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Setting Up Your Own Business: Financing Your Business

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Financing the start-up, development, and growth of your business may be one of the most important challenges you'll face in setting up your own business. Many potential business owners do not have personal funds in the amount needed. And, regardless of how good your business idea or product is, those who could lend you the needed funds may be unwilling to do so.

This NebFact identifies and describes the primary sources of financing and their use in funding your business. Some implications of self-financing your business are identified and discussed. A similar discussion examines the implications of using funding provided by others. In the concluding paragraphs, microloan opportunities are briefly described and contact information is provided.

Sources of Financing

With the infrequent exception of gifts, grants, or awards given directly to a business (not given to the owner or owners), the financing of small-scale entrepreneurial activities usually can be classified as equity sales or borrowing. In equity sales, you sell an equity (ownership) interest in the business to someone (possibly yourself) who provides money you use to fund your business start-up, operations, and growth. In borrowing, a lender (possibly yourself) supplies needed funds in exchange for a promise by your business to repay the borrowed amount by a specified date, or to make payments regularly over a specified period.

There's no legal distinction between you and your business when it is a sole proprietorship — you and the business are considered to be the same. However, for management and income tax record keeping purposes, it's best to treat your business as entirely separate from yourself. Doing so requires separating its finances and records from your personal finances and records. If you establish a business bank account and consistently use it for all business transactions, it will help you to maintain this separation. Treat your investment in the business as a purchase of equity, or make a loan to the business and consider it a purchase or loan as appropriate to the circumstances.

You may be the only person who is both willing and able to put money into the business — to buy equity — as equity will be saleable only when you have a business idea that you and at least one other person (the purchaser) thinks is viable. When you do have a saleable interest and another person joins you in investing in the business, that person also buys an ownership interest — a share of the business idea and/or business unit.

If your business is a sole proprietorship, the purchase of an ownership interest by another person makes it a partnership. When your business is incorporated, the purchaser of an ownership interest becomes a stockholder. Before entering into any form of shared ownership, learn about the advantages and limitations of the form of business organization you intend to use. (For more information on popular forms of business organization read NF253 *Setting Up Your Own Business: The Sole Proprietor*, NF254 *Setting Up Your Own Business: The Partnership*, NF255 *Setting Up Your Own Business: The S Corporation*, NF256 *Setting Up Your Own Business: The C Corporation* and NF257 *Setting Up Your Own Business: The Limited Liability Company*.)

Other methods of selling equity seldom apply to a very small business. They include selling a major ownership interest to a venture capital supplier; and, selling stock or ownership interests on the open market through a public offering. Businesses that can sell equity in these ways usually are started by persons with a track record of experience and business success. Since these methods generally are used only by larger businesses, they will not be discussed further here.

When you are the financing source:

When you or anyone else purchase equity in your business, it's important to recognize that the risk of losing your equity is part of equity ownership. An equity purchase may generate little or no net return. Over a period of months or years it may grow, remain about the same, or decline in value. Possibly, it will be lost. If you make equity purchases, they typically are funded by income from another occupation; savings; retirement account deposits; current income made available by increasing personal credit card balances; inheritances;

proceeds from the sale of personal assets; proceeds from the sale of assets in another business; or proceeds from borrowing against equity in your home or other property owned by you and your family.

All of these funding sources place claims on assets important to the security of yourself and your family. Be sure to balance your enthusiasm for your business with a realistic assessment of the consequences of partial or complete loss of your investment. Be very careful if you can't afford to lose the money you are considering investing in your business.

Borrowing money from yourself should be documented through notes and other written records. Place the borrowed funds in a business bank account and spend them from that account. When you have a sole proprietorship, document the loan in the same way as you would when the business unit is a partnership or corporation. Funding sources for your loan will be about the same as those listed for equity purchases, and any decision to loan your money to your business should be based on projections indicating capacity to make timely debt service payments. Keep in mind that if the business cannot repay your loan, your loss will be the same as an equity loss, and generally will not be retrievable.

Any time you lend to your business, you need to evaluate the proposed arrangement as a business transaction and satisfy yourself that the risks are acceptable. If the level of risk appears to be unreasonably high, or if the business cannot pay the going rate of interest, you really are not making a loan to the business. Instead, you are purchasing an equity interest that may earn little or no return and will be lost if the business fails.

Commercial lenders do have one tool that is available exclusively to small-business owners — the U.S. Small Business Administration (SBA) Loan Guaranty Program. It can fund the varied long-term needs of small business when necessary financing is unavailable on reasonable terms through normal lending channels. Private lenders, usually banks, make loans that are guaranteed up to 90 percent by the SBA. The borrower then makes loan payments to the lender.

When others are the financing source:

Securing financing from a source other than yourself can be very difficult when your business is very small and has little or no history. In such instances, relatives or friends of the proprietors may make equity purchases or loans to the business. In doing so, they may create a partnership (discussed below) through an equity purchase. These arrangements usually are often based on family relationships and a desire to help the proprietor — it's not surprising that the parties providing funding sometimes are called "angels." It's much better if an angel's equity purchase or loan is based on careful assessment of the viability of the business. If the business fails and the angel's funds are lost, severe strains or conflict within the family can result.

In a partnership, each partner buys equity in the business and shares in the returns in proportion to his or her ownership share. Sometimes, all partners work in the business. Or, the partnership may have one or more silent partners (partners who are not visibly involved). Partnerships are particularly desirable when the business is large enough that the efforts of more than one person are needed, the partners have complementary skills, and they have compatible personalities.

In Nebraska, both general partnerships and limited partnerships are authorized forms of business organization (NF 96-254 *Setting Up Your Own Business: The Partnership*.) A written partnership agreement should be prepared and signed prior to committing funds or entering into agreements with parties outside the partnership. (The limited partnership agreement must be filed with the Secretary of State prior to the partnership engaging in business activity.) The most important consideration in using the general partnership form of business organization is the unlimited responsibility of each partner for the actions and decisions of all other partners. High limit liability insurance coverage can provide each partner with protection against most liability claims. There is no protection from the consequences of mistakes, bad decisions, and business losses.

When the proprietor is the general partner of a limited partnership, he or she retains full responsibility for management decisions and has unlimited financial responsibility for the partnership's liabilities. Unless a personal guarantee has been given by a limited partner, his or her financial responsibility cannot exceed the amount he or she has invested in the partnership.

Other local funding sources should not be overlooked. Local economic development associations, certified development companies, business incubators, and enterprise zones may have special programs or financing available for your area.

Finally, the last option in financing could be finding a venture capitalist. They loan money to businesses or take an equity position in a business in exchange for the business using the investor's money. The venture capitalists goal is to obtain a return on his or her investments. A desire for a 20 percent to 30 percent return on investment is not uncommon.

Microloan opportunities:

Numerous microloan programs have been established in Nebraska during the past five years. Their purpose is to provide small amounts of credit to businesses that do not have a commercial credit source. Each program has its own credit limits, with most lending amounts of a few hundred to not more than $25,000. Some provide only loans, others provide business management training, counseling, and/or business plan reviews prior to loan approval. Repayment of initial loans may qualify the proprietor for larger replacement loans if the need for more credit is documented.

For persons establishing or operating very small businesses, Nebraska's microloan programs are likely to be the most suitable credit source. The number and scope of these programs is changing constantly so it's not feasible to list them here. For current information on microloan programs that may be available in your vicinity, contact:

Steve Williams
Nebraska Department of Economic Development
1-800-426-6505
stevew@neded.org

or

Center for Rural Affairs-Rural Enterprise Assistance Program
(402) 846-5428
REAPinfo@cfra.org.

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