UNIT-5 Developing Financial Projections

Learning Outcomes

By the end of this unit the learner will be able to:

- ✓ Explain the purpose and future of your business in easy to understand terms

Unit 5

Developing Financial Projections

Accounting Terminology

The Importance of Financial Planning

Financial planning for your business plan is another essential step, and one that you must learn to do well. Often in business we say that we should delegate the things that we are not good at, but as the owner you must have a basic understanding of financial management to make sure that your business is viable and that you know where you stand financially at all times.

When it comes to writing the financial projections for your business plan, you will need to work with an accountant. The person you choose should understand your industry, the challenges of new business, tax planning, and the needs of the audience you are preparing your business plan for (whether you are applying for funding through a bank, a grant, etc.).

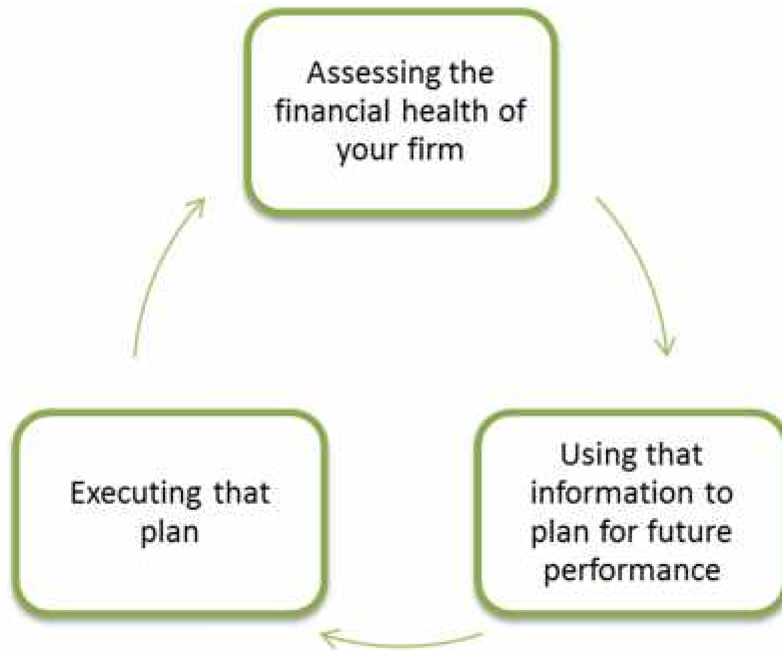
If your financial projections are too optimistic, they won't hold credibility to your investors or banker. Gather some average industry ratios and work with your accountant to make sure your projections are realistic. You'll need to include and be familiar with terms like profit and loss, cash flow, balance sheet, and break-even. We'll explore those terms and key financial reports throughout this session.

Depending on the purpose of your business plan, you may need to create one, three, and five year projections. This will be the focus of the final part of this session.

What is Finance?

The Encarta Dictionary defines finance as, "the business or art of managing the monetary resources of an organization, country, or person." Bookkeeping, banking, and accounting are all separate processes with their own definitions.

Seth Godin describes finance as a three-cycle process that continues endlessly:



Recording Financial Transactions

Bookkeeping is the exercise of identifying, categorizing, and recording all the transactions that take place in a business. In general, everything a company does results in a bookkeeping transaction, including things that take place between the business and:

- Customers, who buy products and services sold by the business
- Employees, who are paid wages and provided benefits
- Vendors, who sell services, equipment, and supplies to the business
- Government agencies, who collect taxes from the business
- Sources of equity capital (investors or owners who put money in and take it out of the business)
- Sources of debt capital (banks and lending institutions)

Accounting, on the other hand, is the methodology used to record the transactions and prepare financial statements and reports. Accounting guidelines govern how businesses record transactions. They also dictate the design of the recordkeeping system that a business uses and how reports are prepared, based on the information gathered and put into the system.

General Accepted Accounting Principles (GAAP)

Accounting is simply a measurement. Measurements allow for consistency. Just like everyone knows what one foot (or 30 centimeters) of distance is, the business owner (or CEO) and all stakeholders should be confident that they know what a company's assets are. The accounting concepts and standards that govern consistency are called **generally accepted accounting principles** (GAAP).

There can be slight differences between regions, but GAAP typically includes the following principles:

- Comparability among different companies.
- Reliability of information.
- The **business entity concept**: A business is a separate distinct entity from its owner/owners.
- The **matching principle**: Earnings and expenses must be recorded in the same accounting period that they relate to each other.
- The **cost principle**: Assets and service, and the resulting liability, are taken into the accounting records at cost.
- The **consistency principle**: A company's accounting procedures need to remain consistent over time. If they are changed, the reasons for the change and the financial impact of the change must be documented in detail.
- The **time period principle**: The operating period of the business is divided into equal periods of time, such as a month or a quarter.
- The **going-concern principle**: The business will continue to operate, using its assets to carry on its operations and, with the exception of merchandise, not offering the assets for sale that are necessary to run the business.
- The **objectivity principle**: Whenever possible, the amounts used in recording transactions are based upon objective evidence rather than on subjective judgments.
- The **stable currency assumption**: The idea that the purchasing power of the unit of measure used in accounting (such as the dollar or the euro) does not change. (In other words, a dollar bill will not become worthless overnight.)
- The **realization principle**: This principle defines revenue as an inflow of assets (not necessarily cash) in exchange for goods or services. It requires the revenue to be recognized at the time, but not before it is earned.

Key Reports

The Income Statement

The **income statement** can also be called a profit and loss statement or operating statement. This is a summary of the income and expenses of a business during a certain period: monthly, quarterly, or annually. If the company has more income than expenses for a certain period it has net income (a profit). If the expenses exceed income, the company has a net loss.

Income can be broken into two broad categories: **service income** and **sales income**. The difference between the two lies in the need to consider inventory costs. Service income is derived from performing a service while sales income is derived from selling a product. In general, service companies have staff that perform a service for a customer, while sales companies have product that they sell.

With service income, the profit can be determined simply by deducting expenses associated with performing the service. With sales income, however, you must consider the cost of creating the product (raw materials, labor, overhead, etc.). This inventory cost is referred to as the **cost of goods sold**.

Income Statement Equation

The income statement equation typically looks like this:

$$Revenue - Expenses = Net\ Income\ or\ Loss$$

- **Revenue** is what the business earned from the sale of goods and services during this period.
- **Expenses** are bills (phone and Internet bill, insurance, payroll, advertising, etc.) incurred during this period.
- **Net income or loss** is the net financial result of the business efforts during that period. It must be added to the Equity portion of the balance sheet, which we will discuss in a moment.

Some examples of the types of accounts that influence net income and are reported on the income statement include:

- Revenue
- Advertising expenses
- Repair expenses
- Utilities expenses
- Wage expenses

Sample Income Statement

Acme Widgets Inc. **Income Statement** **For the Month Ended February 28, 20xx**		
REVENUE		
Widget Sales		$20,000
Widget Installation		$1,500
Interest Income		$500
Total Revenue		**$22,000**
EXPENSES		
Rent	$4,500	
Utilities	$1,200	
Advertising	$8,000	

Wages	$5,000	
Total Expenses		**$18,700**
NET INCOME (LOSS)		**$3,300**

The Balance Sheet

The purpose of a balance sheet is to show what a company owns and owes as of a specific date. Income statements are prepared "for the period ending" and balance sheets are prepared "as at" a certain date.

The balance sheet summarizes what the business owns and compares it to what the business owes. It does so in a standard format to make it easy to see what kind of financial shape the business is in. If a business has more assets than liabilities, that's a good sign. On the other hand, if a company has more liabilities than assets, it might be a sign of trouble.

Balance Sheet Equation

$$Assets - Liabilities = Equity$$

- **Assets** are anything that the business owns. Some examples: cash, office equipment, vehicles, tools, real estate, buildings, and land. **Bills that are prepaid** (such as monthly insurance premiums) are also considered an asset, as are **accounts receivable** (money that others owe to you).
- **Liabilities** are anything the business owes to others, including banks and suppliers. Money which a company owes as a result of its ongoing trading are generally called **accounts payable**.
- **Equity** is often a measure of what the business is worth. It is the combination of profits and money invested in or withdrawn from the company by its owners.

This is what people refer to as balancing the books: ensuring that this equation is always in balance.

Accounts typically reported on the balance sheet include:

- Accounts receivable (money owed to the company but not collected)
- Cash
- Equipment
- Accounts and notes payable
- Prepaid items
- Unearned revenue
- Vehicles, land, and buildings, and their accumulated, individual depreciation (decrease in value)

The term **consolidated balance sheet** refers to the "consolidation," or adding together, of individual balance sheets of various related companies into one balance sheet which shows the financial position of the entire group of companies.

Current vs. Fixed Assets

On a balance sheet, the assets of a business are generally broken down into two groups: current assets and fixed assets.

Current assets are generally considered to be anything that will be converted into cash within one year, such as cash, accounts receivable, and inventory. Current assets continually turn over through the company.

Fixed assets are more permanent in nature. This includes vehicles, equipment, machinery, land, and buildings. They represent an investment in items that are necessary to carry on its normal operations. Fixed assets can also revolve (to purchase new equipment or update technology, for example) but usually they revolve very slowly.

Liquidity measures how quickly a company can convert its assets into cash. An ample cash balance provides security that the company can meet its obligations. The easier the conversion is, the more liquid the asset. Here is a list of current assets in order from most to least liquid:

- Accounts receivable
- Inventory
- Fixed assets

Cash Flow Statement

This shows the flow of cash for an accounting period. This statement is a bridge between the cash accounting method and the accrual accounting method in that it analyzes what transactions impacted cash and what were accruals.

The cash flow statement is usually divided into three sections.

Operating

- Cash flow for day-to-day operations
- Examples: Customer revenue, tax payments, interest, supplies purchased

Investing

- Cash flow generated from or consumed by assets
- Examples: Sale of a vehicle or purchase of a building

Financing

- Cash flow in from selling stocks or bonds or borrowing

- Cash flow out from purchasing stock back, paying out dividends, and repaying borrowed money

Statement of Retained Earnings

This statement shows how much of the company's profits were kept inside the company, and not paid out in dividends.

Sample Statement of Retained Earnings

Statement of Retained Earnings for Acme Widgets Inc. As At February 28, 20xx	
Opening retained earnings	0
Add net income for the period	$3,300
Total Retained Earnings	**$3,300**
Minus dividends paid	(300)
Retained earnings	**$3,000**

Financial Projections

What Do Projections Include?

Investors need to see your projections, even though they can be very difficult to figure out. You might be tempted to skip this part of the business plan if you are not looking for investment help. However, this is good information for you if you are funding your own business. This can help you see where you need to make adjustments, and whether your plan as it currently exists is even realistic.

The income statement is the standard measurement tool used to report your projected revenues and expenses. Your financial projection has to include how much money you plan to borrow, the interest charges, and money you will invest from your savings. While you create this plan, you need to use the financial terms covered previously. Since financial projections and reporting are new undertakings for most of us, make sure you work with an accountant on these projections.

At a minimum, your projection needs to include:

- Short-term projection, by month, for the first year
- Mid-term projection, typically two to three years, broken down by year
- Long-term projection, typically five years, broken down by year

This is not an easy task, so remember:

- Compare your numbers with similar companies in your industry to keep things realistic.
- If your projections are too optimistic, you can lose credibility with investors and banks.
- Startup costs, like licenses, permits, and equipment costs, go into your short-term projection.
- Allow for variation in things, including the price you are planning to sell your products or services at, future funding requirements, changes in raw material or staffing costs, and anything else you can reasonably think of.
- Investors need to see a best-case scenario and a worst-case scenario. Avoid the temptation to create all kinds of in-between cases, which will take up space in the business plan without adding a lot of value to your reader.

Use the Writing Rules

Remember that writing rules are important, so you need to use them in this section just as you do in other areas of your business plan. Make any assumptions in your plan clear. You can articulate how you will collect on delinquent accounts and what your billing cycle looks like, but if your industry is softening and you are projecting huge growth in revenues, your credibility falters in the eyes of your reader.

Financial statements are prepared and written in tables and spreadsheets, often in a program like Microsoft Excel. Learn how to read this information, to work with it, and to use spreadsheets as effectively as you use programs such as your word processor and your e-mail.

Putting It All Together

Writing the Executive Summary

Although you write this part of the business plan last (once you have finished all your research and writing), you place it at the beginning of the business plan. The executive summary gives a reader a quick, clear idea of what is coming within the plan. You don't have to hint at big ideas or surprises: you state in very brief terms exactly what the body of the business plan says.

To create the first draft of the executive summary, simply read through your business plan and pull out the first and/or last sentences from each section. You should capture key words and phrases as well. If you have written the rest of your business plan using correct paragraph structure, those selected pieces will contain the main ideas of your entire business plan. If you are missing something, locate it within the business plan, summarize it briefly, and add it to your executive summary. Once you have the elements you need, simply shape and re-write them so that the text flows well together, and then do a second draft. Before you know it, your executive summary is ready to go!

Hint: If your business plan is in the 20-30 page range, your executive summary will likely be in the 350-500 word range.

Remember: Write the executive summary last, and then place it at the beginning of your business plan.

Making a Strong Presentation

Test Your Knowledge

Ask yourself that question again: who is your audience? Your answer is going to help you determine how best to present your information and solicit support for your business plan.

If your business is of a technical nature, should your business plan be written as a document? If you are in the computer or design business, should it be created as a subdomain on your website with restricted views? If you are an author, will you bind it as if it were a book? If you are a trainer, would you set it up as a PowerPoint presentation? How can you take your plan and fit it into the electronic forms that some banks, governments, or grant application systems want?

In the space below, list some different ideas for presenting your business plan, as well as pros and cons of each.

Idea	Pros	Cons

The Finishing Touches

You've put a lot of effort into your business plan, and now is not the time to abandon details. The final stretch is about making sure your plan has the impact and gets the results that you have designed.

The essential closing skills of a fine piece of work bring us to fact-checking, reviewing, and editing. You've put considerable resources into developing your business plan. Whether the goal of your plan is to secure support from stakeholders, fully flesh out your ideas and test their viability, or acquire grant and

operational funding, the plan itself is a huge undertaking with serious consequences. As a result, you want to make sure that it is the absolute best product you can create.

When you check your business plan thoroughly, you must also look at the viability of your plan. If the numbers don't make sense, the product cannot be distributed as you originally planned, or there are legal issues around patents, these are signs that your plan needs some continued work.

A lot of business owners want to protect their ideas so they are not stolen, or they want to launch their product or service before the competition does, so they will complete the business plan on their own. You have to weigh this out, because we do support you wanting to protect your information. However, if you have your spouse proofread the plan and they aren't good at spelling, your plan is not going to have the impact you are looking for.

We recommend that you consider your options carefully and then complete the following steps in order.

- Read through your plan completely. Highlight every fact that you report and any website or external reference you make. Then, validate that they continue to be accurate, valid, and correct.
- Depending on your audience (such as a board of directors, a bank, or grant panel), you could hire an editor to conduct a line edit for spelling and grammar and to complete a content edit to make sure things flow smoothly and make sense to someone outside the business.
- Complete changes highlighted by your editor.
- Have the document edited one final time to make it as complete as possible.

Further Reading: