and information at the core of the planning process (or if the data and information are poor in quality), the output produced will be of little value to the management team. When preparing your company's budgets, try to use data and information that's as complete, accurate, reliable, and timely as possible. Though you can't be 100 percent sure about the data and information accumulated for your plan (because by definition, you're attempting to predict the future with a projection), with proper resources (including appropriate internal management, external subject-matter experts or consultants, and allocating financial resources to secure critical information that's not readily available or free) dedicated to the process, you can avoid large information "black holes."

WARNING!

All too often, we come across budgets and forecasts that were prepared from an outdated business economic model. Just ask any retailer that formerly relied on brick-and-mortar stores and print-based advertising campaigns how the Internet and e-commerce have reshaped the business models. Though management has put forth the effort to restructure the company's operations in a changing market environment, a plan based on an old projection model with outdated assumptions doesn't capture the essence of the new economic realities. Remember, the planning process represents a living, evolving thing that must constantly be updated and adapted to changing market conditions. What worked two years ago may not provide management with the necessary information today on which to make appropriate business decisions.

Using two simple but powerful tools: SWOT and KISS

As described in the preceding sections, the heart of the planning process is the initial business idea or concept (that the plan is being developed around), which is then substantiated by accumulating what may seem like never-ending volumes of information and data. If you're not careful, the data-accumulation process can engulf the entire planning effort; if you get too much data, you can't digest it or draw any type of meaningful conclusion. But fret not, friends, because two simple but powerful planning tools are available to help manage data overload: SWOT and KISS.

The SWOT analysis

Strengths, weaknesses, opportunities, and threats: A SWOT analysis is a very effective planning and budgeting tool used to keep businesses focused on critical issues that may lead to wonderful successes or horrible failures. The SWOT analysis should be as comprehensive as possible and capture both relevant information for the specific idea as well as incorporating more broad-based data about the company, the industry, and the competition. The simple SWOT analysis (or matrix) in Figure 8-1 provides a better understanding of how it works.

Year 2012 Business Plan
Data Worksheet

Internal	**Strengths** (What you do well, competitive advantages)	**Weaknesses** (What you don't do well, competitive disadvantages)
External	**Opportunities** (Potential marketplace openings, new ventures, and ideas to grow your business)	**Threats** (Potential competitive, economic, or environmental factors that may hurt your business)

Figure 8-1: A SWOT analysis.

A SWOT analysis is usually broken down into a matrix containing four segments. Two of the segments are geared toward positive attributes (for instance, what are our strengths and what are the opportunities) and two towards negative attributes (what are our weaknesses and what are the threats). In addition to illustrating these categories, Figure 8-1 makes reference to the terms *internal* versus *external.* This distinction highlights the fact that certain attributes tend to come from internal company sources (namely, strengths and weaknesses) and other attributes from external, or outside of the company sources (typically opportunities and threats).

TIP

If used correctly, a SWOT analysis not only can provide invaluable information to support the planning process but also (and more importantly) can help identify what type of management a business has in place. The responses received from the management team engaged in the planning process provide invaluable information as to whether the party completing the SWOT analysis is nothing more than a frontline manager (that is, a captain needing direction) or a bona fide business person (the colonel leading the charge). When business plans are developed and launched, ultimately their success is dependent on having the right leaders driving the bus to take the opportunity from a concept to reality. Frontline managers can assist with this process but are generally not qualified to lead.

SWOT analyses may be completed by a variety of different parties. In a larger or well-established business, the SWOT analysis may be delegated to the management team assigned a project or opportunity to complete. The SWOT analysis is then evaluated and interpreted by the company's executives, who consider whether it's viable and whether the right people are in place. On the other hand, two founders just starting a business may complete a SWOT analysis (so the concept of senior management evaluations is not relevant, although external investors may have a keen interest in the SWOT analysis). The key concept here is that the parties responsible for preparing the SWOT analysis should be heavily vested in the opportunity and be willing to take possession and responsibility.

Remember to KISS

You know what KISS stands for: Keep it simple, stupid. Used in the marketing world for years, the concept of KISS also applies to the planning process every bit as much. Key company management should be involved in the process of planning, but these executives tend not to be well educated in the world of accounting and finance. So rather than confuse these poor souls with technical accounting and financial jargon, the goal should be to provide guidance and support that allows them to accumulate the information that can easily be translated into accounting and financial results.

REMEMBER

If you're an executive or owner of a business, you must be able to understand the big picture and your company's key economic drivers in order to prepare proper business plans, strategies, and, ultimately, forecasts. The ability to understand and positively affect the key economic drivers of your business and empower the management team to execute the business plan represents the end game. Getting lost in excessive amounts of detail ("Why did you spend an extra $500 on the trip to Florida?") is generally not the best use of senior management's time, because every level of detail adds more and more complexity to the plan, which can get overwhelmed with TMI (too much information).

Incorporating Third-Party Information into Your Plan

When building reliable and credible business plans, the importance of accumulating data and information from reliable (and we want to emphasize *reliable*) independent third parties (including various trade and industry sources) cannot be underestimated. In this section, we expound on this subject to clarify why it's so important.

Gathering the info

To start, the process of actually gathering independent third-party information, data, and reports needs to be addressed. The Internet is, without question, one of the most powerful data- and information-gathering tools available. In the dark ages, valuable market, industry, and technological information was gathered via such archaic methods as researching in a library, subscribing to trade journals and magazines, and attending seminars or educational trade shows. Today, most of the information you need is available electronically over the World Wide Web, which has improved the efficiency of accumulating information significantly. Most industries' trade organizations now regularly produce and provide content via the web, but you have to be prepared to pay for it, because quality and reliable information costs money.

TIP

Incorporate trade shows, seminars, and educational events into your efforts to accumulate third-party data. Not only can these events offer a great source of information, but they also (and potentially more importantly) can be places to make contacts with potential future employees, vendors, customers, and funding sources who can assist with the execution of the business plan.

The third-party information you gather should cover multiple aspects of your business. Following are three examples of data sources for a jewelry company:

- The World Gold Council provides an excellent overview of consumer gold-buying trends and patterns by price points, types of jewelry, and different sales channels. This information can support the marketing segment of the business plan.
- If the production of jewelry is required, then information on available manufacturing sources is needed. Because a large majority of jewelry is produced globally (from Southeast Asia to Europe to Central America), the company needs to make sure that it has a good handle on the political, social, and economic stability of any foreign suppliers.
- In addition, if the jewelry company is going to sell products through retail storefronts, then an overview of commercial real estate rental rates, trends, and so on can be incorporated (for a specific geographical area) to support a critical expense driver in the business.

Using only reliable info

A significant additional benefit of obtaining and incorporating independent and reliable third-party information is that it carries added weight/credibility with readers. Readers see proof that the management team isn't just making up the story in the business plan. In fact, hard facts are available from independent sources supporting the objectives and conclusions of the business plan.

We can't emphasize enough the importance of securing *reliable* third-party or external information. The quality and reliability of your data is way more important than quantity. While the web has become an incredibly powerful data-accumulation and distribution tool, it also has become just as powerful in distributing worthless and/or distorted information. Face it, 99 percent of the information available on the web is just noise or clutter and must be properly evaluated to ensure that the most appropriate and reliable information is accessed. So beware of the data source, because nothing is more embarrassing than finding out you've referenced unreliable third-party information in your business plan.

REMEMBER

Any party reading your business plan expects you to be an industry expert, so if you're not an industry expert, you had better become one very fast. You don't need to have an answer for every question and understand every business topic from top to bottom (professional advice can be secured for additional support), but the management team responsible for the business plan should have strong knowledge of at least 80 percent of the topics presented in the plan.

Riding the CART Concept: Complete, Accurate, Reliable, and Timely

During the whole planning process, you'll do well to remember the importance of data that is CART: complete, accurate, reliable, and timely. Actually, the concept of CART should be applied to all business segments; whether you're developing a business plan, analyzing periodic operating results, or evaluating a employee benefit plan, business owners and managers must have complete, accurate, reliable, and timely information to make appropriate business decisions. Whether the information and data is coming from internal or external sources, from the marketing or manufacturing departments, and is presented in terms of the number of "heads" needed or by the total wages to be paid, the basis of the budget is having access to complete, accurate, reliable, and timely information.

- **Complete:** When financial statements are produced for a company, they include a balance sheet, income statement, and a statement of cash flows. All three are needed in order to understand the entire financial picture of a company. If a projection model is incorporating an expansion of a company's manufacturing facility in a new state (to keep up with rising demand), all information related to the new facility needs to be accumulated to prepare the budget. This info includes the cost of the land and facility, how much utility costs run in the area, what potential environmental issues may be present, whether a trained workforce is available and, if not, how much the training cost will be, and so on. Overkill is not the objective; having access to all "material" information and data is.

- **Accurate:** Incorporating accurate data is absolutely essential for preparing the business plan. Every business plan needs to state the price your company charges for the goods or services it sells, how much employees are paid, what the monthly office rent is, what evolving patterns exist in sales channels, and every other relevant detail. Accumulating accurate information, whether from internal sources or external third parties, represents a critical and ongoing management endeavor.
- **Reliable:** The concepts of reliability and accuracy are closely linked, but they differ as well. A piece of information may be accurate without being reliable. For example, you may conduct some research and find that the average wage for a paralegal in San Diego, California, is $24 per hour. This data sounds accurate, but if the business model you're developing requires paralegals with special training who demand $37 per hour, the information is not reliable.
- **Timely:** Finally, the information and data must be accumulated in a timely fashion. Data provided six months after it was needed doesn't do management much good. Companies live and die by having access to real-time information on which to make business decisions and change course (and forecasts) if needed.

An old phrase that's often quoted, "Put the cart before the horse," means to reverse the accepted order of things. However, the CART principle is a case in which the "cart" always needs to come first. You must put the CART information and data before the horse (the business plan). If you attempt to offer a business plan that hasn't been created through CART data, the end result will be nothing short of disastrous.

Chapter 9

Building Best-in-Class Projection Models to Manage Cash

In This Chapter

- Getting people and software in place to build financial forecasts
- Determining your approach to structuring a plan
- Creating a basic projection
- Putting your forecasts to good use

Chapter 8 focuses on developing a business plan to substantiate an opportunity and, for all intents and purposes, to identify how much capital (cash) is needed to execute the opportunity. The financial summary segment of the business plan pulls together all the parts of the plan from an economic perspective via the preparation of financial forecasts or projections. In this chapter, we now turn our attention to building financial forecasts, or projection models, to quantify the business plan.

KEY CONCEPT

The forecasting process is much easier to undertake (and ultimately understand) if the majority of the relevant data needed is accumulated beforehand because you'll have the big picture in mind. Remember the Boy Scouts' motto and "be prepared." The better prepared you are with the basics of the business plan and key assumptions, the easier it is to build financial projection models that are credible and reliable.

Rounding Up Resources to Build Financial Forecasts

The first thing you want to consider in preparing financial forecasts is identifying and securing the appropriate resources: personnel to complete the projections and software to prepare flexible and adaptable projection models. On the personnel front, the budgeting task tends to fall on the accounting and finance department because these are the people in the organization who seem to work best with "the numbers."

The accounting and finance department may prepare the actual budget, but the base information required for completion of the budget comes from all the critical operations of the organization.

On the software front, the following two choices are readily available to complete company projections:

- **Stand-alone software:** The ever-popular Microsoft Excel is very flexible and relatively easy to use, for both nonfinancial types who simply want to do addition and multiplication and financial types who use the program's more-sophisticated features, like macros and lookup tables. Excel is extremely versatile and can be found in use in companies as small as the local deli to billion-dollar-a-year organizations. If a little more sophistication is desired, then financial-forecasting software is available, such as Alight Planning Enterprise and Budget Maestro (which tend to be geared toward the middle market or companies with annual revenues in excess of $100 million).
- **The budgeting component of accounting software:** Most accounting software packages (QuickBooks, Great Plains, and others) include a budgeting module to support this function, but in general these modules aren't as flexible as Excel (and are a little more difficult to use). ***Note:*** Most accounting software packages easily interface with Excel, so a combination of strategies may be used. For example, you may create the base projection model in Excel and export the results into the accounting software module.

Planning with the Big Picture in Mind

After getting your personnel and software resources in place, one last task needs to be tackled before a basic financial projection model can be structured. You need to take a step back from the mounds of information of data that's been accumulated and take a look from the 20,000-foot level at what you're attempting to accomplish. In other words, make sure that the financial projection model will give you the critical output needed in order to clearly and concisely summarize the economic proposition presented in the business plan.

Deciding on a top-down versus bottom-up projection strategy

Financial forecasts are usually built on one of two logic structures — from the top down or the bottom up.

Top-down projection models build the logic in the model from sales and revenue expectations first (as in the income statement, sales are always listed first), which then drive the cost structure of a business. Key sales information related to unit volumes, price points, different types of revenue (for example, for a technology company, sales can be driven from technology licensing, system integration fees, and other related fees), different sources of revenue (a technology company may sell technology to the government market, which is very different from a manufacturing company), and other factors. This information is then used to build out the cost structure of the business as various expenses are calculated or determined based on projected revenue levels. The following example shows how a top-down projection works:

> **Top down:** In the business plan, the long-term objective of a sales team is for each sales representative to be responsible for generating $1 million per year in sales, starting at $500,000 in year one and growing to $1 million by year three. So the projection model calculates the number of sales representatives needed based on the revenue being generated during a given period. If sales of $6 million are expected in year two and the average sales representative is responsible for $750,000 of sales, eight sales representatives are needed. If each sales representative is paid a base salary of $50,000 and earns a commission of 5 percent of sales, then the total sales representative compensation expense of $700,000 can be easily calculated from the logic in the projection model. The math is as follows:
>
> 8 sales representatives × $50,000 salary = $400,000
>
> 5% commission × $6 million in sales = $300,000
>
> $400,000 in salaries + $300,000 in commissions = $700,000 in total compensation

This example is rather simplistic, as it assumes that all sales representatives would be working from day one for the entire year. In reality, sales and related expenses tend to build over time and not in a linear fashion. So when building a financial projection model, a clear understanding of variable, semivariable, and fixed expenses needs to be obtained and incorporated to produce more accurate output.

So if a top-down projection focuses on sales and revenue levels, then you can probably guess that a bottom-up projection model is driven by cost/expense information first, which then predicts sales and revenue results. Though this type of financial projection model isn't as widely used as the top-down variety, a number of businesses and industries rely on it, as in the following example.

> **Bottom up:** Government defense contracting businesses usually generate revenue from one of two types of contracts — fixed fee or cost plus. In a cost-plus contract, all costs associated with a specific project (as supported by a contract executed with the government) are accumulated and then billed to the government with overhead rates applied and a contract profit margin attached. Hence, revenue is determined based on the actual costs incurred, which are accumulated and billed to the government on a periodic basis. But before the government executes a contract,

it needs an estimate of the anticipated total cost of the contract, which is often based on a financial projection. So in this environment, costs need to be accumulated first to assist with calculating the total value of the contract (that the government will be responsible for paying). Or in other words, the costs drive the sales.

More-sophisticated financial projection models often incorporate elements of both top-down and bottom-up strategies. Certain components of the financial projection model may very well be built on top-down assumptions (such as sales and direct costs of sales, which vary directly with sales levels), whereas various fixed-cost functions within a business are built from the bottom up.

In the end, both projection-modeling strategies end up focusing on the most critical element of every business plan: sales. That is, without sales, the business isn't going to last very long because nobody wants to support a money-losing operation for very long. And of course, the need for sales ties back to the business plan, which at its heart addresses how your business's products or services will satisfy a market need or demand.

Identifying your critical business economic drivers

Most businesses or business units/divisions of larger companies have numerous moving parts that on first glance may appear to be very complex and overly detailed. Looking at all the information from these different areas and then attempting to build a financial projection model to capture every line item of detail can, needless to say, be a very daunting task. So when you get overwhelmed, remember to revisit your 20,000-foot view by taking a step back and identifying and understanding what the key economic drivers of your business are.

Key economic drivers vary from business to business. What may be a key driver in the personnel staffing industry (which is very sensitive to employee wages) is very different from what drives a technology manufacturing company (which is very sensitive to supporting a high fixed-cost manufacturing facility). But though the drivers may be different, the big picture is basically as follows:

- For most companies, economic life or death is usually centered on a half dozen or fewer critical economic drivers. Roughly four to six key items determine whether you make money or lose money.
- The critical economic drivers account for the majority of financial activity, transactions, and management attention within the business. This point should make perfect sense because there's no point investing countless hours tracking down every credit card receipt supporting an employee expense report to confirm whether an $18 charge was valid.

Rather, time and effort should be invested in areas that have the best chance to improve operating results.

- The allocation of key economic drivers is usually split 50/50 between sales and expenses. For example, in a professional service firm (such as a law firm), billable hours per period represents a critical operating metric at the sales level. On the expense side of life, the average wage paid to each professional is extremely important. If the firm charges a market-accepted bill rate, then if the professional has billed enough hours, the firm generates profits.

A high-technology manufacturing company made a significant investment in its production facility to support large volumes of low-cost technological products (through the year 2000). Over the course of the next five years, market conditions changed, with low-cost, high-volume production moving to cheaper foreign markets, leaving only the advanced-technology, higher-cost, and lower-volume products to be produced in the United States. During this transition period, the company's investment in its production facility did not change, because it represented a fixed cost that doesn't vary with production levels.

In order to survive and generate profits on lower sales volumes, significant price increases were required on a per-unit basis to offset the loss in revenue and profits. So the key economic drivers for this business boiled down to two primary items: what price was needed per unit (based on lower volumes) to cover the company's high production-facility fixed costs, and what costs (generally variable or semivariable in nature because they're easier to reduce over a shorter time period) could be decreased to help the company lower its break-even point and improve profitability. As for the first item, the company's average price per unit increased by over 300 percent over a five-year period to drive additional earnings. As for the second item, unproductive personnel (related to the older business model) were eliminated to reduce expenses.

As this example helps illustrate, each business owner or manager has the responsibility of clearly understanding what really drives the company's financial performance. When these drivers are clearly understood, top business owners and managers can quickly decipher and translate this data to determine whether a company made money or lost money. If you know your revenue level (over a period of time, such as a month) by types of products and services sold, you should already know whether you made money or lost money.

Well-run businesses often use the periodic production of financial statements to simply confirm what they already know or suspect rather than gain new info. If you're relying on monthly financial statements to relay the performance of your company, which is always something new, unexpected, and/or a surprise, then you're behind the curve.

Building the Basic Projection Model

The best way to dive into preparing a projection is to start by reviewing Figure 9-1, which represents a yearly budget for ACME Distribution, Inc.

When reviewing the projection prepared for the company, take note of the following key issues (which correspond to the topics discussed in this chapter):

- **The most recent year-end financial information is included in the first column to provide a base reference point to work from.** As noted in Chapter 8 on planning, gaining a thorough understanding of your company's historical operating results is an important factor in forecasting the future. Also, by having this base information, a consistent reporting format can be developed so that the format of your financial statements is consistent with your projections (for ease of understanding).
- **The projections are "complete" from a financial statement perspective.** That is, the income statement, balance sheet, and statement of cash flows are all projected to assist management with understanding the entire financial picture of the company. The forecasts prepared for ACME Distribution, Inc., indicate that the line of credit will be used extensively through the third quarter, because between having to finance increases in trade accounts receivable and inventory levels (to support high seasonal sales levels in the third quarter) and reducing trade accounts payable levels, the company will need to ensure that its line of credit is large enough to handle the expected "cash demand" for the third quarter. By the end of the fourth quarter, borrowings on the line of credit are substantially lower because the balance sheet contracts after the seasonal sales rush.
- **The projections are presented with quarterly information.** We normally recommend that projections for the next fiscal year be prepared on a monthly basis to provide management with more frequent information. However, for ease of presentation (in this book), quarterly information was prepared. If we continued, looking several years or more out, we would use annual projections because longer projections mean less precision. A good general rule of thumb to use is to prepare monthly projections for the next 12-month operating period, quarterly projections for the two years after the first 12-month operating period, and then annual projections thereafter.

- **The projections are prepared and presented in a summary format.** Instead of including a lot of detail, groups of detail are combined into one line item. For example, sales may originate from ten different company divisions or branches. Individual budgets are prepared to support each division or branch, but when a companywide forecast is completed, all the sales are rolled up onto one line item.

  Budgets prepared in a summary format are best suited for review by external parties and top company executives, who all tend to be big-picture people who want to first start with understanding the macro-level forecasts to complete a quick sanity check on whether they make sense or not. Furthermore, in revealing too much detail to external parties, you may risk disclosing confidential information that's not appropriate for external consumption. And providing too much information to outside parties can sometimes result in the outside parties asking too many questions (so remember to KISS — keep it simple, stupid).

- **Certain key or critical business economic drivers are highlighted in the projection model.** First, the company's gross margin is called out, because it increases from 22.5 percent in the first quarter to 28 percent in the third quarter. The increase was the result of the company increasing prices in the second quarter and then accelerating the increases in the third quarter to capture higher anticipated demand from customers ramping up for the holidays. Second, the company's pre-tax net income, for the entire year, improves significantly because the company's fixed overhead and corporate infrastructure (expenses) didn't need to increase nearly as much to support the higher sales (as a result of realizing the benefits of economies of scale). In addition, the company didn't have to absorb an inventory write-off of $50,000 (as with the preceding year).

  You may ask why the company has no income tax expense forecast, despite having positive net pre-tax profits. In this example, ACME identified a deferred tax asset the previous year, which was of no value as of the end of that year. (We discuss this scenario in Chapter 5.) Because the company was able to generate a profit in the most recent year, the deferred tax asset now is anticipated to be of value, and any income tax expense anticipated can be offset against the deferred tax asset (producing a net income tax expense of zero for the year). For cash-flow planning purposes, this concept is very critical because the last thing you want to do is overpay income taxes, unnecessarily consuming cash.

The basic budget presented in Figure 9-1 is fairly simplistic but nevertheless very informative. It captures the macro-level economic structure of the company in terms of where it is today and where it expects to be at the end of next year.

Summary Balance Sheet	Actual Year-End 1/1/15	Forecast Quarter-End 4/1/15	Forecast Quarter-End 7/1/15	Forecast Quarter-End 10/1/15	Forecast Quarter-End 1/1/16	Forecast Year-End 1/1/16
Current Assets:						
Cash and Equivalents	$230,000	$54,375	$137,750	$290,375	$199,250	$199,250
Trade Receivables, Net	$705,000	$725,000	$1,150,000	$1,500,000	$937,500	$937,500
Inventory	$450,000	$540,000	$635,000	$525,000	$500,000	$500,000
Other Current Assets	$75,000	$75,000	$75,000	$75,000	$75,000	$75,000
Total Current Assets	$1,460,000	$1,394,375	$1,997,750	$2,390,375	$1,711,750	$1,711,750
Fixed and Other Assets:						
Property, Plant, and Equipment, Net	$1,340,000	$1,337,500	$1,332,500	$1,325,000	$1,315,000	$1,315,000
Other Assets	$470,000	$452,500	$435,000	$417,500	$400,000	$400,000
Total Fixed and Other Assets	$1,810,000	$1,790,000	$1,767,500	$1,742,500	$1,715,000	$1,715,000
Total Assets	$3,270,000	$3,184,375	$3,765,250	$4,132,875	$3,426,750	$3,426,750
Current Liabilities:						
Trade Payables	$385,000	$450,000	$525,000	$600,000	$425,000	$425,000
Accrued Liabilities	$215,000	$225,000	$250,000	$275,000	$200,000	$200,000
Line of Credit Borrowings	$350,000	$350,000	$750,000	$750,000	$250,000	$250,000
Current Portion of Long-Term Liabilities	$250,000	$250,000	$250,000	$250,000	$250,000	$250,000
Other Current Liabilities	$75,000	$75,000	$75,000	$75,000	$75,000	$75,000
Total Current Liabilities	$1,275,000	$1,350,000	$1,850,000	$1,950,000	$1,200,000	$1,200,000
Long-Term Liabilities:						
Notes Payable, Less Current Portion	$800,000	$750,000	$700,000	$650,000	$600,000	$600,000
Capital Leases, Less Current Portion	$100,000	$87,500	$75,000	$62,500	$50,000	$50,000
Subordinated Debt	$250,000	$250,000	$250,000	$250,000	$250,000	$250,000
Total Long-Term Liabilities	$1,150,000	$1,087,500	$1,025,000	$962,500	$900,000	$900,000
Total Liabilities	$2,425,000	$2,437,500	$2,875,000	$2,912,500	$2,100,000	$2,100,000
Equity:						
Common Equity	$100,000	$100,000	$100,000	$100,000	$100,000	$100,000
Retained Earnings	$555,000	$745,000	$745,000	$745,000	$745,000	$745,000
Current Earnings	$190,000	($98,125)	$45,250	$375,375	$481,750	$481,750
Total Equity	$845,000	$746,875	$890,250	$1,220,375	$1,326,750	$1,326,750
Total Liabilities & Equity	$3,270,000	$3,184,375	$3,765,250	$4,132,875	$3,426,750	$3,426,750

Summary Income Statement	Actual Year-End 1/1/15	Forecast Quarter-End 4/1/15	Forecast Quarter-End 7/1/15	Forecast Quarter-End 10/1/15	Forecast Quarter-End 1/1/16	Forecast Year-End 1/1/16
Revenue	$8,043,750	$1,450,000	$2,300,000	$3,000,000	$2,250,000	$9,000,000
Costs of Goods Sold	$6,032,813	$1,123,750	$1,702,000	$2,160,000	$1,687,500	$6,673,250
Gross Profit	$2,010,937	$326,250	$598,000	$840,000	$562,500	$2,326,750
Gross Margin	25.00%	22.50%	26.00%	28.00%	25.00%	25.85%
Selling, General, and Administrative Expenses	$1,395,000	$325,000	$350,000	$400,000	$350,000	$1,425,000
Depreciation and Amortization Expense	$250,000	$65,000	$67,500	$70,000	$72,500	$275,000
Interest Expense	$125,938	$34,375	$37,125	$39,875	$33,625	$145,000
Other (Income) Expenses	$50,000	$0	$0	$0	$0	$0
Net Profit Before Tax	$190,000	($98,125)	$143,375	$330,125	$106,375	$481,750
Income Tax Expense (Benefit)	$0	$0	$0	$0	$0	$0
Net Profit (Loss)	$190,000	($98,125)	$143,375	$330,125	$106,375	$481,750

Summary Cash Flow Statement	Actual Year-End 1/1/15	Forecast Quarter-End 4/1/15	Forecast Quarter-End 7/1/15	Forecast Quarter-End 10/1/15	Forecast Quarter-End 1/1/16	Forecast Year-End 1/1/16
Operating Cash Flow:						
Net Income (Loss)	$190,000	($98,125)	$143,375	$330,125	$106,375	$481,750
Depreciation and Amortization Expense	$250,000	$65,000	$67,500	$70,000	$72,500	$275,000
Net Operating Cash Flow	$440,000	($33,125)	$210,875	$400,125	$178,875	$756,750
Working Capital:						
(Increase) Decrease in Trade Receivables	($69,130)	($20,000)	($425,000)	($350,000)	$562,500	($232,500)
(Increase) Decrease in Inventory	$50,000)	($90,000)	($95,000)	$110,000	$25,000	($50,000)
(Increase) Decrease in Other Current Assets	$200,000	$0	$0	$0	$0	$0
Increase (Decrease) in Trade Payables	($115,000)	$65,000	$75,000	$75,000	($175,000)	$40,000
Increase (Decrease) in Accrued Liabilities	($35,000)	$10,000	$25,000	$25,000	($75,000)	($15,000)
Increase (Decrease) in Current Debt	$25,000	$0	$400,000	$0	($500,000)	($100,000)
Increase (Decrease) in Other Current Liabilities	$0	$0	$0	$0	$0	$0
Net Working Capital Cash Flow	($44,130)	($35,000)	($20,000)	($140,000)	($162,500)	($357,500)
Financing Capital:						
Equity Contributions	$0	$0	$0	$0	$0	$0
Additions to Long-Term Debt	$0	$0	$0	$0	$0	$0
Deletions to Long-Term Debt	($250,000)	($62,500)	($62,500)	($62,500)	($62,500)	($250,000)
Fixed Asset Additions	$0	($50,000)	($50,000)	($50,000)	($50,000)	($200,000)
Change to Other Long-Term Assets	$30,000	$5,000	$5,000	$5,000	$5,000	$20,000
Change to Other Long-Term Liabilities	$0	$0	$0	$0	$0	$0
Net Financial Capital Cash Flow	($220,000)	($107,500)	($107,500)	($107,500)	($107,500)	($430,000)
Beginning Cash	$54,131	$230,000	$54,375	$137,750	$290,375	$230,000
Ending Cash	$230,000	$54,375	$137,750	$290,375	$199,250	$199,250

Figure 9-1: A quarterly forecast for ACME Distribution, Inc.

Making the Most of Your Projections

The previous sections of this chapter focus on actually producing a business plan and corresponding projection as opposed to utilizing the projections as an active management tool. Just like any other piece of financial information generated from the company, the real key lies in management being able to understand the information and then act on it. Producing a plan and projection that are never fully utilized is simply a waste of everyone's time. But with "Projection 101" under your belt, you can now turn your attention to working with more advanced forecasting techniques and concepts that can be utilized to achieve the plan.

The concepts presented in this section by no means require PhD-level thinking (like applying linear regression analysis to sales trends for the past 20 years). Rather, the goal here is to provide some additional forecasting tools, techniques, and strategies that can assist you in managing your business interests. We aim to enlighten you with forecasting strategies that provide the greatest value to your organization in terms of managing everyday challenges, stress, and growing pains.

Developing and utilizing financial projections should not be viewed as just an annual management process/function. Instead, forecasts should be managed proactively and adjusted as needed to adapt to changing business conditions. Staying actively connected and involved in the business planning process (including utilizing financial forecasts) is essential to remaining competitive in today's economic environment.

Getting familiar with some useful terms

Before we jump into an actual financial projection model, we review some basic terminology to help you "speak the language" (that is, accountant-ese or finance-ese) a little bit better. The following list is by no means all-inclusive; it's focused more on terminology that's used when evaluating financial forecasts (based on forward-looking information) as opposed to terminology applied to evaluating periodic financial statements (for example, calculating the current ratio):

- **Break-even:** The *break-even* point is the level of sales required to produce operating results with no profits or losses (that is, sales less costs of sales less expenses equals zero). For example, if a company has $50,000 a month in expenses and generates a gross margin on sales of 40 percent, it must generate $125,000 a month to break even. Or looking at the concept from the top down, sales of $125,000 would generate a gross profit of $50,000 (40 percent of $125,000), from which expenses are then subtracted, producing a profit of zero.

- **Burn rate:** The *burn rate* is the rate at which cash is burned or consumed in a business. For example, if a company's expenses are $100,000 per month and sales are $40,000 per month, it is losing, or *burning,* $60,000 per month. If the company has $600,000 in cash, then it basically has ten months left to operate.
- **Cap table:** A *cap table,* or *capitalization table,* simply offers a summary of who owns what portion of a company and in what structure. Ownership structures are a very sensitive and important issue with third-party financing sources.
- **Extending the runway:** The idea of *extending the runway* means that if you're forecasting your cash to run out in four months but a new source of cash won't be available for six months, a company must find a way to stretch its cash to reach the next funding date. The idea is to always conserve your cash resources and stretch every dollar as far and as long as possible.
- **Fume date:** Closely related to the burn rate, the *fume date* simply estimates what date a company will run out of cash and be left running on fumes (just like a car that's running on empty and can only make it a little longer).
- **Sustainable growth rate:** A company's *sustainable growth rate* is based on how quickly a company can grow with internal resources alone (that is, without securing external capital or cash to support future growth). This rate varies depending on the specific business and industry in which it operates, but when any company grows at rates in excess of 25 percent, supporting this growth with internal resources alone is very difficult. Hence, a breach of the sustainable growth rate indicates that external capital is most likely needed to support the company.
- **Dual bottom lines:** A concept that's becoming more and more important in today's socially responsible environment is that companies often measure their results on multiple fronts, also called *dual bottom lines.* For example, in addition to measuring how much profit the company generated, a company's results may also be measured on how much it returned to the community in terms of new jobs, charitable contributions, overall benefits to society, and so on.

When building financial projection models, make sure that your output in the models supports all bottom-line objectives. Everyone expects the output from a financial projection model to identify how much profit will be produced, but generating output reports and information such as the number of jobs created, how healthcare costs may be lowered (for a healthcare information technology company), and so on are also very useful. To a politician who went out of her way to promote your business by offering tax breaks, relaying job creation does wonders for everyone involved.

Treating forecasts as living, breathing management tools

The concept of a living projection model is based in the idea that in today's fiercely competitive marketplace, business models change much quicker than they did ten-plus years ago. Though the forecast prepared in the fourth quarter of the previous year looked reasonable, six months later the story can easily change. Any number of factors may occur, such as losing a key sales executive, having a competitor go out of business (opening up new opportunities), or experiencing a significant increase in the price of raw materials to produce your products, that can cause the best-prepared budgets to be useless by midyear. But if you understand two key forecasting practices, you can make sure that your forecasts continue to live and breathe throughout the year.

Recasting to avoid surprises

When you hear the term *recast* used, it generally means a company is going to update its original budgets or forecasts during some point of the year to update or revise the information through the end of the year. Companies are constantly under pressure to provide updated information on how they think the year will turn out.

In this economic environment, basically everyone is demanding updated information, so at the end of select periods (usually a month end or quarter end), the actual results for the company through that period are incorporated into the original forecast. Using the actual results through the cutoff period as the base starting point, the original forecast for the remainder of the year is then updated (based on business conditions that may have changed), so the operating results for the entire year are a combination of actual results and updated projected results and thus have been recast. Having access to updated information can greatly assist business owners and managers in properly directing the company and adapting to changing conditions, not to mention being able to provide timely updates to key external parties (on how the company is progressing).

Remember, nobody likes surprises (especially bad ones), and nothing will get an external party such as a bank or investor more fired up than management not being able to deliver information on the company's performance.

Using rolling forecasts

Rolling forecasts are similar to recast financial results with the exception that a rolling forecast always looks out over a period of time (for example, the next 12 months) from the most recent period end, whereas a recast is simply updating the original forecast during the current year to provide a revised outlook or forecast for the remainder of the current fiscal year. For example, if a company has a fiscal year-end of 12/31/10 and has prepared a projection for the fiscal year-end 12/31/11, an updated rolling 12-month forecast may be prepared for the period of 4/1/11 through 3/31/12 when the financial results are known for the first quarter ending 3/31/11. This way, management always has 12 months of projections available to work with.

Rolling forecasts tend to be utilized in companies operating in highly fluid or uncertain times that need to always look ahead a certain amount of time. However, more and more companies are utilizing rolling forecasts to better prepare for future uncertainties.

Understanding the difference between internal versus external projections

Businesses produce financial information for use by internal management and for external parties. Some businesses overlook the different needs of internal and external groups, and the company accountant may prepare financial statements from the internal accounting system and simply forward the same information to outside parties. Our thought about that approach is, to use the famous line from *Apollo 13,* "Houston, we have a problem."

The problem is that the information that's prepared for and delivered to external users (such as a financing source, taxing authorities, or company creditors) should not be the same as what's prepared for and utilized internally in the company. This is not to say that the information for external parties should be fabricated, misleading, or incorrect. The core information is still the same, but it's "conditioned" or formatted for delivery to the various parties in the most informative manner possible.

The following examples explain how a business can utilize the same information for different objectives:

- **Sales-driven versus accounting-driven budgets:** Companies often have more than one set of projections completed and used for different purposes. To date, we have yet to see a budget prepared based on sales and marketing information that is more conservative than a similar budget prepared based from operations or accounting information. By nature, sales and marketing personnel tend to be far more optimistic about the opportunities present than other segments of the business (which of course includes the ultraconservative accountants).

  Rather than attempt to have these two groups battle it out over what forecast model is the most accurate, some businesses simply prepare two sets of projections. The marketing and sales–based projection can be used as a management and motivational tool, whereas a more-conservative projection can be used for delivery to external financing sources (thus ensuring "reasonable" expectations so the company isn't under enormous pressure to hit aggressive plans). Granted, this strategy has to be properly managed (and kept in balance), because one forecast shouldn't be drastically different from another. You don't want to have to defend management's integrity by explaining to external parties who happen to get their hands on both why the forecasts have a large difference.

- **Drilling down into the detail:** Information delivered to external parties should contain far less detail than what is utilized internally by management on a daily basis. This concept, of course, holds true for the forecasting process as well. The level and amount of detail at the base of the projection model often drills down to the core elements of your business. For example, the summary projection in Figure 9-1 displays corporate overhead expenses as one line item. This one line item can, in fact, be the summation of over 100 lines of data (or more) and capture everything from the cost of personnel in the accounting department to the current year's advertising budget. An outside party doesn't need (nor want) to see that level of detail because it tends to only confuse matters and lead to unnecessary questions.

  However, by being able to drill down into the detail at any given time by using the internal information, you can kill two birds with one stone. Internally, you have the necessary detail to hold management team members responsible for expense and cost control. Externally, if needed you can provide real support for financial information presented in the budget, strengthening your credibility and giving your partners confidence that the business is being tightly managed.

REMEMBER

Preparing and presenting different information internally and externally applies to a business's planning and projection documentation just like other critical operational and financial reporting. In this day and age of management transparency and accountability, you don't want to be left holding the bag on unkept forecasting promises made to external parties (especially investors thinking that they have the next Facebook on their hands). The summarized, final results aren't different, but rather the structure and level of detail you provide to different parties should be formatted accordingly.

Preparing multiple projection scenarios: The what-if analysis

A *what-if* analysis is just what it sounds like. That is, you consider what the impact on your business or the market will be if a particular something happens. For example, "If I can land this new account, what additional costs will I need to incur, and when, to support the account?" Utilizing the what-if projection technique is a highly effective business management strategy that can be applied to all levels of the forecasting process, from a single division to the company as a whole. Figure 9-2 presents the original forecast of ACME Distribution, Inc., from Figure 9-1 (the expected case) alongside two other scenarios, one of which is a worst-case scenario and the other a best-case scenario.

By having the ability to complete what-if projections, ACME provides itself with a better understanding of what business decisions need to be made in case different operating scenarios are realized.

TIP

Investing the time and effort into developing a projection model that's very flexible and adaptable and can easily incorporate changes to critical economic assumptions is invaluable. If you properly identify, manage, and incorporate critical economic drivers into the planning process, your company can quickly prepare and evaluate different operating scenarios with limited effort.

Low, medium, and high forecasting

A very worthwhile and valuable exercise to undertake each year is to prepare a complete set of projections by using a classic forecasting strategy referred to as *low, medium, and high* (or worst, expected, and best cases):

- The *low* forecast scenario is based on somewhat of a worst-case or reduced-expectation operating scenario.
- The *medium* case is based on a very comfortable and achievable operating scenario.
- The *high* case is based on an operating scenario that's basically best case, in which a number of events, transactions, and so on have to go right to hit the projection goals.

No set rules dictate what ranges should be use to determine the difference between the three operating scenarios. A good rule of thumb is that when a scenario triggers a ±20 percent change in critical operating results (such as revenue or net profit levels), a unique projection and operating scenario has been achieved that generally produces results that require a material or significant management adjustment to be undertaken. As highlighted in Figure 9-2, dramatic differences in the company's pre-tax profit occur between the different operating scenarios, which may lead management to develop a contingency plan in the worst case (to cut expenses or reduce personnel) to creating an added bonus plan if the best case is realized.

Arm forecasting

One additional scenario we often recommend that companies develop is the *Arm* version. Arm is short for Armageddon, and this scenario is basically when all hell breaks loose (as a number of companies experienced in 2008 and 2009 during the Great Recession). The point of the Arm version is to always have it available for disaster planning purposes in the event unforeseen "shocks" to the business operating model are realized (so that actions plans can be enacted to protect your business interests). Although you may never have to experience an Arm environment, the Great Recession and the devastating earthquake and tsunami in Japan in 2011 underscore just how invaluable these types of plans can be.

Summary Balance Sheet	Actual Year-End 1/1/15	Worst Case Year-End 1/1/16	Expected Cast Year-End 1/1/16	Best Case Year-End 1/1/16
Current Assets:				
Cash and Equivalents	$230,000	$67,613	$199,250	$125,039
Trade Receivables, Net	$705,000	$700,000	$937,500	$1,000,000
Inventory	$450,000	$425,000	$500,000	$600,000
Other Current Assets	$75,000	$75,000	$75,000	$100,000
Total Current Assets	$1,460,000	$1,267,613	$1,711,750	$1,825,039
Fixed & Other Assets:				
Property, Plant, and Equipment, Net	$1,340,000	$1,265,000	$1,315,000	$1,340,000
Other Assets	$470,000	$400,000	$400,000	$400,000
Total Fixed and Other Assets	$1,810,000	$1,665,000	$1,715,000	$1,740,000
Total Assets	$3,270,000	$2,932,613	$3,426,750	$3,565,039
Current Liabilities:				
Trade Payables	$385,000	$400,000	$425,000	$500,000
Accrued Liabilities	$215,000	$190,000	$200,000	$210,000
Line of Credit Borrowings	$350,000	$250,000	$250,000	$100,000
Current Portion of Long-Term Liabilities	$250,000	$250,000	$250,000	$250,000
Other Current Liabilities	$75,000	$75,000	$75,000	$75,000
Total Current Liabilities	$1,275,000	$1,165,000	$1,200,000	$1,135,000
Long-Term Liabilities:				
Notes Payable, Less Current Portion	$800,000	$600,000	$600,000	$600,000
Capital Leases, Less Current Portion	$100,000	$50,000	$50,000	$50,000
Subordinated Debt	$250,000	$250,000	$250,000	$250,000
Total Long-term Liabilities	$1,150,000	$900,000	$900,000	$900,000
Total Liabilities	$2,425,000	$2,065,000	$2,100,000	$2,035,000
Equity:				
Common Equity	$100,000	$100,000	$100,000	$100,000
Retained Earnings	$555,000	$745,000	$745,000	$745,000
Current Earnings	$190,000	$22,613	$481,750	$685,039
Total Equity	$845,000	$867,613	$1,326,750	$1,530,039
Total Liabilities & Equity	$3,270,000	$2,932,613	$3,426,750	$3,565,039

Summary Income Statement	Actual Year-End 1/1/15	Worst Case Year-End 1/1/16	Expected Cast Year-End 1/1/16	Best Case Year-End 1/1/16
Revenue	$8,043,750	$7,038,281	$9,000,000	$10,054,688
Costs of Goods Sold	$6,032,813	$5,454,668	$6,673,250	$7,289,648
Gross Profit	$2,010,937	$1,583,613	$2,326,750	$2,765,039
Gross Margin	25.00%	22.50%	25.85%	27.50%
Selling, General, and Administrative Expenses	$1,395,000	$1,250,000	$1,425,000	$1,550,000
Depreciation and Amortization Expense	$250,000	$225,000	$275,000	$300,000
Interest Expense	$125,938	$86,000	$145,000	$80,000
Other (Income) Expenses	$50,000	$0	$0	$0
Net Profit Before Tax	$190,000	$22,613	$481,750	$835,039
Income Tax Expense (Benefit)	$0	$0	$0	$150,000
Net Profit (Loss)	$190,000	$22,613	$481,750	$685,039

Summary Cash Flow Statement	Actual Year-End 1/1/15	Worst Case Year-End 1/1/16	Expected Cast Year-End 1/1/16	Best Case Year-End 1/1/16
Operating Cash Flow:				
Net Income (Loss)	$190,000	$22,613	$481,750	$685,039
Depreciation and Amortization Expense	$250,000	$225,000	$275,000	$300,000
Net Operating Cash Flow	$440,000	$247,613	$756,750	$985,039
Working Capital:				
(Increase) Decrease in Trade Receivables	($69,130)	$5,000	($232,500)	($295,000)
(Increase) Decrease in Inventory	($50,000)	$25,000	($50,000)	($150,000)
(Increase) Decrease in Other Current Assets	$200,000	$0	$0	($25,000)
Increase (Decrease) in Trade Payables	($115,000)	$15,000	$40,000	$115,000
Increase (Decrease) in Accrued Liabilities	($35,000)	($25,000)	($15,000)	($5,000)
Increase (Decrease) in Current Debt	$25,000	($100,000)	($100,000)	($250,000)
Increase (Decrease) in Other Current Liabilities	$0	$0	$0	$0
Net Working Capital Cash Flow	($44,130)	($80,000)	($357,500)	($610,000)
Financing Capital:				
Equity Contributions	$0	$0	$0	$0
Additions to Long-Term Debt	$0	$0	$0	$0
Deletions to Long-Term Debt	($250,000)	($250,000)	($250,000)	($250,000)
Fixed Asset Additions	$0	($100,000)	($200,000)	($250,000)
Change to Other Long-Term Assets	$30,000	$20,000	$20,000	$20,000
Change to Other Long-Term Liabilities	$0	$0	$0	$0
Net Financial Capital Cash Flow	($220,000)	($330,000)	($430,000)	($480,000)
Beginning Cash	$54,131	$230,000	$230,000	$230,000
Ending Cash	$230,000	$67,613	$199,250	$125,039

Figure 9-2: What-if forecasts for ACME Distribution, Inc.

Integrating forecasts into the active management of your business

Thus far in this section of the chapter, we focus on making the most of financial forecasts from a forward-looking perspective as opposed to actively using forecasts on a periodic operating basis (with actual operating results). So we now turn our attention to incorporating projections with the active periodic management of a business by exploring three additional concepts: the variance analysis, operating plan implementation, and management discussion and analyses.

The variance analysis

An important step in integrating forecasts into operations is taking a look at the projection and comparing it to actual results for a period of time. This concept, called a *variance analysis,* is shown for ACME Distribution, Inc., in Figure 9-3. It presents a report that compares the budgeted results for the quarter against the company's actual results.

With a quick glance at the company's profitability, you could easily draw the conclusion that the company performed right in line with management's expectations, as the actual net loss of $100,100 is consistent with the forecast net loss of $98,125. But on further review, two problems appear. First, the company generated $1.585 million of revenue in the quarter compared to a forecast revenue level of $1.450 million. Yet when the company's gross margin is analyzed, the actual gross margin of 20.19 percent is well below the forecast gross margin of 22.50 percent. So all that effort to increase sales did not produce any improvement in gross profits earned. Obviously, management needs to understand what caused the gross margin to decrease (was it from lower sales prices, higher product costs, or a different product sales mix?).

The second issue is the fact that the company's trade accounts receivable balance was forecasted to reach $725,000 but actually amounted to $815,000, or $90,000 higher than expected. This difference appears to make sense in light of the increased revenue level, because higher sales generally translate into higher trade accounts receivable balances. But the issue to note is that the company had to borrow another $100,000 from the line of credit (forecast borrowings of $350,000 compared to actual borrowings of $450,000) to finance the increase in trade receivables (coming from higher sales), which adds interest expense and increases the leverage of the company.

Of critical importance, however, is that management needs to act on the information. If the market is looking for lower prices in general, then the company may want to revisit pricing strategies for the second through fourth quarters to take advantage of conditions that may allow it to improve the company's annual financial performance.

Summary Balance Sheet	Actual Quarter-End 4/1/15	Projected Quarter-End 4/1/15	Variance Quarter-End 4/1/15
Current Assets:			
Cash and Equivalents	$39,900	$54,375	$14,475
Trade Receivables, Net	$815,000	$725,000	($90,000)
Inventory	$555,000	$540,000	($15,000)
Other Current Assets	$75,000	$75,000	$0
Total Current Assets	$1,484,900	$1,394,375	($90,525)
Fixed and Other Assets:			
Property, Plant, and Equipment, Net	$1,325,000	$1,337,500	$12,500
Other Assets	$452,500	$452,500	$0
Total Fixed and Other Assets	$1,777,500	$1,790,000	$12,500
Total Assets	$3,262,400	$3,184,375	($78,025)
Current Liabilities:			
Trade Payables	$435,000	$450,000	$15,000
Accrued Liabilities	$220,000	$225,000	$5,000
Line of Credit Borrowings	$450,000	$350,000	($100,000)
Current Portion of Long-Term Liabilities	$250,000	$250,000	$0
Other Current Liabilities	$75,000	$75,000	$0
Total Current Liabilities	$1,430,000	$1,350,000	($80,000)
Long-Term Liabilities:			
Notes Payable, Less Current Portion	$750,000	$750,000	$0
Capital Leases, Less Current Portion	$87,500	$87,500	$0
Subordinated Debt	$250,000	$250,000	$0
Total Long-Term Liabilities	$1,087,500	$1,087,500	$0
Total Liabilities	$2,517,500	$2,437,500	($80,000)
Equity:			
Common Equity	$100,000	$100,000	$0
Retained Earnings	$745,000	$745,000	($0)
Current Earnings	($100,100)	($98,125)	$1,975
Total Equity	$744,900	$746,875	$1,975
Total Liabilities and Equity	$3,262,400	$3,184,375	($78,025)

Summary Income Statement	Actual Quarter-End 4/1/15	Projected Quarter-End 4/1/15	Variance Quarter-End 4/1/15
Revenue	$1,585,000	$1,450,000	$135,000
Costs of Goods Sold	$1,265,000	$1,123,750	($141,250)
Gross Profit	$320,000	$326,250	($6,250)
Gross Margin	20.19%	22.50%	-4.63%
Selling, General, and Administrative Expenses	$317,850	$325,000	$7,150
Depreciation and Amortization Expense	$64,750	$65,000	$250
Interest Expense	$37,500	$34,375	($3,125)
Other (Income) Expenses	$0	$0	$0
Net Profit Before Tax	($100,100)	($98,125)	($1,975)
Income Tax Expense (Benefit)	$0	$0	$0
Net Profit (Loss)	($100,100)	($98,125)	($1,975)

Summary Cash Flow Statement	Actual Quarter-End 4/1/15	Projected Quarter-End 4/1/15	Variance Quarter-End 4/1/15
Operating Cash Flow:			
Net Income (Loss)	($100,100)	($98,125)	$1,975
Depreciation and Amortization Expense	$64,750	$65,000	$250
Net Operating Cash Flow	($35,350)	($33,125)	$2,225
Working Capital:			
(Increase) Decrease in Trade Receivables	($110,000)	($20,000)	$90,000
(Increase) Decrease in Inventory	($105,000)	($90,000)	$15,000
(Increase) Decrease in Other Current Assets	$0	$0	$0
Increase (Decrease) in Trade Payables	$50,000	$65,000	$15,000
Increase (Decrease) in Accrued Liabilities	$5,000	$10,000	$5,000
Increase (Decrease) in Current Debt	$100,000	$0	($100,000)
Increase (Decrease) in Other Current Liabilities	$0	$0	$0
Net Working Capital Cash Flow	($60,000)	($35,000)	$25,000
Financing Capital:			
Equity Contributions	$0	$0	$0
Additions to Long-Term Debt	$0	$0	$0
Deletions to Long-Term Debt	($62,500)	($62,500)	$0
Fixed Asset Additions	($37,250)	($50,000)	($12,750)
Change to Other Long-Term Assets	$5,000	$5,000	$0
Change to Other Long-Term Liabilities	$0	$0	$0
Net Financial Capital Cash Flow	($94,750)	($107,500)	($12,750)
Beginning Cash	$230,000	$230,000	$0
Ending Cash	$39,900	$54,375	$14,475

Figure 9-3: A variance analysis for ACME Distribution, Inc.

Budgets, financial statements, variance analyses, and other prepared statements are pointless if management is not prepared to respond to the information they provide.

Operating plan implementation

Beyond the variance report, another obvious use of the forecasts is to support the implementation of specific plans and action steps. For example, if a new production distribution facility is set to open in the third quarter of the year, then the staff to support this facility will need to be secured in the middle of the second quarter and then trained to ensure that they are ready when the new facility opens. The original budget for the new facility should also have accumulated and incorporated that info, but the idea is to turn the budget into a proactive working document (easily accessible for reference) rather than a onetime effort left on the shelf to die.

Management discussions and analyses

The budget plays an important part in helping businesses prepare a financial document that most companies ignore (either intentionally or out of ignorance): the MDOR *(management discussion of operating results),* or MDA *(management discussion and analysis).*

MDOR and MDA are essentially the same document and serve the same purpose, which is to provide a written narrative of how the company is performing. These documents translate financial information, results, and numbers into written words, strategies, plans, and events. Though this type of documentation sounds relative easy to complete, the MDOR and MDA can be very difficult to prepare because the translation process can be very difficult.

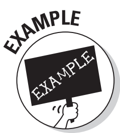
At the base of the MDOR and MDA, when explaining actual results versus planned, is a well-developed budget that provides a clear road map to understanding operating result variances. You may wonder why a business would bother putting together these difficult documents if they simply summarize information available elsewhere. We recommend them for the following two critical reasons:

- If you present financial information without explaining it, readers (whether internal or external) often come to their own conclusions about why the company is performing a certain way. More times than not, their conclusions are incorrect, which may lead to adverse decisions that negatively impact your business. Remember, assumptions are the mother of all you-know-whats, so the more you can do to eliminate assumptions from being made, the better.

- By being able to clearly relay your company's financial results, key parties (whether internal or external) will gain more confidence in your management abilities, which gives your business more creditability. This may not sound like much payoff for the work, but believe us when we tell you that management integrity and creditability have saved more than a few businesses. For financing sources, *credit decisions* are easy and tend to be based on the financial information. But when a *business decision* needs to be made, management integrity and creditability rise to the surface.

Broadening the use of projections even further

When preparing projections, you must remember that the base data and information accumulated (to prepare the budget) can be used to support other business planning and management functions as well. For example, a well-developed budget can be used not only to prepare forecast financial statements but, in addition, to prepare the estimated taxable income or loss of a company. For some companies, the difference between book and tax income is small. However for others, the difference can be significant and must be anticipated, as the following real world example demonstrates.



A large provider of personnel services elected to implement a strategy to self-fund their workers' compensation insurance costs. The preliminary analysis indicated that an average annual savings of 30 percent or more could be achieved if properly managed. At the end of the third year of the self-funded workers' compensation insurance program, the company had established an accrued liability for over $1 million to account for potential future claims. (That is, workers' compensation insurance claims for injuries sustained on the job, which required subsequent payments to be made over a period of time). In total, the claims amounted to $1.2 million, of which $200,000 was paid by the end of the year and the expected additional payouts required for medical services, lost wages, and other damages amounted to another $1 million. For book purposes, the $1 million represented an expense recorded in the financial statements, which resulted in the company producing net income of roughly zero dollars. For tax purposes, the IRS would not allow the expense until the claims were actually paid, so the taxable income of the company was $1 million (resulting in a tax liability of $400,000). If the company did not properly budget for this business event, it might have been in for a rude surprise, as per the books the company made nothing yet owed $400,000 in taxes. You can be assured that this is not the type of surprise an executive wants to experience on short notice.

The budget can be used for other purposes as well, ranging from preparing information for specialized needs from external parties (such as governmental agencies that require information to be prepared in a specific format) to training a new division manager on the basic economics of how his division should perform. The better the forecasts are designed and structured from the beginning, the more uses and value they provide your business down the road.

Chapter 10

Identifying and Securing External Sources of Capital

In This Chapter

- Checking out debt and equity capital
- Starting the search close to home
- Finding investment sources of capital
- Going to the public markets and other sources of capital
- Getting the most out of capital

Over the past 100 years, the face of the United States has been shaped by waves of industrial visionaries, technology giants, and innovative entrepreneurs who were in the right place at the right time. From Ford, Carnegie, Mellon, and Vanderbilt to Hewlett Packard, IBM, Google, and Facebook, the most prosperous companies have certain characteristics in common. The ultimate success of companies is based in a combination of the ability to secure all the essential ingredients needed to build a business (including leadership, vision, talent, planning, determination, and more) at the most opportune time, with a little luck, combined with the all-important element of securing the proper amount and type of capital (cash) to support the business concept.

Whether big or small, public or private, foreign or domestic, or 1 month new or 20 years old, securing and managing capital resources represents the lifeline of any company looking to operate in today's challenging economic climate. In this chapter you get a quick look at why capital is so important before delving into the details of one of the two types of capital, equity. We explain how equity works, what sources are available, and how you can go about securing them. And to make sure that your newly acquired capital works hard for you, we discuss how capital should be used and what you should know about the capital markets.

Getting a Grip on the Capital Concept

Securing capital for a company represents one of the most painstaking and time-consuming efforts a business undertakes. Getting a party interested in providing capital to your organization is one thing; actually receiving the commitment and securing the capital is an entirely different thing. Securing capital represents a full-time job requiring the undivided attention of a company's senior management team and ultimately the CEO, because that's where the buck stops.

Countless technical and/or theoretical definitions are available (to peruse at your leisure) on what capital actually is, but to keep it simple, when managing a business opportunity, you really only need to consider one expression to understand the real essence of capital: *It takes money to make money.* Launching any new business concept, from the aspiring entrepreneur designing a new software product from his home office to an executive of a multinational corporation looking to expand foreign distribution channels for new product introductions, requires capital (cash, money, greenbacks, or whatever you like to call it) as a basis to execute the business plan.

One of the most common reasons cited as to why businesses fail is a lack of capital, or inappropriately structured capital (to support the needs of the business). This problem not only applies to the more easily understandable business environment when continued losses consume all of a company's cash, but it also applies (maybe more importantly) when a company grows too fast and doesn't have enough capital or cash to support its growth. Companies can literally grow themselves right out of business if the growth isn't properly planned for and managed.

Business capital can basically be classified into one of two primary types: debt (loans that must be repaid), or equity (investments that should generate a return). This chapter explores some of the ways you can raise capital through equity. When these opportunities are paired with debt capital, available from banks and other lenders (and more fully overviewed in Chapter 11), a savvy and well-informed accountant can find plenty of potential sources to raise cash.

Deciding what form of capital, debt or equity, is most suitable for your company really depends on the company's stage in terms of its operating history, industry profile, profitability levels, asset structure, future growth prospects, and general capital requirements, all considered in relation to where the sources of capital lie. After exploring potential sources of capital in this chapter (on equity) and Chapter 11 (on debt), analyzing your company's financial condition in Chapter 7, and considering future requirements in Chapters 8 and 9, you'll be ready to answer this question and (hopefully) secure your financial future.

KEY CONCEPT

Keep in mind that capital should not be perceived as just the amount of cash on hand but rather the amount of financial resources available to support the execution of a business plan. This point is clearly illustrated throughout this chapter's discussion of raising/securing capital.

Understanding the Basics of Equity Capital

Equity-based capital is money provided to a company in the form of an investment in the business, which is looking for the generation of a return (such as a dividend being paid on stock you might own). This capital doesn't have set repayment terms but does have a right to future earnings. Unlike debt, equity investors may be provided dividends or distributions if profits and cash flows are available. For example, a software technology company requires approximately $2 million in capital to develop and launch a new Internet-based software solution. A niche venture capitalist group invests the required capital under the terms and conditions present in the equity offering, including what their percentage ownership in company will be, rights to future earnings, representation on the board of directors, preferred versus common equity status, conversion rights, antidilution provisions, and so on. Under this scenario, the company receiving the equity is not required to remit any payments to the capital source per a set repayment agreement, but it has given up a partial right to ownership (which can be even more costly).

Equity is best evaluated by understanding its two most important characteristics: preference and management influence.

Equity preference

Preference refers to the fact that certain types of equity have priority over other types in collecting earnings and, if needed, company assets. For example, a Series A preferred stock may be issued to investors that have an interest in making an equity investment but want to protect or prioritize their investments in relation to the common shareholders or another series of preferred stock. A Series B preferred stock may hold a lower preference to the Series A preferred stock in terms of asset liquidations but may have a slightly higher dividend yield attached or offered with a warrant that allows it to purchase common shares at a later date at a favorable price.

Actually, the features built into preferred stock are almost endless and can create a large number of different types of preferred stock (A through Z). For common equity, so too can preferences exist. Common stock Type A may have full voting rights and dividends (after the preferred shareholders receive their dividend), whereas a common stock Type B may only have rights to dividends and not voting. To list all the potential preferences and/or features built into equity instruments (including the ability to convert, antidilution provisions, cumulative versus noncumulative dividends, voting rights, acceleration clauses, liquidation criteria, and more) is well beyond the scope of this book.

The key point in understanding equity preferences is that equity investors attempt to secure as many preferences and features that protect their interests as possible. Though this strategy may be good for them, it may not be in the best interests of the company, and it may restrict the company's ability to operate farther down the road.

Equity and management influence

The concept of management influence is centered in the fact that when equity capital is raised, the provider of the capital is considered an owner or shareowner of the company. By its very nature, this involvement entitles the shareowner to have a say in the company's operations (unless otherwise restricted) with the ability to vote with the board of directors and on other critical matters (for example, on approving the company's external auditor or allocating equity to be distributed to company management). This management influence can be extended significantly when preferences are factored into the equation.

In the end, the old adage of "Money talks and you-know-what walks" really applies in today's economic environment as it relates to management influence. When investors with big money come to the show, they tend to have a significant influence on not only the composition of a company's board of directors but even on the actual management team running the business daily.

If you remember only one thing when raising equity capital, it should be this: Be prepared to co-manage the business with your new best friends — the equity investors — because for the business to run smoothly and efficiently, your dictatorship must give way to a democracy.

Starting to Look for Capital

In the movie *Jerry Maguire,* Cuba Gooding Jr. utters the now-somewhat-infamous line, "Show me the money." These four words sum up the capital-raising process as well as any, because until you have the money in hand, a business concept is really nothing more than the paper the business plan is written on. And as author Tage's dad (who is in fact the coauthor of this book) has always told him, that and one dollar should get you a cup of coffee.

To make that business plan worth something, you need to look at the potential sources of capital available to launch your new business, open a new product/service niche within a corporate conglomerate, or acquire a pesky competitor. The sources listed in this section are by no means all-inclusive, but they provide an overview of the variety of avenues available to raise capital and the pluses and minuses associated with each one.

Looking in the mirror

First up, the business founders need to look no farther than themselves to secure initial capital to launch or support a company. Their assistance may range from tapping their own savings to selling personal assets and holdings (to raise cash) to leveraging their creditworthiness with debt such as home equity loans, credit cards, and/or other sources. The bottom line is that just about every business venture starts with some type of initial capital or cash contribution being made by the founders.

Providing this preliminary *(seed)* capital is critical for two reasons. First, and most obviously, the new business venture needs cash to launch its operations, including covering the costs to legally form the company, supporting the initial operating expenses and payroll, and so on. Second, and just as important, most external capital sources want to see that the founders have actually invested some of their own hard-earned cash and effort into the business. If you haven't stepped up with the capital needed to launch a business, your lack of financial participation may raise a question about your real commitment to the business.

WARNING!

Retirement accounts, including 401(k)s, company-sponsored profit-sharing plans, IRAs, SEPs, and the like, are often considered as a source of cash by individuals when starting a business. Though tempting, a complete and full understanding of the risks and added costs associated with using these funds should be considered. For instance, significant additional tax burdens may arise from using these funds if not properly planned for and managed. And don't forget that this is your retirement money, so it should go without saying that tapping this capital source should be done with the utmost caution.

JARGON ALERT

Sweat equity is the amount of time, effort, and energy an individual invests in a company in lieu of actual cash contributions. For example, if you work for free during the first year the business is formed but have a market worth of $100,000 in annual compensation, then that amount is considered sweat equity. Most likely, external capital sources are not going to assign significant value to this component, but it's a very important number to calculate and quantify when negotiating equity investments.

Turning to family, friends, and close business associates

Family, friends, and close business associates (or *FF&CBAs*) have been one of the primary capital sources to launch new business concepts since the beginning of time and will most likely continue to fill this role in the future. The involvement of FF&CBAs ranges from the founders of a business having mom and dad offer up the initial ante to a trusted business associate stepping in with the needed seed money to launch the company.

Generally, this type of capital tends to be for low dollar amounts, be geared toward equity as opposed to debt (given the uncertain nature of the business and higher risks present in terms of generating cash flow), and be provided to closely held and/or family operated businesses. However, debt can be effectively utilized with more mature businesses generating solid profitability with some type of security present (such as real estate).

The good news is that raising capital from FF&CBAs can often be completed quickly and without a significant amount of legal paperwork and/or similar investor creditability issues. The bad news is threefold:

- The amount of capital available from these sources is often restricted. Pulling together a couple of hundred thousand dollars is one thing, but when a business concept needs a million or two, not too many FF&CBAs have this type of liquidity available (unless maybe your last name is DuPont, Getty, Gates, or Buffett).
- The recent economic turmoil experienced in the United States from 2008 through 2010 has made this source of capital more difficult to access because personal wealth has eroded via decreasing real estate values, reductions in savings/investment values, and lost employment income, and many people are very nervous about protecting their nest egg. And given that traditional sources of capital (like from banks) have become scarce, many people among your FF&CBA may want to conserve cash for their own business interests.
- Having unsophisticated FF&CBAs provide capital to a business carries unforeseen risks and volatile emotional elements. Reporting back to a seasoned investor that a business concept didn't work and that his investment is worthless may not be the most pleasant task in the world, but at least the investor was aware of the risks. Telling your aunt and uncle that you've just blown through their nest egg may get your name replaced with something nasty when spoken at subsequent family gatherings. The costs of losing a family member's investment can be much greater than the actual amount of capital invested.

WARNING!

Be very wary of FF&CBA capital sources and the subjective costs that are often attached. Only FF&CBA sources who clearly understand the investment process and business in general, as well as can afford the potential loss, should be approached and evaluated as capital sources. Nothing is worse than having a business fail and then watching the family disintegrate as a result of the failed business.

Seeking Equity Sources of Capital

When your business has reached a point where external equity is needed to support its growth, a large number of private capital sources are available and generally fall into one of the four following primary sources: angel investors, venture capitalists, private equity groups, and other private investment groups.

These sources of private capital come in a variety shapes, sizes, and forms, but all tend to gravitate toward a common set of criteria:

- The dollar size of the capital commitment is generally larger than with FF&CBAs. These groups are comprised of highly trained and sophisticated professionals responsible for managing large pools of capital and, as such, frequently apply the concept of economy of scale (that is, they will spend the same amount of time and energy on evaluating an opportunity that needs $1 million of equity funding versus an opportunity that needs $10 million of equity money, with the latter providing a greater chance of turning into a much bigger and more valuable business).
- These groups tend to be more risk-based capital sources and look for higher returns from equity-driven transactions (as well as expect additional involvement in the management of the business, usually at the board level). These groups are comfortable making equity investments in relatively early-stage businesses without proven profitability (but with significant potential) or structuring risk-based debt facilities to support a higher-risk business opportunity (for example, the debt is secured by nothing more than goodwill). Just remember, higher investment returns will be expected for taking on the added risk.
- These groups are generally not looking to invest in a company with a revenue potential in the ballpark of only $5 million after five years (such as regionally based construction subcontracting company). With the types of capital these groups have available, the business opportunity must be relatively grand to pique their interest. Though you don’t need to be the next Microsoft, you do need to provide a solid opportunity to produce in excess of $50 million in annual revenue (over a reasonable time), generate solid profits, and have an efficient exit strategy.

So the good news with private capital is that larger capital amounts are available, the groups are generally very sophisticated and can provide invaluable management support, and the capital is often equity based so that aspiring businesses in needs of large capital infusions have a resource. The bad news is that these groups tend to ask for (and receive) a higher ownership stake in the business and thus can exert a significant amount of management control and influence. In addition, these groups retain highly trained professionals who are very demanding when undertaking their due diligence.

Due diligence is the process by which a capital source evaluates, examines, tests, audits, and otherwise reviews the business information being provided from a company looking to secure capital. Or in other words, and for lack of a better comparison, due diligence is basically the equivalent of your business receiving a colonoscopy.

In the following sections, the ordering of these private capital sources is presented from most willing to assume and accept risk to least willing (with angel investors often taking on more risk and more-immature business opportunities and private equity groups looking for lower risk and more-mature business opportunities).

Angel investors

Angel investors typically are high-net-worth individuals that have ample financial resources to invest in new ventures. In addition, based on their past experiences or own curiosity, angel investors tend to have a strong interest in the business concept, product, technology, or service of the company seeking capital, and they're not afraid to invest in a business at more of a "conceptual" stage (that is, the early stage or before revenue is generated). Angel investment groups come in all shapes, sizes, and forms ranging from geographically based (for instance, a group of high-net-worth individuals who all live in the same city) to interest based (experts with a specific investment interest brought together virtually from around the globe). Capital availability from angel investors, however, tends to be lower than other private capital sources, with investment levels often in the six-figure to low-seven-figure range.

The very important term *accredited investor* (as defined by the Securities and Exchange Commission, or SEC) basically represents an individual who has the appropriate financial strength and business acumen to understand the risks of the investment and bear the brunt of any potential economic loss. The SEC has established a very clear set of tests and criteria to qualify investors as accredited, and you should follow these criteria when pursuing angel investors. The reason for this diligence is simple: If you raise capital from nonqualified parties, the risk of legal action against the owners of the business increases, especially if an investor complains. Trust us when we say that the last thing anyone wants to deal with is the combination of the capital source, the source's attorneys, and the SEC all pounding on the company at once.

Venture capitalists (VCs)

Next up in the risk-appetite order are venture capitalists, or VCs. VCs, similar to angel investors, come in groups of varying size and form but are generally aligned along a specific industry expertise or interest. For example, certain VCs have a strong interest and knowledge in the biotech industry, whereas others specialize in social media or green/clean energy.

Capital availability from VCs tends to come in much larger increments, with most VCs looking for investment minimums of $5 million (although some will go lower, depending on your industry and region). In addition to having funds to invest, VCs generally have other significant resources at their disposal, including decades of combined business management experience, in-depth industry knowledge, and well-developed contacts and business relationships. However, this level of funding and support carry with them higher levels of management involvement and much tighter due-diligence efforts.

Note: The *V* (or *venture* part of the name) in VC has become noticeably scarcer over the past decade, particularly since 2007. VCs are tending to hedge their risk and are looking for later-stage opportunities with proven management teams and solid revenue traction that are in need of working capital to support growth rather than innovate new products, technologies, or concepts. The days of VCs funding two guys in a garage with an idea are long gone.

WARNING!

VCs have significant resources at their disposal with professionals and experts available to address any issue, question, or concern that may arise. If your business isn't properly prepared to undertake the rigors of a detailed VC examination, then don't. If your presentation or pitch for capital fails, a VC is unlikely to give you a second chance.

Private equity groups (PEGs)

Private equity groups or (PEGs) offer sources of capital in a similar strategy to VCs in that they look for specific industries that they possess an expertise within. Capital availability from PEGs covers a wide range, with lower limits in the $5 to $10 million range and upper limits well into the hundreds of millions of dollars.

PEGs operate in just about every type of industry you can think of and tend to look for slightly different opportunities than VCs. Whereas a VC looks to invest in a newer concept with significant growth potential, a PEG tends to be more focused on mature businesses that have untapped potential that the PEG can help unlock. For example, a large regional distribution company may have reached its operating limit as a result of outgrowing the management team's capabilities and capital resources available. A PEG may recognize that by consolidating this operation with others, the combined operation (on a national or even global scale) can expand more efficiently and leverage all the acquired resources into a very large and highly profitable company.

PEGs can be attracted to untapped potential in financially sound businesses just as often as in troubled, financially weak, and/or poorly managed companies. PEGs may be able to unlock the economic value of many kinds of businesses just by bringing in new management and providing adequate capital.

Be very careful with how the *E* (or *equity* part of the name) in PEG is created. PEGs often use both equity and debt when structuring their deals in an effort to utilize the internal cash flow of a company to service the debt. As we note in Chapter 11, debt cuts both ways: It can greatly enhance an investment's return, but the added leverage can also increase the operating risk of the business. So though *E* was plentiful in the PEGs from 2003 through 2007 (when the economy was expanding), a number of PEGs experienced a very quick evaporation of *E* when the economy turned south in 2008.

Similar to VCs, PEGs have significant resources at their disposal with professionals and experts available to address any issue, question, or concern that may arise. So like a good Boy Scout, be prepared when working with PEGs.

Other private investment groups

In the United States, capital formation and deployment can be achieved relatively quickly and efficiently. When a new market opportunity presents itself, capital will find a way to exploit it (as long as the investment returns are appropriate). A case in point is how capital is moving to take advantage of the economic turmoil realized from 2008 through 2010. A variety of new private investment groups that can best be described as having a cross section of characteristics from VCs, PEGs, and lending sources have been formed to pursue opportunities in specific industries. For lack of a better term, I refer to these private investment groups as *pirate funds,* because they tend to look for promising but distressed situations and provide debt- and equity-based capital (with limited management support or involvement).

But although capital markets can form and deploy funding quickly, these types of investment groups also need to be approached with an added level of caution, because they tend to be very expensive when all their fees, costs, requirements, and demands are considered. This isn't to say that these groups are just looking to exploit the situation. A number of the groups are very well structured and provide invaluable resources. But understanding why these groups demand higher returns (in relation to the risks they take) and when they should be used is important.

For example, a business may need to secure $1 million of longer-term capital to execute a turnaround, pay off some pesky secured creditors (such as a bank), and provide working capital to cover short-term losses. A pirate fund may step in and provide this financing in the form of lower-priority debt at a relatively high interest rate, but which also carries an equity kicker to sweeten the deal and improve the investment return.

An *equity kicker,* a right or grant provided to a third party (providing higher-risk debt to a business) in the form of future upside earnings that may be realized from improved cash flows, the sale of a business, or the like, is usually provided to a third party as a way of improving the potential return on an investment in recognition of increased risks being taken. Taking the above example, if an investment group provides a $1 million loan to a business against inferior collateral (like intangible assets, such as goodwill, or intellectual property, such as patents or trade names), an interest rate in the mid to high teens (16 percent) should be expected along with a warrant attached to purchase 10 percent of the company at a very low price. So not only does the source providing the $1 million of capital earn 16 percent on the loan, but if the company is successful in executing its business plan and sells down the road for a handsome price, the investment group then also has an opportunity to participate in the increased value of the business. Numerous types of equity kickers are used, but the objective remains the same — to enhance an investment return in a high-risk transaction.

In terms of capital availability, these types of private investment groups have a significant bandwidth in deal size, which may range from as low as $500,000 to $1 million to the hundreds of millions of dollars. It just depends on the size of the investment fund and industry specialty.

Accessing Public Sources of Capital

Almost every business owner, professional, and manager is aware of the public markets for trading stocks and bonds, including the New York Stock Exchange, NASDAQ, and similar venues (that is, Wall Street). Instruments of both equity (such as the common stock of Microsoft) and debt (like United States Treasury Bills) are actively traded in these open markets. Though the allure of the public markets is very appealing to business owners and often is viewed as the end game ("I took my company public and now am worth X million dollars"), the reality of operating in a public market can be very different. As such, public capital sources have developed a unique set of qualifications in terms of making it the most appropriate capital source to pursue.

- **Think big.** Public markets are better suited for companies thinking in hundreds of millions or billions than in millions.
- **Think public.** Basically, all your company's information, financial records, activities, and so on will be available for public viewing. You must not only be prepared to disclose the information, but also make sure that the disclosure is prepared in the proper format.
- **Understand risk.** Are the returns and rewards for being public adequate in relation to the risks you and your business assume?

Public capital market's positive attributes include having access to extremely large capital levels that can tap the widest range of sources available (stretching the globe). As the national debt of the United States clearly displays, no deal is too big for public markets. The liquidity that public markets offer (allowing investments to be efficiently bought, sold, and traded), the ability to establish fair-market values almost instantaneously, and access to both debt and equity sources are also positive attributes.

But as everyone knows, no capital source is perfect, so there must be a downside to public capital as well:

- **Cost:** Staying in compliance with all the public reporting requirements can be extremely expensive and only continues to increase as investors demand more disclosures and the government looks to protect investors further (for example, with the Sarbanes-Oxley Act of 2003).
- **Management exposure:** Even when fraud isn't present, investors in public debt and equity instruments can turn into a company's worst nightmare when things aren't going as planned. The additional burden placed on the management team can be extensive and distract the company from actually running its business.
- **Misconception about liquidity:** Just because your company is publicly traded doesn't mean that it has liquidity. Stocks of smaller companies (with less than $100 million of market capitalization) are often not actively traded on the open market, which can make selling or buying a large block of stock more difficult (not to mention the scrutiny the company insiders, original founders, large equity owners, management, board members, officers, and similar parties receive when undertaking these transactions).

KEY CONCEPT

This discussion on public markets is fairly short, but the topic of accessing public capital markets could fill a book by itself. However, the long and short of public markets is fairly straightforward: Though plenty of small companies are publicly traded, public markets are generally best suited for the big boys of corporate America.

Putting Your Capital to Good Use

Raising or securing capital is without question one of the most difficult and time-consuming tasks the senior management team of a company undertakes. Preparing, packaging, marketing, negotiating, and closing the deal can easily consume 80 to 100 percent of an executive's time, depending on the stage of the company. For a start-up operation, chief executive officers (CEOs) and other senior executives often find themselves closing on one round of financing, resting for a day or two, and then starting the process all over again, looking for the next financing source. For chief financial officers (CFOs) of publicly traded companies, the majority of their time may be consumed in preparing information for the capital sources and markets and then managing the capital sources expectations, inquiries, and/or other needs. To a certain degree, managing the capital sources after the capital is secured can be even more challenging and difficult than raising the capital itself.

Managing this element of capital risks is somewhat intangible in nature because it's geared toward relationships and communication efforts as opposed to hard financial and accounting data. With that said, we now turn our attention toward the more tangible elements of managing capital risks, from both the accounting and financial perspectives. Check out Figure 10-1 to see these capital risks illustrated.

As you can see in Figure 10-1, all elements of this business are exactly the same, with the exception of how the business was capitalized. Under the equity scenario, a total of $1 million of capital was raised, all in the form of equity. Under the debt scenario, a total of $200,000 of equity was raised and $800,000 of debt was secured (of which $200,000 is due over the next 12 months and is thus classified as a current liability in the balance sheet). The income statements are exactly the same with the exception of the fact that the debt scenario has interest expense present.

The quick financial analysis highlights the key differences and indicates that, by using debt, the company was able to generate better returns for the equity owners in 2008 as follows:

- **Returns:** The debt scenario produces a return on equity of 16.65 percent compared to a return on equity of 11.84 percent with the equity scenario. The return on assets is almost identical for both scenarios.
- **Earnings:** The debt scenario generates earnings per share of roughly 4.5 times that of the equity scenario ($1.20 per share compared to $0.27 per share).
- **Leverage:** The only real downside to the debt scenario lies in the fact that this scenario has a much higher debt-to-equity ratio (1.09) compared to for the equity scenario (.34) in addition to having a debt service coverage ratio of approximately 1.16. Although using debt was beneficial in terms of enhancing returns, it also has placed the company in a higher risk status due to the amount of debt leverage used. This risk will be clearly illustrated when the next year's operating results are realized, as presented in Figure 10-2.

Summary Balance Sheet	Equity FYE 12/31/08	Debt FYE 12/31/08
Current Assets:		
Cash and Equivalents	$145,180	$116,380
Trade Receivables, Net	$750,000	$750,000
Inventory	$815,625	$815,625
Total Current Assets	$1,710,805	$1,682,005
Fixed and Other Assets:		
Property, Plant, and Equipment, Net	$1,250,000	$1,250,000
Other Assets	$75,000	$75,000
Total Fixed and Other Assets	$1,325,000	$1,325,000
Total Assets	$3,035,805	$3,007,005
Current Liabilities:		
Trade Payables	$611,719	$611,719
Accrued Liabilities	$30,586	$30,586
Line of Credit Borrowings	$0	$0
Current Portion of Long-Term Liabilities	$0	$200,000
Total Current Liabilities	$642,305	$842,305
Long-Term Liabilities:		
Notes Payable, Less Current Portion	$0	$600,000
Other Long-Term Liabilities	$125,000	$125,000
Total Long-Term Liabilities	$125,000	$725,000
Total Liabilities	$767,305	$1,567,305
Equity:		
Common and Preferred Equity, $1 Per Share	$1,000,000	$200,000
Retained Earnings	$1,000,000	$1,000,000
Current Earnings	$268,500	$239,700
Total Equity	$2,268,500	$1,439,700
Total Liabilities & Equity	$3,035,805	$3,007,005

Summary Income Statement	Equity FYE 12/31/08	Debt FYE 12/31/08
Revenue	$9,000,000	$9,000,000
Costs of Goods Sold	$6,525,000	$6,525,000
Gross Profit	$2,475,000	$2,475,000
Gross Margin	27.50%	27.50%
Selling, General, and Administrative Expenses	$2,000,000	$2,000,000
Interest Expense	$0	$48,000
Other (Income) Expenses	$27,500	$27,500
Net Profit Before Tax	$447,500	$399,500
Income Tax Expense (Benefit)	$179,000	$159,800
Net Profit (Loss)	$268,500	$239,700

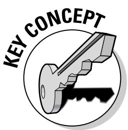
Quick Financial Analysis	Equity FYE 12/31/08	Debt FYE 12/31/08
Debt-to-Equity Ratio	0.34	1.09
Debt Service Coverage Ratio	N/A	1.16
Return on Equity	11.84%	16.65%
Return on Assets	8.84%	7.97%
Earnings Per Share	$0.27	$1.20

Figure 10-1: Unaudited financial statement comparison for a normal operating period.

Now we fast-forward to 2009 (as presented in Figure 10-2), during which time the company has gone from having a robust year (in 2008) with strong margins and profitability to now having to deal with the Great Recession driving sales lower by 25 percent and reducing gross margins as a result of having to lower prices (to stay competitive). Whereas the selling, general, and administrative expenses were reduced as result of the difficult times, the reduction wasn't enough to enable the debt company to generate a profit. Now the equity-financed company is able to generate a small profit and produce positive returns on assets and equity and the debt-financed company incurs a loss and negative returns.

Making matters even worse is that the debt-financed company may now be in violation of certain debt covenants and in default of the loan agreement. For example, the loan agreement may read that the company needs to maintain a debt service coverage ratio of at least 1 and/or produce profitable results on an annual basis (both common covenants for lending sources). Because the company has violated both, it is in technical default on the loan, which will require a fair amount of management attention moving forward.

And just to add a little more insult to injury, the real damage may not be realized until 2010 and beyond. While the equity-financed company has a strong balance sheet and ample cash to expand after the recession ends, the debt-financed company is stuck with restructuring its balance sheet to please its creditors. Thus, it may miss significant growth opportunities in 2010 and beyond, costing the company sales and profits.



In summary, debt- and equity-financing strategies cut both ways. Although debt-financing strategies can enhance returns, they also increase the company's operating risks by leveraging its assets. In good times, when profits and cash flows are ample and everyone's making a buck, debt-financing strategies look great. When the tide turns, profits dry up, and cash flows become restricted, debt financing can look like the evil stepchild that nobody wants around but which must be fed (usually at the expense of some good kids). Remember, debt-financing sources are focused on providing loans that generate sound returns and are repaid in a reasonable time frame. You won't get much sympathy from a bank if you ask them to suspend debt payments in order to keep a business unit open on the hopes of an eventual rebound.

Conversely, equity capital offers a chance to strengthen the balance sheet and help manage the company's operating risks through good times and bad. Maintaining a strong balance sheet can really provide a competitive weapon when expanding a business into new markets or exploring a unique business opportunity. However, having too much equity without being able to generate adequate returns can dampen investor enthusiasm and produce a rather restless group of shareholders and board members. Remember, equity-financing sources do not invest capital to watch it generate below-average returns. Equity capital, although representing a lower perceived risk to the company, is by its nature a higher-risk capital source (to the providers) and must produce a satisfactory investment return. If not, the equity capital will find an opportunity that does provide the necessary return.

Summary Balance Sheet	Equity FYE 12/31/09	Debt FYE 12/31/09
Current Assets:		
Cash and Equivalents	$876,027	$425,627
Trade Receivables, Net	$562,500	$562,500
Inventory	$632,813	$632,813
Total Current Assets	$2,071,340	$1,620,940
Fixed and Other Assets:		
Property, Plant, and Equipment, Net	$1,000,000	$1,000,000
Other Assets	$75,000	$75,000
Total Fixed and Other Assets	$1,075,000	$1,075,000
Total Assets	$3,146,340	$2,695,940
Current Liabilities:		
Trade Payables	$474,609	$474,609
Accrued Liabilities	$23,730	$23,730
Line of Credit Borrowings	$0	$0
Current Portion of Long-Term Liabilities	$0	$200,000
Total Current Liabilities	$498,340	$698,340
Long-Term Liabilities:		
Notes Payable, Less Current Portion	$0	$400,000
Other Long-Term Liabilities	$125,000	$125,000
Total Long-Term Liabilities	$125,000	$525,000
Total Liabilities	$623,340	$1,223,340
Equity:		
Common and Preferred Equity, $1 Per Share	$1,500,000	$500,000
Retained Earnings	$1,018,500	$989,700
Current Earnings	$4,500	($17,100)
Total Equity	$2,523,000	$1,472,600
Total Liabilities and Equity	$3,146,340	$2,695,940

Summary Income Statement	Equity FYE 12/31/09	Debt FYE 12/31/09
Revenue	$6,750,000	$6,750,000
Costs of Goods Sold	$5,062,500	$5,062,500
Gross Profit	$1,687,500	$1,687,500
Gross Margin	25.00%	25.00%
Selling, General, and Administrative Expenses	$1,600,000	$1,600,000
Interest Expense	$0	$36,000
Other (Income) Expenses	$80,000	$80,000
Net Profit Before Tax	$7,500	($28,500)
Income Tax Expense (Benefit)	$3,000	($11,400)
Net Profit (Loss)	$4,500	($17,100)

Quick Financial Analysis	Equity FYE 12/31/09	Debt FYE 12/31/09
Debt-to-Equity Ratio	0.25	0.83
Debt Service Coverage Ratio	N/A	0.08
Return on Equity	0.18%	-1.16%
Return on Assets	0.14%	-0.63%
Earnings Per Share	$0.00	-$0.03

Figure 10-2: Unaudited financial statement comparison for a recession period.

Looking at the Reality of the Current Capital Markets

Raising capital really does represent the ultimate sale: You have to convince a capital source to actually believe in your business and then fork over the money. Terms such as *nerve-racking, frustrating, euphoric, riding a roller coaster* and the like become common in addition to the experiences of hair loss, stress, and joy. And the economic turmoil experienced across the globe from 2007 through 2010 has only made the capital-raising process even more challenging. So as a friendly reminder to help you with this challenge, we summarize ten key capital-raising tips along with five critical realities of the capital markets.

Ten tips for raising capital

As you navigate the complicated job of raising capital, keep the following advice in mind:

- **Be prepared.** Always be prepared for anything and everything. Capital sources expect and demand the highest quality information, plans, and underlying support be made available when evaluating an investment opportunity.
- **Be persistent.** Capital sources are just looking for reasons to say no. The attributes of persistence and determination can't be emphasized enough when pursuing and securing capital.
- **Qualify the capital sources.** Make every effort to qualify your capital sources to ensure that the most appropriate avenue is pursued in relation to the operating status of your business. Don't waste your time or theirs, and by all means make sure that the capital source is capable and accredited to support the request.
- **Give yourself plenty of time.** Raising capital can be a painstakingly slow process, so make sure you plan well in advance and use one simple rule: If you need money in three months, plan on needing twice that long to obtain it.
- **Communicate.** Communication efforts are critical to successfully securing and managing capital. To keep capital sources happy, you absolutely must keep them up-to-date with all relevant information, good or bad.
- **Document and disclose.** Do not underestimate the importance of properly documenting all capital-raising activities, from the initial communications to final agreements. In addition, full and complete disclosures are a must in today's hostile economic environment and are often

referred to as "representations and warranties." These disclosures include, but are not limited to, stating that the company has the rights to all intellectual property claimed as owned, no legal actions or lawsuits are present (and if they are present, they must be disclosed), is a company in good standing (has the right to legally conduct business), has executed the following material contracts or commitments, and on and on and on. Basically, representations and warranties cover just about every aspect of the business.

- **Keep your options open.** Having more than one financing option available is always helpful. Although it may not be feasible for every business, keeping more than one iron in the fire is important in this era of economic uncertainty.
- **Treat capital sources as partners.** Whether a business's source of capital is debt or equity, the party providing the capital represents a key partner to a company's current and future success. So by including the capital source in active and appropriate elements of the business, they are more likely to stay engaged, offer support, and advise to assist the company.
- **Have exit strategies.** Remember, all capital sources want their money back with a solid return at some point. Offer clear and reasonable exit strategies to assure the capital sources that a light will be present at the end of the tunnel (and that it's not a freight train barreling down the other direction).
- **Balance the risk/reward relationship.** To a capital source, equity investments carry more risk than debt investments, and as such the return realized on the investment must be higher. To a business, debt can expose the company to greater risks but also higher returns. The trick is to find the right balance between the two so returns are enhanced (with the equity source being happy) but not overleverage the company (which would place the entire livelihood of the business at risk). As with the so-called "stress tests" undertaken by banks in the United States in 2010 to evaluate how well they could hold up under adverse economic conditions, a similar stress test should be performed on your company to evaluate where its key tipping points may be.

Five realities of the current capital markets

As if capital sourcing wasn't difficult enough in the best of times, the current economic environment has made your job harder. Knowing the following unfortunate facts about today's capital markets will prepare you to deal with the current climate and reassure you that everyone is facing the same tall hurdles.

- **Longer lead times:** Plain and simple, securing capital takes much longer today than it did five to ten years ago. With fewer sources, added scrutiny, and increased regulations, all businesses should be prepared for a much longer sales or securing cycle.
- **More expensive:** Almost all forms of capital, debt or equity, are more expensive for most businesses than a decade ago. The current low-interest-rate environment should not be used as a basis when determining the cost of capital, because unless your company name is Apple, McDonald's, or Microsoft, access to cheap capital will not be available.
- **Fewer sources:** The Great Recession of 2007 through 2009 definitely thinned the herd in terms of available sources of capital. Bank failures were well documented, but other sources of capital, including VCs, PEGs, alternative lending sources, and even FF&CBAs, also saw contractions. There just aren't as many choices today compared to a decade ago.
- **Stringent underwriting:** As noted throughout this chapter, capital source underwriting and due-diligence efforts are as detailed, thorough, and intense as ever. The heightened concerns involving accountability and transparency have amplified the need for additional underwriting procedures.
- **Tighter reporting and management:** When capital is secured, you have to be prepared for much tighter management and reporting controls by the capital source. As the capital sources are under more pressure to manage their resources more efficiently, this requirement simply works down the food chain.

Chapter 11

Knowing When to Use Debt to Finance Your Business

In This Chapter

- Checking out how debt works
- Recognizing when debt is a good option
- Exploring your lender options
- Wrangling some cash from the government

When discussing the concept of debt in today's economy, a very serious and unfortunate misconception needs to be clarified. That is, contrary to popular belief, the term *debt* is not a four-letter word. Although the excesses of the debt housing binge have been well documented since the housing market started to crash in 2007 and conjure up numerous horror stories at the neighborhood barbeque, the crash really just highlighted how dangerous debt is — when used inappropriately.

KEY CONCEPT

If you remember one concept from this chapter, it should be this: Debt is most appropriately used when an asset is available to support the eventual repayment of the debt. Whether the asset is tangible (such as equipment used in a manufacturing process), paper based (such as a trade accounts receivable where a valid claim is present against a third party), or centered in the ability to reliably predict a positive cash-flow stream, the business must have a clearly identifiable asset that can, if needed, be validated by an independent third party.

The goal of this chapter is to pick up where Chapter 10 (on securing capital from equity sources) left off by beginning our discussion on debt with a more complete overview of its key attributes and characteristics.

Understanding the Basics of Debt Capital

Debt-based capital is money given to the business in the form of a loan. It represents a liability or obligation to a business because it's generally governed by set repayment terms as provided by the party extending credit and accompanied by a claim against specific assets. For example, suppose a bank lends $2 million to a company to purchase additional production equipment to support the expansion of a manufacturing facility. The bank establishes the terms and conditions of the debt agreement, including the interest rate (for instance, 8 percent), repayment term (say, 60 months), the periodic payment, collateral required, and other elements of the agreement. The company must adhere to these terms and conditions or run the risk of default.

But debt is not limited to just loans, leases, notes payable, and/or other similar agreements. Countless other sources of debt are used by a company to support daily operations. Examples of these sources include using payment terms (for example, due in 30 days) provided by vendors when purchasing products or services, leveraging customers to provide advances or deposits against future purchases, or remitting commissions to employees when the cash for a sale is received compared to when the actual sale is made.

Debt is best evaluated by understanding its two primary and critical characteristics: maturity and security.

Debt maturity

Debt maturity refers to the length of time the debt instrument has until the maturity date, which is the date the debt becomes due and payable. For example, in the case of trade accounts payable, vendors commonly extend credit terms of 30 days to their customers, which means payment is due within 30 days of receipt of the product or service. Any debt instrument requiring payment within one year or less is classified as *current (short-term)* in the balance sheet. Logic then dictates that *long-term debt* is any obligation with a payment due beyond one year. For example, mortgage loans provided by banks for real estate purchases are often structured over a 30-year period. Hence, the portion of the debt due past the first year is considered long term in nature.

Debt security

Debt security refers to the type of asset the debt is supported by or secured with. If a bank lends $2 million to support the expansion of a manufacturing facility, the bank takes a "secured position" in the assets acquired with the

$2 million loan. That is, the bank issues a public notice (generally through the issuance of a Uniform Commercial Code [UCC] document) that it has lent money to the manufacturing company and that it has a first right to the equipment financed in the case of a future default. This security provides the bank with additional comfort that if the company can't cover its debt service obligations, a tangible asset can be retrieved and liquidated to cover the outstanding obligation. Other forms of security also include intangible assets (like a patent or rights to intellectual property), inventory, trade accounts receivable, real estate, and future cash-flow streams (for example, a future annuity payment stream that guarantees X dollars to be paid each year).

You may assume, logically, that most organizations that provide credit to businesses prefer to be in a secured status to reduce the inherent risks present. However, for the majority of a company's transactions related to the periodic purchases of goods and services, this arrangement is logistically almost impossible due to the sheer volume of transactions being executed on a day-to-day basis (as filing paperwork with the state on a per-transaction basis to note a secured position is present is incredibly inefficient and would overwhelm the system).

Hence, the secured creditors are usually the ones focused on a company's infrequent or nonrecurring transactions, such as a bank. They tend to be associated with formal credit extension agreements (such as a lease or equipment loan), which are both relatively large from a dollars-committed standpoint and cover longer periods of time. Because the dollar amounts committed are large (and thus the risk is higher) and these transactions are less frequent, the secured creditors (such as a bank) are more than willing to prepare and file the necessary paperwork to "secure" their position with the asset they've loaned money against.

So in general, the majority of creditors actually turn out to be unsecured. This type of creditor tends to be the mass of vendors that provide basic goods and services to a company for general operating requirements. Examples of these vendors are professional service firms, utility and telecommunication companies, material suppliers, and general office services. Unsecured creditors obviously take on more risk in that a specific company asset is not pledged as collateral to support the repayment of the obligation. This risk is mitigated by the fact that unsecured creditors tend to extend credit with shorter repayment terms (for instance, the invoice is due on net 30-day terms) and in lower dollar amounts. In addition, if unsecured creditors are concerned about getting paid, then they may use other strategies including requiring the company to make a deposit or a prepayment.

When lenders refer to *security interest or position,* they're discussing the legal documentation (for example, a UCC) that's prepared and filed with the respective governmental authorities (usually a state commission) to publicly place on notice that the lenders have the first right to the asset to which they extended a loan against. This arrangement is very similar to a lender providing a first deed of trust against real estate to which it helped finance the purchase of. A similar process is used with business assets such as equipment, machines, inventory, trade accounts receivables, and other assets.

Other debt attributes

Beyond the maturity and security elements of debt are a number of additional attributes. Debt capital may involve the following distinctions and arrangements:

- **Personal guarantees:** A party outside the company guarantees the repayment of a debt, similar to how a cosigner on a debt instrument works.
- **Priority creditors:** Certain creditors to a business may maintain a priority status due to the type of obligation present, such as payroll taxes withheld for the IRS, which by law overrides almost all other liabilities.
- **Subordination agreements:** A creditor may specifically take a secondary position to a secured lender.
- **Default provisions:** In the event of a loan default, set provisions indicate what the remedies of the parties involved are.
- **Lending agreement covenants:** The business must perform at a certain level to avoid triggering a default.

TIP

Before you structure and execute any type of loan, lease, note payable, and/or set terms and conditions with a creditor, professional counsel should be secured and utilized to make sure that you clearly understand the agreement and risks present and protect your company's business interests.

Determining When Debt Is Most Appropriate

For almost any debt-based need, some type of lender is usually available in the market. On one end of the spectrum are traditional banks and credit unions, which tend to be the most conservative lenders but also provide some of the best rates. On the other end of the spectrum are investment funds that specialize in providing high-risk loans, but of course loans from these sources tend to carry the highest rates. And in between are a slew of lenders that all have a unique niche in the market, depending on the credit risks, and that carry interest rates appropriately matched to the associated risks.

TIP

Businesses often secure capital from more than one source on a periodic basis. For instance, risk-based capital (in the form of equity) may be secured to develop a new product and support the initial launch into the marketplace, whereas debt-based capital may be secured to support an increase in inventory and to carry trade accounts receivable as customers purchase the products. Not only are both forms of capital appropriate for this company's needs, but in addition the lenders may be more willing to step forward and provide the necessary capital knowing that another partner has made a commitment. The "herd" mentality holds true for capital sources because they view the opportunity in a more positive light (by assuming a higher degree of success) if they know that the right amount and types of capital have been secured.

Debt-based lenders, similar to equity sources discussed in Chapter 10, tend to look for a common (but different) set of characteristics when extending capital in the form of debt. Different lending sources give different weight to each characteristic in each unique business environment, but some definite deal killers apply to each. The three primary characteristics are discussed in the following sections.

When you can offer security or collateral

The business seeking a loan must offer primary and secondary sources of security or collateral (for example, a pledged asset or personal guarantee). If the amount of loan required is in excess of the collateral or security being pledged, then securing a loan will be very difficult (unless additional collateral is pledged).

The best scenario for securing a loan is a company that's highly profitable, has sound collateral, and offers a strong secondary repayment source. Of course, you may ask why debt would be needed in this scenario. The answer is that a company may want to use debt appropriately to enhance economic returns and results (because when all factors are considered, debt is cheaper than equity).

When business is stable

Lenders only want to get involved in stable business environments. The company must have been in business for an extended period of time, have a proven track record, and have a solid management team at the helm. This is not to say that businesses must generate a profit to secure debt financing, but it certainly helps expand the number of sources available and can help secure lower rates.

If the lending sources in any way, shape, or form become concerned with the credibility of the management team and/or stability of the business operation, then chances are that the lending source will pass on extending a loan. The last thing any lender wants to do is provide a loan and then, 90 days later, see the loan go into default and require collection actions.

When you have financial strength

Debt-capital sources are generally more conservative in nature than equity sources. Their goal is to ensure that the debt can be repaid, while generating an adequate return. Therefore, the company's ability to maintain solid financial returns and strong ratios is more important than its likelihood of doubling in size. Again, the same concept applies with financial strength as with business stability. The stronger the financial condition, the lower the interest rates. The weaker the financial condition, the higher the interest rates.

Some businesses, even if adequate collateral is available to secure the loan and no business credibility issues are present, may be just too financially "stressed" to extend a loan. In this situation, a lender may evaluate the company from its ability to survive a shock to the operating structure in terms of having enough financial resources to manage through turbulent times. If the lender becomes your last chance at survival, then its interest level generally falls off unless alternative financial resources can be secured to prop up the business.

Using Loans, Leases, and Other Sources of Debt

After you conclude that your business meets the security, stability, and financial strength requirements for appropriately using debt-based capital (discussed in "Determining When Debt Is Most Appropriate"), you can turn your attention to evaluating the different sources of debt and when each is generally used in a business.

WARNING!

No matter what source you choose, we can't stress enough the importance of qualifying the capital source. Nothing is worse than wasting your time in pursuing a loan that has no chance of being funded.

Borrowing from banks

Looking to secure capital from banks in the form of loans is one of the most tried and proven sources of capital. The old (and, yes, outdated) image of a business looking to grow and in need of a loan to expand, hire new employees, and increase sales and profitability has always been a mantra of the banks. Sorry to spoil the party, but we're here to explain why, due to the criteria they use to underwrite the loan, banks are not ideally suited to handle a good portion of business-loan needs in today's economy.

When a bank or any type of lender refers to *underwriting* a loan, it basically means the same concept of a private capital source performing due diligence. The lender undertakes a detailed review of the loan applicant's financial and business information to ensure that the borrower is credit worthy.

Banks do provide an important source of debt-based capital to some businesses, but they require five key criteria to be met before they consider providing a loan:

- **Positive earnings:** In most cases, a company must generate positive cash flow or earnings to secure a loan. Banks are cash-flow lenders, which basically means that for any type of debt they offer, internal cash flows must be adequate to repay the debt. So if a business has historical losses or is forecasting losses in the future, strike one.
- **Sound collateral:** Banks lend against assets to protect their loans. So every business looking to secure a bank loan needs to have sound collateral available (to repay the loan in case the business cannot). Generally, banks like to lend against the most liquid and best-performing assets, such as trade accounts receivable. They tend to be more cautious when asked to accept collateral such as inventory (which can become obsolete quickly and also carries the risk of simply disappearing from a business) and equipment (which can depreciate in value very quickly and is expensive to liquidate if needed). So the preference with banks is to lend primarily against trade receivables and, if needed, then offer reduced loans or lending facilities against higher risk assets such as inventory. If you don't have quality collateral or the right collateral, strike two.
- **Solid financial performance:** The strength of a company's balance sheet is just as important as positive earnings when requesting a loan. When a business has excessive leverage (too much debt compared to too little equity), its business risks increase and a bank's interest decreases. So if your business is too leveraged, strike three.
- **Secondary repayment:** For most smaller- to medium-size businesses (the vast majority operating in America), banks generally look for a secondary source of repayment to ensure that the debt gets paid. Or in other words, if internal cash flow is not adequate and the collateral (if liquidated) doesn't cover the debt obligation, the bank needs to turn to another source of repayment to cover the debt. This secondary source generally falls back on the personal assets of the company's owners, which may range from real estate to personal savings to retirement accounts to other business interests owned (by offering a personal guarantee). If no secondary repayment sources are available, strike four.

  A personal guarantee (or PG) pretty much means what it implies. That is, if your business can't repay a loan, then the lender will pursue the assets of the individual who signed the PG to ensure that full payment is received. Needless to say, PGs should be executed with the utmost caution and understanding, but at the same time, you also keep an important concept in mind: If you elect to not execute a PG, then the bank views your reluctance as a sign that you, the owner or founder, do not have faith in the business. So why would a bank lend money if the owners aren't willing to stand behind the company (even if all the other criteria is met)?

- **Business plan:** To get a bank loan, your company needs a solid business plan with a highly experienced and credible management team. These requirements reassure the bank that their cash is being turned over to a third party who knows how to run a business and generate profits. Any plan that a bank reviews that is short on these items will certainly lead to strike five.

Since 2007, just about every bank (notice it's a four-letter word) has been maligned, fairly or not (and been referred to in the same sentence with just about every other unflattering four-letter word). The frustration with the banking industry, at both the personal and business levels, has been well documented and has really reshaped the banking industry's role in the capital markets. For example, prior to 2007, a bank might have been able to bend a little when extending credit to a good business that had some flaws (such as a relatively high debt-to-equity ratio). However, businesses are now being treated to a new normal that makes securing loans much more challenging. Banks still play a very important and vital role in the capital markets, but businesses must clearly understand when a bank can provide debt-based capital and when it cannot.

TIP

If your business meets the five criteria outlined previously, then approaching a bank is appropriate. Banks are always looking for A/A+ deals, and if your business qualifies, then taking advantage of this source of debt capital is advantageous because it usually carries far lower fees and interest rates than other forms of debt-based capital. However, if just one of the five criteria is not met, then banks may lose interest, so it's imperative that businesses understand the alternative forms of debt-based capital available. And if you fail two or more of the criteria, then bank financing options will likely be very limited, so the next step in evaluating securing financing is to explore the wonderful world of asset-based lending.

Making friends with asset-based lenders

Asset-based lending utilizes the same criteria as banks but with one critical difference. Asset-based lenders (ABLs) focus on the quality of the asset (such as trade accounts receivable or inventory) being offered as collateral first and the company's financial performance and strength second. In fact, ABLs often look past one or two years of poor financial performances and are more comfortable with weak balance sheets because they understand that businesses sometimes experience problems (look no farther than the 2009 recession and its impact on businesses). However, similar to banks, the need for sound collateral, solid secondary repayment support, and a well-developed business plan are essential to secure a loan.

But ABLs have a hidden benefit that a business should exploit when appropriate: ABLs may extend higher borrowing levels against certain assets than banks. For example, banks tend to be more conservative in nature and may only advance 75 percent against eligible trade accounts receivable, so if you have $1 million of eligible trade receivables, you can borrow a maximum of $750,000. If the collateral strength of the trade receivables is strong, an ABL may lend 80 or even 85 percent against the eligible trade receivables, which would allow a company to borrow $800,000 to $850,000. The additional borrowing availability may not seem like much, but when cash is tight, having an extra few dollars of liquidity available is invaluable.

So you may ask, why not skip the bank and simply secure financing from an ABL? Well, ABLs are more expensive. Period! From the interest rates charged on the loans to the fees assessed to manage the relationship, the cost of ABL-provided financing is much higher than traditional banks. As a general reference point, it's safe to say that ABLs will be about double what the bank costs "all in all" or when all costs, fees, and expenses are accounted for. (If bank-provided financing costs roughly 6 percent, then an ABL is around 12 percent). This source may appear expensive, but remember, an ABL absorbs additional risks with weaker companies and thus requires a higher rate of return.

Another downside of an ABL is that you need to be prepared to implement much tighter management reporting requirements than you would with a bank. Whereas a bank may require monthly reports and information, ABLs often look for weekly or, in some cases, daily reporting procedures to be implemented to properly track and manage the assets they're lending against.

Leasing as a source of capital

Leasing or renting an asset is an effective source of debt-based capital. The most common example is leasing office space. Instead of tying up cash in purchasing a building or investing in leasehold improvements, most companies simply execute a lease with a landlord.

An e-commerce retail company was growing rapidly and needed additional warehouse and distribution space for the company's products. Adjacent space was available but needed a number of improvements to be workable. Instead of making the improvements itself, the retail company negotiated with the landlord to make the improvements and then simply increased the rent proportionately to cover the additional costs. This arrangement allowed the retail company to utilize cash internally and finance the building improvements over the life of the lease (which was at a very reasonable rate).

Leases are most commonly structured with assets that have an extended life, such as buildings and capital equipment (like manufacturing equipment, furniture, computers, and autos). Structuring leases for capital equipment are also used extensively in the business community and provided by numerous financing or leasing companies. But before a business dives headfirst into leasing, the following key concepts and risks should be understood:

- **Risk of ownership:** Most equipment leases are structured to transfer the risk of ownership to the lessee, so insurance, property taxes, maintenance, and so on all fall on the shoulders of the party leasing the equipment. But in the same breath, remember that the leasing company has a secured interest in the asset being leased (to protect their interests). In other words, in most cases the leasing company retains legal title to the assets being leased. If the business defaults on terms of the lease, the owner (the lessor) can repossess the asset.
- **Real financing cost:** Understanding the internal cost of a lease in terms of the implied interest rate being charged is very important. Leasing companies use all types of tricks and tactics to improve their returns, including requiring payments to be made in advance (for example, on the first day of the month rather than the last), having the first and last months' lease payments made in advance, structuring fair-market value buyout options, and so on.
- **Used versus new equipment:** Leasing is best utilized when the equipment is new rather than used, because the interest rate charged and the amount of lease financing provided will be most favorable to the lessee. Attempting to secure lease financing on used equipment is both very difficult and expensive.

The bottom line in equipment leasing is the same with securing other forms of debt. The leasing companies generally take on higher levels of risk than a bank and, as such, demand higher returns (so leasing tends to be more expensive than other forms of debt). But though more expensive, leasing companies often extend leases based on 90 to 100 percent of the equipment's new value, so instead of having to place 20 percent down on the asset (with a traditional bank loan), more cash can be conserved inside the business when using leases.

In every debt-based financing decision, the borrower needs to make a critical decision based on the trade-off between higher financing costs and access to additional capital or cash. Or in other words, if the excess cash can be invested or used in the business to generate returns greater than the costs of the financing, then using more-expensive and flexible financing programs is appropriate. One mistake commonly made by businesses is that they're so consumed with making sure they get the lowest interest rate available that they don't consider the impact the loan facility may have on restricting available borrowing levels and access to cash. In a number of cases, paying a little extra for higher loan balances and/or access to cash is well worth the added expense.

Tapping government programs and the SBA

Government lending programs, at both the state and federal levels, are accessible for businesses. The most popular program at the federal level is provided through the Small Business Administration, or SBA, which offers programs geared toward real estate (for owner-occupied buildings) and general business working-capital requirements. Contrary to popular belief, the government is not handing out free cash (which we know is hard to believe) and in fact applies basically the same stringent underwriting criteria as the banks.

The government relies heavily on the banking industry to market and underwrite SBA loans. As such, the common perception that loans from the SBA are readily available and easy to obtain is a myth. In fact, securing an SBA loan can be more time consuming and challenging than a traditional bank loan.

In addition to the federal government's SBA program, various states also have lending programs to assist small businesses. The availability of these programs has declined over the years as state and local governments struggle with large budget deficits and limited financial resources. Turn to the later section "Leveraging Uncle Sam for Cash" for a more thorough discussion on tapping the government for cash.

Using other sources of debt-based capital

Numerous other forms of debt-based capital are available, and two common sources are particularly worth highlighting:

- **Factoring receivables:** When trade accounts receivable are factored, technically the receivable is sold to a third party who becomes the owner of the receivable (as cash is paid to the seller). Unlike banks and ABLs that lend against an asset (and thus the asset remains the property of the company), in this case, the asset is actually sold to a third party. When the customer pays, the cash goes to the factoring company and the transaction is completed. Factoring financing agreements are used in a wide range of industries, and as with all forms of debt financing, they carry both pros (high advance rates and quick turnarounds) and cons (they're relatively expensive).

TIP

Factoring trade accounts receivable involves selling an asset to a third party who then may notify your customer that the receivable has been sold (and where to properly remit payment). Needless to say, this may send a negative message to your customer in terms of the financial strength of your business (they may wonder, are you that desperate for cash?). When factoring agreements are used, you must properly communicate the transaction with customers to prevent misunderstandings or misinterpretations. The last thing you want to do is surprise your customers by introducing an unknown third party into the business relationship.

- **Subordinated debt:** Quite often, parties with a vested interest in a business may provide loans in the form of subordinated debt. The loan often comes from an owner or related third party. Subordinated debt has terms and conditions established just like other types of debt but is offered a lower security position in company assets than senior lenders. That is, if a company liquidates, the last creditors in the pecking order in terms of having claims against company assets are the subordinated debt holders.

Getting Creative with Capital

Banks, leasing companies, and other lenders are all viable and accessible sources of debt-based capital, with specific characteristics that give each source competitive strengths and weaknesses. However, the discussion of sources of capital wouldn't be complete if we didn't look a little deeper into some more-creative capital sources that can often be overlooked.

The number of creative capital sources is endless, so rather than attempt to cover every trick of the trade, we present a diversified list of examples to provide you with a sense of how businesses manufacture capital.

Generating internal cash flow

The primary concept of this book is educating business owners and managers on understanding, generating, and managing internal cash flow. To be quite honest, the best way to get capital is to look internally and manage business operations more efficiently to produce additional capital. Positive internal cash flow is both readily available and logistically much easier to secure. However, you need to keep in mind that positive internal cash flow must be managed and invested appropriately within the best interests of the company and its shareowners.

Leveraging unsecured creditors

Beyond generating additional cash from internal management efforts, a business is often afforded the opportunity to utilize creative forms of unsecured financing from vendors, partners, and customers. Following are three such examples:

- **Require customers to prepay 20 percent of their order as a requirement to start the production and future delivery process.** In addition, terms such as 20 percent down, 30 percent upon half completion, and the remainder due upon delivery can also be utilized. Companies that produce and sell customized products often use this strategy because active alternative markets are generally not present for "one of a kind" items.
- **Ask key product suppliers to grant extended terms from 30 days to 90 days during certain seasonal periods (for example, to support higher sales during the holiday season).** After the determined period, terms are brought back to 30 days when the cash flow from the increased sales catches up. Retailers often use this strategy during the holiday season as inventory levels are built up from October through November (with cash receipts realized in December and then used to repay the extended credit granted from its suppliers).
- **Work with a downstream customer to obtain funding to develop a new product or technology that can greatly improve the customer's future performance.** For example, a hardware technology company may need to ensure that software is available for use with its new products. Hence, a capital infusion into the software supplier to develop the technology for which it receives a royalty from future sales may be warranted.

Going after government aid, gifts, and grants

Governments, universities, and nonprofit organizations have resources available in the form of grants, low-interest-rate loans (with limited downside risk), incentive credits, gifts, and so on that are intended to be used for special interests or purposes. The general idea is to provide this capital to organizations that will use it in the best interest of the general public. For instance, biotechnology companies often secure research grants for work being completed on disease detection, prevention, and possible cures. Educational organizations may receive grants that help retrain a displaced group of workers or poorly educated work force.

Partnering up

A vast array of other creative capital sources is available to companies. In this section we summarize one such source, a partnership, in an example.

A software company was in the process of developing a new fraud-protection system for use in the banking system. Not only did the development of the system need to be capitalized, but the initial marketplace launch also required additional capital to ensure that the end customers, mainly banks, could review, test, evaluate, and implement the systems. Internally, the company didn't have enough capital to support this project, so they completed an acquisition of a sister company (which was related through partial common ownership) that was producing strong internal cash flows to support the project. The company issued its equity in exchange for all the assets of the target company (which in effect was the future cash-flow stream). This trade provided the company with enough ongoing cash flow (from the acquired businesses product sales) to both fund the system development and market it to the banks.

Leveraging Uncle Sam for Cash

This discussion on using debt to secure cash for your business ends most appropriately with tapping the government to assist with improving cash flows. However, before we dive into this topic and discuss specific strategies, two critical concepts should be noted.

First, we want to debunk the myth that the federal government simply hands out free cash. Yes, the bailouts provided to various banks, General Motors, and other companies during the Great Recession appeared to be rather generous, but these bailouts carried very specific terms and conditions and were due to extreme economic conditions. The federal government does have cash available for businesses, but as previously noted in the section "Tapping government programs and the SBA," it is looking to provide this cash to viable business operations with specific and somewhat strenuous terms and conditions.

Second, keep in mind that the strategies offered in this section of the chapter are fully endorsed and accepted by the federal government but carry a number of rules and regulations (the fine print). If you don't properly manage and comply with the rules, you can create unforeseen problems and headaches for your business.

You may wonder why we elected to incorporate a discussion on the impact of taxes in the chapter on using debt in a business. The simple answer is that taxes represent an expense and liability to a business (or debt), either short term or long-term in nature, and debt represents a source of cash for businesses. If tax obligations and liabilities can be managed more effectively, this in turn can help improve cash flows. But in order to capture the benefits of increased cash flows on the taxation front, the following four key points should be kept in mind:

- **Securing professional support:** Proper professional counsel, including CPAs, attorneys, and other taxation experts, should be secured and actively utilized to assist with appropriately managing tax liabilities and improving cash flows. Given the complexity of the tax laws, combined with how frequently tax rules and regulations are changed, high-quality tax professionals are usually worth their weight in gold. They often are aware of tax breaks, credits, and/or strategies that can save significant dollars.
- **Complying with all tax requirements:** Tax compliance can be a very frustrating, time- consuming, and expensive endeavor. But as the old saying goes, don't be penny-wise and pound-foolish. Skipping on the front end will ultimately cost far more down the road when the taxing authorities finally catch up to you.
- **Deferring tax obligations:** Most tax savings opportunities (and related improvements in cash flow) come from deferring tax liabilities rather than eliminating them altogether. Granted, tax credits represent a permanent method of reducing tax liabilities, but the vast majority of tax strategies, including utilizing the cash method to report taxable income, leveraging flow-through entities, and taking advantage of accelerated deductions, are based more on strategies of timing, offering the ability to delay paying the tax. Sometimes they also offer the possibility of deferring some taxable income to a future period when the tax rate may be lower.
- **Basing economic decisions on tax factors:** Business decisions should be based on sound economic and financial considerations first and tax factors a distant second. You always want to consider how you can structure business transactions to capture tax benefits, but the tax benefits should be the icing on the cake used to enhance the economic return (rather than the sole reason an economic return is even realized).

Four government-endorsed strategies to help improve cash flow

The number and variety of tax savings opportunities offered by the federal government are extensive and are generally designed to encourage or direct third parties toward undertaking a specific activity or transaction. For example, when the housing market and economy collapsed between 2007 and 2009, the government provided a first-time homebuyer tax credit to encourage the purchase of residential property. The government also encourages businesses to invest in various activities (such as research and development and alternative or clean energy) by providing a variety of tax credits. Of course, the majority of the opportunities are not applicable for most businesses, given the uniqueness of certain tax deductions, credits, and other savings opportunities. So rather than attempt to list every potential tax savings opportunity, we summarize the primary avenues available for small businesses to leverage Uncle Sam for some cash in the following four sections.

Reporting taxable income on a cash basis

One of the most common strategies utilized by small businesses to manage tax liabilities (and associated cash payments to the government) is electing to report taxable income by using cash-based as opposed to accrual-based accounting for profit. Most businesses are required to prepare periodic financial statements using generally accepted accounting principles (GAAP), which require financial information to be prepared on an accrual basis. (You can find out the details in Chapter 2.) Though this basis is without question the most appropriate method to prepare, report, analyze, and distribute the financial results of a business, the IRS allows companies that meet certain conditions to report taxable income on a cash basis.

What does this switch to cash basis mean? Well, to explain it as simply as possible, we look at the two main drivers that create differences between accrual- and cash-based taxable income — sales and expenses:

- **Sales:** Under the accrual method, sales are recognized and reported in the financial statements when fully earned, whether or not cash has been collected for the sale. Under the cash method, sales are only recognized and reported when cash is actually received.
- **Expenses:** What's good for the goose is good for the gander, so on the expense side of the accrual method, expenses also can be recognized and reported in the financial statements when fully incurred (with an obligation present), whether or not cash has been distributed to a third party. Under the cash method, expenses can only be recognized and reported when cash is actually distributed.

Figure 11-1 provides an example of how taxable income can be lowered by using the cash method as compared to the accrual method. The significance of using the cash method to report taxable income is that it allows for the deferral of tax obligations and payments to the government, which translates into more cash being retained in the business.

KEY CONCEPT

The IRS has a number of rules and regulations established to determine if a business qualifies to use cash-basis reporting. Thoroughly review these rules and regulations with help from professional counsel to make sure that your business qualifies to report taxable income using the cash method.

Description	Accrual Method	Adjustments	Cash Method
Revenue (A)	$2,500,000	$200,000	$2,300,000
Costs of Goods Sold (B)	$1,750,000	$75,000	$1,675,000
Gross Profit	$750,000	$125,000	$625,000
Corporate Overhead Expenses (B)	$500,000	$25,000	$475,000
Net Profit before Tax	$250,000	$100,000	$150,000
Income Tax Expense - 25% Rate	$62,500	n/a	$37,500
Deferral of Tax Obligation	n/a		$25,000

A - The $200,000 trade accounts receivable increase at year-end has not been collected, so it does not need to be recognized as revenue in the current year using the cash method.

B - Of the $100,000 trade accounts payable increase at year-end, $75,000 relates to direct costs of good sold and $25,000 to corporate overhead. These expenses would not be allowed using cash method, because they were not paid as of the end of the year.

Figure 11-1: The impact of cash-basis accounting reporting on taxable income.

Remember that when using cash-based accounting to report taxable income, the taxes are not being *eliminated* but rather *deferred* or *delayed* to a future period, allowing a company to manage cash resources more efficiently and remit tax payments when cash is available. Eventually, income tax obligations will be realized when cash is received; so don't make a very common and often fatal mistake of spending the deferred taxable income inappropriately and having bare pockets when the tax bill comes due.

Structuring the business to impact cash resources

You can also manage income tax obligations and improve cash availability by utilizing the most appropriate legal structure to manage your business operations. Basically, IRS rules and regulations provide for the following two main types of legal structures when it comes to taxation:

- **Flow-through taxable entities:** Flow-through taxable entities allow taxable income or loss generated by the entity to be taxed not at the entity level but rather at the personal level when it flows through to the individual owners of the entity. So any tax liability and related cash requirement is an obligation of the individuals and not the legal entity. General partnerships, limited partnerships, limited liability companies, and subchapter S corporations are all flow-through entities.

- **Regular taxable entities:** Regular taxable entities, which include C corporations, among others, are taxed at the entity level with no impact on the individual owners. So any tax liability and related cash requirement is an obligation of the legal entity, not the individual owners.

So how exactly can the legal formation impact tax obligations and cash resources? An example can help explain. Two entrepreneurs coming out of Corporate America formed and launched a new technology business in the middle of the year. In the first six months of the year, both owners had worked and generated significant earnings that they were going to use to launch the business. They initially formed the company as a flow-through entity, so the losses from the new venture in the second half of the year, which amounted to over $200,000, flowed through to the owners' individual tax returns. The owners then could offset and reduce roughly $250,000 of regular earnings from the first half of the year.

The net effect was that their adjusted gross income was reduced to $50,000, which carried less than $5,000 of tax liabilities, compared to having to report $250,000 of gross income with resulting tax liabilities of over $60,000. By managing the legal form of the new company, they were able to reduce personal tax obligations, which resulted in increased cash availability (via not having to remit tax payments to the government). If the company had been formed as a regular C corporation (a non-flow-through entity), the loss in year one would have been "trapped" inside the legal entity and only available for use against future earnings of the company.

Flow-through entities can help lower and/or defer tax liabilities in countless other ways. The main point to understand is that the use of flow-through tax entities, if properly planned for and correctly structured, can enhance and improve cash flows by lowering or deferring income tax obligations. And as with all the topics presented on leveraging Uncle Sam, once again we can't emphasize enough the importance of securing proper professional counsel when evaluating the most appropriate legal form for your business.

As the old saying goes, "Never let the tax tail wag the economic dog," and you certainly shouldn't let the tax implications be your sole guide when deciding on what legal entity to utilize for your company. Numerous other factors may impact the economic viability of your company. For example, subchapter S corporations have restrictions on the number of parties that can own a portion of the company and must generally be individual persons (and not other legal entities, such as a C corporation). If your business is formed as a subchapter S corporation and is looking to secure an investment to fund operations, certain investors may be eliminated if they don't qualify.

A number of businesses formed initially as a tax-flow-through entity (such as a subchapter S corporation) later transition into a regular taxable entity (such as a C corporation) when business conditions dictate the need for change. This switch allows for these companies to maximize the benefits of being a tax-flow-through entity in the early years of the business (similar to the real-world example offered previously) and then transition into a regular taxable entity, which allows for more flexibility when securing financing. For most businesses, the transition from a subchapter S corporation to a regular C corporation is far easier and efficient than attempting to undertake the reverse.

Managing owner wages and business earnings

Another area that warrants a discussion on properly managing tax obligations to improve cash flows concerns how small businesses manage owner wages and business earnings. More specially, you want to consider the two basic strategies of estimating tax payments and reducing owner W-2 earnings.

Estimated tax payments

Most businesses (or the owners of the businesses, for flow-through entities) are required to make estimated taxes on a quarterly basis to cover anticipated income tax obligations throughout the year. For example, if a business anticipates generating $200,000 of taxable income throughout the year, it reasonably assumes that one-fourth, or $50,000, would be earned each quarter. If the business operates in a 25 percent federal government marginal tax bracket, then $12,500 is due each quarter.

Although this arrangement is relatively easy to understand, most businesses don't operate in a perfect utopia of guaranteed quarterly performances that will always produce a quarterly tax liability in equal amounts (plus or minus 5 percent). Rather, most businesses have to deal with issues that can create rather significant changes between quarterly operating performances (such as seasonal sales patterns, nonrecurring large projects, sales and expense timing in relation to cash receipts and disbursements, and so on).

So in order to properly manage estimated tax payments on a quarterly basis, the company's actual quarterly financial results should be used as the basis for calculating annualized net taxable income levels and resulting tax obligations. In other words, the quarter-by-quarter profit of the business may fluctuate widely. The busy season of the year may show large profits, which are offset by low profit numbers or even losses in other quarters. In short, the company may have relatively large swings in quarterly estimated payments. Be sure to properly calculate and document the financial results used as the basis for the estimated tax payments (in case an inquiry is ever made).

TIP

Don't overpay your estimated tax payments! Whether at the business or personal level, properly calculating and remitting estimated tax payments should be completed on a quarterly basis to avoid making the ever-so-popular statement, "I'm getting a big tax refund back." Not only have you let the government use your money at no cost, but you've also more than likely parked money with state governments that are strapped for cash and may take some time to issue a refund.

TIP

When possible, individuals should take advantage of the IRS's safe harbor rules. Though generally not available at the state level, the IRS provides for a simple way to pay estimated tax payments at the personal or individual on a quarterly basis. You take your previous-year tax obligation and multiply by 110 percent, and then use the resulting amount as the basis of your current-year tax obligation. For example, if your prior-year tax obligation was $20,000, you would multiply by 110 percent, which results in $22,000. As long as you make tax payments of $22,000 during the year, the IRS doesn't tack on penalties or interest charges if in fact you end up owing $40,000 in taxes that year. Granted, the difference or shortfall of $18,000 would still be due on the tax-reporting deadline, but by using the safe harbor rules, you've been able to defer paying the tax obligation and use that cash for a 6- to 12-month period for other purposes.

Using the safe harbor rules to keep cash in the business is generally most effective during a period of continued net earnings growth and increases in tax obligations because, in effect, the added income tax obligations are pushed out to the next year (for payment).

Owner W-2 earnings versus distributions of earnings

One decision every business must make is what compensation rate to set for senior management. In large companies, the decision is usually dictated by a number of factors, including the competition, board/shareholder approvals, and other factors. For smaller, closely held companies that are structured as pass-through entities, the decision is somewhat more arbitrary and is often influenced by tax savings opportunities (not to mention the performance of the company).

These types of companies often keep owners' taxable wages relatively low to deflate or reduce traditional W-2 wages to reduce the amount of Social Security and Medicare, taxes the company must pay. The current tax rules and regulations dictate that for regular W-2 wages, Social Security taxes (at a rate of 6.2 percent) are assessed on the first $106,800 (for 2011, unchanged from 2010) of W-2 wages with preliminary estimates of $110,100 being the base for 2012, whereas Medicare taxes (at a rate of 1.45 percent) are assessed on all W-2 wages. These taxes are important to understand, because they're not only withheld from the employee's pay but also matched by the company paying the wages. So if W-2 wages are deflated or reduced, the amount of taxes paid is reduced as well.

Figure 11-2 reflects the impact of using this strategy on total taxes paid, reduced tax expense, and increased cash flows:

Description	Low Wage Scenario #1	High Wage Scenario #2
Net Profit Before Owner W-2 Wages	$500,000	$500,000
Gross W-2 Owner Wages, One Owner	$100,000	$300,000
Net Company Profit, before Payroll Taxes	$400,000	$200,000
Total Payroll Tax Obligation:		
Social Security Taxes, Employee - 6.2% Base	$6,200	$6,622
Medicare Taxes, Employee - 1.45% Unlimited	$1,450	$4,350
Social Security Taxes, Employer - 6.2% Base	$6,200	$6,622
Medicare Taxes, Employer - 1.45% Unlimited	$1,450	$4,350
Total Payroll Tax Obligation	$15,300	$21,943
Net Company Profit, after Payroll Taxes	$392,350	$189,028
Gross W-2 Owner Wages	$100,000	$300,000
Total Individual Taxable Income	$492,350	$489,028
Marginal Tax Bracket/Tax Rate	35%	35%
Total Income Taxes Due	$172,323	$171,160
Total Payroll Tax Obligation:	$15,300	$21,943
Total Tax Obligation, Payroll and Income	$187,623	$193,103
Total Tax Savings		$5,481

The maximum wage level (or base) in 2010 subject to Social Security taxes as set by the IRS was $106,800. This base is adjusted each year by the IRS to account for inflation.

Figure 11-2: Comparison of owner wages and impact on net tax obligation.

W-2 wages are treated as an expense to the company, which reduces taxable income. So if W-2 wages are reduced, taxable income is increased, which results in larger amounts of taxable income being passed through to the owners of the company. However, the savings from reduced Social Security and Medicare taxes are large enough to offset the increased tax on the net business income passed through. The owner's total income remains about the same whether earned as W-2 wages or passed through as taxable earnings from the company, but when applying a constant marginal tax rate, the strategy of reducing W-2 wages and increasing taxable income, as in the example in Figure 11-2, results in tax savings of $5,481.

This particular strategy can become very complex very quickly and contains a number of potential traps to unsuspecting business owners, so you should use it with an abundance of caution. However, when used at the optimal time (especially when a company is struggling with limited profits and tight cash flows), it can help lower tax liabilities and improve cash flows by directing more cash into the business as opposed to the government.

The W-2 wages can't be reduced to an amount that's unrealistically low for the job and that particular field, and the IRS is targeting owners who artificially deflate regular W-2 earnings to lower Social Security and Medicare taxes. For instance, if a partner in a law firm pays herself $80,000 a year in W-2 wages, with the going rate for similar paid professionals in other law firms at $300,000, not to mention that the partner's law firm generated taxable income of $1,000,000, the IRS will most likely challenge the W-2 wages paid (as being too low). The key in managing this issue is to make sure that the W-2 wages paid are reasonable, given the operating performance of the company and comparable wages earned by similar workers. Remember that the term *reasonable* provides for a fair amount of latitude, so again, if you're uncertain what is reasonable, consult professional counsel.

Finding hidden tax gems: Tax credits, accelerated deductions, and other incentives

The fourth government "hand-out" assists businesses with reducing expenses and improving cash flows by offering special tax credits, accelerated deductions, and other specialized incentives. We don't even attempt to summarize all the potential tax savings opportunities governments offer, because they could fill an entire book. Rather, we summarize these issues in three primary topics: tax credits, accelerated deductions, and other incentives:

- **Tax credits:** The most commonly used tax credits by businesses are offered for R&D (research and development) activities, clean and green investments (like solar power), and focused hiring in disadvantaged employment groups (such as the *WOTC,* or work opportunity tax credit). Tax credits are a great tool to utilize when available and appropriate because unlike tax deductions, tax credits represent a dollar-for-dollar offset of tax liabilities. For example, if a company has taxable income of $100,000 before claiming an accelerated deduction of $20,000, the company reports taxable income of $80,000. At a tax rate of 25 percent, the company then has a tax liability of $20,000. However, if a tax credit of $20,000 is obtained as a result of R&D efforts, quite a different result is achieved. Using the same $100,000 figure, which now represents the taxable income, and applying a 25 percent tax rate, the tax liability is $25,000. Then applying the tax credit of $20,000, the net tax liability is reduced to just $5,000. So it's no wonder why companies look to secure and utilize tax credits so aggressively.

- **Accelerated deductions:** The government aggressively encourages businesses to invest in new property, plant, and equipment by providing for accelerated deductions when qualified assets are purchased. The idea is that by providing an accelerated deduction, increased purchase activity in qualified assets will help stimulate the economy. The most common example of this encouragement is in equipment purchases. In a normal year, the IRS may allow a depreciation deduction of 20 percent of the equipment's purchase price in the first year, but during a targeted period (such as 2009, when the economy fell off a cliff), the deduction can be increased to 50 percent during the first year. For an asset that cost $100,000, the increased depreciation expense of $50,000 instead of $20,000 reduces taxable income by $30,000 and thus reduces the company's tax liability by an additional $7,500 (assuming a 25 percent tax rate).

  The benefits of accelerated deductions are often maximized in a highly profitable operating year for a business. That is, if a company is in a high marginal tax bracket, say at 35 percent, the deduction saves far more taxes than if the company is in a low marginal tax bracket (say 15 percent). Proper tax planning becomes an important element of knowing when accelerated deductions give you the most bang for your buck.

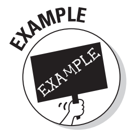
- **Specialized incentives:** Government legislation is littered with all types of specialized incentives, awards, grants, and/or other types of windfalls that can be obtained if the right criteria are met. For example, the government supports a number of grant programs designed to encourage investments in desirable markets, such as the healthcare industry. The government also gives preferential treatment to women-, minority-, and disadvantaged-owned businesses in securing contracts when conducting business with the government.

The list of incentives at both the state and federal government levels is extensive, but we offer words of caution: To have any hope of securing specialized incentives, you must be very patient, persistent, and well prepared because the qualifications can sometimes be extremely rigid. Although the government generally has good intentions when providing incentives, remember that you're dealing with the largest bureaucracy in the world.

Don't forget the SALT: State and local taxation

Probably every Baby Boomer who has visited the doctor recently has been told three things: Exercise, watch your weight, and eat right (with a special emphasis on cutting down your salt consumption). Well, businesses may also want to reduce their SALT intake — that is, your state and local taxation. The fact of the matter is that with most states, counties, cities, and municipalities being strapped for cash, the exact opposite is happening. State and local governments are not only looking for ways to generate revenue from just about any source of SALT they can but also implementing policies to accelerate payments from these types of taxes.

We use the term SALT to refer to the plethora of taxes applied and administered at the state and local level, including property taxes, sales and use taxes, state income taxes, unclaimed property taxes, environment fees or taxes, new and expanded business licensing fees, employee head taxes, and the list goes on and on. Whether these expenses are actually called a *tax* or a *fee* doesn't change the fundamental principle: Your business is going to pay more.



The state of California now requires every business generating over $100,000 a year in revenue to complete an annual use-tax return. For a quick refresher course, *use taxes* are due from businesses that buy and consume tangible personal property that was acquired without paying sales tax (to the seller). For instance, a business may purchase technology equipment over the Internet from a supplier in Texas that's not required to collect and remit taxes in California (because it delivers the goods via a common carrier). So although the supplier isn't required to collect and remit the sales tax, the purchaser, or user, is required to report the purchase on a use-tax return and remit the appropriate tax to the state of California. It's probably not too hard to figure out why states are targeting this issue, given the explosion of Internet purchases and the loss of associated sales tax revenue.

The impact of SALT really hammers businesses on three fronts. First, existing tax rates, government-mandated fees, and so on are increasing. Second, new taxes and government-mandated fees are being created. And third, governments are looking for more ways to accelerate the collection of taxes and fees to "pull forward" these revenue sources into current budgetary years. Though we would love to summarize our discussion on SALT with ways to improve cash flows, our advice on SALT and cash flows is to make sure your business properly administers and complies with all SALT-related matters in your operating jurisdiction to avoid very nasty and problematic assessments.

In real estate, location, location, and location mean everything. For SALT, compliance, compliance, and compliance mean everything. With state and local governments pursuing every dollar they can (going as far as multiple states setting up tax-auditing groups in other states to ensure proper tax compliance), proactively managing this issue is imperative in order to avoid incurring added costs and management efforts to clean up old compliance issues (with will undoubtedly carry past penalties and interest charges, which aren't cheap).

The concept of nexus is very closely related to SALT. In the business world, *nexus* means that a company has established a business operating presence in another governmental jurisdiction, which in turn triggers the need to comply with all SALT reporting requirements there. Nexus can be established by having an office in that jurisdiction with employees or even by having simply a piece of property with no office or employees located there. Even if a company has only one employee covering the sales efforts of an entire state, nexus has been established. And remember, the state and local taxing authorities talk to one another, so if you're paying payroll taxes in a state, then the state is going to look for income tax returns, property tax returns, sales and use tax returns, and so on to be filed.

The pros and cons of debt

To help you remember how you can effectively use debt in a business as a source of capital or cash, look at debt from both ends of the spectrum: the pros and cons.

The advantages of using debt as a source of cash can be best summarized in following three attributes:

- **Flexibility:** Debt covers a broad spectrum of financing requirements, ranging from as little as $50,000 (a niche factoring or leasing company providing capital to small businesses) to billions of dollars (the world's largest banks providing financing for a multibillion-dollar public-company buyout). In addition, numerous sources of debt are available from the market, covering just about every type of risk scenario.
- **Management/ownership control:** Management and ownership control is not relinquished, because debt providers generally don't have a direct say in ongoing business matters.
- **Economic returns:** Economic returns can be enhanced when debt is used appropriately by leveraging this source of cash. Instead of being limited by the amount of equity (ownership) capital a business can raise, it can leverage or multiply its total capital by adding debt on top of the equity capital that should provide a larger base for sales and to earn more profit.

But unfortunately, you can't have your cake and eat it too when using debt, so here are the primary disadvantages when debt is used as a source of capital:

- **Secured interest:** Security in some form of asset, guarantee, or pledge is usually required, which places the business's assets (and potentially the personal assets of its owners) at risk. If the business defaults on the loan, these assets may have to be used to repay the debt if other means are not available to satisfy the obligation.
- **Debt must be repaid, with interest:** The debt must be repaid per the terms and conditions established, regardless of whether the company's performance allows for the repayment. Unlike equity investments, which tend to only generate a distribution of earnings or dividend if the company's performance dictates, debt repayment terms are rigid and must be adhered to. If not, the company suffers the wrath of its creditors demanding repayment.
- **Business restrictions:** Although direct management and ownership in a business is not sacrificed, debt sources often place restrictions on certain business activities (in the form of loan covenants), which may limit a company's ability to undertaken business transactions. Whether you like it or not, debt sources are partners that can influence management decisions.