ENTR: Analyzing Finances

Income Statement

OBJECTIVES

- ***Explain the importance of an income statement.***
- ***Understand the parts of an income statement.***
- ***Prepare an income statement.***

Financial statements are important when you are trying to raise capital for your business. The financial statements you prepare for your business plan are pro forma financial statements and are based on projections. The income statement, cash flow statement, and balance sheet all tell you something different about the condition of your business.

INCOME STATEMENT

One of the most important documents for a business is an income statement. An income statement is a financial document that summarizes a business's income and expenses over a given time period and shows whether the business made a profit or took a loss. That's why it's also called a profit and loss statement. If a business's sales are greater than its expenses, the income statement will show a profit. If sales are less than expenses, the income statement will show a negative number, a loss.

When to Prepare an Income Statement

Because income statements show how a business is performing, they are prepared periodically. Most small-business owners should create both a monthly income statement and a quarterly income statement. Companies also prepare income statements on an annual basis that show how the company performed during the year. A business can choose to use a calendar year accounting period (January 1-December 31) or a fiscal year accounting period. A fiscal year is the 12-month period chosen by the business (for example, July 1-June 30).

Joan Barry Hair Styles
Income Statement
For Month Ended December 31, 20--

Sales	$ 6,900
Cost of Goods Sold	4,160
Gross Profit	$ 2,740
Operating Expenses	650
Operating Income	$ 2,090
Selling & Administrative Expenses	500
Depreciation Expense	100
Interest Expense	150
Pre-Tax Profit	$ 1,340
Taxes (40%)	536
Net Income	$ 804

ENTR: Analyzing Finances

The Balance Sheet

OBJECTIVES
- ***Identify the purpose and components of a balance sheet.***
- ***Explain how balance sheets are prepared.***
- ***Provide two methods used to analyze balance sheets.***

THE BALANCE SHEET

We just finished talking about two important financial statements: the income statement and the cash flow statement. Now, we will introduce another very important financial statement: the balance sheet.

A balance sheet is a financial statement that summarizes the assets and liabilities (debts) of a business. It shows how much a business is worth at a particular time. A balance sheet is like a snapshot of a business on a specific date. An income statement is more like a movie, reflecting changes in the business over a period of time.

A balance sheet answers the questions: What does the company own? To whom does it owe money? How much is the business worth? The balance sheet focuses on the fundamental accounting equation:

Assets = Liabilities + Owner's Equity

Let's examine each of the terms in this equation:
- Assets. Everything owned by the business that has a monetary value is an asset. This could include such things as cash, inventory, equipment, and supplies.
- Liabilities. Any outstanding bill or loan that must be repaid is a liability.
- Owner's Equity. The value of the business on a specific date is referred to as the owner's equity. It's the value of the business if all the assets were sold and all the liabilities were paid.

The balance sheet shows you the value of your business on a specific date. For example, if you decided to close down your business, your first step would be to sell all your assets. The next step would be to payoff all your liabilities (debts). Any money remaining would be yours to keep. It's the value of your business, your owner's equity.

Assets Are Owned
Assets are the items of value owned by a business: cash, inventory, furniture, machinery, and so on. On a typical balance sheet, assets are usually classified as either current assets or long-term assets.
- Current Assets. Short-term assets that can be converted into cash within one year are current assets. These include cash, inventory, marketable securities, and money owed the business by its customers (called accounts receivable). Accounts receivable is the amount of money owed to a business by its customers for credit sales.
- Long-Term Assets. Assets that usually take longer than one year to turn into cash are long-term assets. Examples of long-term assets are equipment, computers, furniture, machinery, buildings, and long-term investments.

Liabilities Are Owed
Liabilities are all sums of money owed by the business. One of the most common types of liability is accounts payable, which represents the amount of money a business owes to its suppliers for purchases made on credit. Other liabilities include bills owed for telephone, utilities, insurance, and taxes. Liabilities include such debts as short-term bank loans, mortgages, and loans from families or friends. On a typical balance sheet, liabilities are classified as either current liabilities or long-term liabilities.
- Current Liabilities. Short-term debts that must be repaid within one year are current liabilities. These include debts to suppliers for credit purchases (accounts payable), bank loans, and state sales taxes collected from customers and owed to the state.
- Long-Term Liabilities. Debts that usually take longer than one year to repay are long-term liabilities. The money owed on a mortgage, for example, is a long-term liability.

ENTR: Analyzing Finances

PREPARING BALANCE SHEETS

Balance sheets are divided into two sections. All the assets of the business are in the first section and the liabilities of the business and the owner's equity are included in the second section. Think of this second section as the creditors of the business, those to whom the business owes money, having the first claim on the assets. The owner receives any money remaining after all of the debts have been paid. There are two formats for a balance sheet: one-column and two-column. Most large companies use the one-column format. For simplicity, we will focus on the one-column format in this example.

Matt Washington has been very successful over the past eight years. Matt's Hats now has a store that is famous for its large selection. Matt is preparing the annual balance sheet. The accounting period for Matt's Hats is the calendar year.

Matt's Hats
Balance Sheet
December 31, 20--

ASSETS		
Current Assets		
Cash	$ 25,000	
Accounts Receivable	20,000	
Inventory	75,000	
Prepaid Expenses	20,000	
Supplies	5,000	
Total Current Assets	$ 145,000	
Long-Term Assets		
Equipment	$ 20,000	
Less: Accum. Depreciation	(5,000)	
Building	145,000	
Less: Accum. Depreciation	(5,000)	
Total Long-Term Assets	$ 155,000	
Total Assets	**$ 300,000**	
LIABILITIES & OWNER'S EQUITY		
Current Liabilities		
Accounts Payable	$ 55,000	
Wages Payable	15,000	
Total Current Liabilities	$ 70,000	
Long-Term Liabilities		
Notes Payable	$ 5,000	
Mortgage Payable	$ 65,000	
Total Long-Term Liabilities	$ 70,000	
Total Liabilities	$ 140,000	
Owner's Equity		
Matt, Capital	$ 160,000	(Capital - Drawing + Net Income)
Total Liabilities & Owner's Equity	**$ 300,000**	

ENTR: Analyzing Finances

Financial Ratios

OBJECTIVES

- ***Recognize financial ratios used to analyze the financial condition of a business.***
- ***Discuss how ratios aid in financial decision making.***

UNDERSTANDING FINANCIAL RATIOS

How do entrepreneurs know if a company is healthy? They often rely on information from financial records. But it's not always easy to analyze these records, to see the relationships, patterns, and the trends they show. One of the most effective ways for entrepreneurs to analyze their financial statements is to use financial ratios. These are relationships between important financial data that are expressed as fractions or as percentages. Entrepreneurs calculate financial ratios by using the data from the financial statements. All financial ratios are calculated by dividing one number by another. An entrepreneur should not rely on just one or two ratios. Ratios are only indicators and each will shed light on a different aspect of the business.

LIQUIDITY RATIOS

No matter how profitable a company is, an important measure of its financial health is its ability to pay debts on time. To be able to finance short-term debt, a company should be in a favorable liquid position. That means it either has a good cash balance or other current assets than can be converted quickly to cash without substantial loss of their value. Commonly used liquidity ratios are the current ratio, the quick ratio, and the cash ratio.

CURRENT RATIO

A measure of the ability to meet current debt.

$$\textit{Current Ratio} = \frac{\textit{Current Assets}}{\textit{Current Liabilities}}$$

The current ratio shows how well the company is prepared to pay current liabilities, those debts that will come due within a year. Of course it is expected that a business has more current assets than current liabilities. A strong position in most industries is a ratio of 2:1. Financial managers and investors will look at the current assets to determine how quickly they can be converted to cash and the value of the assets listed on the company's balance sheet to make sure it is an accurate reflection of an asset's real cash value.

QUICK RATIO (ACID TEST RATIO): A more precise liquidity measure that reduces the value of current assets by the value of the inventory.

$$\textit{Quick Ratio} = \frac{\textit{Current Assets - Inventory}}{\textit{Current Liabilities}}$$

Current assets cannot all be disposed of quickly in order to obtain cash to pay a company's short-term debts. Inventory is a particular problem in some industries. An inventory level is developed and maintained to meet customer needs over a period of time. If it must be liquidated quickly, prices may have to be reduced dramatically. By reducing the value of current assets by the value of the inventory, the quick ratio provides a more specific value of available current assets to cover the liabilities. The quick ratio does not have to be as high as the current ratio since the current assets used are highly liquid. A ratio of 1:1 may be acceptable in many industries.

CASH RATIO: The cash ratio is an indicator of a company's liquidity that further refines both the current ratio and the quick ratio by measuring the amount of cash, cash equivalents or invested funds there are to cover current liabilities.

$$\textit{Cash Ratio} = \frac{\textit{Cash + Cash Equivalents + Investments}}{\textit{Current Liabilities}}$$

The cash ratio is the most stringent and conservative of the three short-term liquidity ratios. It only looks at the most liquid short-term assets of the company, which are those that can be most easily used to payoff current obligations. It also ignores inventory and receivables, as there are no assurances that these two accounts can be converted to cash In a timely matter to meet current liabilities.

ENTR: Analyzing Finances

ASSET MANAGEMENT RATIOS

Businesses use their assets to make money. Assets produce sales and sales generate profits. A company that can use assets efficiently by keeping their values low in relation to sales and profits is financially stronger than companies that require a higher value of assets for the same results. Asset management ratios compare the value of key assets to sales performance.

INVENTORY TURNOVER RATIO: Measures the efficiency of a company in maintaining inventory to generate sales.

$$\text{Inventory Turnover Ratio} = \frac{\text{Sales (or Revenues)}}{\text{Inventory}}$$

A company doesn't earn money on its inventory until it is sold. The more rapidly inventory is sold, the lower the amount of financing required. If a company can maintain low inventory levels and still have high sales volume, it is using inventory very efficiently. Some industries require a lower volume of inventory or have lower total inventory costs to generate sales. Other industries require a high inventory level or the cost of inventory is quite high. A business with a low ratio should be evaluated to see if the inventory is dated or obsolete or if there is another reason that it is not being converted to sales more quickly.

TOTAL ASSETS TURNOVER RATIO: Measures how efficiently all assets generate sales.

$$\text{Total Assets Turnover Ratio} = \frac{\text{Sales (or Revenues)}}{\text{Total Assets}}$$

The total assets turnover ratio is similar to the inventory turnover ratio except that it focuses on the efficient use of all company assets. By comparing the value of all current and fixed assets to sales, the company can determine if it has a reasonable amount of assets for the sales being produced. A low value suggests assets are not being used efficiently. Some businesses also calculate a fixed assets turnover ratio to examine the efficiency of land, buildings, and major equipment.

ACCOUNTS RECEIVABLE TURNOVER RATIO: Measures how quickly credit sales are converted to cash.

$$\text{Accounts Receivable Turnover Ratio} = \frac{\text{Sales (or Revenues)}}{\text{Accounts Receivable (or Net Receivables)}}$$

The accounts receivable turnover ratio identifies how quickly customer accounts are paid. Higher ratios mean that accounts receivable are collected quickly. Long collection periods usually result in losses when older accounts are not paid. Some companies use total credit sales rather than total sales to determine the accounts receivable turnover. Another related ratio is the average collection period ratio, determined by dividing accounts receivable by the average daily sales. This ratio identifies how many days on average it takes to collect accounts receivable. A smaller number of days demonstrates effective credit procedures.

DEBT MANAGEMENT RATIOS

Using debt to finance some parts of a business' operations allows owners to maintain control of the business with a lower level of investment. If debt is used effectively it is possible to get a higher rate of return on the use of the money than the actual cost of the debt. Using debt financing to increase the rate of return on assets is known as financial leverage. As long as a company can pay its debts when they come due, a high level of debt financing is not necessarily a problem. Stockholders like to see higher debt ratios as long as the firm is profitable because they provide higher potential earnings. Creditors on the other hand get concerned when debt ratios are high because they have fewer claims on assets if the business should fail.

DEBT RATIO: Measures how much of a company's assets are owned by creditors.

$$\text{Debt Ratio} = \frac{\text{Total Debt*}}{\text{Total Assets}}$$

** total debt includes all payables, short-term debt, and long-term debt.*

The appropriate ratio is guided by the industry in which the company operates and the financial stability of the company. A stable company with a long operating history can carry a ratio where debt is greater than 50 percent of total assets. A new company, risky industry, or volatile economy may require a ratio where debt is one-third or one-fourth of the asset value.

Related debt management ratios are total debt divided by net worth, which provides a direct comparison of equity and debt financing levels; and long-term debt divided by total assets, which shows the extent to which the company's assets are financed by long-term debt.

TIMES-INTEREST-EARNED RATIO (TIE): Shows how well-positioned the company is to pay interest on its debt.

$$\textit{Times-Interest-Earned Ratio} = \frac{\textit{Operating Income}}{\textit{Interest Expense}}$$

A high times-interest-earned ratio means the company has a high margin of safety in being able to pay creditors. Operating income would have to decline significantly before the company would be at risk from its creditors. To be particularly cautious, the ratio could be calculated by using the total of interest and principal charges rather than just the interest. Most creditors are satisfied if interest payments are kept up to date, but to remove debt obligations a business needs adequate income to make full payments.

PROFITABILITY RATIOS

All of the financial decisions and operations of a company ultimately result in bottom-line performance. Both financial managers and investors are interested in tracking improvement in profitability and comparing it to the profitability of competitors as well as the results that could be obtained from other possible investments.

PROFIT MARGIN ON SALES RATIO: Measures the profit generated by each dollar of sales.

$$\textit{Profit Margin on Sales Ratio} = \frac{\textit{Net Income}}{\textit{Sales (or Revenues)}}$$

The main revenues of a business come from sales. The greater the return on sales, the more efficient is the business. A lower ratio may indicate there is pressure on prices so little margin is available for profit after expenses have been paid. To assist with that analysis, companies calculate the gross profit margin ratio which divides gross profit by net sales. Carrying a high level of debt with accompanying interest payments could also reduce the profit margin on sales. The effect of interest and taxes on profit margins can be determined by calculating the operating profit margin ratio. It is determined by dividing operating income by net sales. Operating income is the company's earnings before interest and taxes.

RETURN ON TOTAL ASSETS (ROA): Ratio Measures the company's earnings on each dollar of assets. This ratio is sometimes called "Return on Investment".

$$\textit{Return on Total Assets Ratio} = \frac{\textit{Net Income}}{\textit{Total Assets}}$$

This ratio is particularly meaningful to managers, creditors, and investors because it evaluates the efficiency of the assets of the company. Does the company have too much money invested in assets based on the profit or are the assets particularly effective in generating income? When managers make plans for capital investments, consideration of the contribution to this ratio will be very important. A similar important profitability ratio is the return on equity ratio.

RETURN ON EQUITY RATIO (ROE): Measures how each dollar of investment by stockholders contributes to net income.

$$\textit{Return on Equity Ratio} = \frac{\textit{Net Income}}{\textit{Stockholders' Equity}}$$

Return on equity measures a corporation's profitability by revealing how much profit a company generates with the money shareholders have invested. The ROE is especially useful for comparing the profitability of a company to that of other firms in the same industry.

MARKET PERFORMANCE RATIOS

The final set of ratios examines the overall financial performance of the business in contributing to shareholder value. The results are usually examined over several years to see changes in the company's performance. These ratios are considered by both stockholders and the board of directors as important evidence of the effectiveness of executive leadership. Market performance ratios are most useful as a way to compare the financial performance of similar companies or of several companies being considered for investment purposes.

ENTR: Analyzing Finances

EARNINGS PER SHARE (EPS): Measures the amount of profit earned by each share of stock.

$$\textit{Earnings Per Share} = \frac{\textit{Net Income}}{\textit{Number of Shares Issued}}$$

If the company issues preferred stock, the dividends paid to preferred stockholders are subtracted from net income before dividing by the number of shares of common stock issued. Preferred stockholders receive a specified dividend which affects the overall earnings for other stockholders.

PRICE EARNINGS RATIO (P/E RATIO): A measure of the strength of a company's earnings in affecting the price of its stock.

$$\textit{Price Earnings Ratio} = \frac{\textit{Market Stock Price}}{\textit{Earnings Per Share*}}$$

** as calculated above.*

When investors decide on the price to pay for a company's stock, an important consideration is the earnings they expect to receive on their investments. A company with a strong record of earnings is likely to command a higher price than one with poor earnings.

MARKET TO BOOK RATIO: The relationship between the value of stock as recorded on the company's balance sheet and its value determined by the stock price.

$$\textit{Market to Book Ratio} = \frac{\textit{Market Stock Price}}{\textit{Book Value Per Share*}}$$

** book value per share is calculated by dividing stockholders' equity by the number of shares issued.*

The book value of stock is calculated by dividing the stockholder equity by the number of shares issued. Market to book ratios are often greater than 1, meaning that investors are willing to pay more for stock than it is valued by the company. One of the reasons is that accounting valuations are conservative so the value of assets listed on the balance sheet is lower than their actual value. Also, a company has intangible assets such as goodwill that affect its market value.

USE OF FINANCIAL RATIOS

Financial ratios should be used carefully because they are only general measures of a company's financial condition. Ratios calculated from only one set of a company's financial statements can be used to examine current relationships among key financial elements. For example, ratios can illustrate the proportion of assets and liabilities that are liquid versus long-term or the proportion of assets that are owned versus financed. That one-time analysis may point out strengths of the company's current financial position and performance and, more importantly, identify areas of concern if ratios indicate potential problems with some of the proportions. Those relationships are likely to change over time, so comparing ratios over several time periods provides a better picture of the company's financial condition. Another use of ratios is to compare specific aspects of the company's financial condition and performance with that of similar businesses. Examining industry trends in financial performance using financial ratios is an important part of financial analysis.

SOURCES OF COMPARATIVE INFORMATION

One of the uses of financial ratios is to compare specific aspects of a company's financial performance with other companies. Since most public corporations are required to publish financial statements at least annually, it is relatively easy to obtain comparative financial information. Investors also use financial statement information and financial ratios to evaluate companies in order to make sound investment decisions. Many companies serving investors collect and publish that information. Industry and trade associations frequently collect information from their members and provide comparative financial performance data. Often that information is provided only to members or to others for a fee. Some organizations make information available to the public for free.

ENTR: Analyzing Finances

Financing Your Business

OBJECTIVES

- ***Estimate your startup costs and personal net worth.***
- ***Identify sources of equity capital for your business.***
- ***Identify sources of debt capital for your business.***

ASSESS YOUR FINANCIAL NEEDS

Determine if you need financial assistance. As you start a business, you will have many decisions to make regarding its financing. Your financial needs will vary depending on the size and type of business you start. If you are starting a very small business, you may be able to provide all the startup money you will need. If your business will be large or require special equipment, you may need to look to others for help raising the startup money.

Before you can approach a lender or investor about financing your business, you will have to prepare some financial documents. To begin, you should estimate your startup costs and create a personal financial statement. Then you will prepare pro forma financial statements of the cash flow statement, income statement, and balance sheet. Financial statements based on projections are known as pro forma financial statements. You will learn more about pro forma financial statements in the next lesson. These items allow potential lenders and investors to determine if your business is viable. They also help lenders decide whether the financing you are requesting is reasonable.

STARTUP COSTS
Walters Electric

Item	Estimated Cost
Equipment and supplies	
Computers (3 @ $1,500)	$ 4,500
Scanner	175
Cash registers (2 @ $1,800)	3,600
Printer	400
Supplies	300
Subtotal	$ 8,975
Furniture and Fixtures	
Desks (4 @ $400)	$ 1,600
Chairs (8 @ $75)	600
Subtotal	$ 2,200
Vehicles	
Delivery truck	$10,000
Automobile	8,000
Subtotal	$18,000
Remodeling	
Drywall replacement	$ 1,000
Electrical work	2,500
Paint	1,000
Carpet	3,000
Subtotal	$ 7,500
Legal and accounting fees	$ 3,000
Total	$39,675

Startup Costs

Itemizing your startup costs is an important part of determining how much money you need to start your business. You will want to be sure you have accounted for all of the items you will need. Common startup items to be purchased include the following:

- Equipment and supplies, such as computers, printers, telephones, and paper
- Furniture and fixtures, such as desks and chairs
- Vehicles, such as delivery trucks
- Remodeling, such as electrical and plumbing expenses
- Legal and accounting fees
- Licensing fees

Felicia Walters plans to start a lighting fixture store. To help her determine how much money she will need to borrow, she calculates her startup costs. She must include her estimate of startup costs with the other documents she provides to lenders or investors.

PERSONAL FINANCIAL STATEMENT
Felicia Walters

Assets		Liabilities	
Cash	$ 5,000	Car loan	$ 6,900
Checking account	13,500	College loan	4,000
Certificate of Deposit	6,000	Credit cards	1,300
Stock	10,000		
Computer equipment	3,000		
Coin collection	2,500		
Total assets	$ 40,000	Total liabilities	$12,200

Total assets − Total liabilities = **Net worth**
$40,000 − $12,200 = $27,800

Personal Financial Statement

In order to determine if you have the resources you need to finance your business, begin by assessing your net worth. Net worth is the difference between what you own, called assets, and what you owe, called liabilities. Net worth is also referred to as equity. To calculate your net worth, you should prepare a personal financial statement. On the left side, list all of your assets with their value. Include cash, investments, and any property.

Total the worth of these items. On the right side, list your liabilities and total the amount that you owe. Then subtract your total liabilities from your total assets to determine your net worth. Felicia Walters prepares a personal financial statement to help her determine whether she is able to finance her new business. She finds that her net worth is $27,800, as shown on the next page. After comparing her startup costs to her net worth, Felicia determines that she will need to seek additional financial

resources for her business. Felicia will share her personal financial statement and startup cost estimates with potential lenders and investors when she seeks financing for her business.

FINANCING YOUR BUSINESS

There are two types of financing available for your business-equity and debt financing. When obtaining financing, you must consider your company's debt-to-equity ratio, or the relation between the dollars you have borrowed (debt) and the dollars you have invested in your business (equity). This ratio measures how much money a company can safely borrow over time. The formula for debt-to-equity ratio is:

Total Liabilities ÷ Total Equity

A high ratio indicates that a business is mostly financed through debt, while a low ratio indicates that a business is primarily financed through equity. The debt-to-equity ratio can vary among industries, so comparisons of ratios among companies within the same industry should be made. Lenders and investors look at this ratio to assess risk. Lenders usually prefer low debt-to-equity ratios. A high debt-to-equity ratio indicates that a company may not be able to generate enough cash to meet its debt obligations. Thus, a bank runs the risk of not being repaid for its loan. Having the right mix of debt and equity will help ensure your business's sound financial future.

EQUITY CAPITAL

Equity capital is money invested in a business in return for a share in the profits of the business. Equity capital includes money invested by the owner. Entrepreneurs may seek additional equity capital when they do not quality for other types of financing and are not able to fully finance their business out of their own savings. Other sources of equity capital include people you know or venture capitalists.

Personal Contributions

Many entrepreneurs use their personal savings to finance the start of their business. Investing personal finances can help you get a loan from a bank. By investing your own money, you demonstrate to the bank that you have faith that your business will succeed. Financing the startup costs entirely by yourself is called bootstrapping.

Friends and Relatives

Friends and relatives can be a good source of equity capital. They will already be familiar with your business idea and know whether you are trustworthy and a good risk. They may be willing to invest more money in your business than other sources in return for a share of the business profits.

Venture Capitalists

Some privately owned companies get financing through venture capitalists. Venture capitalists are individuals or companies that make a living investing in startup companies. They carefully research opportunities that they believe will mal(e above-average profits. They are usually interested in companies that have the potential of earning hundreds of millions of dollars within a few years. The prospect of a company going public by publicly offering shares of stock for sale also attracts venture capitalists. Because of the desired criteria, many small businesses would have trouble attracting the interest of venture capitalists.

DEBT CAPITAL

Debt capital is money loaned to a business with the understanding that the money will be repaid, usually with interest. You can borrow money from friends, relatives, and banks. Bank loans may be secured or unsecured.

Friends and Relatives

If friends and relatives are not interested in investing in your business with equity capital, they may be
willing to loan you money. Before borrowing from friends or relatives, consider how the loan may affect your relationship with them. Those who loan you money might also feel they can give you advice along with their money. You may decide that the risk of losing a friend if you are unable to pay back the borrowed funds is not worth taking. If you take a loan from friends or relatives, you should prepare a formal agreement that spells out the terms of the loan. Be sure both you and the individuals loaning the money understand exactly how much interest and principal you will pay each month. Also, specify what your obligations are to pay back the loan if your business is not successful.

ENTR: Analyzing Finances

Commercial Bank loans

Most businesses take out loans from banks. Entrepreneurs usually have an established relationship with a bank and begin looking for funds there. When a loan is obtained, it must be repaid with interest in a certain time period. There are different types of loans that banks offer their customers.

Secured Loans. Loans that are backed by collateral are called secured loans. Collateral is property that the borrower forfeits if he or she defaults on the loan. Banks demand collateral so that they have some recourse if the borrower fails to repay the loan. Suppose you take out a $25,000 business loan and use your home as collateral. If you fail to repay the loan, the bank has the right to take ownership of your home and sell it to collect the money you owe. Banks accept different forms of collateral, including real estate, savings accounts, life insurance policies, stocks, and bonds. Types of secured loans include the following:

1. Line of credit An agreement by a bank to lend up to a certain amount of money whenever the borrower needs it is called a line of credit. Banks will charge a fee for this program whether or not money is actually borrowed. In addition, they will charge interest on the borrowed funds. Most businesses establish lines of credit so that funds are readily available to help them make purchases when necessary.
2. Long-term loan A loan payable over a period longer than a year is a long-term loan. Long-term loans are generally made to help a business make improvements that will boost profits. For example, the owner of a small coffee shop may obtain a $50,000, five-year loan to increase the size of the shop to accommodate more customers.
3. Accounts receivable financing Many businesses allow their customers to charge merchandise and services and pay for them later. The balances owed by customers are called the business's accounts receivable. A bank will loan a business up to 85 percent of the total value of its accounts receivable if it feels that the business's customers are good credit risks. As the receivables are paid, the payments are forwarded to the bank. The interest rate for accounts receivable financing is often higher than for other types of loans.
4. Inventory financing When banks use the inventory held by a business as collateral for a loan, it is called inventory financing. Banks usually require that the value of the inventory be at least double the amount of the loan, and the business must have already paid its vendors in full for the inventory. Banks are often not eager to mal(e this kind of loan. If the business defaults, the bank ends up with inventory it may have trouble reselling.

Unsecured Loans. Loans that are not guaranteed with collateral are unsecured loans. These loans are made only to the bank's most creditworthy customers. Unsecured loans are usually made for very specific purposes. They are usually short-term loans that have to be repaid within a year. A business may obtain a short-term loan to help with temporary cash flow problems during slow or seasonal periods. Unsecured lines of credit are also available for those who have good credit.

Reasons A Bank May Not Lend Money. Banks use various guidelines to determine whether borrowers are a good risk. They reject applications that do not meet their criteria. Some of the main reasons banks turn down loan applicants include the following:

1. The business is a startup. Banks are often reluctant to lend money to startup businesses because new businesses have no record of repaying loans. They are more likely to default on their loans than established companies.
2. Lack of a solid business plan. Banks evaluate businesses based on their business plans. A company with a poorly written or poorly conceived business plan will not be able to obtain financing from a bank.
3. Lack of adequate experience. Banks want to be sure that the people setting up or running a business know what they are doing. You will have to show that you are familiar with the industry and have the management experience to run your own business.
4. Lack of confidence in the borrower. Even if your business plan looks solid and you have adequate experience, you may fail to qualify for financing if you make a bad impression on your banker. Make sure you dress and behave professionally. Show up on time for appointments, and provide all information your banker requests.
5. Inadequate investment in the business. Banks are suspicious of entrepreneurs who do not invest their own money in their businesses. You will have to commit a significant amount of your own money if you are to receive financing from a bank.

Obtaining bank financing for a startup business is difficult but not impossible if you can show that you are confident, well prepared, and able to repay the loan. Being aware of banks' most common objections can help you prepare for the application process. For instance, you can properly prepare your business plan, wear a business suit to bank appointments, and arrive on time to make a good impression.