Enterprising Rural Families™

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TIP OF THE MONTH:

Fran Rees, in *How to Lead Work Teams*, lists characteristics of a good facilitative leader:

- Listens actively
- Asks questions and listens to the whole answer
- Reserves judgment and keeps an open mind
- Actively seeks ideas and opinions from others
- Solicits different viewpoints
- Teaches others how to solve problems, without solving the problems for them
- Teaches and coaches others, without telling them what to do
- Organizes information and data so others can understand and act on it
- Models the behavior he or she would like to see in others
- Know how to bring the right people together for a task
- Is aware of his or her own limitations and knows who is better qualified to make a decision or complete a task
- Helps people reach consensus and strives for win-win agreements
- Does not take personal credit for what other individuals or the team does, but ensures that credit goes where credit is due

We'll finish this list next month.

Forecast Financial Statements for Your New Venture

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Once you have identified a possible venture, an initial assessment should have yielded general market and cost information. If your research has indicated the potential for success, then you should refine your estimates to a complete an accurate set of financial forecasts. These will be used to

- help you decide whether your venture is still advisable,
- determine how much capital you may require, and
- convince lenders and investors to join the venture.

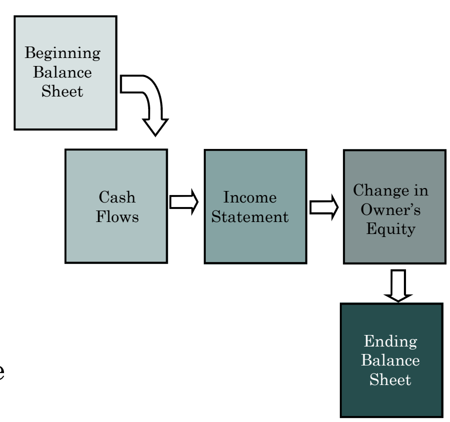
To prepare a set of forecasted financial statements is a straightforward process. This publication will outline the process and, if you are not familiar with financial statements, their important elements.

The Forecasted Financial Statements

Forecasting your business finances may seem difficult, but it really is only a matter of making educated estimates about how much money you'll generate and spend. There are four general purpose business financial statements that are typically part of a complete set of forecasted financial statements. We recommend that you prepare these for each of the first three to five years of your venture:

- Statement of cash flows
- Income statement
- Statement of changes in owners' equity
- Balance sheet

An illustrative set of forecasted financial statements for the first year of a hypothetical start-up company is included in this document. Don't get hung up on the formatting or which types of accounts to include. The sample forecasted financial statements presented in this document use typical formats and typical accounts, but accounting and financial reporting favors substance and usefulness over format. Focus on the numbers.



The Statement of Cash Flows

The forecasted cash flow statement (see example) shows how the cash balance of your business is expected to change from the beginning to the end of each year as a result of operating, investing, and financing activities. It summarizes the net cash flow either provided or used by each of these three major categories of business activity. Generally for a business to be successful, the operating activity needs to become a significant provider of cash at some point in the early life of the business.

The sources and uses of cash reported for an accounting period must equal. If not, look for an error. Likewise, the net cash provided or used during the year by operating, investing, and financing activities should exactly explain the increase or decrease in the cash balance reported on the ending balance sheet.

The Income Statement

The forecasted income statement shows your expected revenues, expenses, and profit for each year of operation. Revenues increase owner's equity. Expenses decrease owner's equity. Profit occurs when revenues exceed expenses, producing a net increase in owner's equity for an accounting period.

Net cash flow and profit are fundamentally quite different. Cash is necessary to pay the bills, but profit is necessary if your business is ultimately going to generate money to repay debt and to pay a return to yourself (the owner). The fact that a business is temporarily awash in cash is not proof that it is profitable. Nor is the fact that a business is temporarily short of cash proof that the business is not profitable. Cash flow and profitability are both important to a business.

The Statement of Changes in Owners' Equity

This is usually the shortest of the four general purpose business financial statements. It shows how the owners' investment in a business changes as a result of profitability and transactions between the owners and the business during the accounting period. Oftentimes, because it is short and so heavily influenced by profitability, it is combined with the income statement as in the example in this document. The net profit of the business (after adjustment for any contributions or withdrawals by the owners) reported on the income statement for a particular year should completely explain the change in the net financial position of the business (owners' equity) as reported on the ending balance sheet for that year.

Arguably the most important change in owners' equity results from business profits or losses. Other changes can come from capital paid in by the owners or dividends/withdrawals from the owner's invested capital. Typically stock or an interest in the company will be exchanged for cash or other property as a part of the initial capitalization of the business during start-up. This paid-in capital will be included in the owner's equity section of the balance sheet and should be forecast when preparing forecasted financial statements.

The Balance Sheet

The forecasted balance sheet shows your financial position as of a particular future date by listing the expected value of your venture's assets, liabilities, and owner's equity on that date. If the forecasted statement of cash flows reports that the cash provided by operating, financing, and investing activities is expected to exceed the cash used by such activities, the cash balance reported on the ending balance sheet will increase by a corresponding amount. If the forecasted income statement reports that the business is expected to be profitable, then the owner's equity reported on the ending balance sheet will increase by a corresponding amount unless the owners withdraw that profit before the ending balance sheet date.

The balance sheet summarizes the financial strength of your business at a stated point in time. It lists the assets and liabilities of your company and shows your owners' equity. Owners' equity equals the difference between assets and liabilities. Thus it will help you determine your financial condition at a given point in time. Many businesses do their financial reporting on a calendar year basis so their balance sheet date is December 31 of each year.

Classified balance sheets separate assets and liabilities into current and noncurrent classes. The noncurrent assets consist primarily of assets that are used to operate the business, such as land, buildings, and equipment. Current assets are cash and other assets that will be converted to cash as part of normal operations during the next year. The most common current assets include

- Cash
- Accounts receivable
- Inventory
- Prepaid expenses

Liabilities are classified in a similar fashion as either current or noncurrent liabilities. Current liabilities are those enforceable obligations to pay that will be paid during the next year. Noncurrent liabilities are debts and other enforceable obligations to pay over more than one year. Both your assets and liabilities should reflect your intended production capacity. If you are unsure of what assets you might require and their cost, then do research to find out.

The final lines on the balance sheet track the business' equity accounts – the portion of the business' assets owned by investors in the business. The two main sources of equity that will be reported in the owners' equity section of the balance sheet are: 1) contributed/paid-in capital, and 2) retained earnings. If any noncurrent assets are reported in the balance sheet at fair market value, then a third source of equity called "valuation equity" will need to be reported.

Remember, the Financial Statements are Interrelated

The general purpose financial statements are always interrelated systematically. Financial statements interrelate because they reflect different aspects of the same transactions or other events affecting the business. They summarize amounts derived from an accounting system. Thus if something changes on one of the statements, such as the balance sheet, one should expect to need to make corresponding changes in the other financial statements.

Construction Process Outlined

Estimating the financials for your venture follows a relatively straightforward process, which is outlined here and will be expanded on later in the discussions of each statement.

Step 1.

Begin by constructing a cash flow budget for each month of the first year of operations. Longer periods than a month, such as quarterly or annual periods, can be used but will be less useful than a monthly cash budget for managing the timing of cash flows. A cash budget generally is prepared in a format that shows a beginning cash balance for each period and expected cash inflows during the period followed by expected cash outflows during the period. Beginning cash plus cash inflows minus cash outflows results in either a cash balance or a cash deficit at the end of each period. Generally, borrowing is required to make up a cash deficit at the end of any period.

It may be helpful to prepare a separate sales forecast first that estimates sales by month. Here you can record details about product mix, product quantities, pricing considerations, demand forecasting methods, key customers, and other information pertinent to the sales forecast that there won't be room for in the cash flow budget.

Then summarize expected monthly sales to the cash flow budget. Sales volume ultimately drives product costs. Add estimated costs for labor and materials scaled to the sales volume you have projected. Then estimate other expense items based on what you expect the company will need to operate: rent, utilities, advertising, personnel and so on. By doing this you will have completed the first draft of your cash flow budget. The monthly revenues and expenditures can then be summarized into your forecasted statement of cash flows for the first year of operations.

Continue the work you've done by preparing cash flow budgets for each of the first few years of business operations. Typically a new business must transition toward expected normal operating capacity during the first few months (or years) of operation. Creating forecasted cash flow budgets for this growth period will provide you a valuable management tool.

Step 2.

With a statement of cash flows in hand you can then project what resources you require to produce the product volume you are expecting. This information will be the starting point for your forecasted balance sheets. The estimate of the sales volume for each year will guide the capital equipment and financing requirements needed to satisfy production. First list the equipment, materials and other physical resources you will need to operate, as well as other assets such as receivables and inventory. For instance, a wholesale business would use its estimate of sales volume to determine how large a warehouse to buy, how many forklifts and delivery trucks are needed, and how much inventory is needed.

	Jan	Feb	Mar	Apr
Starting Cash	1,000	1,200	900	(300)
■ In				
– Sales	1,000	1,100	1,200	1,300
Total In	2,000	2,300	2,100	1,000
■ Out				
– Payroll	300	500	600	400
– Purchases	300	400	400	400
– Overhead	200	500	400	300
– Capital Expenses	0	0	1,000	0
Total Out	800	1,400	2,400	1,100
■ Cash Balance	1,200	900	(300)	(100)

(Starting Cash Plus "In" minus "Out")

Liabilities too, should be estimated. Once you know the estimated dollar value of the assets you'll require, you can then estimate the financing needed to gain those resources. Borrowed and invested capital and trade credit should be among your list of expected liabilities. These important liabilities should be typical for your industry. The list of assets and liabilities will be reported on your balance sheet.

Carefully examine your cash flow budget by period to identify cash shortfalls that will require financing. An operating loan will needed to be arranged to finance a cash shortfall at the end of any monthly period. Alternatively businesses may sell their products to their customers on account with the expectation that they will be paid 30 to 90 days after the delivery of the goods. The resulting accounts receivable are oftentimes used as a source of cash by assigning the receivables to a lender to secure a loan. The cash proceeds of such trade credit on so-called "trade receivables" is then used to purchase new inventory and to continue the business of turning out more products. Make sure that you plugged your trade credit amounts and your collections against trade receivables into your cash flow statement. It is relatively easy to overlook what can be sizeable short-term liabilities if the financing required to continue operations while earlier sales are still being converted to cash receipts is overlooked.

The cash flow budget should also anticipate transactions between the business and its owners, such as additional paid-in capital or planned dividend distributions. These will need to be reported in the statement of changes in owners' equity as well.

Step 3.

To this point in the forecasting process you will have created information for the statement of cash flows and some information for the ending balance sheet and the statement of changes in owners' equity. In order to measure the profitability during any accounting period revenues and expenses must be measured. Revenues and expenses generally are different than the cash receipts and cash expenditures Reported on the statement of cash flows. Why? Let's consider revenues first.

Income is earned at the point of sale. Cash receipts associated with the collection of accounts receivable may not be collected from customers until well after the point in time that a sale occurs. Generally a sale occurs when a product is delivered to a customer. Thus cash receipts will oftentimes lag behind the actual revenues of your business if products are sold on account. If accounts receivable exist at year end, they are an asset of the business and should be added to the ending balance sheet. Accounts receivable will be reported as a current asset on the balance sheet, because one would expect them to be converted to cash through collections of the accounts receivable during the upcoming year.

If the ending balance of accounts receivable increased from the last balance sheet date, this means that sales revenue exceeded cash collected from customers during the accounting period and reported on the statement of cash flows. Sales revenues reported on the income statement will thus exceed cash income and will provide a more accurate measure of the revenue earned by the business than cash receipts can provide. Also, the income statement provides the rationale for the increase in the accounts receivable balance on its balance sheet and the amount of the increase.

Revenues:		
Sales to Customers		$480,000
Expenses:		
Cost of Goods Sold	$250,000	
Salary Expense	60,000	
Rent Expense	30,000	
Depreciation Expense	80,000	420,000
Operating Income		60,000
Other Gains and Losses:		
Gain on Sale of Equipment		40,000
Net Income		$100,000

Now let's consider expenses instead. Expense recognition for income statement reporting follows the matching concept, which states that costs associated with the revenue of a period are expenses in that period. Generally two different types of expenses are reported on an income statement. The first of these are product expenses which are traceable to the products a company sells. Product related expenses should be recognized as an expense when the product is sold. If we don't match the product expense to the product sale how can we ever determine the profit from selling the product? Product expenses show up on an income statement in the cost of goods sold. All other expenses are period expenses. Period expenses are matched against revenues in the accounting period in which they are incurred. Period expenses include the general and administrative expenses and selling expenses of the business. A typical income statement reporting format would report revenues at the top followed by cost of goods sold (product expenses) and then followed by period expenses.

Those materials that were purchased and paid for in one year, but still in the ending inventory of unfinished products at year end, will be reported in cash expenditures on the statement of cash flows. But, the cash expenditures won't be included in expenses on the income statement until the following year when the inventory has been turned into finished product and the product has been sold. Thus, product expenses are not necessarily incurred in the same accounting period that the corresponding cash expenditure is made. The benefit to the business from incurring expense to generate revenue does not occur until product is sold. Until that time the cost of products is carried as an asset by the business.

Even period expenses can result in differences between cash expenditures reported on the statement of cash flows and expenses reported on the income statement. Office supplies expense is a good example of a period expense. Consider the possibility that your company, which prepares its financial statements on a calendar year basis, buys office supplies on account in early December and uses them up in December. When an asset is used up or consumed in the operation of your business an expense is incurred. Assume that you pay the account balance in early January of the following year. An enforceable obligation to pay existed on the balance sheet date even though no cash had yet changed hands, and the supplies have already been used so they cannot be returned. Expenses on your income statement for the period ending in December should include the amount of this obligation because the benefit from the purchased supplies was received in the accounting period. The obligation should be reported on the ending balance sheet as a current liability. The amount won't be reported as a cash expenditure on the statement of cash flows until next year. The liability reported on the balance sheet explains how expenses could exceed cash expenditures.

Timing is the key to accurately measuring revenues, expenses, and profitability. Timing is the reason that net cash provided or used by operating the business in a particular accounting period will invariably be different than business profitability. The process of getting the timing right in terms of when revenues and expenses are reported in the Income Statement is oftentimes described as the accrual accounting to distinguish it from accounting for cash receipts and cash expenditures. Only accrual accounting can produce a reliable measure of profitability for a particular accounting period whether it be in the past or in the future.

Draw up forecasted financial statements for each period in the first few critical transition years of starting up a new business. Examine the statements carefully to make sure they represent your expectations as completely and accurately as possible.

illustrative Statement of Cash Flows

Year one of Stewart Winery Inc. (a start-up company)
Forecasted Cash Flow Statement
Year Ending 31 December 2010

Cash flows from operating activities		
Cash inflows received from customers		82,270
Cash paid to suppliers		55,885
Selling expenses	9,075	
General and administrative expenses	7,130	
Interest expense	1,950	
Other operating cash outflows and interest payments		18,155
Cash tax payments		1,200
Net cash provided (used) by operating		7,030
Cash flows from investing activities		
Purchase of fixed assets		7,900
Purchase of other current assets		30
Purchase of patents and other intangible assets		2,500
Net cash provided (used) for investing		-10,430
Cash flows from financing activities		
Proceeds from long-term debt		5,400
Common stock dividends		-1,500
Net cash provided (used) by financing activities		3,900
Cash at Beginning of Year		
Net Increase in Cash		500
Cash at End of Year		4400

Reconciliation of net cash provided by operating activities to net income	
Net cash provided by operating activity	7,030
Plus increases in current assets (inventory 3,440 and receivables 7,50)	4,190
Minus increases in current liabilities (accrued expenses 50, taxes 539, interest payable 50, and accounts payable)	-2,169
Minus depreciation expense	2,820
Equals Net Income	6,231

Illustrative Income and Owners' Equity Statement

Year one of Stewart Winery, Inc. (a start-up company)
Forecasted Statement of Income and Changes in Owners' Equity
Year Ending 31 December 2010

		Forecasted 2009
Net Sales		83,020
Cost of Goods Sold		53,975
Gross Profit (Net Sales - Cost of Goods Sold)		29,045
Operating expenses		
Selling expenses	9,075	
Production wages		
Sales commissions		
Uncollectible Accounts		
Advertising		
Automobile		
Office Supplies		
Miscellaneous Expenses		
Total operating expenses	9,075	
General and administrative expenses (fixed expenses)		
Rent	7,180	
Depreciation	2,820	
Utilities		
Insurance		
License/permits		
Legal/Accounting		
Loan payments		
Total fixed expenses	10,000	
Total Expenses		19,075
Operating income		9,970
Interest expense		2,000
Earnings before tax		7,970
Income tax		1,739
Net income		6,231
Dividends Paid		1,500
Change in retained earnings		4,731

Illustrative Balance Sheet

Year one of Stewart Winery, Inc. (a start-up company)
Forecasted Balance Sheet
31 December 2010

Assets	
Current Assets	
Cash	4,400
Accounts receivable	7,800
Inventory	21,140
Other current assets	1,380
Total current assets	34,720
Noncurrent Assets	
Plant (buildings)	56,400
Equipment	27,400
Accumulated depreciation (buildings & equipment)	(38,320)
Net plant and equipment	45,480
Land	7,000
Total Property, Plant, and Equipment	52,480
Purchased goodwill	
Patents	3,500
Trademarks	2,000
Total intangible assets	5,500
Total Noncurrent Assets	92,700
Liabilities and Equity	
Current Liabilities	
Accounts Payable	7,611
Notes Payables	
Interest Payable	250
Payroll	390
Taxes Payable (federal, state, self-employment, sales, property)	1,739
Total current liabilities	9,990
Noncurrent Liabilities	20,000
Total Liabilities	29,990
Stockholder's equity	
Capital stock (paid-in capital)	30,000
Retained earnings	32,710
Valuation equity (if any)	
Total stockholders' equity	62,710
Total liabilities and equity	92,700

Managing By the Numbers

The financials in our example are for Stewart Winery, a small closely-held business that is trying to break into the highly competitive winemaking industry. The purpose of the following exposition is to provide tips and pointers relative to preparing and using forecasted financial statements that will be valuable to anyone who is embarking on an effort to develop forecasted financial statements for their own startup business venture. The more you learn about preparing and using forecasted financial information, the more comfortable you will become with your own forecasted financial statements and the more valuable they will become to you as a tool for planning and managing your new business venture.

Using Ranges versus Point Estimates

Forecasted financial statements are developed for future time periods based on the owner's expectations of what is most likely to happen to the startup business. They are a quantitative representation of your expectations of what the results of your proposed business operations will be and what the financial health of your company will become. Typically these forecasted financial statements present a single so-called "point estimate" of the outcome the business owner expects. But, a range could be presented instead and might be much more realistic.

It is important to think about and estimate a range of possible outcomes, including "best case" and "worst case" scenarios when working on your forecasted financial statements. Uncertainty is a fact of life in investing in and managing a new business venture. A range of outcomes attempts to quantify the variability in results that will likely actually result from that uncertainty.
The range of outcomes between the "best case" and "worst case" scenarios indicates the potential upside profit, as well as provides an idea of how much capital would be required should the worst case scenario occur. These ranges of outcomes may actually be more useful to the managers than the point estimates, but can also be fairly difficult to summarize in financial forecasts. For that reason, the forecasts will oftentimes present point estimates, but the notes about the assumptions on which the financial forecasts are based will often discuss the range of potential outcomes upon which the point estimates are based.

Stewart Winery has prepared a set of forecasted financial statements for each of the first three years they expect to operate. Owners of small business startups usually project ahead three to five years with their forecasted financial statements like our example firm. Stewart Company has chosen to provide a single point estimate of what the owners consider the most likely outcome for each year for their new business. They chose a point estimate rather than a range for the sake of convenience, ease of reporting, and simplicity. But, in an accompanying set of notes to the financial statements, the company has set forth a range of expectations about expected sales for each of its first three years of operation.

Developing Your Sales Forecast

Existing businesses will be able to estimate sales based on past experience. New ventures must estimate sales from scratch. Forecasted sales heavily influence the size and scale of the business and drive the rest of the numbers. So, the sales forecast always deserve extra attention. Here we use our example business to set forth a three-step process for estimating future sales for a new venture.

Step 1: Develop a customer profile and determine the trends in your industry. A customer profile will help you narrow down who your most likely customers will be. Understanding the trends in the industry will help to identify opportunities.

Angela Goff is the majority stockholder in Stewart Company which owns the Stewart Vineyard and Winery. She thinks that most of her customers will reside in households with an annual income that is more than $50,000. Her target audience includes only adults in these households. Angela believes that wine consumers are willing to buy locally when they are able to visit the grower and observe the winemaking process. Other wine industry data suggests that she target adults between the ages of 25 and 34.

Step 2: Establish the approximate size and location of your planned trading area. Use available statistics to determine the general characteristics of this area. Clarifying your trading area will guide research on the number of potential customers that fit your customer profile.

Angela Goff thinks she can draw people to visit her winery from a three-county area. Stewart Company expects to depend heavily on a customer base that resides within a 75 mile radius of the company's vineyard. Census reports show 21,524 households in her three county area that filter target customer profile of being between the ages of 25 and 34. Of these, 7,725 have household with incomes in excess of $50,000. According to Census data there are 1.75 adults per household in her target households. The trade association for Indiana wineries estimates that the average adult consumer will drink nine bottles of wine a year. As part of her market research, she consulted with a university researcher who provided her with estimated market share information for the Indiana wine industry She hopes to gradually capture a ten percent share of the potential market for all wine consumed in her target area.
(Source: Bureau of the Census, Indiana Wine Grape Council, Jay Akridge Guesstimate)

Step 3: Estimate your sales on a monthly basis for your first year. Using your research, make an educated estimate at your market share. You may want to keep it conservative. While the sales forecast for the first year should be monthly, the forecast for the next two years could be expressed as a quarterly or annual figure. The reason for this step is that sales are rarely uniform across the accounting period. And the timing can be extremely critical in terms of anticipating borrowing needs.

Angela Goff expects a lot of seasonality in her sales. She hopes one aspect of the appeal of her product will be the visit to the winery. She plans to promote the product using festivals and other events designed to draw a crowd to the vineyards at those times of year where there will be something interesting to see and do. She expects the bulk of her sales to occur in two time periods: between grape harvest and Christmas and during a series of events planned for the late spring and summer.

Angela expects the average price of her bottled wines will be $8.35. Cases of wine are expected to sell for an average of $180. She expects that a high percentage of her sales will be credit card sales, which will cost her 3% of the sales revenues, but will make collection of the cash from sales more timely. She doesn't expect a significant time lag between sales and collection of accounts receivable, because she doesn't expect to sell much on account.

Angela has prepared a monthly sales forecast based on her expectations, which was summarized to the monthly cash flow budget and then further summarized into the Statement of Cash Flows presented here.

Angela's business illustrates two key elements of the process of developing useful financial statement forecasts. First, estimates should be based on the best available evidence and market research the business owner can muster. Reliable estimates can come from a variety of sources including experts' opinions, Census data, industry standards, and survey data. Market research can greatly increase the confidence level of everyone who uses the Forecasted Financial Statements. Second, a smart planner will use the conservative estimates of sales and income, and liberal estimates of expenses.

Get Help When You Need It

Your business plan may help you attract investors and it will certainly be an important planning tool for yourself. Your forecasted financials will be a core component of that plan. So your financial forecasts should be clearly presented and accurate. If you are considering hiring a consultant to develop forecasts based on his or her specialized knowledge of the industry, remember that you are the one that is going to have to live with the results. This means that you should do enough of the research yourself to take ownership of the forecasts and understand the financials well enough to benefit from them. A consulting professional brings knowledge of the methods used to prepare financial forecasts and can also provide a second opinion on the reasonableness of the numbers. Create a polished and professional business plan by using appropriate advisors in this or other aspects of your plan.

36 Month Sales Forecast

2009

	Jan	Feb	Mar	Apr	May	Jun	Jul	Aug	Sep	Oct	Nov	Dec	Totals
Product Name	Bottled Wine												
Units	250	150	100	300	350	350	500	500	700	900	900	1,000	6,000
Selling Price	$8.35	$8.35	$8.35	$8.35	$8.35	$8.35	$8.35	$8.35	$8.35	$8.35	$8.35	$8.35	
Total Sales	$2,088	$1,253	$835	$2,505	$2,923	$2,923	$4,175	$4,175	$5,845	$7,515	$7,515	$8,350	$50,100
% of Total	4.17%	2.50%	1.67%	5.00%	5.83%	5.83%	8.33%	8.33%	11.67%	15.00%	15.00%	16.67%	100.00%

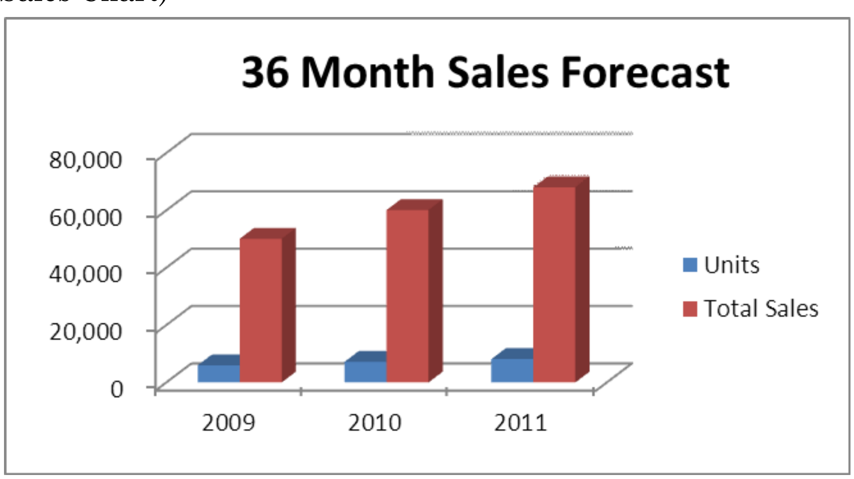
2010

	Jan	Feb	Mar	Apr	May	Jun	Jul	Aug	Sep	Oct	Nov	Dec	Totals
Units	300	200	150	350	400	400	550	550	800	950	950	1,600	7,200
Selling Price	$8.35	$8.35	$8.34	$8.35	$8.35	$8.35	$8.35	$8.35	$8.35	$8.35	$8.35	$8.35	
Total Sales	$2,505	$1,670	$1,251	$2,923	$3,340	$3,340	$4,593	$4,593	$6,680	$7,933	$7,933	$13,360	$60,119
% of Total	4.17%	2.78%	2.08%	4.86%	5.56%	5.56%	7.64%	7.64%	11.11%	13.19%	13.19%	22.22%	100.00%

2011

	Jan	Feb	Mar	Apr	May	Jun	Jul	Aug	Sep	Oct	Nov	Dec	Totals
Units	500	250	200	400	500	500	600	600	900	1,000	1,000	1,700	8,150
Selling Price	$8.35	$8.35	$8.35	$8.35	$8.35	$8.35	$8.35	$8.35	$8.35	$8.35	$8.35	$8.35	
Total Sales	$4,175	$2,088	$1,670	$3,340	$4,175	$4,175	$5,010	$5,010	$7,515	$8,350	$8,350	$14,195	$68,053
% of Total	6.13%	3.07%	2.45%	4.91%	6.13%	6.13%	7.36%	7.36%	11.04%	12.27%	12.27%	20.86%	100.00%

(Example of Forecast Sales Chart)



Evaluating the Potential for Success

Without these forecasted financial statements for the early years of the startup, it is hard to conceive of how potential investors (yourself included) can evaluate the potential for the success of the proposed business venture. Without these forecasted financial statements it is hard to imagine how creditors can evaluate the merits of making loans to the new business. If you cannot make money on paper, you aren't likely to make money when actual operations commence, so it is always a good idea to quantify your business plans with forecasted financial information.

Once business operations commence, the very same financial statements should be used at the end of each year to assess the actual results of operations and the actual financial position of the business. Without these financial statements you may think you're making money right up until the day you go broke.

Managing Cash Flows

A monthly cash flow budget tells you when you'll have cash and when you'll need it. In addition to providing information to support your Forecasted Statement of Cash Flows, the monthly cash flow budget is a superb management tool. You can use the monthly cash flow budget to plan financing for operations, to achieve control over spending (by comparing actual spending to the planned spending reported in the budget), and to recognize when plans are not being achieved and strategies need rethinking. New businesses have to survive in order to thrive. Cash flow is the lifeblood of a new business. Without it, the business withers and dies.

Careful cash management will be most important during the first few years. Inevitably, new businesses go through a period of growth. As your venture grows it will have to fund increased expenses before sales can increase. The monthly cash flow budget will help you anticipate both how much and when cash infusions are necessary.

Reporting Start-up and Organizational Costs

New businesses will also need to estimate start-up and organizational costs – the one-time expenses associated with preparing for operation. Start-up costs include the costs of investigating the creation or acquisition of a trade or business such as legal and professional fees. Startup costs also include costs incurred in anticipation of an activity becoming a trade or business that would otherwise be currently deductible as trade or business expenses if the business was up and running. Organizational costs are actual costs of organizing the business. These costs are treated by the federal tax code as capital expenses.

But, business owners can elect to deduct the first $5,000 of eligible start-up costs and the first $5,000 of eligible organizational costs that are paid or incurred after October 22, 2004 may be expensed as tax deductible trade or business expenses. The deductible amount must be reduced for every dollar start-up costs or organizational costs exceed $50,000. Costs in excess of the amount deductible under this rule must be amortized ratably over the first 180 months of business operation. For a more detailed and authoritative discussion of this topic, see Internal Revenue Service Publication 535, *Business Expenses*. This publication can be accessed on the Internet at www.irs.gov.

As a general rule, large start-up businesses that will need accountant audited or reviewed historical financial statements will typically recognize these costs as expenses on their business income statements in the first accounting period in which they have revenue. Many small businesses would recognize these expenses on their actual income statements in the same accounting periods and in the same amounts as they report on their federal income tax returns. Pick whichever approach you feel more comfortable with for your forecasted financial statements and go with it.

Outsourcing Production

If you choose to produce your product in your own production facility then your cost of goods sold would reflect significant wages and raw input costs. But if you outsource your production then you may need more cash on hand to fulfill the contractual obligations resulting from those outsourcing arrangements. On the income statement a reader would expect to see how you anticipate costs will change over the forecast period. Additionally, if you forecast the need for cash to purchase land, facilities or equipment as your business expands then those assets should appear at the appropriate time on the balance sheet.

Using Industry Standards

Before you start your forecasting, do research to find any published performance data available for the type of business you plan to start. Robert Morris Associates Annual Financial Statement Studies is one example of a source for actual performance data of real operating businesses. Also, trade groups may be a source of financial performance data for the trade or business type that interests you. This kind of information can be invaluable as you start the planning process.

You need to keep your forecasts realistic. First, make sure your forecasts contain a reasonable salary for yourself and your other owner-managers. Then make sure your forecasted financial statements produce performance measures that are reasonably in line with the standard performance in your industry. For example, RMA Annual Statement Studies show that the typical net profit margin (net profit/net sales) for businesses in general is 9.3 percent. If your forecasted income statements report a 50 percent net profit margin, you need to rethink your forecast. Have you missed something? Through this process of comparing their own forecasted financials to industry standards, entrepreneurs can develop more realistic expectations about the future financial performance of their new business.

General Tips for Constructing Forecasted Financial Statements

- After starting a business you will want to hire an accountant or employ a good accounting software program to keep financial records for your business. That accountant or software may be just as helpful when you are preparing and using forecasted financial statements.
- Support market and sales forecasts by market research. When your financial forecasts are part of a business plan ensure that there is a direct link between market analysis, sales forecasts and financial forecasts.
- Use the best information available.
- Be realistic about sales expectations and operating costs. Unreasonably optimistic forecasts will only hurt you once your venture is started.
- Keep track of your assumptions. A narrative set of notes should accompany your financial forecasts in which you summarize and highlight your assumptions and their impact on the numbers you've estimated. Make sure you discuss important assumptions in detail and that you explain the background.
- Try to anticipate the questions the readers of your forecasted financial statements (creditors, investors, business partners, family members) will ask.
- Compare your forecasts with industry standards before start-up, then adjust your forecast accordingly.
- Compare your forecasts with reality after start-up, then adjust your management of the new business accordingly.
- A good working knowledge of your forecasted financial statements is useful not only for decision making, but also for communicating effectively with potential investors and lenders.

Analyzing the Forecasted Financial Information

Often when exploring a new venture a manager will use data from the forecasted financial statements to conduct financial analyses of the proposed business. One purpose of these analyses is to evaluate the investment, but they may also help test the reasonableness of the business owners' forecasts. Finally, your analysis of the forecasted financial statements can help you spot weaknesses and anticipate management challenges before you actually start the business, which will increase your chances of success.

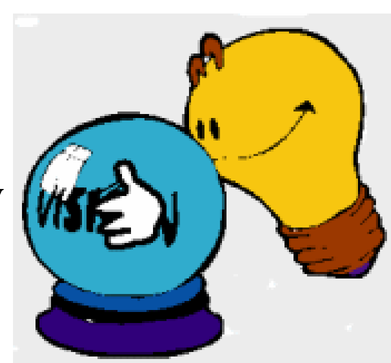
If you have forecasted financial statements for the first three to five years, use them to full advantage. Examine the changes that take place over time. One thing, in particular, that you should look for is financial growth. If equity is increasing then there is financial growth. This comparison of results from one period to the next is oftentimes called "trend analysis" and is a simple yet effective tool for analyzing the forecasted financial statements.

Equity growth should be substantial and should be driven by earnings. Financial growth should not come at the expense of the equity investors. If they don't get compensated somehow, don't expect them to stay happy. At the same time being able to retain earnings in the business rather than paying them out as dividends is really advantageous for a growing new business. One way to keep the cash while compensating the equity investors is to pay stock dividends rather than paying dividends in cash. Stock dividends increase the value of common stock and reduce the value of retained earnings reported in the owners' equity section of the balance sheet.

One type of analysis that is well-supported by the forecasted financial statements is ratio analysis. Key profitability and financial efficiency ratios like operating profit margin, asset turnover, return on assets, and return on equity should be computed and analyzed. Not only will they provide valuable insight to the potential performance of the new business, but they can help test the reasonableness of the forecast. By testing whether future financial ratios are within the normal range for your type of business venture you will be aware of areas for management focus.

Another type of analysis that would be useful before start-up is a breakeven analysis of the minimum level of sales a business must have to be profitable. This can produce extremely valuable information in terms of understanding the likely cost-volume-profit relationship of the proposed business and managing the size and scale of the operation. Information on a breakeven analysis is available in the Purdue Extension publication *Estimating Breakeven Sales for Your Small Business*, EC-725.

Financing Your New Venture and Attracting Investors



There are two sources of operating funds: debt and equity. Debt (loans) will be acquired through a bank or other creditor. Equity will come through stock sales to people (investors) you know or through public offerings. Other equity sources will come from your own contributions to the business. Equity capital is generally considered more costly then debt capital, but is more resilient in the face of risk. So the more risky a new venture, the more likely that significant equity capital financing will be required. Debt capital can be extremely limiting in terms of growing the business and achieving competitive size/scale. The amount that may be borrowed from creditors is typically limited by the amount of equity brought to the table by the business owners. Business owners that can attract additional equity capital to their ventures can minimize this constraint.

Getting a loan will require forecasted financial information and supporting data such as a forecast of sales, costs and profit or loss organized by time period. Your forecasted financial statements should be well supported. Potential creditors and equity investors alike will be very interested in how you arrived at your forecasts to evaluate whether your assumptions are reasonable.

Your forecasted balance sheets will be essential for determining the creditworthiness of the proposed business. Balance sheets provide evidence of anticipated liquidity (the ability to meet financial obligations as they come due) and solvency (the ability to repay all liabilities with the assets of the business). Lenders generally need collateral and the balance sheet indicates the likely sources of that collateral and whether there is sufficient collateral to support the loans that will be required. Monthly or quarterly cash flow budgets are extremely helpful for anticipating the amount and timing of operating loans. The forecasted income statement provides the lender with critical information for documenting the potential for repayment capacity.

Points to Ponder on New Venture Financing

- Does the monthly cash flow budget have a negative ending cash balance at the end of any month? If so, plan to increase sales, cut expenses, or obtain more money through equity investments or loans from creditors.
- Does the forecasted Statement of Cash Flows show that the net source of cash each year for the first few years is borrowing? New business owners can only go to the credit well so often before it starts to dry up. Focus on managing the business to generate net cash inflows from operating activities as soon as possible.
- Maintain tight control of the net use of cash for investments after the initial start-up period. Don't sink huge amounts of additional cash into the business until and unless it is clear that the operating activity is going to provide plenty of net cash flow. Generally it is not a good sign for a business that isn't growing revenues to be a net user of large amounts of cash for investing activities year after year. Unproductive investments lead to unprofitable businesses. If the business turns out to be a dog, don't throw good money after bad.
- Does the income statement forecast sufficient profit to grow business equity? Earned income retained in the business is generally an important source of funds for financing growth.
- Does the balance sheet forecast adequate working capital (current assets – current liabilities) and owners' equity to ride out the challenges facing a start-up business?
- Have you developed both best case and worst case scenarios?

Final Comment

Creating a successful business starts with developing a good business plan complete with forecasted financial information. These are the key to becoming aware of the pitfalls and costs of the planned venture as well as the opportunities. Your financial statement forecasts will help you decide whether a potential venture is worthwhile financially, how big the business will need to be, how much capital will be needed and the optimal capital structure, and other insights that are critical to business success. These financial statements allow a business manager to evaluate how the business is doing and plan for the future.

Resources

A Review of Essentials of Accounting by Robert Anthony and Leslie Pearlman. Prentice Hall.