DOCUMENT RESUME

ED 228 524 CE 035 718

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TITLE Financing the Business. PACE Revised. Level 3. Unit 8. Research & Development Series No. 240CB8.
INSTITUTION Ohio State Univ., Columbus. National Center for Research in Vocational Education.
SPONS AGENCY Office of Vocational and Adult Education (ED), Washington, DC.
PUB DATE 83
CONTRACT 300-78-0032
NOTE 35p.; For related documents, see CE 035 672-729.
AVAILABLE FROM National Center Publications, Box F, The Ohio State University, 1960 Kenny Road, Columbus, OH 43210 (Complete set--$120.00; individual levels--$45.00 each; instructors' guides--$14.50 each; resource guide--$7.95; module sets--$35.00 each level; individual modules--$2.50 each).
PUB TYPE Guides - Classroom Use - Materials (For Learner) (051)

EDRS PRICE MF01/PC02 Plus Postage.
DESCRIPTORS Adult Education; Behavioral Objectives; Business Administration; *Business Education; Career Choice; Competency Based Education; *Cost Estimates; *Entrepreneurship; Financial Aid Applicants; *Financial Needs; Financial Support; Individualized Instruction; Learning Activities; Learning Modules; Postsecondary Education; Retraining; *Small Businesses; Units of Study
IDENTIFIERS *Program for Acquiring Competence Entrepreneurship

ABSTRACT

This individualized, competency-based unit on financing businesses, the eighth of 18 modules, is on the third level of the revised Program for Acquiring Competence in Entrepreneurship (PACE). Intended for the advanced secondary and postsecondary levels and for adults wanting training or retraining, this unit, together with the other materials at this level, emphasizes the actual application of a business plan. Four competencies are dealt with in this instructional unit, including (1) describing the sources of information available to help in estimating the financing necessary to start one's new business, (2) determining the financing necessary to start one's new business, (3) preparing a projected profit and loss statement and a projected cash-flow statement for one's new business, and (4) preparing a loan application package. Materials provided include objectives, preparation information, an overview, content (with questions in margins that guide the students' reading), activities, assessment forms, and notes and sources. The unit requires using approximately 3 hours of class time. (YLB)

UNIT 8

PACE REVISED

Program for Acquiring Competence in Entrepreneurship

☐ Level 1

☐ Level 2

☑ Level 3

Financing the Business

Developed by M. Catherine Ashmore and Sandra G. Pritz

You will be able to:

- **Describe the sources of information available to help in estimating the financing necessary to start your new business.**
- **Determine the financing necessary to start your new business.**
- **Prepare a projected profit and loss statement and a projected cash flow statement for your new business.**
- **Prepare a loan application package.**

Research & Development Series No. 240 CB 8

THE NATIONAL CENTER FOR RESEARCH IN VOCATIONAL EDUCATION
THE OHIO STATE UNIVERSITY
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BEFORE YOU BEGIN . . .

1. Consult the *Resource Guide* for instructions if this is your first PACE unit.

2. Read the Unit Objectives on the front cover. If you think you can meet these objectives now, consult your instructor.

3. These objectives were met at Levels 1 and 2:

   Level 1 -

   - Explain the importance of financing in the success of a new business
   - List the different types of costs that must be considered when starting a new business
   - Explain the two major methods of financing a new business
   - Identify the various sources for obtaining financing for a new business
   - List the financial statements that should be included in a business plan

   Level 2 -

   - Explain how to determine the different types of costs that must be considered when starting a new business
   - Compare the advantages and disadvantages of the various sources of financing for a new business
   - Describe the sources of loans that may be available for financing a new business
   - Describe the information that must be provided in a loan application package
   - Explain the criteria used by lending institutions to evaluate loan applicants

   If you feel unsure about any of these topics, ask your instructor for materials to review them.

4. Look for this business term as you read this unit. If you need help with its meaning, turn to the Glossary in the *Resource Guide*.

   disbursement

3

FINANCING THE BUSINESS

WHAT IS THIS UNIT ABOUT?

Financing is the lifeblood of a business. Without capital, a business cannot begin, grow, or ever hope to become successful. Now that you have decided to start a business, here are the two most crucial questions you must ask:

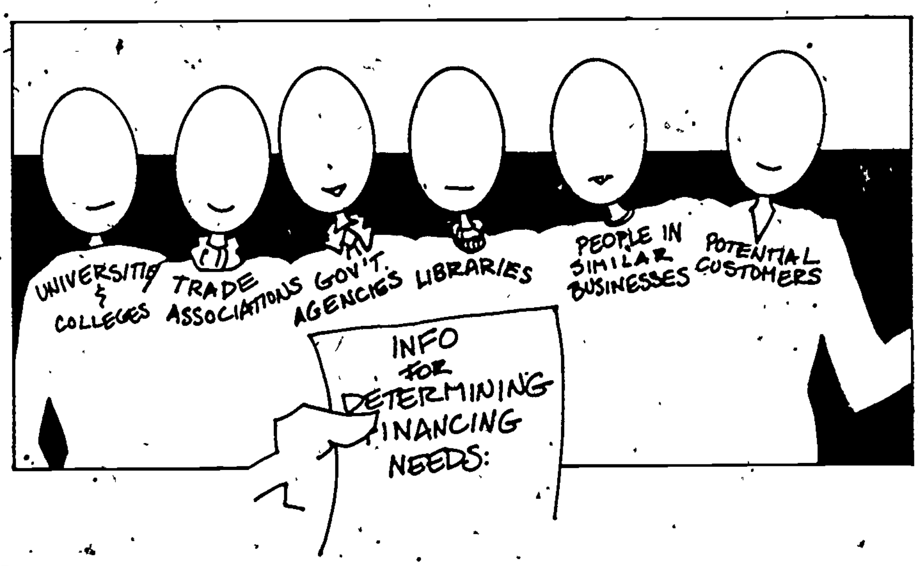
- What are my financial needs?
- How do I satisfy them?

This unit should assist you in answering these two extremely important questions. The first part of this unit presents information you can use to investigate and study your financial needs. Then you will look at how you prepare estimates of your capital needs and the necessary financial statements. After you have examined the preparation of the projected profit-and-loss and cash flow statements, you will study the production and use of the loan application package.

Through an application of the material presented in this unit, you should have a foundation of knowledge that you can use to determine the amount of the financial lifeblood your business needs and the sources for supplying it. Good luck!

WHAT ARE SOME SOURCES OF INFORMATION TO HELP DETERMINE FINANCING NEEDS?

Making a profit is necessary if a business is to succeed, so careful study and investigation of your financing needs are essential. Not only must you estimate how much it will cost to start up your business, but you must also provide figures on how much money will



be required to operate it during the first year. Money needs will vary according to the type of business—whether it is manufacturing, wholesaling, retailing, or service—the kind of merchandise or service offered, the income level of your customers, your personal trade connections, the location of your business, and many other factors.

When determining costs, there is no substitute for first-hand knowledge about your prospective business enterprise. It is far better for you to spend a few hours and dollars now to make these initial investigations than to wait and learn through trial and error. Therefore, get all the information you can from other people in the same or a similar business, from trade associations, government agencies, libraries, and from other likely sources. Many of these sources may be within your own community.

The following sources can be contacted either by mail or by referring to their publications in your local library:

Small Business Administration
Washington D.C. 20416
—or a field office in your area.
(Ask for catalog 115A and 115B.)

Dun & Bradstreet
99 Church Street
New York, NY 10007

The Bank of America
Small Business Reporter
Department 3120
P.O. Box 37000
San Francisco, CA 94137

Robert Morris Associates
Philadelphia National Bank Bldg.
Philadelphia, PA 19107

National Cash Register Corporation
3095 Kettering Blvd.
1st Floor
Dayton, OH 45439
(Ask for annual "Expense in Retailing" publication.)

Here are some other organizations or individuals who may be contacted:

- Colleges and universities
- Your own present or potential customers
- Trade associations
- Chambers of commerce
- Better Business Bureaus
- Credit bureaus
- Business sections of libraries
- Minority economic and business development centers

The more sources of information that you contact, the more accurate your projection of the financing needs for your business will be. All of the sources listed have an abundance of information, such as typical operating ratios for the kind of business in which you are interested. An example of some information that is available is in figure 1.

THE MONEY IT TAKES TO GET A SMALL BUSINESS GOING

Type of Business and Annual Gross Sales	Investment in Inventory	Total Capital Investment (for Start-up and First Three Months' Operation)
Building Maintenance Service $25,000 to $75,000		$8,000 to $16,000
Plant Shop $25,000 to $80,000	$5,000 to $10,000	$11,000 to $24,000
Bookstore $75,000 to $100,000	$12,000 to $20,000	$25,000 to $53,000
Beauty Salon under $100,000		$15,000 to $29,000
Yarn Shop $50,000 to $100,000	$8,000 to $12,000	$16,000 to $25,000
Repair Service		
Furniture		$10,000 to $20,000
Car		15,000 to 40,000
TV/radio		10,000 to 25,000
Appliance		6,000 to 20,000
Clock/watch		8,000 to 12,000
Shoe		15,000 to 25,000
Business machine		6,000 to 10,000
Bicycle		6,000 to 10,000
Contractors (plumbing, carpentry, electrical, etc.)		10,000 to 30,000
Equipment Rental Service $50,000 to $200,000		
Camping/recreation	$7,500 to $15,000	$15,000 to $25,000
Soft goods (party, sickroom)	12,500 to 21,000	25,000 to 35,000
Fabric store $100,000 to $200,000	25,000 to 35,000	38,000 to 58,000
Hobby/crafts store under $200,000	20,000 to 30,000	36,000 to 56,000

Figure 1. Sample of financial start-up information

SOURCE: *Changing Times*, August 1977, p. 40. Reprinted by permission from *Changing Times*, the Kiplinger Magazine, August 1977 issue. Copyright 1977 by the Kiplinger Washington Editors, Inc., 1729 H Street, N.W. Washington, DC 20006. Based on data in Bank of America's *Small Business Reporter* series.

WHAT ARE OPERATING EXPENSES?

One method of comparing and analyzing what your business expenses should be is to use operating ratios. Operating ratios are percentage figures showing what proportions of the sales dollar businesses spend on various components of their operations. For example, the average bookstore with sales of $250,000 to $500,000 might spend 43 percent of its sales on wages and salaries. A bookstore owner in this size range who spends 60 percent of sales in salaries might decide to examine her or his employment policies after finding that the average for similar businesses is 43 percent.

In order to obtain operating ratios, first find out both the total volume of sales and the operating ratios for businesses like yours. Among the sources for sales volume figures and operating ratios are Bank of America's "Small Statement Studies," Robert Morris Associates' "Annual Statement Studies," Dun & Bradstreet, Inc., trade associations, trade magazines, specialized accounting firms, publications prepared by industrial companies (for example, "Expenses in Retail Business," by National Cash Register Co.), and colleges and universities. Next, determine how sales volume can be broken down into the various categories of expenses and profit.

HOW ARE OPERATING RATIOS USED?

Once you have the operating ratio information, it is relatively easy to determine expenses. The typical ratios for your type of business, multiplied by your estimated sales volume, will serve as a benchmark for estimating the various items of expense. However, you should never rely exclusively on this method for estimating each expense item.

As an example of this approach, consider the following hypothetical circumstances. You are planning to open a small retail flower business. Let's suppose that, through the Retail Florists Trade Association, you find that the average flower shop operates on a gross margin of 50 percent, and overhead expenses are 30 percent of sales. The application of this information can help tremendously in determining what the amount of your overhead expenses and what the cost of your merchandise would be.

To apply this information you will have to estimate your first year's sales. If you estimate $100,000 in sales your first year, this is what you would find:

$100,000 in sales x 50% = $50,000 gross margin

$100,000 in sales x 30% = 30,000 in overhead expenses

$ 50,000 gross margin — $30,000 in overhead expenses = $20,000 net profit before taxes

Furthermore, if you found that the average rate of inventory turnover for retail flower shops was ten times annually, you could also figure the average dollar inventory you would need. Since you estimated your gross margin to be $50,000 on sales of $100,000, the cost of the flowers you sold were $50,000. Now, using the following formula, you can determine the average amount of inventory you need to have on hand.

$$\frac{\text{Cost of merchandise (flowers) sold}}{\text{Average rate of inventory turnover}} = \text{Average Inventory To Have in Stock}$$

$$\frac{\$50{,}000}{10} = \$5{,}000$$

One of the first considerations in financing your business is to determine how much money is needed for inventory, accounts receivable, and, of course, for cash. All of these will comprise your current assets. To a large extent, your investment in current assets will depend upon what you anticipate your current liabilities to be on the opening day of business. A rule of thumb is that current assets should be twice that of current liabilities.

In estimating inventory requirements for a wholesale or retail business, talk to your prospective suppliers. Such an estimate should be checked against the typical ratio of inventory in relation to sales, if you have such a ratio for your kind of business. For example, assume that net sales in your type of business are typically six times the inventory. Then for annual net sales of $375,000, your inventory should approximate $62,500. You should make this type of calculation to establish a maximum dollar figure for inventory and not go above it.

Otherwise, you or your suppliers might be over enthusiastic about the amount of merchandise you should stock for your initial inventory.

WHAT IS SPECIAL ABOUT FINANCING A MANUFACTURING BUSINESS?

The procedure for estimating the money needed to start a small factory is similar, but somewhat more complex. For example, suppose you wish to manufacture an automotive part and hope to make an annual net profit of $20,000. Yearly sales of $500,000 will be necessary, computed at a 4 percent profit. How many units must be produced to attain this volume? Assume you plan to manufacture one part that will sell for an average of $20. To reach a sales volume of $500,000, you must sell 25,000 units. This means an average of 500 units per week for fifty weeks. How much machinery and equipment will be required to produce 500 units per week? How much downpayment for the equipment will be necessary? Should you lease some of the equipment? How many operators will be needed? To the equipment cost you must add estimates for materials, wages, rent, sales, office, and other expenses for a period necessary to produce enough units for one complete turn, that is, the annual production (25,000 units in this case) divided by the expected number of *stock turns* per year.

WHAT IS SPECIAL ABOUT FINANCING A SERVICE BUSINESS?

Estimating the money needed to start a service establishment will involve a combination of the methods used for merchandising and manufacturing businesses. To the extent that the service business carries goods for sale, estimates could be made in the manner outlined for wholesale and retail concerns. To the extent that it sells labor or machine work, money needed for equipment and wages could be estimated in a similar fashion as for a factory.

WHAT IS SPECIAL ABOUT FINANCING A FRANCHISED BUSINESS?

Holiday Inn, Kentucky Fried Chicken, and McDonald's are all familiar franchising organizations. The capital required to purchase an outlet of many of the large, successful franchise organizations can range from hundreds of thousands to several million dollars. Yet some franchise outlets can still be purchased for a thousand dollars. Those franchises that require the least start-up cash are in the business aids and service areas—areas that are expected to have rapid growth.

Franchising offers a means of becoming an entrepreneur, being your own boss, and profiting from being a part of a big business with national or regional advertising, large-scale purchasing power, and exclusive distribution of name brands. If you can provide the capital, franchising may be the way to own your own business and make respectable profit.

Information on Franchising. If you are considering opening a franchise, you should check several resources. Write for annual reports and other brochures from the parent company. Ask to be sent disclosure statements. Several publications are good sources for names, addresses, and other details on franchising enterprises:

- The U.S. Department of Commerce's *Franchising Opportunities Handbook*, available from the Superintendent of Documents, Washington, D.C. 20402
- *Classified Directory of Members*, available from International Franchise Association, 7315 Wisconsin Avenue, Washington, D.C. 20014
- The Small Business Administration booklet, *Franchise Index/Profile*, available from the Superintendent of Documents, Washington, D.C. 20402; this provides step-by-step procedures for opening a franchise outlet
- The U.S. Commerce Department's *Franchising in the Economy*, also available from the Superintendent of Documents; this provides current information on trends in the franchising business

Figure 2 lists the median amount of startup costs and median total investment needed to get various types of franchise businesses going. Some of the service businesses can be started with a relatively small total investment. Tax preparation businesses are a good example. Other businesses, like fast food restaurants, may require large investments of $300,000 or more.

HOW DO YOU DETERMINE THE FINANCING NEEDED TO START YOUR BUSINESS?

If you have been thorough in your investigation, you should have sufficient information about industry averages, operating ratios, and other general factors affecting the type and amount of financing that your particular type of business requires. Hopefully, you will have also talked with bankers, suppliers, competitors, and other knowledgeable people in or related to your industry.

FRANCHISE SALES AND INITIAL COSTS 1977

(in thousands)

Type of Business	1977 Average Franchise Sales per Unit	Median Start-up Cash	Median Total Investment
Automobile Products/Services	98	15	50
Business Aids and Services: Accounting, Credit, Collection, and General Business Services	38	6	15
Employment Services	218	15	25
Printing and Copying Services	94	10	45
Tax Preparation Services	23	3	4
Miscellaneous Business Services	60	10	20
Construction, Home Improvement, Maintenance, and Cleaning Services	79	10	25
Convenience Stores	392	10	60
Educational Products and Services	121	10	60
Fast Food Restaurants	335	30	100
Hotels and Motels	852	100	900
Campgrounds	99	50	200
Laundry and Dry Cleaning Services	81	16	50
Recreation, Entertainment, Travel	51	15	30
Rental Services (Auto-Truck)	168	40	100
Rental Services (Equipment)	102	10	50
Retailing (Nonfood)	223	25	50
Retailing, Food (Other than Convenience Stores)	152	21	60
Miscellaneous	221	10	38

Figure 2. Median start-up and investment costs for franchises.

SOURCE: U.S. Department of Commerce. *Frnnchising in the Economy 1977-79.* Washington, DC: U.S. Government Printing Office.

Now is the time to put what you have learned to work. Using the information you have gathered, the next section will assist you in determining your financing needs on a step-by-step basis. The first step involves estimating your sales. The second step is estimating startup costs. The third is calculating monthly operating expenses. The fourth is figuring personal living expense requirements. The fifth step is adding the start-up, operating, and personal living expenses together to determine the total financing needed to put your business into operation.

WHAT IS INVOLVED IN ESTIMATING ANNUAL SALES VOLUME?

The first step in determining the financing you need is to estimate sales volume for your first year of operation. Your estimated sales volume becomes the target or the goal that all of your expenses—in time, effort, and money—are aimed at hitting. Your annual sales goal provides the parameter or means by which you can keep your estimate of financing realistic. There should be a very definite relationship between sales and expenses. They go hand-in-hand together.

There are many factors to consider when estimating sales volume. The volume will depend on the total amount of business in the area, the number and ability of competitors now sharing that business, and your own ability to compete for the customer's dollar.

One approach to determining your independent estimate is to start with the income you desire. Suppose you hope to earn annual profits of $15,000. Your research reveals that the rate of net profit on sales for the type of business you plan to operate is 4 percent. To bring an annual return of $15,000, sales of $375,000 ($15,000, divided by .04 percent) will be required.

In reaching your final estimate of sales, be cautious. A new business generally grows slowly at the start. If you overestimate sales, you are likely to invest too much in equipment and initial inventory and commit yourself to heavier operating expenses than your actual sales volume will justify. You may obtain assistance in making your sales estimate from wholesalers, trade associations, your banker, and other business people. The counsel of others can be compared with your independent estimate of what you believe is needed to make the effort worthwhile to you.

HOW DO YOU ESTIMATE START-UP COSTS AND MONTHLY OPERATING EXPENSES?

The investigation you completed of the financing of your business should now enable you to make educated estimates of your start-up costs and monthly operating expenses. The worksheet in figure 3 provides a logical approach for getting your estimates on paper and a means of comparing your figures with those of others. You will notice also that a section of the worksheet is provided for your estimated sales figures.

The Initial Estimates of Start-up Costs and Monthly Operating Expenses Worksheet is divided into five columns. The first column at the left is a breakdown or listing of the various startup costs and monthly operating expenses you will have. In the remaining four columns you will write in the figures you have discovered or calculated in your investigation.

The second column is your estimate of actual figures of the dollars that a friend, relative, or business colleague has invested in a similar business. The third column is your estimate of the investment made in a business operated by your principal competitor. Competition in this case does not necessarily mean the strongest firm against which you will compete. Rather, it means a business of a similar size that has been engaged in the type of sales or services that you want to establish.

The fourth column is the average of the two firms you surveyed. If possible, make an estimate of more than two competing firms. This will make the average figure more accurate. Much of this information will be difficult to obtain, especially information about a competitor's investment. However, this data is vital and will help you make a more accurate estimate.

As an illustration, consider the estimates listed on the worksheet in figure 3 for a flower shop that is being started. By carefully analyzing the estimates, you may conclude that the individual opening this business foresaw a smaller operation than the average. The average estimated sales were $116,000, whereas this flower shop entrepreneur estimated sales at a more conservative $100,000. Correspondingly, the start-up costs and monthly operating expenses were estimated at lower levels that are in line with the estimated sales.

Now that estimates have been made, you must consider how many months it will take before you will be in a position to pay the monthly expenses from cash generated from the business. Most sources suggest that a business should start with at least two or three months of operating expenses. The worksheet shown in figure 4 provides a format for taking this multiplier effect into account. This worksheet is reproduced from the SBA publication, "Checklist for Going into Business."

At this time you might find it helpful to get from your instructor the three worksheet forms being discussed in this section of the unit. You will use them for an activity later, but you will find them helpful now to follow the discussion.

As you can see from the example in figure 4, the prospective owner of the retail flower shop has used the worksheet to account for the multiplier effect and to determine the money needed to start the business. By transferring the figures from the worksheet in figure 3 and completing Column 2 in figure 4, the entrepreneur has a total cash figure. To handle the monthly operating expenses, $9,000 is needed. This, added to the $18,775 of start-up costs, shows a total need of $27,775 to get the retail flower shop open and operating.

Since the lists of start-up costs and monthly expenses between the two worksheets do not match exactly, it was necessary to adjust the miscellaneous/other category. Under monthly operating expenses, maintenance was included in the miscellaneous/others area on the first worksheet (figure 3). It is a separate item on the worksheet in figure 4.

	Friend	Competition	Average	Yours
Start-up Costs				
Purchase of real estate/rent	1,000	1,500	1,250	1,000
Decorating /remodeling	2,000	3,000	2,500	1,500
Fixtures and equipment	7,500	6,500	7,000	7,000
Initial inventory	5,000	6,000	5,500	5,000
Accounts receivable	500	1,000	750	500
Utility deposits	250	250	250	250
Initial advertising	200	200	150	200
Office supplies	125	175	150	125
Installation of equipment	750	1,250	1,000	650
Legal and professional fees	1,500	2,000	1,750	1,250
Licenses and permits	300	300	300	300
Miscellaneous/Others	1,000	1,500	1,250	1,000
Total	$20,025	$23,675	$21,850	$18,775
Monthly Operating Expenses				
Salary of owner	– 0 –	1,000	500	– 0 –
Other salaries	1,000	300	650	750
Rent/mortgage	400	450	425	400
Advertising	50	100	75	175
Delivery expenses	100	100	100	100
Supplies	200	250	225	150
Telephone	100	100	100	100
Utilities	300	350	325	275
Insurance	200	250	225	150
Taxes	200	250	225	300
Loan repayment	400	350	375	400
Travel	– 0 –	50	25	– 0 –
Legal and Professional fees	100	100	100	100
Miscellaneous/Others	250	250	250	200
Total	$3,300	$3,900	$3.600	$3,000

Projected Sales Income (in thousands)

	J	F	M	A	M	J	J	A	S	O	N	D
Friend	6	11	7	7	10	8	9	9	10	9	10	10
Competition	7	14	12	10	12	9	9	9	11	11	10	12
Average	6.5	12.5	9.5	8.5	11	8.5	9	9	10.5	10	10	11
Yours	5	10	6	6	9	7	8	9	9	10	10	11

Figure 3. Initial estimates of startup costs and monthly operating expenses worksheet.

ESTIMATED MONTHLY EXPENSES			
Item	Your estimate of monthly expenses based on sales of $______ per year	Your estimate of how much cash you need to start your business (See column 3.)	What to put in column 2 (These figures are typical for one kind of business. You will have to decide how many months to allow for in your business.)
	Column 1	Column 2	Column 3
Salary of owner/manager	$ 0	$ 0	2 times column 1
All other salaries and wages	750	2,250	3 times column 1
Rent	400	1,200	3 times column 1
Advertising	75	225	3 times column 1
Delivery expense	100	300	3 times column 1
Supplies	150	450	3 times column 1
Telephone and telegraph	100	300	3 times column 1
Other utilities	275	825	3 times column 1
Insurance	150	150	Payment required by insurance company
Taxes, including Social Security	300	1,200	4 times column 1
Interest (and Principal)	400	1,200	3 times column 1
Maintenance	100	300	3 times column 1
Legal and other professional fees	100	300	3 times column 1
Miscellaneous	100	300	3 times column 1
STARTING COSTS YOU ONLY HAVE TO PAY ONCE			Leave column 2 blank
Fixtures and equipment		7,000	Fill in worksheet 3 on page 12 and put the total here
Decorating and remodeling		1,500	Talk it over with a contractor
Installation of fixtures and equipment		650	Talk to suppliers from who you buy these
Starting inventory		5,000	Suppliers will probably help you estimate this
Deposits with public utilities		250	Find out from utilities companies
Legal and other professional fees		1,250	Lawyer, accountant, and so on
Licenses and permits		300	Find out from city offices what you have to have
Advertising and promotion for opening		200	Estimate what you'll use
Accounts receivable		500	What you need to buy more stock until credit customers pay
Cash		500	For unexpected expenses or losses, special purchases, etc.
Other		1,625	Make a separate list and enter total
TOTAL ESTIMATED CASH YOU NEED TO START WITH		$ 27,775	Add up all the numbers in column 2

Figure 4. Worksheet for figuring the multiplier effect in start-up costs.

SOURCE: Reproduced from "Checklist for Going into Business." Small Marketers Aid, no. 71. Washington, DC: Small Business Administration, 1975, pp. 6-7.

"Purchase of real estate/rent" is listed as a startup cost on the first worksheet, but it is included in miscellaneous/other on the worksheet in figure 4. The office supplies item is a part of the miscellaneous/other category on the second worksheet (figure 4). It is an individually listed startup cost on the first worksheet (figure 3). Also under the startup costs classification, cash was a part of the miscellaneous/other item on the first worksheet, while it is a separate entry on the second worksheet.

Entrepreneurs should also remember to consider their personal living expenses when determining the total financing needed to start the business. In some situations, an entrepreneur will have to take money from the business each month to pay for all or part of the personal living expenses. If this is the case, it is critical that the amount needed be known and at least that much be paid to the owner as a salary.

The business owner's living expenses are handled in numerous ways. Sometimes the owner will continue to hold a regular paying job in order to receive a steady paycheck until the new business is large enough to support the entrepreneur. Other times the income of the owner's spouse is sufficient, and it is not necessary to consider personal living expenses when determining how much cash is needed to get the business going. Then, too, some entrepreneurs will have several months of personal living expenses saved to use until the business has grown enough to take a salary.

The personal living expenses worksheet in figure 5 is an effective means of determining the entrepreneur's costs of living. With a total figure in mind, the business owner can then calculate how the expenses will be handled. The entrepreneur who started the flower shop did not take a salary. This was to keep monthly operating expenses (and, consequently, the cash needed to start the business) as low as possible. Also, this was practical because the entrepreneur's spouse earned enough income to pay all of their personal living expenses. The example, Personal Living Expense Worksheet, illustrates this situation. According to the flower shop entrepreneur, personal living expenses totalled $1,775 per month. The spouse's take-home pay was $1,815.

HOW DO YOU DETERMINE THE TOTAL CASH NEEDED TO START THE BUSINESS?

With the completion of this the fourth step (figuring the amount needed to cover personal living expenses), the procedure for determining the total amount of cash needed to start the business is nearly completed. The fifth and final step simply involves adding the total needed for monthly operating expenses and start-up costs from the second worksheet (figure 4) with the total needed to pay for personal living expenses (figure 5). In the flower shop example, the total cash needed was $27,775 since the spouse's income was sufficient to handle all the personal living expenses.

HOW DO YOU PREPARE TO ARRANGE THE FINANCING?

Over the past seven years, the entrepreneur starting the flower shop has saved $10,000 to use in getting the business off the ground. The question the entrepreneur faces now is where the remaining $17,775 will come from. Since sharing ownership in the business is not

DETAILED PERSONAL BUDGET

Based on average month—does not cover purchase of any new items except emergency replacements.

DETAILED BUDGET

Regular Monthly Payments	
• Rent or House Payments (including taxes)	$ 350
• Car Payments (including insurance)	175
• Appliances/TV Payments	65
• Home Improvement Loan Payments	0
• Personal Loan Payments	35
• Health Plan Payments	55
• Life Insurance Premiums	110
• Other Insurance Premiums	50
• Miscellaneous Payments	50
TOTAL	$ 890

Household Operating Expense	
• Telephone	60
• Gas and Electricity	140
• Water	25
• Other Household Expenses, Repairs, Maintenance	75
TOTAL	$ 300

Food Expense	
• Food—At Home	150
• Food—Away From Home	50
TOTAL	$ 200

Personal Expense	
• Clothing, Cleaning, Laundry, Shoe Repair	65
• Drugs	15
• Doctors and Dentists	30
• Education	0
• Dues	0
• Gifts and Contributions	10
• Travel	0
• Newspapers, Magazines, Books	15
• Auto Upkeep, Gas, and Parking	150
• Spending Money, Allowances	100
TOTAL	$ 385

Total Personal Living Expenses	$ 1,775
Spouse's Net Monthly Pay	$ 1,815

Figure 5. Personal living expenses worksheet

desirable to the entrepreneur, debt financing through some type of loan may be most realistic. With this in mind, the flower shop owner knows that commercial lenders will want financial statements projecting the activity of the business. In addition, a statement reflecting the personal financial position of the entrepreneur is frequently required. If an entrepreneur does not have his or her own personal finances in good condition, lenders will question whether the finances of the business can be handled properly. Therefore, the projected profit-and-loss statement, projected cash flow statement, and personal balance sheet must be prepared.

HOW DO YOU PREPARE THE PROFIT-AND-LOSS STATEMENT?

To lend money to a business just being started, most lenders require a projection of the monthly profit or loss for the first year. This statement provides an estimate of when the business will begin to make money and how much it will make. This is important to the lender, since loan repayments generally are made for business profits.

The projected profit-and-loss statement is fairly easy to construct if you have used the worksheets previously presented to estimate sales and monthly operating expenses. The following steps make the development of the projected profit-and-loss statement simple.

Step 1. List your estimated gross sales on a monthly basis.

Step 2. List the costs of the merchandise (or service) you estimate will be sold monthly.

Step 3. Subtract the costs of the merchandise (or service) from your estimated gross sales. The resulting figure is your gross margin or profit.

Step 4. Itemize the monthly operating expenses.

Step 5. Total the monthly operating expenses.

Step 6. Subtract the monthly operating expenses from the gross margin or profit. The resulting figure is the net profit or loss for the month. Losses are shown by putting parentheses around the number. For example a $500 loss would be listed as ($500).

The projected profit-and-loss statement for the retail flower shop is provided in figure 6. As you can see, the owner is projecting a $500 loss the first month of operation. Sales are estimated to be much higher during February, the second month, because of Valentine's Day. Therefore, a $2,000 profit is estimated for the month. The third and fourth months show an equal amount of gross margin or profit and expenses, so there is neither a profit nor a loss. A profit is estimated for the remaining months of the first year and, subsequently, a $14,000 total profit for the first year.

HOW DO YOU PREPARE A PROJECTED CASH FLOW STATEMENT?

Will you be able to pay the suppliers in time to receive the discount? When during the year will contracts be bringing in cash? To answer these questions, you need to project your cash flow. The cash flow projection gives you a picture of the amount of cash that will come

FIRST YEAR

	Jan	Feb	March	April	May	June	July	August	Sept	Oct	Nov	Dec	Totals
Gross Sales	5,000	10,000	6,000	6,000	9,000	7,000	8,000	9,000	9,000	10,000	10,000	11,000	100,000
Less Cost of Sales	2,500	5,000	3,000	3,000	4,500	3,500	4,000	4,500	4,500	5,000	5,000	5,500	50,000
Gross Margin or Profit	2,500	5,000	3,000	3,000	4,500	3,500	4,000	4,500	4,500	5,000	5,000	5,500	50,000
Expenses													
Salary of Owner	—0—												
Other Salaries	750												
Rent/Mortgage	400												
Advertising	75												
Delivery	100												
Supplies	150	(Expenses for each month are the same as those listed for January)											
Telephone	100												
Utilities	275												
Insurance	150												
Taxes	300												
Loan Repayment	400												
Travel	—0—												
Legal and Pro. Fees	100												
Miscellaneous/ Others	200												
Total Expenses	3,000	8,000	3,000	3,000	3,000	3,000	3,000	3,000	3,000	3,000	3,000	3,000	36,000
Net Profit or (Loss)	(500)	2,000	—0—	—0—	1,500	500	1,000	1,500	1,500	2,000	2,000	2,500	14,000

Figure 6. Retail flower shop projected profit-and-loss statement

into and go out of your business. If you sell on credit, not all sales will produce cash. Also, your firm's income and expenses are not going to be constant each month. Therefore, it is necessary to predict the month-by-month pattern in which cash will actually come in and go out. You can then anticipate, for example, if you will need a loan to cover expenses, and can begin making arrangements to obtain one early.

Like the projected profit-and-loss statement, the projected cash flow statement uses much financial information that you have previously calculated. The net profit or loss you have projected, plus any additional disbursements or expenditures, are the two major components. The step-by-step procedure for preparing the projected cash flow statement is as follows.

Step 1. Add together any cash on hand and loans you have to determine the total amount of cash you have to start the business.

Step 2. Subtract the start-up costs to project the actual amount of cash left over to start the business. (Steps 1 and 2 were completed in the pre-operating column.)

Step 3. For each month of the first year of operation, plug in the estimated profit or loss that you have previously determined.

Step 4. Determine other cash expenditures or disbursements and list them.

Step 5. Total the disbursements.

Step 6. Subtract the total disbursements from the cash received during each month. This is the net cash flow.

Step 7. Add the net cash flow to the cumulative cash flow, which is the total amount of cash left over from the previous months. This gives you the total amount of cash you have accumulated.

As an example, the projected cash flow statement for the retail flower shop is presented in figure 7. The entrepreneur's $10,000 in savings is added to the $17,775 that will be borrowed in order to start up with $27,775. From this total, $17,775 in start-up costs that will be expended in opening the business is subtracted. If you recall, the start-up costs for this business were estimated at $18,775. However, since $500 was for cash and $500 was for accounts receivable, and since these two items were not spent but were actually put into the cash account of the business, they were taken out of the start-up costs disbursement. This left the business with $10,000 in cash to begin operating the business.

Each month the entrepreneur is estimating some additional disbursement beyond monthly operating expenses. In January it is $150. Although these disbursements are not specifically labeled in this example, there should be a specific purpose intended for the money. The $150 in January might be for additional grand opening

FIRST YEAR

	Pre-operating	Jan	Feb	March	April	May	June	July	August	Sept	Oct	Nov	Dec
Sources of Cash													
Cash on Hand	$10,000												
Loan	17,775												
*Net Profit		(500)	2,000	—0—	—0—	1,500	500	1,000	1,500	1,500	2,000	2,000	2,500
Total	27,775	(500)	2,000	—0—	—0—	1,500	500	1,000	1,500	1,500	2,000	2,000	2,500
Disbursements													
Start-up Costs	17,775												
Owner's Draw													
Income Tax					1,500								
Others (beyond monthly operating expenses)		150	200	100	100	300	100	200	300	3,000	300	300	1,750
Total	17,775	150	200	100	1,600	300	100	200	300	3,000	300	300	1,750
Net Cash Flow	10,000	(650)	1,800	(100)	(1,600)	1,200	400	800	1,200	(1,500)	1,700	1,700	750
Cumulative Cash Flow	10,000	9,350	11,150	11,050	9,450	10,650	11,050	11,850	13,050	11,550	13,250	14,950	15,700

Figure 7. Projected cash flow statement for retail flower shop

*Net profit is carried over from the projected profit-and-loss statement expenses. The $3,000 in September is to buy a used van for deliveries. Extra holiday personnel may be needed in December, and $1,750 is designated to pay these people. As you can see, it is important to plan your cash disbursements on a monthly basis to determine the impact they will have on your cash flow.

You may have a negative cash flow in some months. This occurs when you spend more cash than you take in during the month. You will notice this is the case in January, March, April, and September. This is feasible for the flower shop entrepreneur because there will be sufficient cash accumulated to make up the difference. If this were not the case, some type of loan or credit arrangement might be necessary.

HOW DO YOU PREPARE YOUR PERSONAL BALANCE SHEETS?

Your personal balance sheet provides any potential lender with an overall view of your financial condition. If you have a strong personal financial position, illustrated by a sufficiently large net worth, you are generally more appealing as a loan applicant. An entrepreneur with a weak financial position and a large number of debts may not meet the standards of the lenders.

The personal balance sheet includes a summary of your assets, what you own that has cash value, and your liabilities or debts. The example in figure 8 is for the entrepreneur starting the flower shop.

Preparing your personal balance sheet involves just a few simple steps.

Step 1. Determine the value of all your assets. These would be the items you own that have cash value. List them on the balance sheet.

Step 2. Total the value of your assets.

Step 3. List all of your debts.

Step 4. Total the amount of your debts and liabilities.

Step 5. Deduct your total liabilities from your total assets. This is your net worth.

The financial position of the entrepreneur starting the flower business is solid. The assets include cash, personal savings, life insurance, an automobile, real estate, and personal property. The liabilities are fairly limited, with the biggest loan being the mortgage on the real estate. There is about $2.22 worth of assets for every $1.00 of liability. It is evident that the entrepreneur has handled his or her personal financial affairs well. This will certainly help impress a commercial or government lender, and should help obtain the necessary debt financing to get the flower shop started.

HOW DO YOU DETERMINE WHICH FINANCING SOURCES TO USE?

With the financial statements prepared, you are now ready to zero in on the specific financing sources you wish to use. The choice of

PERSONAL BALANCE SHEET STATEMENT

________________________ 19 ______

ASSETS: Everything you own with cash value	
Cash money you have on hand and in the bank	$ 975.00
Savings accounts	$10,000.00
Stocks, bonds, other securities	$ — —
Accounts/notes receivable	$ — —
Life insurance cash value	$ 2,139.00
Rebates/refunds	$ — —
Autos/other vehicles	$ 6,342.00
Real estate	$62,500.00
Vested pension plan/retirement accounts	$ — —
Other assets (furnishings, appliances, jewelry, furs, cameras, tools, pets, trusts, etc.)	$ 5,417.00
TOTAL ASSETS	$87,373.00
LIABILITIES: What you owe; your debts	
Accounts payable	$ 350.00
Contracts payable	$ 1,150.00
Notes payable	$ — —
Taxes	$ 2,485.00
Real estate loans	$35,475.00
Other liabilities (court-demanded payments, etc.)	$ — —
TOTAL LIABILITIES	$39,460.00

TOTAL ASSETS	$87,373.00	
LESS TOTAL LIABILITIES	$39,460.00	
NET WORTH		$47,913.00

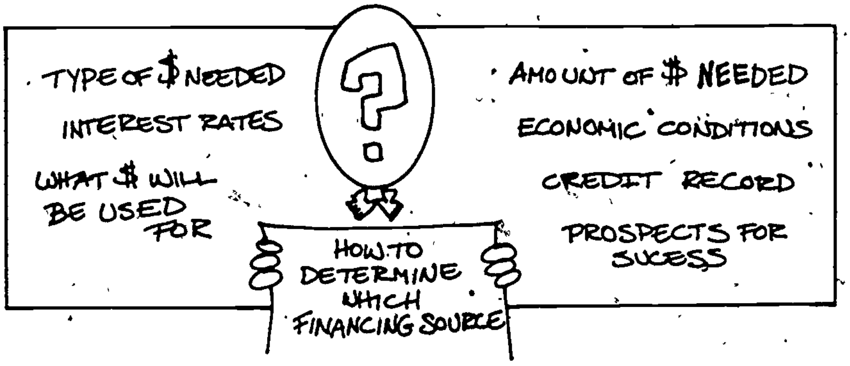
Figure 8. Personal balance sheet for retail flower shop owner

SOURCE: Reprinted with permission from Bank of America NT&SA, "Steps to Starting a Business," Vol. 10, No. 10, *Small Business Reporter*, Copyright 1976.

sources that the entrepreneur will make will be based upon the interaction of several variables. Some of these variables are as follows:

- The amount and type of money needed
- Current economic conditions and prevailing interest rates
- The credit record of the entrepreneur
- The specific purpose that the financing will be used for
- The type of business being started and its prospect for success

An aspiring entrepreneur should study the situation carefully. It may be wise to discuss the matter with your local banker, SBA office, or financial consultant. The Small Business Financing Guide presented in table 1 on the following pages may be helpful, too.



The choice of financing sources you qualify for and decide to use will essentially dictate the contents of your loan application package. While some lenders may request a very detailed presentation, others—who may already know you—may ask for less information.

The breadth, depth, and quality of your loan application package will dramatically affect your chances for approval. It is vital to put together a package that presents you, your ideas, and your business plan in as impressive a manner as possible.

The following loan application package outline will serve as a guide in the preparation of your package.

Loan Application Package Outline

I. Basic Application Information

A. Applicant's name, address, and telephone number
B. Business name, address, and telephone number
C. Type of business
D. Size of business
E. Type of ownership
F. Applicant's financial contribution to business

TABLE 1

SMALL BUSINESS FINANCING GUIDE

Use of Funds	Type of Money	Source	Financing Vehicle
Business	Equity	Nonprofessional investor	Partnership formation Stock issue
		Venture capitalist SBIC-MESBIC	Stock issue Convertible debentures Debt with warrants
	Long-term debt	Bank	Term Loan (limited) Unsecured term loan Equipment loan Equipment leasing Real estate loan
		SBIC-MESBIC	Term loan (limited) Unsecured term loan Equipment loan Equipment leasing
		Commercial finance company	Equipment loan Equipment leasing Real estate loan
		Life insurance company	Policy loan Real estate loan
		Savings and loan association	Real estate loan
		Leasing company	Equipment leasing
		Consumer finance company	Personal property term loan
		Small Business Administration Economic Development Administration	Term loan guarantee Direct term loan (limited)
		Local development company	Facilities/equipment financing
		Farmers Home Administration	Term loan guarantee
Working Capital	Long-term debt	Bank	Unsecured term loan Equipment loan Real estate loan
		Commercial finance company	Equipment loan Real estate loan
		Life insurance company	Policy loan Real estate loan Unsecured term loan (limited)
		Savings and loan association	Real estate loan
		Consumer finance company	Personal property loan
		Small Business Administration Economic Development Administration SBIC-MESBIC	Term loan guarantee Direct term loan (limited)
		Farmers Home Administration	Term loan guarantee
Seasonal Peak	Short-term debt and Line of Credit	Supplier	Trade credit
		Bank	Commercial loan Accounts receivable financing Inventory financing Flooring Indirect collection financing Unsecured line of credit
		Commercial finance company	Accounts receivable financing Inventory financing Factoring
		Factor	Factoring
		Life insurance company	Policy loan
		Consumer finance company	Personal property loan
		Small Business Administration	Line of credit guarantee (limited)

SOURCE: Reproduced from *Financing Small Business*, Bank of America, Small Business Reporter Series, 1980, pp. 30-31.

TABLE 1 (continued)
SMALL BUSINESS FINANCING GUIDE

Use of Funds	Type of Money	Source	Financing Vehicle
Equipment or Facilities Acquisition	Long-term debt	SBIC-MESBIC	Term Loan
		Bank Commercial finance company	Equipment loan Equipment leasing Real estate loan
		Life insurance company	Policy loan Unsecured loan (limited) Real estate loan
		Savings and loan association	Real estate loan
		Consumer finance company	Personal property term loan
		Leasing company	Equipment leasing
		Small Business Administration	Term loan guarantee
		Economic Development Administration	Direct term loan (limited)
		Local development company	Facilities/equipment financing
		Farmer's Home Administration	Term loan guarantee
Sharp, Sustained Growth	Equity	Nonprofessional investor	Partnership formation Stock issue
		Venture capitalist	Stock issue Convertible debentures Debt with warrants
	Long-term debt	SBIC-MESBIC	Term loan
		Bank	Unsecured term loan Equipment loan Equipment leasing Real estate loan
		Commercial finance company	Equipment leasing Real estate loan
		Life insurance company	Unsecured term loan Policy loan Real estate loan
		Savings and loan association	Real estate loan
		Consumer finance company	Personal property loan
		Leasing company	Equipment leasing
		Small Business Administration Economic Development Administration	Term loan guarantee Direct term loan (limited)
		Local development company	Facilities/equipment financing
		Farmers Home Administration	Term loan guarantee
	Line of credit	Supplier	Trade credit
		Bank	Unsecured line of credit Accounts receivable financing Inventory financing Flooring Indirect collection financing
		Commercial finance company	Accounts receivable financing Inventory financing Factoring
		Factor	Factoring
		Small Business Administration	Line of credit guarantee (limited)

II. Loan Request

A. Purpose of loan
B. Amount
C. Terms, including desired interest rate
D. Debt/equity ratio
E. Collateral
F. Specific use of money borrowed

III. Applicant's Personal Information

A. Resume, including education, work experience, and business background.
B. Credit references
C. Personal balance sheet
D. Past two to three years' income tax statements

IV. Business Information

A. Business plan
B. Life and casualty insurance coverage
C. Business licenses or permits
D. Lease/facilities agreement
E. Other supporting information

V. Financial Projections

A. Projected monthly profit-and-loss statement for at least one year
B. Projected cash flow statement for at least one year
C. Some lenders may also ask for a projected balance sheet for the first year

HOW DO YOU CONSTRUCT A PLAN OF ACTION TO SATISFY YOUR FINANCING NEEDS?

Determining and satisfying the financing needs of your business takes a great deal of thought, planning, and organizing. You need to develop and execute a complete plan of action. The following Checklist for Financing Your Business should help you as you devise your plan. The checklist items are organized by the steps you need to take to arrange your financing. To determine whether you are being thorough in completing the financial steps, ask yourself each question on the checklist. If you have completed the activity, put a check mark (✓) beside the item. If you answer no to the question, leave the line blank. Then, ask yourself if the item is applicable to your situation. If it is, you should plan to complete the activity. If it is not, put N/A beside the question and go on to the next item. After completing all the checklist items, your financing plan should be ready to go.

Checklist for Financing your Business

Step 1. Investigate Your Financial Needs.

Have you obtained a variety of published information from trade associations, the SBA, financial service companies, and other sources?

Have you talked with others, including competitors in your field?

Have you talked with your banker, suppliers, and other knowledgeable sources about your financing needs?

Have you obtained operating ratio information?

Have you determine what is special about financing your particular type of business?

Step 2. Determine the Type and Amount of Financing You Need

Have you used the information gathered in your investigation?

Have you used operating ratios to estimate your financial needs?

Have you used actual quotations of prices for inventory and equipment needs?

Have you estimated your sales volume for the first year?

Have you determined what type of startup costs and monthly operating expenses you will have?

Have you used the Initial Estimates of Startup Costs and Monthly Operating Expenses Worksheets (figures 3 and 4)?

Have you used the second worksheet (figure 4) from the SBA to figure the total amount needed for start-up costs and operating expenses?

Have you determined where the money will come from to cover your personal living expenses while you start the business?

Have you used the Personal Living Expense Worksheet (figure 5) to determine your monthly personal budget?

Step 3. Prepare to Arrange the Financing You Need

Have you determined how much you are personally going to invest in the business?

Have you determined how much additional financing you are going to need, beyond your personal investment, to get the business started?

Have you prepared a projected profit-and-loss statement (figure 6)?

Have you prepared a projected cash flow statement (figure 7)?

Have you prepared a personal balance sheet (figure 8)?

Step 4. Determine which Financing to Use

Have you considered the advantages and disadvantages of the equity financing alternatives?

Have you considered the advantages and disadvantages of the debt financing alternatives?

Have you considered which sources of financing you qualify for?

Have you determined the type and form of financing that best suits the needs of your business?

Have you determined the priority for approaching and using your potential financing sources?

Step 5. Prepare the Loan Application Package

Have you discussed with potential lenders their loan application procedures?

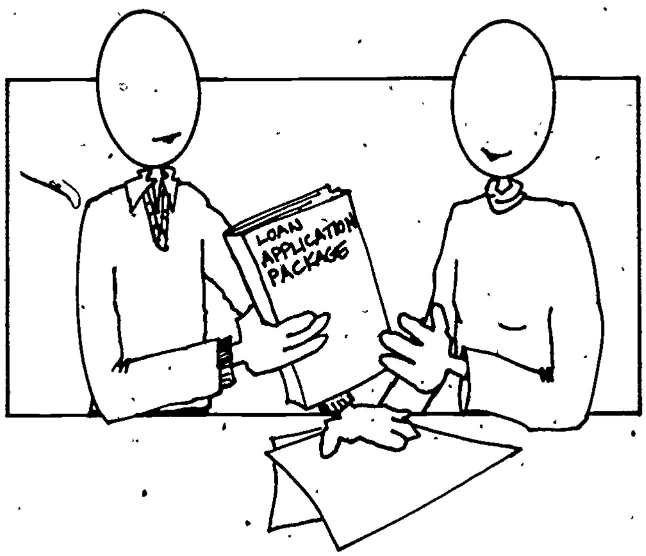
Have you determined the information required for the loan application package?

Have you determined what collateral you will use?

Have you gathered and organized the information needed for your loan application package?

Have you completed your loan application package so that it is thorough and impressive looking?

Step 6. Present the Loan Application Package and Negotiate the Financing Needed to Start Your Business



ACTIVITIES

The following activities are provided so that you can try out what you have learned about financing the business. After completing each one, pause and check your answers. This will help you to measure your knowledge about financing the business.

INDIVIDUAL ACTIVITY

1. Using the worksheet forms provided by your instructor, determine the total amount of money needed to get your business started. Include startup costs, monthly operating expenses, and personal living expenses.

2. Using the information developed in the first activity, prepare the following financial statements:

   - A projected profit-and-loss statement
   - A projected cash flow statement
   - A personal balance sheet

3. Using the guidelines of a local lending institution, prepare a loan application package.

GROUP ACTIVITY

Divide into small groups of three or four students. Taking turns, each student in the group should explain his or her startup costs and monthly operating expenses estimate, financial statement, and loan application package.

Group members should carefully consider one another's presentation, and then comment on the following:

- Are the start-up costs and monthly operating expenses complete? Should others be included? Are the figures realistic? Suggestions?

- Are the financial statements complete? Is the sales volume estimate realistic? Are the calculations mathematically correct? Suggestions?

- Is the loan application package complete? Does it have a neat and businesslike appearance? Should any information be deleted? Should any additional information be included? Suggestions?

CASE STUDY

Mr. and Mrs. Harold DeBusko are very interested in opening a hobby and craft store. They are currently trying to determine how much money is needed to start their business. They have already agreed that the store must make $15,000 net profit the first year so they can pay all their personal living expenses.

Through their investigation of financing, they have discovered the following information about hobby and craft stores:

- They usually operate on a gross margin of 50 percent.

- Overhead costs are 40 percent of gross sales.

- The average rate of inventory turnover is six times per year.
- The rate of net profit on sales is 10 percent.

Explain the use of operating ratios when determining financing needs to the DeBuskos. Show them how to calculate the following:

- Their first year sales goal
- Cost of merchandise sold during the first year
- Monthly overhead costs
- Cost of beginning inventory

ASSESSMENT

Directions: Read the following questions concerning financing the business. They are for you to check your knowledge about this topic. When you feel ready, ask you instructor to assess your knowledge of them.

1. Describe the sources of information available to use in estimating the financing necessary to start a new business.

2. Explain the steps involved in determining the financing needed to start a new business.

3. Explain the steps involved in preparing both a projected profit-and-loss statement and a projected cash flow statement.

4. Describe the five basic parts (and their contents) in a loan application package.

NOTES

Burstiner, I. *The Small Business Handbook*. Englewood Cliffs, NJ: Prentice-Hall, 1979.

Dickson, F.I. *Successful Management of the Small and Medium-Sized Business*. Englewood Cliffs, NJ: Prentice-Hall, 1971.

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U.S. Small Business Administration. *Your Business and the SBA*. Washington, DC: U.S. Small Business Administration, Office of Public Communications, 1981.

For further information, consult the list of additional sources in the PACE *Resource Guide*.

Level 3

PACE

Unit 1. Understanding the Nature of Small Business
Unit 2. Determining Your Potential as an Entrepreneur
Unit 3. Developing the Business Plan
Unit 4. Obtaining Technical Assistance
Unit 5. Choosing the Type of Ownership
Unit 6. Planning the Marketing Strategy
Unit 7. Locating the Business
Unit 8. Financing the Business
Unit 9. Dealing with Legal Issues
Unit 10. Complying with Government Regulations
Unit 11. Managing the Business
Unit 12. Managing Human Resources
Unit 13. Promoting the Business
Unit 14. Managing Sales Efforts
Unit 15. Keeping the Business Records
Unit 16. Managing the Finances
Unit 17. Managing Customer Credit and Collections
Unit 18. Protecting the Business
Resource Guide
Instructors' Guide

Units on the above entrepreneurship topics are available at the following three levels:

- Level 1 helps you understand the creation and operation of a business
- Level 2 prepares you to plan for a business in your future
- Level 3 guides you in starting and managing your own business

OSU

The Ohio State University