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How to Write a Business Plan

- Write a winning proposal
- Prepare cash flow and profit & loss forecasts
- Get backers to invest

THE LEADING BUSINESS PLAN BOOK FOR 25 YEARS

Mike McKeever

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The NOLO® Story

Emma Cofod

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10th edition

How to Write a Business Plan

by Mike McKeever

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Please note

We believe accurate, plain-English legal information should help you solve many of your own legal problems. But this text is not a substitute for personalized advice from a knowledgeable lawyer. If you want the help of a trained professional—and we'll always point out situations in which we think that's a good idea—consult an attorney licensed to practice in your state.

Dedication

This book is dedicated to the memory of my late grandmother, Elizabeth Eudora Woodall Darby, whose influence I acknowledged only recently.

Acknowledgments

After more than a decade of working with many people, I am amazed at the uniform spirit of goodwill and cooperation.

My first editor, Ralph "Jake" Warner, showed patience working with a first-time author. My second editor, Lisa Goldoftas, challenged the grammar while gracefully deferring to my knowledge about the subject.

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Mike P. McKeever
Santa Rosa, California

About the Author

Mike P. McKeever's education, work experience, business ownership, writing, and teaching careers give him a broad and unique perspective on business planning. He has a BA in Economics from Whittier College and a Master's in Economics from the London (England) School of Economics, and has done postgraduate work in financial analysis at the USC Business School. Mike has taught classes at numerous community colleges in entrepreneurship and small business management. He has published articles on entrepreneurship for Dow Jones publications, the *Sloan Publications Business Journal,* and numerous newspapers and periodicals.

Mike has successfully purchased, expanded, and sold a number of businesses, including a manufacturing company, tune-up shop, gas station, retail store, and commercial building. He has worked for a variety of companies ranging from small groceries to multimillion-dollar manufacturers. As an independent business broker, he assessed the strengths and weaknesses of hundreds of companies. As senior financial analyst for a Fortune 500 company, he wrote and analyzed nearly 500 business plans.

Currently, Mike enjoys email correspondence with a few readers relating to business plan issues. He also acts as consulting controller and financial advisor to an online retail business. You can contact him at mckeever.mp@gmail.com.

Downloading Forms and Other Materials

The printed version of this book comes with a CD-ROM that contains legal forms and other material. You can download that material by going to www.nolo.com/back-of-book/sbs.html. You'll get editable versions of the forms, which you can fill in or modify and then print.

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Your Legal Companion

"Nine to five ain't takin' me where I'm bound."

—Neil Diamond, from "Thank the Lord for the Nighttime"

"You've got to be careful if you don't know where you're going because you might not get there."

—Yogi Berra

Are you concerned about whether you can put together a first-rate business plan and loan application? Don't worry.

How to Write a Business Plan contains detailed forms and step-by-step instructions designed to help you prepare a well-thought-out, well-organized plan. Coupled with your positive energy and will to succeed, you'll be able to design a business plan and loan package that you will be proud to show to the loan officer at your bank, the Small Business Administration, or your Uncle Harry.

After working with hundreds of business owners, I have observed an almost universal truth about business planning: Writing a plan is a journey through the mind of one person. Even in partnerships and corporations, usually one person has the vision and energy to take an idea and turn it into a business by writing a business plan. For that reason, I have addressed this book to the business owner as a single individual rather than a husband-and-wife team, group, committee, partnership, or corporation. And you'll find that the same financial and analytical tools necessary to convince potential lenders and investors that your business idea is sound can also help you decide whether your idea is the right business for you.

What Kind of Plan Do You Need?

You can use *How to Write a Business Plan* to write whatever type of plan best suits your needs:

- **Complete business plan.** A complete business plan is especially helpful for people who are starting a new business. This form of plan is also excellent for convincing prospective backers to support your business. You'll be more successful in raising the money you need if you answer all of your potential backers' questions. A complete plan should include the following elements: Title Page, Plan Summary, Table of Contents, Problem Statement, Business Description, Business Accomplishments, Marketing Plan, Sales Revenue Forecast, Profit and Loss Forecast, Capital Spending Plan, Cash Flow Forecast, Future Trends, Risks Facing Your Business, Personnel Plan, Business Personality, Staffing Schedule, Job Descriptions, Specific Business Goals, Personal Financial Statement, Personal Background, Appendix, and Supporting Documents.

- **Quick plan (one-day plan).** If you know your business, are familiar with and able to make financial projections, and have done the necessary research, you may be able to create a plan in one day. But understand that a quick plan is a stripped-down version of a business plan. It won't convince either you or your prospective backers that your business idea is sound. It is appropriate only if your business idea is very simple or someone has already committed to backing your venture. A stripped-down quick plan has these few components: Title Page, Plan Summary, Table of Contents, Problem Statement, Business Description, Business Accomplishments, Sales Revenue Forecast, Profit and Loss Forecast, Capital Spending Plan, Cash Flow Forecast, Appendix, and Supporting Documents.

QUICK PLAN

The "quick plan" icon appears at the beginning of each chapter containing quick plan components and guides you to the sections you'll need.

- **Customized plan.** You can start with a quick plan and add components from the complete business plan to suit your needs. When deciding what to include and what to exclude, ask yourself:
  - Which of my statements are the strongest?
  - Which statements do my backers want to see?

Note that the appendixes contain blank forms as well as business plans for a small service business, a manufacturing business, and a project development. All the forms (except for the Loan Interest Calculation Chart) and business plans are included on the CD-ROM located at the back of the book. The forms—for calculating sales forecasts, personal financial information, profit and loss forecasts, and cash flow forecasts—are provided in Microsoft *Excel* spreadsheet format and include helpful formulas for making calculations. The "CD" icon appears whenever forms or business plans are reproduced on the CD. (Note:

If a series of #### symbols appear in a box in a spreadsheet, that means that you will need to widen the column in order to display the numbers.)

Meet Antoinette

In an effort to make sense out of the thousands of types of small businesses, I have roughly divided them into five main ones: retail, wholesale, service, manufacturing, and project development. All the financial tools I present can be used by all five. However, for the sake of simplicity, I follow one particular retail business—a dress shop. In so doing, I illustrate most of the planning concepts and techniques necessary to understand and raise money for any business.

As you read through the text you'll meet Antoinette Gorzak, a friend of mine. Antoinette wants to open a dress shop, and she has allowed me to use her plans and thought processes as an example of a complete and well-prepared business plan for a retail store. You'll find parts of her plan presented in different chapters as we discuss the various components of a complete business plan.

Getting Started

Before you sit down to write your plan, you'll want to gather together these essentials:

- a word processor
- a calculator or computer spreadsheet program
- a good supply of 8½" by 11" paper
- several pencils and a good eraser, and
- access to a photocopy machine.

Now, here's a word about revisions and changing your plan. I firmly believe in writing your first thoughts on paper and letting them rest for a day or two. Then you can edit, expand, and revise later to get a more perfect statement. In this book, I show examples of Antoinette's writing process. (I'm grateful she's such a good sport.)

Most people discover about halfway through writing their plan that they want to change either their assumptions or some of the plan they've already written. My best advice is this: Complete the plan all the way through on your original set of assumptions. That way you can see the financial impact of your ideas, and it will be much easier to make the right changes in the second draft. If you start revising individual parts of the plan before you have the complete picture, you'll waste a lot of energy. If you're like me, you'll rewrite and edit your plan several times once you've finished the first run through.

And a Few More Words

As I write this, the book has been in print for over 25 years and has sold more than 150,000 copies. I have heard that it has been pirated in some parts of the former Soviet Union. Since it first came out I have taught, lectured, and consulted on business plans in a wide variety of forums. I have taken that experience and reformulated the exercises in the book to make them more effective as well as easier and quicker to use.

I remain friends with many of the people I met through the book and occasionally help them over rough spots in their planning, which is the most gratifying part of the experience for me. My business is helping people write business plans that find money for their businesses. Call me at 415-816-2982 and I'll listen or help if I can. You can also email me at mckeever.mp@gmail.com. Please mention "Nolo Business Plan Book" in the subject line of your email, otherwise I might delete it as a spam message. Finally, to avoid always using the pronoun "he" when referring to individuals in general, and to further avoid clumsy neologisms like "s/he" and awkward phraseologies like "he/she" and "he or she," I have compromised by the random use of "he" in some instances and "she" in others. I hope I have arrived at a fair balance. Also, keep in mind that wherever possible, this book uses plain language, not jargon. As a result, you may find that I have often substituted simple terminology for traditional business plan lingo.

CHAPTER 1

Benefits of Writing a Business Plan

"Marry in haste, repent at leisure."

(proverb)

"A stitch in time saves nine."

(proverb)

What Is a Business Plan?

A business plan is a written statement that describes and analyzes your business and gives detailed projections about its future. A business plan also covers the financial aspects of starting or expanding your business—how much money you need and how you'll pay it back.

Writing a business plan is a lot of work. So why take the time to write one? The best answer is the wisdom gained by literally millions of business owners just like you. Almost without exception, each business owner with a plan is pleased she has one, and each owner without a plan wishes he had written one.

Why Write a Business Plan?

Here are some of the specific and immediate benefits you will derive from writing your business plan.

Helps You Get Money

Most lenders or investors require a written business plan before they will consider your proposal seriously. Even some landlords require a sound business plan before they will lease you space. Before making a commitment to you, they want to see that you have thought through critical issues facing you as a business owner and that you really understand your business. They also want to make sure your business has a good chance of succeeding.

In my experience, about 35% to 40% of the people currently in business do not know how money flows through their business. Writing a business plan with this book teaches you where money comes from and where it goes. Is it any wonder that your backers want to see your plan before they consider your financial request?

There are as many potential lenders and investors as there are prospective business owners. If you have a thoroughly thought-out business and financial plan that demonstrates a good likelihood of success and you are persistent, you will find the money you need. Of course, it may take longer than you expect and require more work than you expect, but you will ultimately be successful if you believe in your business.

Helps You Decide to Proceed or Stop

One major theme of the book may surprise you. It's as simple as it is important. You, as the prospective business owner, are the most important person you must convince of the soundness of your proposal. Therefore, much of the work you are asked to do here serves a dual purpose. It is designed to provide answers to all the questions that prospective lenders and investors will ask. But it will also teach you how money flows through your business, what the strengths and weaknesses in your business concept are, and what your realistic chances of success are.

The detailed planning process described in this book is not infallible—nothing is in a small business—but it should help you uncover and correct flaws in your business concept. If this analysis demonstrates that your idea won't work, you'll be able to avoid starting or expanding your business. This is extremely important. It should go without saying that a great many businesspeople owe their ultimate success to an earlier decision not to start a business with built-in problems.

Lets You Improve Your Business Concept

Writing a plan allows you to see how changing parts of the plan increases profits or accomplishes other goals. You can tinker with individual parts of your business with no cash outlay. If you're using a computer spreadsheet to make financial projections, you can try out different alternatives even more quickly. This ability to fine-tune your plans and business design increases your chances of success.

For example, let's say that your idea is to start a business importing Korean leather jackets. Everything looks great on the first pass through your plan. Then you read an article about the declining exchange ratio of U.S. dollars to Korean currency. After doing some homework about exchange rate fluctuations, you decide to increase your profit margin on the jackets to cover anticipated declines in dollar purchasing power. This change shows you that your prices are still competitive with other jackets and that your average profits will increase. And you are now covered for any likely decline in exchange rates.

Improves Your Odds of Success

One way of looking at business is that it's a gamble. You open or expand a business and gamble your and the bank's or investor's money. If you're right, you make a profit and pay back the loans and everyone's happy. But if your estimate is wrong, you and the bank or investors can lose money and experience the discomfort that comes from failure. (Of course, a bank probably is protected because it has title to the collateral you put up to get the loan. See Chapter 4 for a complete discussion.)

Writing a business plan helps beat the odds. Most new, small businesses don't last very long. And, most small businesses don't have a business plan. Is that only a coincidence, or is there a connection between these two seemingly unconnected facts? My suggestion is this: Let someone else prove the connection wrong. Why not be prudent and improve your odds by writing a plan?

Helps You Keep on Track

Many business owners spend countless hours handling emergencies, simply because they haven't learned how to plan ahead. This book helps you anticipate problems and solve them before they become disasters.

A written business plan gives you a clear course toward the future and makes your decision making easier. Some problems and opportunities may represent a change of direction worth following, while others may be distractions that referring to your business plan will enable you to avoid. The black and white of your written business plan will help you face facts if things don't work out as expected. For example, if you planned to be making a living three months after start-up, and six months later you're going into the hole at the rate of $100 per day, your business plan should help you see that changes are necessary. It's all too easy to delude yourself into keeping a business going that will never meet its goals if you approach things with a "just another month or two and I'll be there" attitude, rather than comparing your results to your goals.

Issues Beyond the Plan

I have written this book to provide you with an overview of the issues that determine success or failure in a small business. Experienced lenders, investors, and entrepreneurs want a plan that takes these issues into account. Of course, this book can't cover everything. Here are some of the key business components that are left out of this initial planning process.

Bookkeeping and Accounting

This book discusses the numbers and concepts you as the business owner need in order to open and manage your small business. You have the responsibility to create bookkeeping and accounting systems and make sure they function adequately. (Some suggestions for setting up a system are contained in Chapter 6.)

One of the items generated by your accounting system will be a balance sheet. A balance sheet is a snapshot at a particular moment in time that lists the money value of everything you own and everything you owe to someone else.

Taxes

While there are a few mentions of tax issues throughout the book, most of the planning information doesn't discuss how taxes will be calculated or paid. The book focuses its efforts on making a profit and a positive cash flow. If you make a profit, you'll pay taxes and if you don't make a profit, you'll pay fewer taxes. A CPA or tax advisor can help you with tax strategies.

Securities Laws

If you plan to raise money by selling shares in a corporation or limited partnership, you'll fall under state or federal securities regulations. You can, however, borrow money or take in a general partner without being affected by securities laws. A complete discussion of these issues is beyond the scope of this book. For now, take note that you must comply with securities regulations after you complete your plan and before you take any money into your business from selling shares or partnership interests.

Your Management Skill

This book shows you how to write a very good business plan and loan application. However, your ultimate success rests on your ability to implement your plans—on your management skills. If you have any doubts about your management ability, check out the resources in Chapter 12. Also see Chapter 11 for a thought-stimulating discussion of management.

Issues Specific to Your Business

How successfully your business relates to the market, the business environment, and the competition may be affected by patents, franchises, foreign competition, location, and the like. Of necessity, this book focuses on principles common to all businesses and does not discuss the specific items that distinguish your business from other businesses. For example, this book doesn't discuss how to price your products to meet your competition; I assume that you have enough knowledge about your chosen business to answer that question.

CHAPTER

2

Do You Really Want to Own a Business?

Introduction

"Hope springs eternal in the human breast," said English poet and essayist Alexander Pope several centuries ago. He wasn't describing people expanding or starting a business, but he may as well have been. Everyone who goes into business for themselves hopes to meet or surpass a set of personal goals. While your particular configuration is sure to be unique, perhaps you will agree with some of the ones I have compiled over the years from talking to hundreds of budding entrepreneurs.

Independence. A search for freedom and independence is the driving force behind many businesspeople. Wasn't it Johnny Paycheck who wrote the song "Take This Job and Shove It?"

Personal Fulfillment. For many people, owning a business is a genuinely fulfilling experience, one that lifetime employees never know.

Lifestyle Change. Many people find that while they can make a good income working for other people, they are missing some of life's precious moments. With the flexibility of small business ownership, you can take time to stop and smell the roses.

Respect. Successful small business owners are respected, both by themselves and their peers.

Money. You can get rich in a small business, or at least do very well financially. Most entrepreneurs don't get wealthy, but some do. If money is your motivator, admit it.

Power. When it is your business, you can have your employees do it your way. There is a little Ghengis Khan in us all, so don't be surprised if power is one of your goals. If it is, think about how to use this goal in a constructive way.

Right Livelihood. From natural foods to solar power to many types of service businesses, a great many cause-driven small businesses have done very well by doing good.

If owning a small business can help a person accomplish these goals, it's small wonder that so many are started. Unfortunately, while the potential for great success exists, so do many risks. Running a small business may require that you sacrifice some short-term comforts for long-term benefits. It is hard, demanding work that requires a wide variety of skills few people are born with. But even if you possess (or more likely acquire) the skills and determination you need to successfully run a business, your business will need one more critical ingredient: Money.

You need money to start your business, money to keep it running, and money to make it grow. This is not the same thing as saying you can guarantee success in your small business if you begin with a fat wallet. Now, let me confess to one major bias here. I believe that most small business owners and founders are better off starting small and borrowing, or otherwise raising, as little money as possible. Put another way, there is no such thing as "raising plenty of capital to ensure success." Unless you, as the prospective business founder, learn to get the most mileage out of every dollar, you may go broke and will surely spend more than you need to. But that doesn't mean that you should try to save money by selling cheap merchandise or providing marginal services. In today's competitive economy, your customers want the best you can give them at the best price. They will remember the quality of what they get from you long after they have forgotten how much they paid.

In practical terms, that means you must buy only the best goods for your customers. Anything that affects the image your business has in your customer's mind should be first-rate. It also means that you shouldn't spend money on things that don't affect the customer. For example, unless you're a real estate broker your customers probably won't care if you drive an old, beat-up car to an office in a converted broom closet, as long as you provide them an honest product or service for an honest price. Save the nice car and fancy office, until after your business is a success.

Self-Evaluation Exercises

Here's a question to ponder: Are you the right person for your business? Because running a business is a very demanding endeavor that can take most of your time and energy, your business probably will suffer if you're unhappy. Your business can become an albatross around your neck if you don't have the skills and temperament to run it. Simply put, I've learned that no business, whether or not it has sound financial backing, is likely to succeed unless you, as the prospective owner, make two decisions correctly:

- You must honestly evaluate yourself to decide whether you possess the skills and personality needed to succeed in a small business.
- You must choose the right business. (How to select the right business is covered extensively in Chapter 3.)

A small business is a very personal endeavor. It will honestly reflect your opinions and attitudes, whether or not you design it that way. Think of it this way: The shadow your business casts will be your shadow. If you are sloppy, rude, or naively trusting, your business will mirror these attributes. If your personal characteristics are more positive than those, your business will be more positive, too. To put this concretely, suppose you go out for the Sunday paper and are met by a store clerk who is groggy from a hangover and badmouths his girlfriend in front of you. Chances are that next Sunday will find you at a different newsstand.

I'm not saying you need to be psychologically perfect to run a small business. But to succeed, you must ask people for their money every day and convince a substantial number of them to give it to you. While providing your goods or services, you will create intimate personal relationships with a number of people. It makes no difference whether you refer to people who give you money as clients, customers, patients, members, students, or disciples. It makes a great deal of difference to your chances of ultimate success if you understand that these people are exchanging their money for the conviction that you are giving them their money's worth.

The following self-evaluation exercises will help you assess whether you have what it takes to successfully run a small business. Take out a blank sheet of paper or open a computer file.

Your Strong and Weak Points

Take a few minutes to list your personal and business strengths and weaknesses. Include everything you can think of, even if it doesn't appear to be related to your business. For instance, your strong points may include the mastery of a hobby, your positive personality traits, and your sexual charisma, as well as your specific business skills. Take your time and be generous.

To provide you with a little help, I include a sample list for Antoinette Gorzak, a personal friend who has what she hopes is a good business idea: a slightly different approach to selling women's clothing. You'll get to know her better as we go along. Her strengths, weaknesses, fantasies, and fears are surely different from yours. So, too, almost certainly, is the business she wants to start. So be sure to make your own lists—don't copy Antoinette's.

Antoinette Gorzak:
My Strong and Weak Points

Strong Points (in no particular order)

1. Knowledge of all aspects of women's fashion business
2. Ability to translate abstract objectives into concrete steps
3. Good cook
4. Faithful friend and kind to animals
5. When I set a goal, I can be relentless in achieving it
6. Ability to make and keep good business friends—I have had many repeat customers at other jobs.

Weak Points

1. Impatience
2. Dislike of repetitive detail
3. Romantic (is this a weak point in business?)
4. Tendency to postpone working on problems
5. Tendency to lose patience with fools (sometimes I carry this too far—especially when I'm tired).

Your list of strong and weak points will help you see any obvious conflicts between your personality and the business you're in or want to start. For example, if you don't like being around people but plan to start a life insurance agency with you as the primary salesperson, you may have a personality clash with your business. The solution might be to find another part of the insurance business that doesn't require as much people contact.

Unfortunately, many people don't realize that their personalities will have a direct bearing on their business success. An example close to the experience of folks at Nolo involves bookstores. In the years since Nolo began publishing, they have seen all sorts of people, from retired librarians to unemployed Ph.D.s, open bookstores. A large percentage of these stores have failed because the skills needed to run a successful bookstore involve more than a love of books.

General and Specific Skills Your Business Needs

Businesses need two kinds of skills to survive and prosper: Skills for business in general and skills specific to the particular business. For example, every business needs someone to keep good financial records. On the other hand, the tender touch and manual dexterity needed by glassblowers are not skills needed by the average paving contractor.

Next, take a few minutes and list the skills your business needs. Don't worry about making an exhaustively complete list, just jot down the first things that come to mind. Make sure you have some general business skills as well as some of the more important skills specific to your particular business.

If you don't have all the skills your business needs, your backers will want to know how you will make up for the deficiency. For example, let's say you want to start a trucking business. You have a good background in maintenance, truck repair, and long distance driving, and you know how to sell and get work. Sounds good so far—but, let's say you don't know the first thing about bookkeeping or cash flow management and the thought of using a computer makes you nervous. Because some trucking businesses work on large dollar volumes, small profit margins, and slow-paying customers, your backers will expect you to learn cash flow management or hire someone qualified to handle that part of the business.

Antoinette Gorzak: General and Specific Skills My Business Needs

1. How to motivate employees
2. How to keep decent records
3. How to make customers and employees think the business is special
4. How to know what the customers want—today and, more important in the clothing business, to keep half-a-step ahead
5. How to sell
6. How to manage inventory
7. How to judge people.

Your Likes and Dislikes

Take a few minutes and make a list of the things you really like doing and those you don't enjoy. Write this list without thinking about the business—simply concentrate on what makes you happy or unhappy.

If you enjoy talking to new people, keeping books, or working with computers, be sure to include those. Put down all the activities you can think of that give you pleasure. Antoinette's list is shown as an example.

As a business owner, you will spend most of your waking hours in the business, and if it doesn't make you happy, you probably won't be very good at it. If this list creates doubts about whether you're pursuing the right business, I suggest you let your unconscious mind work on the problem. Most likely, you'll know the answer after one or two good nights' sleep.

Antoinette Gorzak:
My Likes and Dislikes

Things I Like to Do

1. Be independent and make my own decisions
2. Keep things orderly. I am almost compulsive about this
3. Take skiing trips
4. Work with good, intelligent people
5. Cook with Jack
6. Care about my work.

Things I Don't Like to Do

1. Work for a dimwit boss
2. Feel like I have a dead-end job
3. Make people unhappy.

CAUTION

If your list contains several things you really don't like doing and nothing at all that you like doing, it may be a sign that you have a negative attitude at this time in your life. If so, you may wish to think carefully about your decision to enter or expand a business at this time. Chances are your negative attitude will reduce your chances of business success.

Specific Business Goals

Finally, list your specific business goals. Exactly what do you want your business to accomplish for you? Freedom from 9 to 5? Money—and if so, how much? More time with the children? Making the world or your little part of it a better place? It's your wish list, so be specific and enjoy writing it.

Antoinette Gorzak:
My Specific Business Goals

1. Have my own business that gives me a decent living and financial independence
2. Work with and sell to my friends and acquaintances as well as new customers
3. Introduce clothing presently unavailable in my city and provide a real service for working women
4. Be part of the growing network of successful businesswomen
5. Be respected for my success.

How to Use the Self-Evaluation Lists

After you've completed the four self-evaluation lists, spend some time reading them over. Take a moment to compare the skills needed in your business to the list of skills you have. Do you have what it takes?

Show them to your family and, if you're brave, to your friends or anyone who knows you well and can be objective. Of course, before showing the lists to anyone, you may choose to delete any private information that isn't critical to your business. If you show your lists to someone who knows the tough realities of running a successful small business, so much the better. You may want to find a former teacher, a fellow employee, or someone else whose judgment you respect.

What do they think? Do they point out any obvious inconsistencies between your personality or skills and what you want to accomplish? If so, pay attention. Treat this exercise seriously and you will know yourself better. Oh, and don't destroy your lists. Assuming you go ahead with your business and write your business plan, the lists can serve as background material or even become part of the final plan.

You have accomplished several things if you have followed these steps. You have looked inside and asked yourself some basic questions about who you are and what you are realistically qualified to do. As a result, you should now have a better idea of whether you are willing to pay the price required to be successful as a small businessperson. If you are still eager to have a business, you have said, "Yes, I am willing to make short-term sacrifices to achieve long-term benefits and to do whatever is necessary—no matter the inconvenience—to reach my goals."

Reality Check: Banker's Analysis

Banks and institutions that lend money have a lot of knowledge about the success rate of small businesses. Bankers are often overly cautious in making loans to small businesses. For that very reason it makes sense to study their approach, even though it may seem discouraging at first glance.

Banker's Ideal

Bankers look for an ideal loan applicant, who typically meets these requirements:

- For an existing business, a cash flow sufficient to make the loan payments.
- For a new business, an owner who has a track record of profitably owning and operating the same sort of business.
- An owner with a sound, well-thought-out business plan.
- An owner with financial reserves and personal collateral sufficient to solve the unexpected problems and fluctuations that affect all businesses.

Why does such a person need a loan, you ask? He or she probably doesn't, which, of course, is the point. People who lend money are most comfortable with people so close to their ideal loan candidate that they don't need to borrow. However, to stay in business themselves, banks and other lenders must lend out the money deposited with them. To do this, they must lend to at least some people whose creditworthiness is less than perfect.

Measuring Up to the Banker's Ideal

Who are these ordinary mortals who slip through bankers' fine screens of approval? And more to the point, how can you qualify as one of them? Your job is to show how your situation is similar to the banker's ideal.

A good bet is the person who has worked for, or preferably managed, a successful business in the same field as the proposed new business. For example, if you have profitably run a clothing store for an absentee owner for a year or two, a lender may believe you are ready to do it on your own. All you need is a good location, a sound business plan, and a little capital. Then, watch out Neiman-Marcus!

Further away from a lender's ideal is the person who has sound experience managing one type of business, but proposes to start one in a different field. Let's say you ran the most profitable hot dog stand in the Squaw Valley ski resort, and now you want to market computer software in the Silicon Valley of California. In your favor is your experience running a successful business. On the negative side is the fact that computer software marketing has no relationship to hot dog selling. In this situation, you might be able to get a loan if you hire people who make up for your lack of experience. At the very least, you would need someone with a strong software marketing background, as well as a person with experience managing retail sales and service businesses. Naturally, both of those people are most desirable if they have many years of successful experience in the software marketing business, preferably in California.

Use the Banker's Ideal

It's helpful to use the bankers' model in your decision-making process. Use a skeptical attitude as a counterweight to your optimism to get a balanced view of your prospects. What is it that makes you think you will be one of the minority of small business owners who will succeed? If you don't have some specific answers, you are in trouble. Most new businesses fail, and the large majority of survivors do not genuinely prosper.

Many people start their own business because they can't stand working for others. They don't have a choice. They must be either boss or bum. They are more than willing to trade security for the chance to call the shots. They meet a good chunk of their goals when they leave their paycheck behind. This is fine as far as it goes, but in my experience, the more successful small business owners have other goals as well.

A small distributor we know has a well-thought-out business and a sound business plan for the future. Still, he believes that his own personal commitment is the most important thing he has going for him. He puts it this way: "I break my tail to live up to the commitments I make to my customers. If a supplier doesn't perform for me, I'll still do everything I can to keep my promise to my customer, even if it costs me money." This sort of personal commitment enables this successful business owner to make short-term adjustments to meet his long-range goals. And while it would be an exaggeration to say he pays this price gladly, he does pay it.

CHAPTER

3

Choosing the Right Business

QUICK PLAN

If you've chosen the quick plan method to prepare a business plan (see Introduction), you need to read and complete only these sections of Chapter 3:

- "Problem Statement"
- "Business Description"
- "Forecast Sales Revenue."

Introduction

This chapter helps you determine whether you have chosen the "right" business for you—one that you know, like, and will work hard for and that makes economic sense. Most experienced businesspeople complete several steps as a rough and ready template to decide whether to complete a plan. If your business passes all these steps with flying colors, it means it's a good idea to write a full business plan (although it doesn't guarantee success). On the other hand, if your proposal doesn't pass, you'll probably want to modify or change your plans altogether.

If you're like most people, chances are your business will pass some tests easily and fail some of the others. Antoinette faces just that problem in this chapter. Pay careful attention to how she approaches that dilemma; her method of proceeding may help you in your decision.

Know Your Business

One of the most common questions people ask me is this: What business should I start? My answer is always the same—start a venture that you know intimately already. I don't believe any business exists that is so foolproof that anyone can enter and make a sure profit. On the other hand, a skilled, dedicated owner often can make a venture successful when others have failed. Remember, your potential customers will exchange their money only for the conviction that you are giving them their money's worth. And that means you'll need to know what you're doing. While this point should appear obvious, sadly—it isn't.

Many people enter businesses they know little or nothing about. I did it once myself. I opened an automobile tune-up shop at a time when, seemingly, they couldn't miss. I knew a good deal about running a small business, had a personality well suited for it, and could borrow enough money to begin. The end of what turned out to be a very sad story is that it took me two years and $30,000 to get rid of the business. Why? Because in my hurry to make a profit, I overlooked several crucial facts. The most important of these was that I knew virtually nothing about cars and I didn't really want to learn. Not only was I unable to roll up my sleeves and pitch in when it was needed, I didn't even know enough to properly hire and supervise mechanics. In short, I made a classic mistake—I started a business in a "hot" field because someone was foolish enough to lend me the money.

How can you apply my lesson to your situation? Let's say you've heard pasta shops make lots of money and you want to start one. First, if at all possible, get a job working in one, even if you work for free. Learn everything you can about every aspect of the business. After a few months, you should be an expert in every aspect of pasta making, from mixing eggs and flour, flattening the dough, and slicing it into strips. Ask yourself whether you enjoy the work and whether you are good at it. If you answer "Yes," go on to the second important question: Is the business a potential money maker? You should have a pretty good answer to this question after working in the field for a few months.

If you're unable to find employment in the pasta business, make a tour of delicatessens and shops that make their own pasta. Interview the owners. To get reliable answers, it's best to do this in a different locale from the one in which you plan to locate. Small business owners are often quite willing to share their knowledge once they are sure you will not compete with them.

I remember reading a management philosophy that said that a good manager doesn't have to know every job, only how to get other people to do them. That approach may work well in a large corporation, but for a small business, it's dangerously naive. In short, don't start your small venture until you know it from the ground up. I mean this literally. If you're opening a print shop, you should be able to run the presses and do paste-up and layout, as well as keep a coherent set of books. If it's your elegant little restaurant and the food isn't perfect, you're the one who either improves it in a hurry or goes broke. If you don't like getting your hands dirty, choose a clean business.

Are You Choosing a Risky Business?

When considering the businesses you know, it is helpful to know how well they typically fare. For instance, these businesses have higher than average failure rates:

- computer stores
- laundries and dry cleaners
- florists
- used car dealerships
- gas stations
- local trucking firms
- restaurants
- infant clothing stores
- bakeries
- machine shops
- car washes
- e-commerce
- grocery and meat stores.

If your business idea is on this list, it doesn't mean you should abandon it automatically. However, it should remind you to be extra critical and careful when preparing your plan. I've known successful businesspeople in every category listed, just as I have known people who have failed in each of them.

Be Sure You Like Your Business

Does the business you want to own require skills and talents you already possess? If you have the necessary skills, do you enjoy exercising them? Think about this for a good long time. The average small business owner spends more time with his venture than with his family. This being so, it makes sense to be at least as careful about choosing your endeavor as you are about picking your mate. A few of us are sufficiently blessed that we can meet someone on a blind date, settle down a week later, and have it work out wonderfully. However, in relationships, as in business, most of us make better decisions if we approach them with a little more care.

Be sure you aren't so blinded by one part of a small business that you overlook all others. For example, suppose you love music and making musical instruments. Running your own guitar shop sounds like it would be great fun. Maybe it would be, but if you see yourself contentedly making guitars all day in a cozy little workroom, you'd better think again. Who is going to meet customers, keep the books, answer the phone, and let potential customers know you are in business? If you hate all these activities, you either have to work with someone who can handle them, or do something else.

Here's one last thing to think about when considering how much you like your business idea. In fact, it's a danger that threatens almost every potential entrepreneur. Precisely because your business idea is yours, you have an emotional attachment to it. You should. Your belief in your idea will help you wade through all the unavoidable muck and mire that lies between a good idea and a profitable business. However, your ego involvement can also entail a loss of perspective. I've seen people start hopeless endeavors and lose small fortunes because they were so enamored with their "brilliant ideas" that they never examined honestly the negative factors that doomed their ventures from the start.

Describe Your Business

What is your good idea? What business do you want to be in? It's time to look at the specifics. Let's say you want to open a restaurant. What will you serve? What will your sample menu look like? What equipment will you need? Note that including french fries means you'll have to install french-fryers, grease traps in the sewer line, hoods and fire extinguishing systems. On the other hand, by not serving fried foods you will save a lot of money in the kitchen, but maybe you'll go broke when all the grease addicts go next door.

Or suppose you want to sell DVDs, games, or digital cameras. Do you plan to have a service department? If so, will you make house calls, or only accept repairs at your store? What sort of security system will you install to protect your inventory? What about selling component sound systems or home entertainment centers?

What about competition from nearby retailers?

Answers to these types of questions will be crucial to the success of your venture and to writing your business plan. Let me tell you from hard, personal experience that you need a written document—even if you're sure you know exactly what your business will do.

With this foundation document to refer to, you are less likely to forget your good plans and resolutions in the heat of getting your business under way. Any changes you later make can be made both consciously and with consideration.

To write a complete description of your proposed business, simply follow the suggestions on the next few pages.

Identify Your Type of Business

Find the business category listed below that most closely matches your business. You'll use the description that follows as a reference when you describe your own business.

CAUTION

Each of the business categories requires different skills to run efficiently. Many small businesses involve one or two types of business in the same endeavor. But if your idea will involve you in several types of business, it may be too complicated for you to run efficiently. As a general rule, small businesses work best when their owners know exactly what they are about and strive for simplicity.

- **Retail.** Retail businesses buy merchandise from a variety of wholesalers and sell it directly to consumers. Some retailers provide service and repair facilities, while most do not. Most retailers just take in the goods and mark up the price, sometimes doubling their purchase price to arrive at a sales price.

  Supermarkets, mail order catalogue merchants, online stores (e-tailers), computer stores, dress shops, department stores, and convenience marts are retailers.
- **Wholesale.** Wholesalers buy merchandise from manufacturers or brokers and resell the goods to retailers. Normally, a wholesaler maintains an inventory of a number of lines. A wholesaler normally does not sell to consumers, in order to avoid competing with his retailer customers. Wholesalers usually offer delivery service and credit to customers. This type of business is characterized by low gross profit margins (sometimes varying between 15% and 33% of the wholesaler's selling price) and high inventory investment.

  Wholesalers typically buy in large lots and sell in smaller lots. Like retailers, they seldom make any changes to the products. Most wholesalers aren't well known to the general public.
- **Service.** People with a particular skill sell it to consumers or to other

businesses, depending on the skill. The end product of a service business is normally some sort of advice or the completion of a task. Occasionally, a service business sells products as an ancillary function. For example, a baby diaper cleaning service may also sell diapers and baby accessories. Service business customers normally come from repeats and referrals. It's common to have to meet state licensing requirements.

Hairdressers, carpet cleaners, consultants, housecleaners, accountants, building contractors, and architects are examples of service businesses.

- **Manufacturing.** Manufacturers assemble components or process raw materials into products usable by consumers or other businesses. This type of business ranges from an artisan who makes craft items to Toyota. The most difficult part of the manufacturing business is to find a product, or even better, a series of products, that have acceptance in the marketplace and generate a steady sales volume. Or, as one businessperson put it: "Production without sales is scrap."
- **Project development.** Developers create and finish a saleable commodity by assembling resources for a one-time project. Normally, the developer knows the market value of the finished product before she begins work. When the project is complete, the developer sells her interest in the project, normally directly to the user or consumer.

  To understand project developers, consider a woman building a single-family house on speculation. She buys the lot, secures permits, hires a contractor, gets a loan, builds a house, and sells it. She is then ready to go on to another project. Other examples of project developers include someone who buys, restores, and sells antique cars and someone who purchases dilapidated buildings at a bargain price, fixes them up, and sells them.

TIP

Software development note: Software development differs from software production and sales in that software developers create a product that another entity produces and markets. For example, Fred Jones creates a bookkeeping program for employment agencies on his own time. Then he sells or licenses production and marketing rights to the Acme Programs Co. for $1,000 cash and 5% of future sales. Fred is the project developer and Acme is the manufacturer. If Fred also produces copies and markets them himself, he acts as both developer and manufacturer.

Problem Statement

Successful businesses share a common attribute: They do something useful for their customers. One way to determine what is useful for your customers is to identify and describe the problem that your business will solve. For example, a window washing service solves the customer's twin problems of wanting clean windows and lacking either the time or physical ability to clean windows himself. If you accurately understand your customers' problems and needs, your business will have a better chance of success.

For example, here's a problem faced by a customer of a pizza-by-the-slice stand: "I'm hungry and I don't have much time or money, but I'm tired of hamburgers and want a change of pace. Also, I'd like to be able to specify the exact ingredients I want in my meal. And, it would be really swell to have a glass of wine or beer with the meal."

Now, think about your customers for a minute. What is the problem that you solve for them? Write out your description of the problem your business solves for its customers. This statement will become part of your completed business plan.

Problem Antoinette's Dress Shop Will Solve

Professional working women like to buy fashionable, slightly conservative clothing at moderate prices. They prefer shopping at convenient times and patronizing stores that offer a wide selection of merchandise. These women like to talk to sales clerks who understand fashion and know their store's merchandise; few clerks in the local department stores have this knowledge. At the present time, many of these women travel 45 miles to shop because no local store meets their needs or carries today's most popular labels.

Business Description

Next, describe how your business will solve your customers' problem. Take your time and do a thorough job. It's very likely that the first time you attempt this task, questions will occur to you that you didn't consider previously. If so, figure out a good answer and rewrite your description. The important thing is not how long it takes to do this, but that you end up with a realistic, well-thought-out business description. After all, it's cheaper to answer questions and solve problems on paper than it is with real money.

Your business description should explain exactly what you will provide for the customer as well as what you'll exclude.

Each of the choices you make in your business description will affect the amount of money you'll need to start or expand and how much sales revenue you can expect.

Consider the following series of questions when writing your business description. If you answer both the general business questions and each question that applies to your business, you'll present your business accurately and fairly.

For an example of a well-thought-out business, refer to the accompanying sample, which contains the first draft of Antoinette's Dress Shop's business description. You will find three additional business descriptions in Appendixes A, B, and C at the back of the book.

General Business Questions

These questions apply to most small businesses. Feel free to skip any questions that don't pertain to you.

1. What problem do I solve for my customers?
2. Who is my typical (target) customer?
3. How will I communicate with my target customer?
4. What products and/or services will I provide? Are there any products or services my customers may expect me to provide that I don't plan to provide?
5. Where will my business be located?
6. Where will I buy the products I need?
7. What hours will I operate?
8. Who will work for me and how will they be paid?
9. Who will handle critical tasks like selling, ordering, bookkeeping, marketing, and shipping?
10. How will I advertise and promote my business?
11. What are the competition's strengths and weaknesses?
12. How am I different from the competition, as seen through the eyes of my customers? (Make sure that you answer this question from a customer's perspective and not from an owner's point of view.)

Specific Business Questions

Some issues your business faces can be categorized by business type. Make sure your business description addresses both the general business questions that apply to your business and the questions specific to your type of business.

CAUTION

If you plan to conduct operations in more than one category, be sure to use the specific questions for each type of business that applies.

Retail

1. How will I keep abreast of fashion and taste in my field?
2. Does my location have enough drive-by or walk-by traffic to support my business, or must I rely on heavy advertising for sales?

Business Description for Antoinette's Dress Shop

Antoinette's Dress Shop will be a women's retail clothing store designed to serve the growing market of professional working women. Our store will buy clothing and accessories from the most popular labels that provide consistent quality and service. Antoinette's Dress Shop will resell them "as is" to our target market. Antoinette's will specialize in fashionable, reasonably priced clothing suitable to this city's working environment. The store will sell a limited line of sportswear or leisure wear. We will carry business suits, pantsuits, and dresses for daytime wear, together with accessories like purses and belts. We will make prompt minor alterations at no charge.

Antoinette's will regularly publish a newsletter containing clothing tips for working women, which we will send to customers on our email list. We will maintain a file on each customer that contains their size and style and color preferences. Antoinette's will schedule fashion shows for our customer base as a marketing device.

Antoinette's will offer a relaxed atmosphere with personalized attention and unlimited fitting-room time. Our store will feature a contemporary design and inviting feeling. All our employees will be knowledgeable about fashion in general and about the clothing we sell. Antoinette's will be located in approximately 2,000 square feet in the downtown mall and will maintain regular mall hours of Monday through Friday from 11:00 a.m. until 9:00 p.m. and Saturdays from 10:00 a.m. until 6:00 p.m. These hours will be a convenience to our customer base. The store will not offer delivery on a regular basis, although we will offer Federal Express shipments when requested and we will maintain a website together with an active email correspondence with customers so they can express their feelings about any concerns.

3. Is it better to be in a shopping center with high rents and operating restrictions, or in a separate location with lower costs and less drive-by or walk-by traffic?
4. How much inventory will I buy in comparison to my expected sales revenues? (This is a critical question in the retail field and deserves your close attention.)

Wholesale

1. Which product lines will I carry in inventory and which will I order as required?
2. Will I carry accounts for my customers or work on cash only?
3. Are there any exclusive distributorships available to me?
4. Will I have to market all the products myself or will the manufacturers have marketing programs?

Service

1. Are my credentials and skills equal to or better than others in my field?
2. Can I sell my service as well as I can perform it?
3. Will I take work on speculation or will I insist on cash for each job?
4. Do I have a client list to begin with or will I start cold?
5. Am I better off associating with others or being independent?

Manufacturing

1. Does my manufacturing process create toxic or polluting materials? If so, how will I deal with them and what regulatory agencies handle them?
2. Is there a pool of readily available, affordable skilled labor where I want to locate?
3. Will I make products for inventory or per order?
4. Will I make one product only or a line of products?
5. If I succeed on a small scale, do I plan to sell out to a larger company or try to compete nationally or internationally?
6. Is my competition from small or large firms?

Project Development

1. Am I sure of the selling price of my project?
2. Am I sure of my projected costs? What will happen if my costs are higher than estimated?
3. Am I sure of the time factors? What will happen if it takes longer than expected to complete and sell the project?
4. What portions of the work will I contract with others to perform?
5. Is there a definite buyer for my project? If not, what costs will I incur before it's sold?

Taste, Trends, and Technology: How Will the Future Affect Your Business?

Let's assume you have a good description of your proposed business, and the business is an extension of something you like and know how to do well. Perhaps you have been a chef for ten years and have always dreamed of opening your own restaurant. So far, so good—but you aren't home free yet. There is another fundamental question that needs answering: Does the world need, and is it willing to pay for, the product or service you want to sell? For example, do the people in the small town where you live really want an Indonesian restaurant? If your answer is "Yes" because times are good and people have extra money, ask yourself what is likely to happen if the economy goes into a slump ten minutes after you open your doors.

To make this point more broadly, let's use a railroad train as a metaphor for our economic society. And let's have you, as a potential new businessperson, stand by the tracks. How do you deal with the train when it arrives? You can get on and ride. You can continue to stand by the tracks and watch the train disappear in the distance. Or you can stand in the middle of the tracks and get run over.

To continue this metaphor, let's now assume the economic train has three engines: taste, trends, and technology. Together they pull the heavy steel cars which can give you a comfortable ride or flatten you. Let's take a moment to think more about each of these engines.

Taste

People's tastes drive many of the changes our society speeds through. For example, in the 1970s, many of us changed our taste in automobiles from large gas guzzlers to small, well-built cars. American manufacturers didn't recognize this change in taste until they almost went broke. The Japanese were in the right place with small, reliable cars and realized great prosperity.

Consider popular music as another example. Music styles change every few years, and some bright businesspeople succeed by selling clothing and other accessories associated with each new music style.

What does this mean to you? Look at your business idea again. How does it fit with today's tastes? Is your business idea part of a six-month fad? Are you going into something that was more popular five years ago than it is now and is declining rapidly? If so, you are likely to go broke no matter how good a manager you are and how much you love your business.

Trends

It's one thing to understand that people's tastes have changed and will undoubtedly change again and again, but it's a lot harder to accurately predict what will be popular in a few years. I wish there were a central source of information about predicting future trends in any field, but there isn't. You have the task of looking into the future and deciding where it is going and how that affects what you do today. Fortunately, a little research can do wonders. Here are some tips on how to proceed.

Read everything you can about your field of interest. Attend trade shows and talk to people in small businesses at the cutting edge of the field. Talk to people in similar businesses. Read back issues of magazines aimed at your proposed field. Your goal is to know enough about your proposed business to spot the trends that will continue into the next decade. For example, if you're interested in opening a night club from the 1950s featuring a piano bar, mixed drinks, and lots of room for smokers, you should know that the consumption of hard liquor and cigarettes has gone down sharply in recent years and that nonsmoking lounges with wine and imported beer are doing very well. Putting this information together with other factors, such as your anticipated location and target customers, should give you a pretty good idea of what drinks you should offer. You might decide to serve a number of varieties of fine wine and imported beer and forget about a hard liquor license altogether.

Technology

Technology is your innovative kitchen appliance, your home computer, NASA's new spacecraft, and even the proverbial better mousetrap. For example, lots and lots of people are working feverishly to come up with better video games, laser toothbrushes, wristwatches, TVs, and the like. Sometimes it takes years to perfect an item. That can be good news for small business owners, as there is plenty of time to prepare to profit.

Of course, there is a downside to new technology, too. It often involves high risk. There's no guarantee of success just because the product is new. In fact, something like 80% of the new products introduced into the marketplace die a quick death. Remember HD-DVD players, the Edsel, and eight-track tape players?

What should you do to take advantage of new technologies? First, recognize that large-scale new technology ventures require vast amounts of money and will be beyond your reach unless you plan to have your small business grow in a hurry. Many companies expect to lose money for years during product development and approval before developing a big hit. However, there are often ways creative small business owners can find to participate in new technological trends. For example, many computer software companies started with little more than a good idea and a computer. Or to think even smaller—but not necessarily less profitably—lots of carpenters have done well making ergonomically correct furniture for computer work stations.

Pay attention to new developments in your chosen field and think about how you can take advantage of them. The explosion in mobile devices has popularized applications (or "apps") that enable users to accomplish many functions previously associated with desk bound computers. Can your business benefit from creating such an app? Can you modify your software or website development business to accommodate the massive app market?

In short, new technology is a mighty engine that can pull the economy in new directions at terrific speed. Be sure you are riding on the train and not picking daisies on the tracks in front of it.

E-Business Basics

From the initial dot-com boom in the late 1990s through the subsequent "dot bomb" in 2001, through the post 2001 rebound and 2008 mortgage meltdown, the only "constant" in the in online business world is "constant change."

One thing is certain: the pre-2001 approach of just exploiting a hot domain name and buying up cyber "real estate" no longer guarantees success. Today, successful online companies track the same metrics as their offline counterparts—that is, they carefully watch revenues, costs, and profit and loss analysis. For example, one savvy Internet entrepreneur eventually closed his retail sporting goods store because employees—too busy shipping orders to Internet customers—were neglecting brick-and-mortar customers.

Some trends for success have emerged: a successful online retailer commonly carries a wider assortment of goods than a traditional brick-and-mortar store. Online retailers cater to an international market that operates around the clock. Many online retailers try to keep inventory investment as low as possible by having some of their suppliers ship orders directly from the manufacturer's location to the retail customer (known as "drop shipping"). In this model, the online retailer pays the manufacturer's invoice at a wholesale cost and collects cash via the customer's credit card before an electronic purchase order is issued to the manufacturer.

And online retail business also requires intensive management and sometimes requires a bit more vigilance than a typical retail store. These businesses often work on lower than average gross profit margins. Since many online shoppers use the shopping bots mentioned earlier, savvy retailers make sure their products are found by the search engines. Finally, online retailers must either know, or must hire others who know, website programming as well as online banking and fulfillment operations—all of which are necessary to generate profits.

Online retail sales have been growing steadily and are forecast to continue growing. The same is true for online companies that provide services. Google, for example, earns steady profits from its online advertising program where a business pays a fee for each click through to the sponsored link. One advantage of this program is that a merchant can track the cost effectiveness of the program on a daily basis (and stop or start it at any time).

Write a Future Trends Statement

With this discussion of taste, trends, and technology, I have attempted to focus your attention on the broad movements in the economy that can affect your business idea. Also, remember that there are similar trends in your local community. It's at least as important that you pay attention to these. For example, perhaps you live in a farming community with no manufacturing industries and many migrant workers. It is unlikely that a high fashion clothing store would do well there, but you might do very well selling a new lighter, stronger, cheaper work boot, or chain saw, or stump puller.

Write down your first thoughts about what trends affect your business and where they will be in five years. Nobody expects a perfect forecast, but most financial backers want to know that you have thought through how your business will fit into the world in the next few years.

Future Trends Affecting Antoinette's Dress Shop

There are two conflicting trends affecting my business. First, more women are entering the workforce. However, women increasingly must work to pay for family necessities rather than to make money for extras. For my business, this means that professional working women will appreciate even more in the years ahead the extra service and convenience that we offer.

Second, as the baby boom matures, the number of women in the age group that enters the workforce is declining. This means that I cannot count on an ever-expanding population base for my business.

To accommodate these trends, I plan to pay attention to my customers' changing tastes as they grow older. I also intend to find new ways to market to the smaller number of younger women entering the workforce.

Break-Even Analysis: Will Your Business Make Money?

Some people have a bigger problem than others when opening a new business. These are folks who are positively enamored with their business concept and are desperately eager to begin. They are so smitten and eager to start, they have no patience with the economic realities involved in their business. If you recognize this tendency in yourself, it's extra important that you prepare a financial forecast carefully and pay attention to what it tells you. This step tells you whether your idea is a sure winner or a sure loser or, like most ideas, whether it needs work and polishing to make it presentable.

How can you tell if your business idea will be profitable before you implement it? The honest answer is, you can't. This essential fact makes business scary. It also makes it adventurous. After all, if it were a sure thing, everyone would go into business.

Just because you can't be sure you will make money doesn't mean you should throw up your hands and ignore the whole problem. You can and should make some educated guesses. I like to call them SWAGs ("Scientific," Wild Ass Guesses). The challenging part is to make your profit estimate SWAGs as realistic as possible and then make them come true.

The best way to make a SWAG about your business profitability is to do a break-even forecast. Although a break-even analysis or forecast can never take the place of a complete business plan, it can help you decide if your idea is worth pursuing.

Most financial backers expect you to know how to apply break-even analyses to your business. Your backer may ask what your profits will be if sales are slightly higher or lower than your forecast.

Many experienced entrepreneurs use a break-even forecast as a primary screening tool for new business ventures. They won't write a complete business plan unless their break-even forecast shows that the sales revenue they expect to obtain far exceeds what they need just to pay all the bills. Otherwise, they know their business will not last very long.

CAUTION

You can use this technique as a "quick and dirty" profit analysis, but don't use it as a substitute for the full profit and loss forecast presented in Chapter 6. A break-even forecast is a great screening tool, but you need a more complete analysis before spending any money.

TIP

Project development note: The break-even analysis described below does not apply to a project development, since only one sale occurs. This exercise is designed for a continuing business with ongoing sales revenue. Before they begin, developers must know how much profit they will make after the project is completed. A developer prepares a break-even forecast every time she calculates the likely sale proceeds and subtracts estimated costs. Developers can skip this section, unless they need a refresher course on break-even analyses.

To complete a break-even forecast of your business, you'll make four separate estimates:

- **Sales revenue.** This consists of the total dollars from sales activity that you bring into your business each month, week, or year.

- **Fixed costs.** These are sometimes called "overhead," and you must pay them regardless of how well you do. Fixed costs don't vary much from month to month. They include rent, insurance, and other set expenses.
- **Gross profit for each sale.** This is defined as how much is left from each sales dollar after paying for the direct costs of that sale. For example, if Antoinette pays $100 for a dress that she sells for $300, her gross profit for that sale is $200.
- **Break-even sales revenue.** This will be the dollar amount your business needs each week or month to pay for both direct product costs and fixed costs. It will not include any profit.

CAUTION

Math alert: The following section requires that you make some simple mathematical calculations, which you'll use to analyze your business before writing a complete plan. If the very thought of math makes your head spin, you'll probably want to find someone to help you.

Forecast Sales Revenue

Your first task is to estimate your most likely sales revenue by month for your first two years of operation. This is both the hardest thing to do and the most important part of your business plan. Much of your hope for success rides on how accurately you estimate sales revenue.

Keep in mind that you're honestly trying to decide if your business will be profitable. This means that you must base your forecast on the volume of business you really expect—not on how much you need to make a good profit. If you estimate sales too high, your business won't have enough money to operate. But if you estimate sales too low, you won't be prepared or able to handle all the business you get.

Here are some methods different types of businesses use to forecast sales revenues.

CD-ROM

A copy of the Sales Revenue Forecast is also included on the CD-ROM in *Excel* spreadsheet format (known as .xls). You can find it under the filename SalesRevenue.xls. Note that formulas have been embedded in the spreadsheet document so that it will automatically calculate revenue totals.

TIP

You may decide to round off your forecasts to the nearest $1,000 instead of writing out each single dollar amount. For instance, a monthly sale of $33,333 would become $33,000. After all, these are guesses, and it's hard to guess at single dollar amounts when you're in the five-figure area.

Retail Sales Revenue Forecast

The simplest way to forecast retail sales revenue is to find the annual sales revenue per square foot of a comparable store. Then multiply that dollar figure by your estimated floor space to derive an estimate of your annual sales revenue.

EXAMPLE:

> A similar business shows $200 of sales per square foot per year. If you have 1,000 square feet of floor space, your estimated annual sales revenue will be $200,000 (1,000 × $200). Naturally, your estimate should take into account everything that makes you different from the other store.

Some chain stores, such as supermarkets and drugstores, have refined the art of estimating sales to a science. Of course, they have the advantage of learning from their experience with their other stores. Even so, they occasionally make bad estimates.

Supermarket executives first gather statistics on how much the average person living in town spends every week in grocery stores. In some states, these numbers are available by obtaining total sales volume of grocery stores from the state sales tax agency; normally that data is broken down by county. They estimate how many people live in the area for which sales volume statistics are gathered. Dividing the sales volume data by the number of people in the area gives them the average sales per person from grocery stores.

Then they compare the average sales per person with state averages. If it's higher, it might mean that people living in the area have a higher-than-average income. They can verify that by referring to the United States Census, which lists average income per family and per person for every census tract. If the income per person is average or below average, and sales per person are higher than average, it probably means that people come from surrounding areas to do their shopping. If the sales per person are lower than average in the area, it might mean that income is below average or that people leave the area to do their shopping. On the basis of this sort of data, together with an analysis of competition and demographics, supermarket executives can develop relatively accurate estimates of sales volume for a new store.

Service Business Sales Revenue Forecast

To estimate sales revenue for a service business, you'll need a good understanding of what steps you go through to generate a billable sale. Then make a forecast of how many times you expect to go through all those steps every week or month and how much revenue you'll derive from those steps.

Don't forget to allow time for internal matters and marketing. If you're a sole proprietor, you'll need to allow somewhere between 20% and 40% of your time

Sales Revenue Forecast for Antoinette's Dress Shop

Antoinette wants to open a 2,000-square-foot dress store in a downtown shopping mall. The shopping mall manager says that revenue for women's clothing stores in the mall average between $200 and $250 per foot per year.

After checking with other clothing retailers, reading trade magazines, visiting similar stores in other cities, and integrating her own experience in the business, Antoinette decides that she can achieve the $250-per-foot-per-year figure. This means her annual sales should be $500,000 (2,000 × $250). To be conservative, she plans for the first year's sales to be about 20% below that level to allow for her business to build. This means that first-year sales will be about $400,000, or $200 per foot.

Because Antoinette must forecast monthly sales for the first two years, she now has to decide how the sales revenue will occur each month. She could simply divide this $400,000 by 12 months and get $33,333 per month. But in the dress business, Antoinette knows, this would be inaccurate. In women's clothing, there are four sales seasons: spring, early summer, fall, and Christmas. The kind of shop Antoinette plans to open is slow in midsummer and in January and February. Antoinette also figures that sales will be a little lower than the average for the first few months until her advertising campaign catches on.

Antoinette's monthly sales add up to $401,000 for the first year, so she reduces the December figure by $1,000 to make a nice, round $400,000. For the second year, she increases revenues to $504,000 to allow for normal growth.

Sales Revenue Forecast — Year 1: March 1, 2010 to February 28, 2011

Month			**Revenue**
Month 1:	March	20% below average due to just opening	$ 27,000
Month 2:	April	10% below average due to just opening	30,000
Month 3:	May	20% above average because of cumulative effects of grand opening & seasonal peak	40,000
Month 4:	June	An average month	33,000
Month 5:	July	10% below average due to seasonal slowdown	30,000
Month 6:	August	10% below average due to summer slowdown	30,000
Month 7:	September	10% above average due to back to school	37,000
Month 8:	October	10% above average due to fall season	37,000
Month 9:	November	20% above average due to fall season	40,000
Month 10:	December	40% above average due to Christmas	47,000
Month 11:	January	30% below average since everybody's broke after Christmas	23,000
Month 12:	February	20% below average	27,000
		Year One Total:	$ 401,000

for nonbillable activities. If you have employees or partners, you'll want to make similar allowances for them.

The sales revenue forecasting process for Central Personnel Agency shows the kind of logical process you'll need to go through. (Central's complete business plan is provided in Appendix A.)

Manufacturing or Wholesale Business Sales Revenue Forecast

If you plan to be in a manufacturing or wholesale business, read the sections "Retail Sales Revenue Forecast" and "Service Business Sales Revenue Forecast," just above, and combine some of the concepts to estimate your sales volume. If you know as much about your business as you should, it shouldn't be difficult to develop a reasonable estimate. If you're having great difficulty, the chances are that you need to learn more about your business.

EXAMPLE:

Patty plans to import and wholesale modems for Acme computers. Acme has told her that they have sold 100,000 computers to date and projections show about 1,000 per month for the next three

Sales Revenue Forecast for Central Personnel Agency

I like to allow room for mistakes in my forecast, so this sales forecast seems like overkill; my experience shows the overage is needed.

Since it's harder to find qualified people than it is to find job openings, I'll concentrate on finding people after I build a backlog of openings. I estimate I can find about ten job openings per week. I will allow myself two weeks to find 20 job openings. After the first 20, I'll get plenty of openings by referrals and repeats. My income goal is to gross $3,000 to $4,000 per month, and I know that the average job order filled is worth $500 to $600 in gross fees, so filling only ten openings per month should give me about $5,000 to $6,000 in gross fees.

This means that to fill six to eight job orders per month and meet my gross income goal, I need 25 to 30 good people on file. Finding good people is the hard part. It takes me up to 20 interviews to find one excellent person. Some of these interviews are done in a few minutes over the phone, but just the same, I allow one hour per interview. I can average five to eight per day, and it will take me about 60 days of interviewing to build a base of qualified people. It takes an average of three good people sent out on interviews to fill one job. Of course, once I have a good person, I send that person out on every interview I can. I anticipate three months of fairly low income before I begin to reach my income goals.

years. Patty realizes she doesn't know what percentage of Acme owners will want modems and decides to conduct a mail survey of Acme owners before completing her sales forecast.

Project Development Sales Revenue Forecast

Project developers are not required to complete a monthly sales revenue forecast. They need to know the likely amount they can sell the project for before they begin work; all revenue comes when the project is sold.

Forecast Fixed Costs

For most small businesses, the difference between success and failure lies with keeping costs down. Many smart people start successful businesses in a spare room in their house, the corner of a warehouse, or a storefront in a low-rent neighborhood. Unfortunately, others sink their original capital into essentially cosmetic aspects of their business, such as fancy offices, and then go broke.

Make a list of the fixed or regular monthly expenses of your business. Your objective is to develop a dollar amount of expense that you are committed to pay every month. This is your "nut," or the dollar figure you must be able to pay to keep the business viable. Include rent, utilities, salaries of employees, payroll taxes, insurance payments, postage, telephone, utilities, bookkeeping, and so forth. Some costs will be paid each month and others will be paid once or twice a year. If a cost is less than about 10% of your total fixed costs, you can divide the cost by 12 and show an amount each month. If the cost is larger than 10% of the total, record the cost in the month you expect to pay it. You can choose whether to include a draw for yourself as part of the fixed costs. If you plan to take your compensation only if the business shows a profit, do not include your draw.

Your fixed-cost list should also include some "discretionary costs"—expenses that change from time to time due to your conscious decision. For example, your promotion expenses may change occasionally as you increase or decrease advertising to take advantage of slow or busy times. Include them in the fixed-cost category even though the amount may fluctuate from time to time.

CAUTION

Certain expenses are not "fixed costs." Do not include as fixed costs:

- the costs to actually open your business (covered in Chapter 7)
- loan repayments (covered in Chapter 7), or
- the costs you pay for any goods you'll resell or use in the manufacturing or development process (covered in Chapter 6).

Fixed Costs Forecast for Antoinette's Dress Shop

Antoinette estimates her fixed costs on a monthly basis:

Rent, including taxes, maintenance	$	3,850
Wages, employees only (average including payroll taxes, etc.)		3,600
Utilities		800
Advertising		1,000
Telephone		600
Supplies		900
Insurance		1,500
Freight		700
Accounting/Legal		600
Bad debts		500
Miscellaneous		2,000
Total per month	$	16,050

By completing this simple exercise, Antoinette has gained important information. She now knows that she must sell enough every month so that she has at least $16,050 left after accounting for the merchandise she sells. On an annual basis, that's $192,600 ($16,050 multiplied by 12). Antoinette must also bear in mind that she has not shown any salary or draw for herself. To prosper, she obviously must not only cover fixed costs, but also must take in enough to make a decent living.

Forecast Gross Profit for Each Sales Dollar

How much of each sales dollar will be left after subtracting the costs of the goods sold? That number will pay fixed costs and determine your profit for your business. At this stage, you are trying for a broad-brush, quick and dirty forecast, so it's okay to make a rough estimate of your average gross profit.

Let's look at how Antoinette calculates her gross profit for her first year of business. Antoinette plans to sell about half her products at double the cost she pays. A dress she buys for $125 she sells for $250. That means that her gross profit per dress sale is 50%. She plans to derive her selling price for sale dresses, mark-downs, and accessories by adding one-half of her cost to her selling price; for example, if a belt cost her $10, she'll sell it for $15.

The calculations are similar for different type businesses. Service businesses will have higher gross profit margins than retailers; most revenue is gross profit because little merchandise is sold. Wholesale businesses will be similar to the retail example. Manufacturing businesses will be similar in appearance even though the cost of goods will include materials from a variety of sources and any labor that is paid per piece.

Project developers have only variable costs in each project. There are usually no fixed costs since the developer's business ends with the sale of the project. However,

Gross Profit Calculation for Antoinette's Dress Shop

	Regular Dresses	Sale Dresses & Accessories	Total
Average Costs each	$125	$10	N/A
Bags, wrap	1	1	N/A
Average Total Cost	126	11	N/A
Average Selling Price	250	15	N/A
Gross Profit (Selling Price less Total Cost)	124	4	N/A
Gross Profit % (Gross Profit ÷ Selling Price)	49.6% (or 0.496)	26.7% (or 0.267)	N/A
Total Annual Sales	$200,000	$200,000	$400,000
Total Annual Gross Profit	$99,200	$53,400	$152,600

Average gross profit percentage = 38.2% ($152,600 ÷ $400,000 = 38.2%)

if a project developer works on several projects at the same time, he may have some fixed costs that continue after any particular project is sold. For a project developer, the gross profit is the difference between the project's selling price and all the project costs.

TIP

The prices in the Sales Dresses & Accessories column illustrate gross profit calculations; they do not represent the selling price of sale items.

Forecast Gross Profit for a Start-Up Business

For a new business, calculate the average gross profit for your business by following these steps:

1. For each product or service that you sell, list every individual item that goes into that product, including piece-rate labor and commissions. For example, Antoinette buys dresses from outside suppliers and resells them. The cost of the dress is the major component of the total product cost. She may add the cost of the preprinted bag to derive the total cost of the sale.

2. Once you have a complete list of all the cost components for your products or services, add up the cost of each item.
3. Write the selling price of the item below the total cost of the item.
4. Subtract the total cost from the selling price to derive the gross profit from each sale of that item.
5. Divide the selling price into the gross profit to derive the gross profit percentage for each product.
6. Repeat for each product you'll sell; if you have more than four or five individual products, then it's better to group them by gross profit percentage rather than to make an estimate for each individual product.
7. Write down how much total dollar sales you expect for each product or product group.
8. Multiply the gross profit percentage by the total dollar sales to derive the dollar gross profit from each product.
9. Add together the total dollar gross profit figures to derive the total dollar gross profit from the year's sales.
10. Divide the dollar gross profit by the annual sales revenue to derive the average gross profit percentage for the year's sales.

Completing this gives you an average gross profit percentage for your business.

Forecast Gross Profit for an Existing Business

If you're already operating and have a profit and loss statement for your business from prior months, your job is even easier. Simply subtract the total cost of sales from the total revenue to get the gross profit for the period. Then, convert the dollar gross profit figures to a percentage of sales revenue by dividing total dollar gross profit by total sales for the period. The percentage gross profit figure you get will be the percentage gross profit figure you use for your break-even forecast.

If you're already operating and your expansion will change the percentage of total sales revenue that each product group brings, then you will need to forecast your new average gross profit by following the procedure for a new business listed just above.

Forecast Your Break-Even Sales Revenue

Now that you have the fixed costs per month for your business and the average gross profit per sale, you can estimate how much revenue you will need to just break even. You can use any period you wish, although most people use a month or a year. As this chart shows, it's simple to calculate. Just divide the fixed costs by the average gross profits expressed as a decimal.

Break-Even Sales Revenue Forecast

A	B	C
Fixed costs per month (or year)	Average gross profit percentage expressed as a decimal	Break-even sales revenue (A ÷ B)

EXAMPLE:

Ronnie Ryann runs the Religious Sounds Round Table in Rye, New York. It's a small business, but she loves it dearly. The gross profit on the CDs, tapes, and videos she sells is 50%. This is the same as saying that after adding up the cost of the products, packaging, and postage (all variable costs), Ronnie is able to sell at double this amount. Ronnie rents 1,000 square feet for $800 per month, pays her part-time clerk $950 per month, and budgets $650 per month for utilities, taxes, and so forth. This means her operating expenses (all fixed costs) are $2,400 per month. (Her costs seem low because some parts of New York State are behind the inflation curve.) Therefore, Ronnie has to sell $4,800 of records per month to break even. Her salary comes out of the money she takes in over the $4,800. Fortunately, it will cost Ronnie very little in extra overhead to sell up to $10,000 of records per month, so if she can achieve this volume, she will get to keep close to half of it.

How to Calculate Your Profit

Perhaps you're lucky enough that your break-even sales forecast shows you'll make more than you need to break even. If so, you can easily calculate your profit. Simply multiply your projected sales revenue that is over the break-even point by your average gross profit percentage.

EXAMPLE:

Deborah needs $140,000 to break even in her bookkeeping business. Her projected sales revenue shows that she will be bringing in $185,000 the first year—or $45,000 more than she needs to break even. To determine the profit, she multiplies her average gross profit percentage (0.692) by $45,000. Her profit will be $31,140.

If Your Forecast Shows a Loss

What will you do if your break-even sales forecast shows that you'll lose money? First of all, don't panic. You'll need to do some sober, serious, and meticulous thinking. Carefully check all your numbers and double-check your arithmetic. Incidentally, many people doing this exercise for the first time make some simple mistake in arithmetic that throws off the whole forecast. You might have someone with good math skills review your work.

Let's look at Antoinette's situation and see how her figures have turned out.

Break-Even Sales Revenue Forecast

A	B	C
Fixed costs per year	Average gross profit percentage expressed as a decimal	Break-even sales revenue (A ÷ B)
$192,600	0.382	$504,188

Antoinette needs $504,188 in sales revenue just to break even. That is $104,188 more than she expects the first year and $4,188 more than she expects for the second year. Despite her enthusiasm and determination, Antoinette's first reaction to this news is to panic and consider giving up. After some reflection, she reexamines the calculations to make sure she hasn't made a mistake in her arithmetic. Then she starts considering her options. Should she abandon her idea and work for someone else? Should she proceed with her loan application and fudge figures to show a profit? Or is there some other alternative?

In any business, only these things can improve profits:

- you can increase the sales revenue by selling more of your product or service
- you can reduce fixed costs
- you can increase the gross profit percentage by raising selling prices or by lowering your product cost.

Let's see how Antoinette applies that knowledge to her break-even analysis.

First, Antoinette thinks about increasing sales. Maybe she was too conservative in her original sales forecast. What would happen if she increased her annual sales forecast by $150,000 (to $550,000) and kept the same fixed costs and gross profit margin? That is more than the break-even sales and should be enough to give her a profit for her efforts. How much profit? Let's see.

Break-Even Sales Revenue Forecast for Antoinette's Dress Shop

Revision 1: Increase Sales Volume to $550,000

Annual sales	$550,000
Annual fixed costs	192,600
Gross profit	0.382
Break-even sales ($192,600 ÷ 0.382)	504,188
Sales over break-even ($550,000 – $504,188)	45,812
Profit ($45,812 × 0.382)	$ 17,500

Antoinette concludes that a very aggressive sales increase alone brings her a small profit, but believes that the sales increase of $150,000 is very high. The profit resulting from that sales increase is probably not enough to justify the risk of that high an increase in the sales forecast.

If a sales increase of $40,000 or $50,000 would show that profit, she would be more comfortable increasing sales. She just isn't sure she can do as well as the most established women's clothing store in the mall in her first year. After all, the range of women's clothing sales per square foot per year is $200 to $250, and she used the $250 figure to project sales of $500,000 in the second year.

As a second thought, and even though she has no idea how to accomplish it, she wonders what would happen to profits if she reduced fixed costs by $50,000 per year (about one-quarter of the current total) and left the sales forecast at $400,000 and her gross profit at 38.2%.

Let's see what would happen.

That fixed cost reduction shows a profit of $10,200, but it requires a reduction of one-quarter of the fixed costs. Antoinette believes it will be very difficult to reduce fixed costs that much. Perhaps a combination of fixed-cost reduction and sales increase will improve the profits enough and still be possible. Before she thinks about that option, though, she completes the break-even forecast analysis by seeing what will happen if she can increase the average gross profit to 50% while leaving the sales revenue and the fixed costs the same. She doesn't know if she can really do it, but wants to see what will happen to the numbers.

Break-Even Sales Revenue Forecast for Antoinette's Dress Shop

Revision 2: Reduce Fixed Costs by $50,000

Annual sales	$400,000
Annual fixed costs ($192,600 – 50,000)	142,600
Gross profit	0.382
Break-even sales ($142,600 ÷ 0.382)	373,300
Sales over break-even ($400,000 – 373,300)	26,700
Profit ($26,700 × 0.382)	$ 10,200

Break-Even Sales Revenue Forecast for Antoinette's Dress Shop

Revision 3: Increase Gross Margin to 50%

Annual sales	$400,000
Annual fixed costs	192,600
Gross profit	0.5
Break-even sales ($192,600 ÷ 0.5)	385,200
Sales over break-even ($400,000 – 385,200)	14,800
Profit ($14,800 × 0.5)	$ 7,400

It seems that Antoinette needs to find some combination of higher sales estimates, lower fixed costs, and higher gross profit margin that will improve profits so that she can make a living wage. But the really critical part is this: She must be absolutely sure that she can meet all the forecast changes she makes.

Antoinette was sure of her first forecasts; unfortunately, those forecasts produced a loss for the first year of business. Now, while she can manipulate the numbers to show a profit, the danger is that the numbers may not be achievable. She may be able to create a good-looking business plan but may be unable to meet those revised projections. Or, just as dangerous, she may become uneasy about the project's success. A lack of confidence may just be enough to take the edge off her drive and dedication and enough to make the project fail.

CAUTION

Make sure that you have the same level of confidence in the revised forecast that you had in the first forecast. Obviously, you can fiddle with the numbers and show good profits, but the danger lies in making the goals impossible to reach. We all have a desire to make things work, and making the numbers work is very easy to do. Just remember that you'll have to live with the numbers you write down for a very long time. Make sure they're right.

What You Have Accomplished

We'll follow Antoinette throughout her journey later in the book and see what combination of figures she settles on. For now, let's review what you've learned so far. You've decided whether to write a complete plan for your business by completing these steps:

- choosing a business you know well
- identifying a need you can fill (the customer's problem)
- describing your business and how it will fill that need
- deciding that your business is the right idea at the right time
- deciding that you like your business, and
- forecasting enough profits to make writing a complete business plan worthwhile.

In this chapter, you've been answering questions for yourself. Now that you've answered the questions positively, you can proceed to sell your idea and your answers to potential financial partners. The next few chapters show you how to write a document that sells your idea.

CHAPTER 4

Potential Sources of Money to Start or Expand Your Small Business

Introduction

This chapter helps your writing process because it gives you an idea of what lenders and investors want to see in a finished plan. Your ability to understand your financiers' motives can mean the difference between getting a loan or investment and coming up empty-handed. If you already have financial backing, you can skip this chapter.

Many people and institutions are looking for sound loans and investments. From their side of the fence, it can often seem extremely difficult to find a good one. Many potential financiers have been frightened by news stories about small business financial problems, con artists selling phony tax shelters, business bankruptcies, and so on.

What does this mean to you? Simply that you must both create a sound business plan and present it, and yourself, in a way that appeals to lenders' and investors' needs for security and profit.

If you have a good business idea and are patient and persevering, you should be able to find financing. It was Calvin Coolidge who, sometime in the 1920s, said, "The business of America is business." It's no less true today.

Ways to Raise Money

Before you can sensibly plan to raise money, you need to know how it's commonly done.

Loans

A loan is a simple concept: Someone gives you money in exchange for your promise to pay it back. The lender could be a bank, friend, family member, or anyone else willing to lend you money. The lender will almost always charge interest, which compensates the lender for the risk that you won't pay back the loan. Usually, the lender has you sign some papers (called a note and loan agreement) spelling out the details of your loan agreement. (See Chapter 10 for examples.)

While these basic concepts are simple, not everyone seems to clearly understand them. For example, some people put a great deal of energy into arranging to borrow money, but think little about the hard work that goes into repaying it. The important thing to understand is that the lender expects you to pay the money back. It's only fair that you honor your promise if you possibly can.

Your business may be so successful that you can pay back the loan sooner than the original note calls for and save some interest expense in the process. Some state laws allow repayment of the entire principal at any time with no penalty. However, laws in some states allow the lender to charge a penalty of lost interest if the borrower pays the loan back sooner than called for. Make sure you read the loan documents and ask about prepayment penalties. Your lender may be willing to cross a prepayment penalty clause out of the agreement if you ask.

As for the manner in which loans are repaid, there are about as many variations as there are loans. Here are the most typical:

- **Fully amortized loan.** This type of loan repayment provides for principal and interest to be paid off in equal monthly payments for a certain number of months. When you've made all the payments, you don't owe anything else. The amount of the interest rate and the number of years or months you agree to make payments can change your monthly payments a great deal; pay close attention to these details. For example, if you borrow $10,000 for five years at 10% interest, you will agree to make 60 monthly payments of $212.48, for a total repayment of $12,748.80. That means you will pay $2,748.80 in interest. Now let's say you borrow $10,000 for five years at 20% interest. Your monthly payments will be $264.92 and you will end up paying $15,895, including $5,895 in interest.
- **Balloon payment loan.** This loan (sometimes called an interest-only loan) calls for repayment of relatively small amounts for a preestablished period of time. You then pay the entire remaining amount off at once. This last large payment is called a "balloon payment," because it's so much larger than the others. Most balloon payment loans require interest-only payments for a number of years until the entire principal amount becomes due and payable. Although this type of repayment schedule sounds unwieldy, it can be very useful if you can't make large payments now, but expect that to change in the near future.

Problems With Cosigned Loans

Bankers sometimes request that you find a cosigner for your loan. This is likely if you have insufficient collateral or a poor or nonexistent credit history. Perhaps someone who likes your idea and has a lot of property, but little cash, will cosign for a bank loan.

A cosigner agrees to make all payments you can't make. It doesn't matter if the cosigner gets anything from the loan—she'll still be responsible. And if you can't pay, the lender can sue both you and the cosigner. The exception is that you're off the hook if you declare Chapter 7 bankruptcy, but the cosigner isn't. Cosigning a loan is a big obligation, and it can strain even the best of friendships. If someone cosigns your loan, you might want to consider rewarding your angel for taking this risk.

From my own experience, I cosigned a car loan for an employee once, and I'll think twice before I do it again. I didn't lose any money, but the bank called me every time a payment was 24 hours late, and a couple of times I thought I might have to pay. I didn't like being financially responsible for a car that I had never driven and might never see again.

Secured Loans

Lenders often protect themselves by taking a security interest in something valuable that you own, called "collateral." If you pledge collateral, the lender will hold title to your house, your inventory, accounts receivable, or other valuable property until the loan is paid off. Loans with collateral are called "secured" loans.

If you don't repay a secured loan, the lender sells your collateral and pockets the unpaid balance of your loan, plus any costs of sale. Not surprisingly, if you have valuable property to secure a loan, a lender will be much more willing to advance you money. But you also risk losing your house or other collateral if you can't pay back the loan.

A lender will expect you to maintain some ownership stake in the asset. This will normally be 10% to 30%, depending on the type of asset and the type of lender. That means you can't expect to get a loan for the same amount as your collateral is worth.

If you default on a loan and proceeds from the sale of the collateral are not enough to pay off the loan, the lender can sue you for the remaining amount. The best advice is this: Be very cautious when considering a secured loan. Make sure you know your obligations if the business fails and the loan can't be repaid.

Lenders like collateral, but it never substitutes for a sound business plan. They don't want to be selling houses or cars to recoup their money. In fact, lenders often only accept real property, stocks and bonds, and vehicles as collateral. Items of personal property, such as jewelry, furniture, artwork, or collections usually don't qualify. All lenders really want is for you to pay back the loan, plus interest. If they have to foreclose on your house, it makes them look, and probably feel, bad. Here's an example of a loan secured by real estate and used to open a business.

EXAMPLE:

Mary needs to borrow $50,000 to open a take-out bagel shop. She owns a house worth $200,000 and has a first mortgage with a remaining balance of $100,000. Uncle Albert has offered to lend Mary the amount she needs at a favorable interest rate, taking a second mortgage on Mary's house as collateral for the loan. Mary agrees and borrows $50,000, obligating herself to repay in five years with interest at 10%, by making 60 payments of $1,062.50. If Mary can't make all the payments, the second mortgage gives Uncle Albert the right to foreclose on Mary's home and sell it to recover the money he loaned her. Uncle Albert feels secure, since he is confident the house will sell for at least $150,000, and the only other lien against the house is the $100,000 first mortgage. If a foreclosure did occur, Mary would, of course collect any difference between the selling price and the balance of the two mortgages.

Unsecured Loans

Loans without collateral are called "unsecured" loans. The lender has nothing to take if you don't pay. However, the lender is still entitled to sue you if you fail to repay an unsecured loan. If he wins, he can go after your bank account, property, and business.

Lenders typically don't make unsecured loans for a new business, although a sound business plan may sway them. Remember, the lender's maximum profit from the loan will be the interest he charges you. Since he won't participate in the profits, naturally he is going to be more concerned with security.

Equity Investments

An equity investor buys a portion of your business and becomes part owner. The equity investor shares in your profits when you succeed. Depending on the legal form of ownership, she only shares in your losses up to the amount of her initial investment. Put another way, most equity investors' risk is limited to the money they put up, which can be lost if the business fails.

Investors expect you to think of their money as a tool; you will use their tool for a while, and then you will give it back. Your business plan should include a forecast of when and how that will happen. Failing to discuss a repayment strategy in your plan can cause a potential investor to wonder about your motives.

To understand a little more about your potential backers, let's look at the dilemma they face when they consider investing in a small business like yours. On one extreme are the very safe investments that produce a low profit. At the other extreme lie investments that promise a very high profit but that also carry a high risk of losing the entire investment.

Your new business proposal will be far less safe than an insured bank deposit. This means that to attract money, you must offer investors the possibility of fairly high returns. While investors will not find your proposal as risky as casino gambling, the smart ones will know that, statistically, putting money into a new small business isn't a whole lot safer. In addition to the possibility of a big gain, investors will want to minimize their risks by looking for any security-enhancing feature your investment proposal offers, such as your skill at making businesses succeed or your business's profitable track record.

You will want to offer investors the possibility of a good financial return, a sense of security, and, if possible, a little more. Often, this is a vision of engaging in a business designed to enhance some particularly worthwhile objective such as health, education, or environmental concerns. Or it can be simply an opportunity to help someone with enthusiasm and drive. One of the best ways to convince a potential lender or investor that his money is secure is to convince him that you are an honest, sincere person. At least as many businesses fail to get financed because potential investors don't like the person making the sales pitch as fail because they don't like the pitch itself.

In fact, when they like you and your idea, some investors and banks want to make sure that you have something to lose other than just your pride if the business fails. They will want to see that you are backing your ideas with your hard-earned dollars. Be prepared to put up most of your own money to get the business open. This lets them know that you will do everything in your power to make the business work; sometimes, your dollar commitment can take the place of any other guarantees.

Return on Equity Investments: What's Fair

Every investor has her personal requirements and every deal is different. The important thing is that both parties understand the risks and think it is a good deal. Here are some suggestions that have worked well for others in situations where the potential investors weren't well acquainted with the entrepreneur. Obviously, if your investors are family members, close friends, or people who wish to support your business for political or personal reasons, they may be willing to accept a lower rate of return.

Should You Guarantee a Return?

Very few investment proposals offer the investor any guarantees. Nevertheless, some equity investors want a guaranteed return in addition to a share of the profits. If you guarantee a return, you will pay back the original investment plus a profit on the investment, even if the deal goes sour. Doing this is great if the project makes the profit you think it will. But it's a risk for you since you'll have to get the money to pay off the investor from some other source if your business fails.

If you are willing to guarantee the repayment and the profits, you may be able to get an investor to accept the return of her investment plus a reasonable profit of 20% or 30% on her investment, within a year or two time frame.

Guaranteed investments are rare, and I suggest you avoid the temptation to offer a guarantee. Most entrepreneurs with the ability and assets to offer a guarantee can secure financing at a lower cost from more conventional sources. Perhaps they can pledge their assets for a straight bank loan or sell their assets and obtain money that way.

If you are starting a new business and do not plan to guarantee the return of the investment, you'll almost always need to offer investors a high possible return. If you don't put up any money, investors may expect as much as 75% of the profits. You, the promoter, may get as little as 25% of the profits plus a reasonable salary for your work to make the project go. Of course, it is rare that a person who starts a business doesn't invest at least some of his own money, so the investors' percentage would normally be adjusted downward.

Another alternative for a start-up business where investors bear the entire risk of loss is for the founder to work in the business on a daily basis and receive a small wage as a project expense. The first profits are used to pay back all the money advanced. Profits are split on an agreed percentage. If the investor puts up all the money, this might be 50/50; if the investor puts up less, his share should also be less. Sometimes these profit splits terminate after a specific number of years, and sometimes they continue indefinitely. Occasionally, the parties agree on a formula to establish a price for which one party may buy out the other party in the future.

If you're expanding an established business, the returns can be adjusted toward normal bank loan rates if the expansion appears conservative. Investment profits will have to be considerably higher than bank rates if the project appears risky. The main thing that increases risk for an established business is changing its normal course of business. For example, an established employee leasing company that plans to expand its receivables in the face of increasing demand is more conservative than the same company that plans to open a new office in another state. It's a higher risk if the same company plans to enter a completely new line of business, such as management consulting.

Legal Forms of Owning Equity Investments

An equity investor chooses among three options in sharing ownership in your small business. These are the only options available, even if the consideration for the ownership share is something other than cash, such as labor, materials, and so forth:

- **General partnerships.** A general partner joins you in owning the business. He shares in your profits and losses in proportion to his partnership share. General partnerships work best when all partners work full-time in the business. Equity investors normally prefer not to become general partners, because they don't want day-to-day involvement in your business. Also, by law, if the partnership loses money, the investing general partner must pay back part or all of the losses. Everybody has heard stories of partnerships that went sour, with dire consequences. These were usually general partnerships. If you are interested in forming a partnership, limited or general, or learning more about them, see *Form a Partnership,* by Denis Clifford and Ralph Warner (Nolo).

- **Limited Liability Companys (LLCs).** LLCs are becoming more popular for small business owners. They offer the liability protection of a corporation, but are cheaper and easier to create and maintain. The relationship of you (as the entrepreneur) to your investors is similar in many ways to the relationship in the corporate form (discussed below). Limited Liability Partnerships (LLPs) offer similar benefits but are usually reserved for professionals like doctors and dentists. If you are considering either an LLC or LLP, consult with your accountant or attorney before proceeding.
- **Corporations.** One of the most popular methods of selling equity investments is to form a corporation and sell shares of stock. The shareholders' potential losses are typically limited to the purchase price of their shares. A corporation is a legal entity that is separate from you. You form a corporation by paying fees and filing forms at a state office. A corporation lets you keep management control of the business; as long as you retain 51% of the shares of stock, you can call the shots.

  How much people are willing to pay for your stock depends mostly on what they think of your prospects. If you have a firm, exclusive contract to sell a popular, new type of computer peripheral and only need money to build a showroom, potential buyers will probably find you. However, if you're trying to build a factory to mass produce a new and relatively untried type of pooper-scooper, you will almost certainly have more difficulty.

  If you conduct business in a legal and ethical manner, the corporation can shield you and your shareholders from personal liability for business losses. However, officers and directors of a corporation can be held personally liable for any corporate acts that break the law or breach their duty to the shareholders to act responsibly.

  If you are interested in forming a corporation, I recommend *Incorporate Your Business: A Legal Guide to Forming a Corporation in Your State,* or *How to Form Your Own California Corporation,* both by Anthony Mancuso (Nolo). These books show you how to set up your own small profit corporation and also go into considerable detail on limited liability, electing Subchapter S tax status, issuing shares, holding your first Board of Directors meeting, etc.

By the way, Nolo (www.nolo.com), the publisher of this book, provides many ways to assist you when it comes to corporations and LLCs including assistance with state filings, helpful books, and lots of free information. Visit the site and click "Business, LLCs and Corporations" on the left side of the home page.

Corporations and Red Tape

Corporations bring several complications—but most entrepreneurs consider the costs and inconvenience a small price to pay for the ability to raise the capital they need. I only summarize a few issues here:

- **Record keeping in corporations.** Keeping your shareholders informed and your corporation in good standing means that you have to perform certain legal acts and pay various taxes and fees. It's more complicated and expensive than doing business as a sole proprietor.
- **Taxes and corporations.** You can take money out of your corporation in only two ways: salaries and dividends. Both payments have to be approved by your Board of Directors and entered into the minutes of the company. Salaries become your personal income and are taxed at your personal rates. Dividends are payments to shareholders made only after corporate taxes have been paid. Dividends then become personal income to the shareholders and are taxed at personal rates.
- **Selling shares in your corporation.** Both federal and state regulatory authorities have many rules and regulations governing sales of corporate shares or limited partnership interests. The bottom line of all these regulations is this: You can't take any money into your venture until you comply with the appropriate rules. These rules try to protect investors from crooks and con artists and also try to make it relatively easy to raise money for legitimate ventures. Before selling any security, or soliciting for the sale of any security, make sure you have complied with the appropriate regulations.

CAUTION

Lenders and landlords normally require that corporate officers personally guarantee any loans or leases that the corporation enters into until it has a several-year track record and a strong financial position. So, you can expect to be held personally responsible for company debts even though you form a corporation and are protected from routine business losses.

Loans and Equity Investments Compared

To raise money for your new business, you must decide whether you prefer to borrow money or sell part of your project to an equity investor. Often, you may not have many options. The person with money to lend or invest will obviously have a lot to say about it. But you should know the trade-offs you normally make by preferring one to the other:

- **Loan advantages.** The lender has no profit participation or management say in your business. Your only obligation is to repay the loan on time. Interest payments (not principal payments) are a deductible business expense. Loans from close friends or relatives can have flexible repayment terms.
- **Loan disadvantages.** You may have to make loan repayments when your need for cash is greatest, such as during your business's start-up or expansion. Also, you may have to assign a security interest in your property to obtain a loan, thereby placing personal assets at risk. Under most circumstances you can be sued personally for any unpaid balance of the loan, even if it's unsecured.
- **Equity investment advantages.** You can be flexible about repayment requirements. Investors sometimes are partners and often offer valuable advice and assistance. If your business loses money or goes broke, you probably won't have to repay your investors.
- **Equity investment disadvantages.** Equity investors require a larger share of the profits. Your shareholders and partners have a legal right to be informed about all significant business events and a right to ethical management; they can sue you if they feel their rights are compromised.

Loans are better for businesses if the cash flow allows for realistic repayment schedules and the loans can be obtained without jeopardizing personal assets. Equity investments are often the best way to finance start-up ventures because of the flexible repayment schedules.

If you don't already know an accountant specializing in small business affairs, you will be wise to find one. Your personal tax situation, the tax situation of the people who may invest, and the tax status of the type of business you plan to open are all likely to influence your choice.

Common Money Sources to Start or Expand a Business

Most small businesses are started or expanded with money from one of seven readily available sources. They are in order of frequency:

1. the savings of the person starting the business
2. money from close friends and relatives
3. scaling back cash requirements and substituting creative cost-cutting for financial equity
4. selling or borrowing against equity in other property
5. money from supporters or others interested in what you are doing
6. bank loans, and
7. venture capital.

I recommend never financing a business with only borrowed money, even if it's possible. If you're starting a new business and use your own money or sell equity, you can make your inevitable start-up mistakes cheaply and survive to borrow money later, when you know how better to use it.

My general rule is that you should borrow less than half of the money you need, especially if you're starting a new business. If you're expanding an existing business, make sure that you can handle the cash payments necessary to repay the loan even if business isn't as good as you hope. In other words, it's usually more dangerous to borrow too much than too little. If you have to raise nearly all the money from others, I recommend selling equity instead of borrowing.

Now let's look at each of the most likely funding sources for new and expanding businesses in more depth.

Money From Your Personal Savings

Most businesses are financed, at least in part, with personal savings. Sure, it's hard to save money, but this form of financing has so many advantages, it's worth some effort. Incidentally, savings don't necessarily come from a bank account or piggy bank. Lots of entrepreneurs sell or refinance a house or some other valuable property to come up with cash.

Starting a business with your savings is the quintessence of the capitalist idea. As the entrepreneur with capital, you hire people, purchase equipment, and ideally create profits. It's a long and honored tradition. Henry Ford, John D. Rockefeller, and, more recently, Steve Jobs of Apple Computer all started with at least some money from their own pockets and ended up creating industrial empires. While chances are your goals are more modest, the idea is pretty much the same.

If you finance a business with your own money, you won't have to worry about making loan payments or keeping investors happy. Think of it this way: The more you borrow, the more you increase your fixed operating costs—making it more difficult to survive the slow periods and mistakes almost every business faces.

Another reason to start a business with savings is that you enhance your borrowing capacity for the future. The inventory, fixtures, and equipment you purchase with your cash investment are treated as assets should you later apply for a business expansion loan.

Of course, not everybody is lucky enough to be able to start or expand a business entirely from savings. But there are at least two ways you may be able to increase the amount of money you can put into your business.

Living Expense Deferral

People who need just a little more cash than they have sometimes take a risky—but not unheard of—step. This might more appropriately be called "Borrowing from the Future," as it involves deliberately falling behind in monthly living expenses or taking cash advances from credit cards. This way of getting extra money involves risk, and it's not for everybody.

You may have a credit card or two that has more credit available; by running your credit line to the maximum, sometimes you can obtain some cash from an unexpected source or buy material for the business. Of course, the interest rates are high, and you flirt with bankruptcy if you can't make payments. Still, several people I know have used this method to help start a business.

If you have a good payment record with the telephone company, gas and electric company, landlord, bank, and so forth, you should be able to skip several months' payments without seriously damaging your credit rating. Of course, you'll have to catch up again fast. In the meantime, you can use the money to help get your business going.

You may be able to fall behind a month or two on your mortgage payments and generate some quick cash that way. However, the mortgage holder will take the property back from you after a few months. Don't use this method unless you're very sure that you can become current again quickly.

CAUTION

This scheme should be tried only if you're sure you'll be able to come up with the money when you need it. As with everything else, common sense should be applied to living expense deferral plans. Otherwise, you may find yourself trying to read a foreclosure notice in a dark room.

Trade Credit

Arranging for trade credit involves borrowing from the companies from whom you will buy your merchandise or raw materials. This form of borrowing rarely works for service businesses, because salaries are the biggest expense and employees are usually not interested in lending you their salaries. However, I do know of a number of new businesses where friends and family members pitched in for free in the early days; it never hurts to ask.

If you're in the retail, wholesale, or manufacturing business, arranging for trade credit can help considerably. In most businesses, you typically order supplies and pay for them 30 to 60 days after you receive them. The problem for new businesses is that it's also standard practice for suppliers to demand cash up front from start-ups. This policy isn't immutable, however. Often, if you present your business plan to potential suppliers, you can arrange to order at least some supplies and merchandise on credit. After all, your supplier has an interest in helping you succeed so that you will buy his merchandise for many years to come.

The key to maintaining good relations with suppliers while borrowing from them is to keep them informed of what you're doing and why. This communication rule is particularly important for new businesses. If you arrange credit and can only pay a part of your first bill in 30 days, pay that amount and ask the supplier for a short extension.

Some suppliers may offer extended payment terms to get your business. Occasionally a supplier will ship merchandise in a slow part of the season and let you pay for it several months later, in the busy season. Before you try any of this, check with your suppliers' sales reps about company policies. Your suppliers are invaluable to your business, and you want to keep them on your side.

Friends, Relatives, and Business Acquaintances

The type of financing provided by close friends and relatives does not normally vary much from that provided by strangers. The help may be in the form of a gift, a loan, or an equity investment. The big differences are usually the availability of money in the first place and the interest rate or investment return.

With friend- or relative-provided financing, however, the commercial model isn't the only one. A common alternative is the loan-gift hybrid. Here a relative or friend lends you money at either a low interest rate, or with no interest at all, telling you to pay it back when you can and to treat it as a gift if you can't. Obviously, this type of help is invaluable if it's available. It gives you time to get your business established with a minimum of pressure. If you've any doubt about your angels' financial position, make sure they consult their banker, attorney, or financial advisor before advancing you the money. Also, check with a tax advisor if you receive a substantial gift in one year from any individual, since there may be tax implications. Generally, property you receive as a gift, bequest, or inheritance is not included in your income. However, if property you receive this way later produces income such as interest, dividends, or rentals, that income is taxable to you. For additional information, refer to IRS Publication 17, *Your Federal Income Tax*. You can find this publication online at the IRS website www.irs.gov.

Finally, write down the terms of the loan or transaction and make sure everyone thoroughly understands them. After all, you want to feel like you can go to family reunions even if your business fails.

CAUTION

Think twice before you accept. Think about what a business reversal could do to your personal relationship, even if your relative or friend says they don't need the money. I know families that have been torn apart because a borrower didn't meet the agreements she made with a lender. Besides, a loan from a relative or close friend that comes with emotional strings probably isn't worth the cost.

Your Money Machine

Here is a task you can start right now that will save you time and frustration. Begin writing a list of all your relatives, friends, business acquaintances, supporters, professional advisors, and so on. This list will be one of the primary sources of money for your new or growing venture, since people who know you already are most likely to be interested in your business.

One advantage of dealing with your relatives and friends is that they already know your strengths and weaknesses. They are likely to be more understanding than a banker if you have start-up problems and make a few late loan payments. Nevertheless, you'll be wise to treat people close to you in a businesslike manner.

Don't make the money a test of whether they love you or not. If your close relatives feel they can decline the investment opportunity without hurting your feelings, both of you will be happier in the long run. Pay attention to criticism and suggestions, especially if they come from people with business experience. If they don't wish to invest or lend you money, accept their reasons at face value—you might not like their hidden reasons.

Some people looking for business financing will write a business plan and loan package and then show it only to the bank, assuming relatives or friends don't need to see it. This is a mistake. Make sure those people close to you get the benefit of all your hard work. A good business plan may even help them see you in a new light and encourage them to make a financial commitment.

Creative Cost-Cutting

Although not really a funding source, one of the most effective ways to finance a small business is to make do with less. If your initial business proposal calls for $50,000, think about how you can reduce spending on nonessential items. Perhaps you can begin your consulting business in your home or share expensive equipment with an established business rather than buying it.

Of course, there will be many situations where you will need a fair amount of money to get started—it's hard to cook without a stove, paint without a ladder, or program without a computer. The important principle is not that you should avoid raising outside money, but that you should borrow or raise equity capital only if you absolutely can't do without it. For more on this concept, I recommend *Honest Business,* by Michael Phillips and Salli Rasberry (Random House).

Equity in Other Assets

You may choose to raise money by selling existing assets or by pledging your equity in them as collateral for a loan. Remember, collateral is something you own that you give your lender title to until you pay back all the money you borrowed, plus interest. If you fail to repay the loan, the lender keeps the collateral. Basically, equity is the difference between the market value of property you own and what you owe against it, plus any costs necessary to turn the asset into cash.

EXAMPLE:

Eric owns a car worth $9,000, but owes the bank $4,000. His equity in the car is $5,000. To convert the equity to cash, he could try to sell the car for $9,000 cash and pay off the bank loan, leaving him $5,000. If he borrows against the car, he'd probably be lent less than $5,000, since banks don't like to finance 100% of an asset's value.

Supporters

Many types of businesses tend to have loyal and devoted followers—in many ways their customers care about the business as much as the owners do. Examples are as myriad and varied as the likes, loves, and desires of the human community. A health food restaurant, an exercise club, a motorcycle shop, a family counseling facility, a solar heating business, a religious bookstore, or a kayak manufacturing shop all could work, assuming you can find your audience.

As with the discussion about family members, people who care about what you do may well be willing to support you on better terms than would a commercial investor. No matter what your business or business idea, think about who you know or can get to know and who really cares about what you plan to do. Share your idea with these people and be ready to listen to them. You'll surely get lots of good ideas, and you may be surprised at how easy it is to raise money for what people perceive as an honest and needed endeavor.

Banks

When asked why he robbed banks, Willie Sutton said, "Because that's where the money is." For the same reason, banks are high on the list of potential sources people ask about for business funding. Unfortunately, as far as a small business is concerned, banks act cautiously when lending out money. This makes sense when you remember that it isn't their money.

This discussion applies to financial institutions that lend to businesses and individuals. Recent banking deregulation has made it more difficult to locate which of the various departments of institutions such as the Bank of America, Wells Fargo, and others actually make loans, but the same fundamentals apply when you finally locate the right department and person.

Banks always want to see a written business plan along with your loan application. Banks are financial intermediaries. They pay interest to account holders to attract deposits, which they lend out to people like you. When lending, they charge enough interest to pay for their cost of funds and produce a profit. Any transaction you have with a bank will be a loan and will come with a repayment schedule. Banks try to minimize risks by making sure you have enough assets to pay them back, even if your business does badly. They don't make equity investments in businesses.

Some commercial banks work closely with the Small Business Administration (SBA) (www.sba.gov) in offering loan guarantee programs. If you want a loan but don't qualify under the bank's normal guidelines, the banker may suggest that you apply for an SBA guaranteed loan. If you're approved, the SBA guarantees the bank that you will repay the loan and the bank lends you the money. While this program can work for start-ups, it is most used by business owners wanting to expand a successful business. Ask your banker if he knows about the SBA guarantee program. (See below for background on the SBA.)

Commercial banks sometimes lend to a start-up business, but they almost always ask for collateral to secure the loan. The most banks will usually lend a start-up is half the cash needed. In addition, they usually require that you do not borrow all or most of your cash from someone else; they want you to have as much to lose as they do.

The good news about banks is that money generally costs less from banks than from other professional lenders, such as mortgage loan brokers. If the bank lending officer likes your business plan and loan application, and you have sufficient collateral, she may give you an interest-only loan for a short time, with the option of converting it to an amortized loan later. That means you can delay larger principal payments until your business has a chance to generate a positive cash flow.

EXAMPLE 1:

Katherine O'Malley Pertz-Walter has saved $20,000 to start the Rack-a-Frax Fastener Company, but she needs an additional $10,000. After a careful study of her business plan, a banker grants her an interest-only loan with payments to be made quarterly for one year and takes a second mortgage on her home as collateral. At the end of the year, she must repay the entire principal. Her interest rate will probably be something like the prime rate (interest rate charged the bank's favored customers) plus 3%. If the prime rate is 12%, she'll be paying about 15% interest, and her quarterly interest payment will be $375. At the end of the year, she will be obligated to repay the $10,000 in one lump sum.

EXAMPLE 2:

To continue this story, let's assume that at the end of the first year, Ms. Pertz-Walter asks the bank to convert the loan to a three-year payment schedule, including principal and interest. Based on her favorable first-year results, the bank agrees to amortize the loan rather than demand immediate repayment. She now has to make 36 equal monthly payments of $341.75. After she makes those 36 payments, the loan will be paid off completely.

EXAMPLE:

Now let's forget about Rack-a-Frax and switch to the story of a friend of mine. Peter Wong wanted to start a garage specializing in Italian cars in Santa Fe, New Mexico. He estimated that he needed a total of $50,000 to get his business started. He had $25,000 cash saved from his job as chief mechanic at an independent Ferrari garage and $30,000 equity in a house. He thought he was home free and confidently walked into a local bank to ask for a $25,000 loan.

An hour later he walked back out with his head spinning. The banker asked him a number of questions about monthly sales projections, cash flow, and cash for a parts inventory. Peter hemmed and hawed. It came down to this: The banker didn't want to talk to Peter seriously until he produced a written business plan demonstrating that he understood how his business would work. After the initial shock of his bank interview wore off, Peter went to work. Putting his plan down on paper and doing a budget encouraged him to deal with a number of details he had never thought about before. When he did, he changed his plan considerably.

Finally, Peter presented his plan to the bank loan committee. This time they offered to lend him $25,000, provided he put up the other $25,000 and give the bank a second trust deed on his house and title to all equipment purchased for the shop. The bank also asked that Peter buy a life insurance policy for $25,000, naming the bank as beneficiary. He negotiated the second trust deed on his house out of the requirements and then agreed to take the package. The terms were 36 monthly payments at a floating interest rate that was calculated at the prime rate plus 3%.

By this time, Peter and the banker, whose name was Fred, had established a good relationship. When the business got off to a slow start, Peter kept Fred informed of the problems and his plans to deal with them. Fred let Peter delay three payments in a row with no penalty. Eventually, when the business began to do well and Peter wanted to expand, Fred worked out a financing package, this time taking as collateral Peter's accounts receivable and inventory.

Venture Capitalists

A venture capitalist is anyone who invests equity money in a business in the hope of future profits. While this can include any business investor, from your Aunt Rose to the largest investment banker in New York, the term often connotes a group of businesses that look for hot companies in which they can make large profits. Typically, this group won't consider any investment smaller than $500,000 and prefers companies specializing in the emerging technological fields, where a lot of money is needed to get started and where it's possible to achieve enormous returns. Computers, genetic engineering, and medical technology are familiar examples.

Most readers of this book will be interested in starting or expanding small or medium-sized service, retail, wholesale, or low-technology manufacturing businesses. Large-scale venture capitalists traditionally do not invest in these areas. Fortunately, relatives, friends, business acquaintances, and local businesspeople with a little money to invest can all be pint-sized venture capitalists. Many do very well at it.

EXAMPLE:

Jack Boots loved to ride dirt motor bikes on the weekends. He was frustrated that no retailer in his county carried either a good selection of off-road bikes or the right accessories. He and his friends sometimes had to drive 200 miles to buy supplies.

Eventually, it occurred to Jack to quit his job and open a local motorcycle store. He talked to several manufacturers and was encouraged. The only problem was, he would need $50,000 to swing it. As he only had $20,000, he was about to give up the idea when some of his biker buddies offered to help raise the cash. Jack found six people willing to invest $5,000 each in a limited partnership. Each of these friends was, in reality, a small-scale venture capitalist, betting a portion of his savings on the notion that Jack would succeed and they would participate in his financial success.

Jack's Cycles opened for business and is doing well. All the limited partners were paid back their initial investments plus the agreed-upon return set out in their limited partnership agreement, and Jack is now the sole owner. The only sad part of it is that Jack is too busy to ride much anymore.

Many cities have venture capital clubs, comprising groups of individual investors interested in helping businesses start and grow. These clubs often serve as an introductory service—you receive a few minutes to discuss your business at a club meeting. If any investors want to pursue the discussion further, they make an appointment with you privately. You can use these groups to expand the list you are making of investment prospects. You may also be able to obtain computerized lists of venture capitalists and investor magazines in which you can advertise your proposition. Often, these clubs are formed and disbanded rapidly; ask the local Chamber of Commerce or your local bankers if there is an active club in your area.

When thinking about raising money by selling a share in your business, it's important that you have a hard-headed picture of what you're getting into. Amateur venture capitalists or equity investors gamble on your idea for your expansion or new venture. They invest money hoping that you'll make them rich, or at least richer. If you intend to look for equity investors, your business plan needs enough economic and marketing research to show investors that your idea has the potential of making a substantial profit. You'll also need to show potential investors exactly how they'll profit by investing in your business.

EXAMPLE:

Jack Boots spelled out his profit distribution plans in his limited partnership document: Investors received 50% of the profits paid monthly according to their relative share of investment after he paid himself a nominal, agreed-upon salary for running the store. In addition, they qualified to buy merchandise at a substantial discount. They also owned a share of the assets of the business. Jack estimated that a $10,000 investor would receive a monthly cash flow of $200 for an annual return of 24%. When added to the partner's investment share in the inventory of the shop, this would make a $10,000 investment worth $20,000 in three years.

Additional Money Sources for an Existing Business

If you've been in business for at least three or four years and can show a history of profitable operations, a whole new world of financing options opens up to you. The major advantage you have over a start-up is that you can prove what you say, whereas a start-up can't. Be careful if you've been in business for less than three years or can't show a profitable history—financing sources may consider you a start-up and put you in a higher risk category.

Take your latest two or three years' financial statements with you as part of your business plan when you talk to any financing source. That way, the lender or investor can see where you've been and where you're planning to go.

Here is a list of readily available financing sources for expanding your small business. Consider each potential source of money carefully—each has unique advantages and disadvantages as they apply to your business. Approach whatever source makes the most sense for your business first; you can try others if the first one doesn't work.

Trade Credit

After you establish a reliable record of prompt payment with your suppliers, normally they will consider extending additional credit for your expansion plans. Let them know of your plans well in advance; if you begin delaying your payments to finance your expansion without notifying them, they may get annoyed. They have an interest in seeing you grow; after all, you'll be buying more from them in the future. Sometimes they will even introduce you to their bankers and investors if you approach them with a well-thought-out business plan.

Commercial Banks

Remember those banks that were so hard to get money from when you started your business? Well, once you can show a profitable history, they become a lot more friendly. As an established businessperson you can often secure flexibility from banks that you might not expect. For example, they may lend you money and take a security interest in your accounts receivable. Or they may take a security interest in your inventory, equipment, or other business assets.

Equipment Leasing Companies

Leasing companies own equipment that they rent to businesses and individuals. Some leasing companies are similar to rental yards in that they have a supply of equipment on hand that they rent out. Sometimes these companies offer repair and trade-in privileges in addition to short-term rentals.

Other leasing companies—called full finance leasing companies—do not take physical possession of any equipment. You find the equipment you want, and they buy it for you. Full finance leasing companies have no equipment inventory and offer no return or repair services. They borrow money from a bank, so you'll have to pay back the equipment cost plus interest and a leasing company service fee over a fixed time. Normally, you have the option of buying the equipment for an additional price at the end of the lease term. Full finance leasing companies base their credit decisions on your company's financial condition. They will want to see lots of financial records from your company and may request that you pledge some of your personal assets to guarantee the lease. Of course, make sure you understand what you agree to before you sign anything.

Accounts Receivable Factoring Companies

Factoring companies—also called factors—buy your accounts receivable at a discount. Then, they collect your accounts at full face value. This can be a very expensive way to raise cash—I only recommend it as a last resort. Some factors require that your accounts pay them directly instead of paying you. This can cause problems with customers, who'll assume that you are having serious cash flow problems. Approach factors with caution and make sure you understand the implications of the agreement before you sign it.

Factors can buy your receivables with or without recourse—that is, your guarantee of payment to the factor. Factoring with recourse means that the factor pays you a higher percentage of the receivable in cash and makes raising cash less expensive. But you can be seriously damaged if a big account fails to pay its bill and you have to make good on your guarantee.

Venture Capitalists

Some venture capitalists specialize in funding businesses after they have a track record and are willing to take a smaller return as a result. The industry is changing, and more venture capitalists are looking at a wider range of possibilities and client companies. Often a venture capitalist will specialize in a market area and company size or stage of growth. The possibilities have increased, and so has the work involved in finding just the right backers.

Money Brokers and Finders

Money brokers and finders develop and maintain lists of investors and lenders interested in businesses. For a fee, they will circulate your financing proposal to potential money sources. A legitimate broker or finder can look at your business plan and know if he has a good chance of finding money for you.

Finders simply introduce you to possible backers; they cannot negotiate on your behalf, and they are not licensed. Money brokers are licensed and can negotiate on your behalf. Fees for both finders and brokers are comparable. I recommend that you work with people who work on a contingency fee basis only and do not require up-front fees. While some worthwhile finders and brokers require an up-front fee, there are some nonlegitimate people who take the up-front fees and disappear. Also, I recommend that you obtain references from any broker or finder and that you verify the references.

Total fees, including both up-front and contingency, can range up to 10% or 15% of the money raised, so be cautious and remember that everything is negotiable. You can contact finders and brokers in the financial section of your newspaper's classified advertising section.

If No One Will Finance Your Business, Try Again

Let's say that you've been unsuccessful in your attempts to raise money for your business from the primary sources listed above, or you have raised some money, but still need more. What do you do next? The first step is to go back to the people who initially seemed interested but ultimately turned you down and find out why. This is not a waste of time. If you get the same answer from several people, you will know what you have to work on. And then there is the possibility that someone's circumstances have changed and they have more funds now. Remember, it took the man who invented dry paper copying 21 years to raise the money to get the first photocopier made.

If a bank lending officer, or even two or three, turned you down but you still think borrowing is a good way to fund your business, try other lending officers at other banks. A friend of mine got a $15,000 unsecured loan to improve some agricultural property just by going to five different banks. The first banker laughed him out of the office, the second banker listened to his story for five minutes and the third for ten minutes. By the time he got to the fifth bank, he knew what questions the banker was going to ask and was ready with some solid answers. The banker was impressed and he got the loan. In fact, for this very reason, it's not a bad idea to try a longshot bank first and the most likely one last. (See Chapter 10 for ideas on how to present your business plan to bankers.)

EXAMPLE:

Sue Lester tried all the usual sources to get the $20,000 she needed to open a piano school. One person she talked to was her Aunt Hillary, who had loaned her money to go to school several years before. This time Aunt Hillary said, "Sorry, but no." One afternoon a few months later Sue ran into Hillary at her niece's birthday party. Hillary asked how she was doing with plans for the school. Sue told her she was still short $10,000 and was going to try the Small Business Administration as soon as she made one or two changes in her business plan. Aunt Hillary asked about the changes. Sue told her that an experienced teacher had suggested she charge slightly more per hour, start with a good second-hand piano instead of a new one, and try to work out a referral arrangement with a local piano store. This way she could pay herself more salary and wouldn't need to take another job to make ends meet. Hillary asked to see the changes when they were complete.

After Sue showed the revised plan to her Aunt Hillary, she offered to lend her the money. Sue was both delighted and curious. When she asked, Aunt Hillary said there were two reasons for her change of heart. First, she was pleased that the more realistic sales projections left Sue enough money to live on so she would be able to keep her enthusiasm for the hard job of creating a new business. Second, she had sold a small piece of land for more than expected and now had the money to lend.

Secondary Sources of Financing for Start-Ups or Expansions

Let's assume you have tried all of the primary sources of financing small businesses at least twice, and have been turned down each time. Is it time to head for the showers? Not if you really want to start your business. If everyone turns you down, you have no choice but to get creative. Remember Knute Rockne's exhortation, "Winners never quit and quitters never win." Here are some suggestions.

Small Business Administration

Many years ago Congress recognized both that small businesses provide most of the employment and growth in the country and that they have a great deal of trouble borrowing money because large corporations tend to hog too much of the loan money from banks. As a result, Congress created the Small Business Administration (SBA) and several other government organizations specifically to help small businesses compete with larger corporations for loans.

While the SBA can make direct loans to small businesses, it usually guarantees loans from commercial banks. The SBA will guarantee 85% of a bank loan up to $750,000 if the loan meets SBA criteria. These criteria are not as difficult as some readers may think. Typical requirements include that the borrower show profits for at least two years, that the borrower work in the business full-time, and that the borrower have some real or personal property available to offer as collateral.

Some bankers are strongly interested in working with loans guaranteed by the SBA since the bank can make a fee by processing the loans and later selling them to other financial institutions. Since the bank's fee is based on the size of the loan, such banks are typically only interested in processing loan requests for more than $50,000.

Many banks treat SBA loan origination as a profit center and aggressively seek out borrowers. Some of these banks offer assistance in completing the SBA forms for a fee and offer quick turnaround on decisions. If any banks in your area offer this service, make an appointment with a loan officer specializing in SBA loans. Chances are, he will be able to estimate your chances of success based on reading your business plan. Loan approvals sometimes take place as soon as a week or so after you complete all the paperwork. The SBA's past reputation of being hard to deal with and not very cooperative seems to be changing! That's true for the guarantee program, at least.

Your chances of receiving a direct loan in a reasonable time from the SBA will be greatly enhanced if you qualify for a preference category. For example, if you are disabled or a veteran, requirements are slightly less restrictive. Ask your local SBA bank or SBA office about some of the direct loan programs.

There are also small private business lending companies that perform a function similar to a bank's function in assisting small businesses obtain SBA financing. To get names and addresses of organizations in your area, write the SBA, Financial Assistance Division, Office of Lender Relations, Non-Bank Lender Section, 409 3rd Street, SW, Washington, DC 20416, or check the SBA website at www.sba.gov.

Small Business Investment Companies (SBICs)

A Small Business Investment Company (SBIC) is a corporation established with the assistance of the SBA to lend money to small businesses. Some SBICs serve minority enterprises, and are called Minority Small Business Investment Companies (MSBICs). An SBIC can borrow up to four times its invested capital from the SBA. It then lends out these funds to other businesses, aiming to make a profit on each loan transaction. There are some 400 of these across the country, each with different investment goals and objectives. For more information on business financing, click "Small Business Planner" on the SBA home page (www.sba.gov). The SBA site also offers a list of SBIC addresses and areas of investment specialty. And, you can call their helpline at 800-827-5722 or email them at answerdesk@sba.gov.

USDA Rural Development

This loan program is aimed at businesses that provide jobs in rural America. Business loans through the U.S. Department of Agriculture's Rural Development program (formerly the Farmers' Home Administration or FmHA) are guaranteed in towns with a population of 50,000 or less or in suburban areas where the population density is no more than 100 per square mile. Use of the loans varies considerably; loans have been made to enable a grocery clerk to buy the store he worked in and for someone to buy a McDonald's fast food franchise. Rural Development loans are normally made through a local bank. For information on these loans click "Loans" at the USDA Rural Development website (www.rurdev.usda.gov). At the website you can also locate the nearest USDA Service Center. Loans under this program often take months to complete, so allow plenty of lead time.

Economic Development Administration (EDA)

The EDA, which is part of the Department of Commerce, makes or guarantees loans to businesses in redevelopment areas—city areas with high unemployment. Eligible areas are listed in a publication available quarterly from the regional EDA director. Contact your local SBA office to locate the regional EDA director. If you're in one of the designated redevelopment areas, this program bears looking into. For more information, check online at www.eda.gov.

Federal, State, and Local Programs

Other federal programs are published in the *Catalog of Federal Domestic Assistance*, available from the U.S. Government Printing Office, Washington, DC 20402, or at your library, or online at http://bookstore.gpo.gov. There always seems to be a variety of programs available from the federal government, so this directory is worth checking if you're interested in government money.

All states and many local governments have a number of aid programs available to help businesses create jobs. These are normally called Development Agencies or Development Administrations. You can find out about them by contacting your local Chamber of Commerce or by asking a banker.

Overseas Private Investment Corporation (OPIC)

OPIC is a self-funded U.S. government agency that makes direct loans and loan guarantees and insures private businesses against political risks in developing countries. The ideal candidate for assistance is an American company that enters into partnership with a well-established foreign business. To learn more about this agency, check online at www.opic.gov or call 202-336-8400.

Insurance Companies and Pension Funds

You may have heard about the possibility of borrowing money from insurance companies or pension funds. Normally, neither is a viable lending source for small businesses. Some insurance companies have a small fund they can invest in businesses, especially if you can offer a combination of loans and investments. However, most small businesses will find money from less restrictive sources long before they make an application to an insurance company.

Advertising Your Project and Selling Stock to the General Public

Advertising and selling corporate stock to the general public through a public offering is very different from selling stock to your friends, relatives, and business acquaintances. Unless your corporation qualifies for an exemption, you must register every issuance of corporate stock with the federal Securities and Exchange Commission (SEC) and the state securities agency. Registration takes time and costs money. Following any of these procedures requires a knowledgeable attorney—don't try it without help. It can be an expensive, time-consuming process that can easily cost $200,000 in attorney fees, accountant fees, and printing expenses just to meet government filing costs.

Fortunately, however, smaller corporations usually qualify for state and federal securities laws exemptions. For example, SEC rules permit the private sale of securities without registration if all of the shareholders reside in one state and all of the sales are made in the state. This is called the "intrastate offering" exemption. Another federal exemption allows a "private offering" of shares without registration. A private offering can be a sale, without advertising, to a limited number of people (35 or fewer is often used as a yardstick even though the federal statute does not mention a number). Another way to qualify for a private offering exemption is to only sell, without advertising, to persons who, because of their net worth or income earning capacity, can reasonably be expected to take care of themselves—that is, they can adequately assess the risk and bear the cost of investing in the business, without needing the protections afforded by the registration procedures of the securities laws. Most states have enacted their own versions of these popular federal exemptions.

For more information about SEC small business exemptions, visit the SEC website at www.sec.gov. The Question and Answer Portion of the Small Business Information section contains a great deal of useful information, in easy-to-understand language.

Conclusion

There you have it—the primary and some secondary sources of finding money to start your business. If you really believe in your idea, complete the business plan outlined in the rest of this book. Then contact all the sources listed above. If you have a good plan and refuse to take "No" for an answer, you will find the money you need. The Chinese say the longest journey begins with a single step. Let's get started.

CHAPTER

5

Your Resume and Financial Statement

QUICK PLAN

If you've chosen the quick plan method to prepare a business plan (see Introduction), you need to read and complete only this section of Chapter 5: "Draft Your Business Accomplishment Resume."

Introduction

In this chapter you'll draft two important documents for your business plan:

- **a special business accomplishment resume** that focuses on those abilities you'll need to start or expand your business, and
- **a financial statement,** which details the value of your material possessions.

Draft Your Business Accomplishment Resume

Investors and lenders want to be certain that you have the experience, education, and desire to make your business a success. Your resume shows your backers that you can achieve your objectives. This isn't a traditional resume that lists past jobs and the years or months you held each. More correctly, you'll develop a statement of everything you have accomplished that has a direct bearing on your business objectives.

Although you may not have owned or expanded a business before, you have accomplished some demanding tasks that are similar to the tasks you'll undertake when you begin your business. But don't fool yourself into thinking that good credentials alone will get a loan from the first person you approach. When it comes right down to it, few people will part with their money unless they also have a positive feeling about you as a person. Your task is to get them to trust and like you as a businessperson.

If you're like most people, your glowing accomplishments are sprinkled with past mistakes and failures. Everybody makes mistakes, including your backers. Be honest in your resume but don't go overboard. You don't need to give a litany of every sin you have committed, including the time you skipped algebra class in the seventh grade. Only provide details of your errors when they're relevant to your business plan. For example, if you ran a business for five years and eventually went bankrupt, you'll need to mention that.

Be prepared to talk with prospective investors and lenders about everything you present in your resume. The best way to build trust in a financial relationship is to communicate with full disclosure. The worst thing you can do is to lie about or try to cover up a negative. (See Chapter 10 for suggestions about how to discuss your past mistakes.)

Now that that's out of the way, let's deal with the important, positive information: How do you demonstrate that you're qualified to run a business? As with anything else, there are some tricks to writing a resume that will interest a potential investor.

First, make a list of every job and experience in which you produced positive accomplishments for any organization, even if you were a volunteer or working for yourself. Since you're not writing a standard resume, dates of employment are optional. You may be able to create this list by cutting and pasting old resumes, or you might just start from scratch. Also, it's okay to include personal information about your hobbies and family status in this resume. Your financial backers want to know you as a person.

Under each organization, list the business areas you worked in—for instance, sales, management, delivery, credit, and so on. Now, set out the specific things you accomplished for that organization while carrying out your responsibilities. This information will become the raw material from which you choose the accomplishments most likely to support your proposal.

Remember, this isn't the place to be humble. Getting a new business off the ground is no project for the meek. Maybe you reduced costs for your employer by redesigning a delivery route. Perhaps you designed a better canoe or came up with a new marketing strategy that increased sales of tortilla chips. Maybe you figured out how to improve the efficiency of a computer system or revised a recipe to make brownies taste better.

Once you've completed your first list of accomplishments, write a statement that shows how your specific accomplishments relate to your ability to run your business. Include experiences and achievements that support your case and exclude those that are too general or off the point. Emphasize your knowledge of how your potential business works and your knowledge of and respect for financial realities.

Now that you understand the process and the objective, write a first draft of your business accomplishment resume. You may have to rewrite it several times to get the right perspective. Depending on your experience, your resume probably should be between one and three pages long. Ask someone to read your drafts to make sure you're convincing the reader that you're the right person for the job. You needn't prove you can walk on water, but you should show a good understanding of business realities.

EXAMPLE 1:

Here's an example of an inadequate statement for a credit manager's job. This description doesn't give a potential investor any information about the credit manager's ability to run a business:

> ***Credit Manager, XYZ Company:*** Supervised two clerks and the accounts receivable and billing sections.

EXAMPLE 2:

Here is a much better version that details the credit manager's positive accomplishments for the company. It shows that the credit manager understands and can improve critical business factors:

Credit Manager, XYZ Company: Managed a credit department of ten people, consisting of an accounts receivable section, a billing section, and a delinquent accounts section. Reorganized both our collection department and our credit-granting process to accomplish the following:

1. *Collected $200,000 in delinquent accounts that had previously been consigned to the "unlikely to ever collect" category. This was a result of my decision to keep in closer contact with customers.*
2. *Reduced accounts receivable from an average of 90 days to an average of 38 days, considerably below the industry norm, again primarily by getting to know our customers better.*
3. *Reduced bad debt losses from 4% of sales to 0.5% of sales in two years by streamlining the credit application process and credit checking procedures as well as requiring our sales reps to personally vouch for customers' creditworthiness. Maintained the 0.5% loss percentage in the following years. As part of this, we successfully brought 15 lawsuits with no new staff.*
4. *Through sales conferences, newsletters, and frequent phone contact, worked closely with the sales force to ensure that new accounts were creditworthy. During this time, XYZ sales grew from $3 million to $7 million.*

The following two resumes—Jim Phillips's and Sally Baldwin's—share two important attributes:

- knowledge of the particular business the individual wants to start, and
- specific business accomplishments.

In this respect they are somewhat different from many typical job application resumes. For example, a potential employer might be concerned about whether your independent personality will fit in well in a job environment, where these resumes focus on concrete accomplishments.

Jim Phillips wants to start a retail computer store. Here's how he drafts his resume.

Resume

James T. "Jim" Phillips

WORK EXPERIENCE

Manager, The Computer Store, San Jose (2007 to present)

Manager of chain retail computer and electronic store with annual sales of three million dollars.

- Hired, managed, and fired sales and support staff of 15-20 to meet sales goals established by chain management.
- Developed promotional plans and merchandising strategy, which resulted in the store exceeding sales and profitability goals by at least 10% each year.
- Created a computerized inventory plan used by all stores in the 62-store chain. Received Manager of the Month award seven times. .
- Conceived and implemented a quarterly newsletter (Compufacts) that was mailed to all 62 stores' customers. Enabled us to maintain close contact with customers as well as directly market to them.

Self-employed Software Sales Representative (2000 to 2007)

Acted as independent sales representative for three software developers: Softy, Inc. (Cupertino, CA), Biosoft (Colorado Springs, CO), and Playtime (San Jose, CA).

- Increased sales of all three, enabling them to expand and hire more programmers.
- Developed a comprehensive knowledge of the software marketing process. Helped organize a money-back, no-questions-asked warranty program.

Computer Programmer, Southern Atlantic Railroad Company (1991 to 2000)

Worked in FORTRAN, COBOL, and BASIC languages on IBM mainframe computer doing real-time applications on freight car locations as well as miscellaneous business programming.

- Saved the company approximately $2.3 million by designing a better program to handle both automatic banking and collection of receivables.
- Helped design a new freight car location computer program, which resulted in an increase in car utilization from 60% to 65%.

Bookkeeping

I had several part-time jobs doing bookkeeping while attending programming school.

EDUCATION

Bachelor of Arts Degree, History, San Jose State College, 1987

Master of Arts Degree, History, University of California, Berkeley, 1990

Certified Programmer, ACME Programming School, 1996

HOBBIES

Active in Boy Scouts and United Way; handicap golfer.

The next resume typifies people who see their potential business as offering a chance for self-expression as well as profit. Individuals in an art or craft field often want to begin a business primarily to work in an area they love. Normally this sort of business starts and stays small because the business owners want to keep their hands on a cherished activity rather than achieve big profits or learn the business skills needed to handle fast growth.

Sally Baldwin loves to work with fabric and color and has become expert at helping people create a pleasant living and work environment. She needs money to open her own small interior decorating business.

Resume

Sally Baldwin

Commission Sales, Martha's Interior Design Studio (2002 to present)

Work on commission for a full-line interior design studio. Prospect for people who wish to redecorate, prepare a design plan for the project, purchase the supplies and materials necessary, hire workers to install the design, and collect payments from customers.

- Last year I sold over $500,000 worth of projects. The projects consisted of seven complete remodeling jobs, including three offices, one house, two apartments, and a small pet hospital.
- Keep up with all aspects of the business such as new trends, materials, and suppliers. I take continuing education courses at the Design Institute in New York City, and attend at least a dozen textile, furniture, and appliance trade shows per year.
- Maintain a substantial list of contacts in the design field, including potential customers, contractors, and suppliers.

Commission Sales, J.C. Dollar Interior Design Company (1995 to 2000)

Sold drapes and furniture for J.C. Dollar on commission. I was responsible for design, installation, purchase of noncompany products, and account collection.

- Sold nearly one million dollars worth of company merchandise and won Salesperson of the Year award.
- My sales normally required several visits to the customer's home or place of work and I became expert at dealing with all sorts of people.

EDUCATION

Graduated high school in 1995, followed by one year at Mount McKinley Junior College

HOBBIES

Decorating on a low budget; collecting Raggedy Ann Dolls.

The following statement is typical of a person with good general business experience but no work history in the particular business he wants to start. Stephen Brinkle is an attorney who wants to start a gourmet, vegetarian, and low-fat hot dog stand in downtown Chicago. He needs to convince a lender that his general business experience substitutes, at least in part, for his lack of frankfurter finesse. He accomplishes this by demonstrating that he knows enough to hire a manager with enough experience to squeeze the mustard and shake the ketchup.

Resume

Stephen Brinkle

ATTORNEY IN PRIVATE PRACTICE

Specialize in business law matters, along with some general civil law practice.

BUSINESS INVESTMENTS

I have successfully invested in a variety of small businesses, including an auto tune-up shop and a sporting goods store, which I currently own (Bill's Track and Court, 11 Van Renseller Blvd., Chicago).

In some of my small business investments, I took an active role in management. For example, in the tune-up shop, I had to fire the manager and locate more qualified mechanics. After doing that, the business became profitable and I sold it at a profit. In Bill's Track and Court, the manager and I agreed to concentrate on tennis and running equipment. As a result, the store became considerably more profitable.

EDUCATION

B.A., Northwestern University, History, 1994
J.D., Northwestern Law School, 1998
Passed Illinois bar exam, 1999

HOBBIES

Squash

COMMUNITY INVOLVEMENT

Active in various charitable organizations specializing in relieving worldwide hunger.

If you don't possess all the skills needed to run your business, you'll also want to hire people to fill in the gaps. If possible, those resumes should be included in your plan. Because Stephen Brinkle doesn't have experience in selling food, he includes a resume for his key employee, who happens to be his nephew.

Jonathan "Johnny" Brinkle

5678 Palatine Boulevard
West Chicago, IL
(312) 556-1314

CAREER PLANS

Manage hot dog stand, become area manager if franchise plans develop.

WORK HISTORY

MANAGER, BURGER WORLD RESTAURANT (2008 to date)
Supervised three shifts (20 employees in all). Before I took over, Unit 211 had sales of less than two-thirds the Burger World national averages. In two years I brought Unit 211 up to surpass the national averages. My main strategy was to maintain tight quality control and to improve the cleanliness and general appearance of the unit. Within six months after I took over, we began getting top ratings for general appearance and cleanliness from Burger World and many compliments from customers.

MANAGER TRAINEE, JACK IN THE BOX RESTAURANTS (2005 to 2008)
I was trained in fast food management at a number of Jack in the Box locations. The principal training method was to rotate me through every job in the operation. I learned to adjust cooking to demand so that customers always received freshly cooked food. I also learned that the cleaner the restaurant, the more food you sell.

EDUCATION

Graduated Northside High School, 2004

PERSONAL

Single, no dependents

HOBBIES

Restoring a 1968 Ford Mustang; playing softball

Draft Your Personal Financial Statement

You can skip the rest of this chapter unless you are seeking a loan or investors for your business.

Your personal financial statement will list your personal assets, liabilities, income, and expenses. It tells your backers a lot about your ability to handle money. Don't be discouraged if your financial condition is weak. Your backers want to know about you, the good and the bad, and they understand that you need money.

Preparing this statement in a form lenders are used to seeing involves several steps, which this chapter will take you through step by step. As you'll see, the task is not much harder than filling out a credit application.

Drawing up a good personal financial statement isn't difficult, but it does involve attention to detail. I recommend that you do a rough draft first.

If you already own or have an interest in an existing business, you may wish to include a separate statement of the business's net worth or balance sheet and profit and loss statement. If you own all or a portion of a business and don't plan to submit a separate statement on the business, include your share of the business on this personal financial statement.

TIP

Co-owned property note: If you own an item with others and the other owners will not sign for the loan, enter only the value of your share of the assets and corresponding liability. If all parties will sign for the loan, enter the full amount. Describe the ownership type (joint tenancy, community property, tenants in common, partnership, or separate property). If you're not sure how you own property, look at the deed or other title document.

Determine Your Assets

Your task is to briefly describe and estimate the current value of everything you own, even if you owe money against it. If you're not sure how much a particular item is worth, make an estimate now and verify it later. Give the market value—the price for which you could sell the particular piece of property today.

CD-ROM

A copy of the Personal Financial Statement is included on the CD-ROM in *Excel* spreadsheet format. You can find it under the filename FinancialStatement.xls. Note that formulas have been embedded in the spreadsheet document so that it will automatically calculate relevant totals.

CAUTION

Keep assets separate from income. An asset is a money item or something that you could sell, like a car or a house. Income is money you receive periodically, such as a paycheck. Some assets produce regular income—for example, stocks and bonds that pay dividends, patents with royalty agreements, and promissory notes you own. Only list your assets here; you'll list your income later.

Cash and Cash Equivalents: List the approximate cash balance in each of your financial accounts. Include accounts in banks, savings and loans, thrifts, credit unions, or any other institutions. Identify each by institution name, account type, and number. Also list money market funds, certificates of deposit (including maturity date), and cash in your safe deposit box, buried in the back yard, or any other place you keep cash.

Marketable Securities: List any stocks, mutual funds, and bonds you own that are publicly traded. Show the number of shares or the amount (face value) of bonds, the exchange on which they are listed, and the current market value. The value of stocks is the number of shares owned multiplied by the bid price per share listed in a newspaper business section.

The current cash value for savings or bank bonds is listed on the table printed on each bond according to the number of years since it was issued.

Corporate bonds are listed in the newspaper in relation to their face or par value, with a price of 100 being equal to par. To calculate the value of your corporate bonds, multiply the price listed by their face value and divide by 100.

If you can't find the listing for your securities in your local paper, check online, read the *Wall Street Journal* at your library, or call your broker and ask.

TIP

Note about unlisted securities: Call your broker for the value of any stocks that are not publicly traded and enter them under Other Assets, below.

Cash Value of Life Insurance: If you own whole life insurance policies, they may include a cash surrender value, which will probably be less than the face value of the property. Obtain the value from your insurance agent. If you own term insurance, there will be no cash value, so don't list the policies.

Accounts and Notes Receivable: List only those business assets and other assets that are not shown on a separate financial statement for your business or secured by real property. List each note (loan) people owe you and show the unpaid balance and payment schedule, as well as a description of any property securing the note. Briefly state your relationship to the payer and indicate if the payment of the loan is questionable.

Personal Financial Statement

ASSETS

Cash and Cash Equivalents

Checking and Savings Accounts (Include Money Market Accounts)

Institution Name	Account Type and #	Current Balance
Bank of Centerville	Checking Acct. #1114443231	$ 1,876
Thrift Savings	Savings Account #556472	3,000
	Total Checking and Savings Accounts	$ 4,876

Time Deposit Accounts (Include Certificates of Deposit)

Institution Name	Account #	Maturity Date	Current Balance
Charles Chubb Co.	00-12345	1-25-20	$ 2,000
		Total Time Deposit Accounts	$ 2,000

Cash on Hand/Miscellaneous Cash (Drawers, Safety Deposit Box, Etc.)

Cash at home, travelers checks	$ 500
Total Miscellaneous Cash	$ 500

Total Cash and Cash Equivalents $ 7,376

Marketable Securities (Include Mutual Funds)

No. of Shares/ Amt. of Bonds	Name of Stock/Bond	Exchange Listed	Current Market Value
50 sh.	General Computer Stock	NYSE	$ 3,250
100 sh.	Consolidated Radio	NYSE	1,200
5,000	IMB Bonds		6,250
		Total Value of Marketable Securities	$ 10,700

Cash Value of Life Insurance

Policy Description and Company	Cash Surrender Value
Reliable Life Company; whole life insurance policy	$ 2,457
Total Life Insurance Cash Value	$ 2,457

Accounts and Notes Receivable

Note/Account Description	Current Balance
Jack Sprate, nephew; unsecured note, payable monthly	$ 2,356
Total Accounts and Notes Receivable	$ 2,356

Trust Deeds and Mortgages

Note Description	Current Balance
Second deed of trust on former personal residence, single-family	$ 9,786
home at 4445 Karma St., Modesto, CA, payable monthly.	
Borrower is son-in-law, Dan Carnegie. Loan is current.	
First mortgage on unimproved lot, payable monthly. Borrower is	2,098
my mother, Gertrude Hubbard. Loan is current.	
Total Trust Deeds/Mortgages	$ 11,884

Real Estate

Description	Market Value
Personal residence, three bedrm, two bath frame/stucco house,	$ 140,000
33324 Being St., Modesto, CA (Approx. 15 years old)	
Unimproved lot, New City, IL; Parcel #811-2-849. Owned in joint	15,000
tenancy with my mother, Gertrude Hubbard. Total current	
market value is $30,000.	
Total Value of Real Estate	$ 155,000

Personal Property

Description	Current Value
1958 Buick Century hardtop, good condition	$ 2,500
2005 Honda Accord	4,000
Stamp collection	2,000
Household furniture	3,500
Total Value Personal Property	$ 12,000

Other Assets (Include interests in Partnerships and Private-Held Stock)

Description	Current Value
N/A	$ 0
Total Other Assets	$ 0

Total Assets	$ 201,773

Trust Deeds and Mortgages: Itemize any properties you have sold or lent money against for which you are carrying back a mortgage (deed of trust). Also list notes you hold that are secured by real property. Loans against property you own will be listed under Liabilities, below. Show the street address of the property, type of improvements (house, duplex, etc.), name of payer, payment terms, and the current unpaid balance. State your relationship to the payer and the status of the note.

Real Estate: Describe each piece of real estate you own. State whether it is unimproved, a personal residence, a rental, or whatever. Include the street address or parcel number of each property. Estimate the market value of your property by checking newspaper listings for your neighborhood, calling a local realtor, or comparing the recent sale prices of similar property. If you own valuable property other than your house, it's best to include a written appraisal.

If you own real estate with others and the co-owners are not going to cosign your business loan, describe how title is held, such as, "John Jones as separate property" or "John Jones and Mary Smith in joint tenancy."

Personal Property: Personal property is anything you own that is not real estate. Separately itemize each of the more valuable items like cars, boats, and collections, describing each item in as much detail as possible. Less-valuable property can be grouped together, such as "household furniture," "appliances," or "power tools." You don't need to be overly detailed. Don't forget household items, valuable clothing, jewelry, electronic equipment, musical instruments, and sports equipment.

Estimate the current market value. For cars, start with the high *Edmund's Used Car* or *Kelley Blue Book* price. Jewelry, antiques, and other collectibles should be appraised if you plan to show them as a significant part of your assets. Make a ballpark figure of less-valuable groups of property; garage sale prices should suffice.

Other Assets: List any assets that weren't covered elsewhere. Items such as annuities, IRAs, vested portions of pensions or profit sharing retirement plans, business interests (value of partnerships, etc.), unlisted securities, trusts, life estates, copyrights, patents, trademarks, and so forth should be listed in this section.

Remember not to list the income generated by your assets.

Total Assets: Finally, add up the values of all your property listed on the form. The result is your total assets.

Determine Your Liabilities

In your Personal Financial Statement—Liabilities and Net Worth you'll write down everything you owe to others. To a considerable degree, the information on this form will be the flip side of what you just did. That is, if you showed a house as an asset, you will now list the mortgage on that same house as a liability.

Personal Financial Statement

LIABILITIES & NET WORTH

Credit Cards and Revolving Credit Accounts

Name of Creditor	Amount Owed
VISA (Bank of Centerville)	$ 1,600
American Local	290
Total Credit Cards and Revolving Credit Accounts	$ 1,890

Unsecured Loans

Bank (or other lender)	Terms	Amount Owed
Merchant's Bank	interest only quarterly at prime + 2%, due 9/1/xx	$ 5,000
	Total Unsecured Loans	$ 5,000

Loans Secured by Real Estate

Bank (or other lender)	Terms	Amount Owed
Bank of Centerville	First trust deed and note on personal residence:	$ 87,583
	Fixed rate (10%); 30 years ending 20xx	
Abner Small	Mortgage on unimproved lot; monthly interest	
	only at 18%, to be paid off January 1, 20xx	10,000
	Total Loans Secured by Real Estate	$ 97,583

Loans Secured by Personal Property

Bank (or other lender)	Terms	Amount Owed
Merchant's Bank	Secured by 1989 Honda: 48 mos; will be paid off Sept. 20xx	$ 1,000
	Total Personal Property Loans	$ 1,000

Loans Against Life Insurance Policies

Insurance Company	Terms	Amount Owed
Reliable Life	$5,000 against policy; 60 mos. at 6% interest	$ 3,987
	Total Insurance Policy Loans	$ 3,987

Other Liabilities

Name of Creditor	Terms	Amount Owed
Mother-in-law	Whenever I can repay—no worry	$ 1,000
	Total Other Liabilities	$ 1,000

Total Liabilities $ 110,460

Total Net Worth (Total Assets Minus Total Liabilities) $ 91,313

Total Liabilities and Net Worth $ 201,773

Credit Cards and Revolving Credit Account: List bank cards and revolving accounts at stores and with gasoline companies, and fill in the outstanding balance.

Unsecured Loans: List any unsecured notes to banks, individuals, credit unions, savings and loans, or any other person or institution. These are commonly called signature loans because all the lender gets is your signature on your promise to repay the loan—you don't pledge any collateral. Examples include student loans and loans from relatives. State the lender and terms of payment, including any balloon payments and when the loan will be paid in full, as well as the outstanding balance.

Loans Secured by Real Estate: List each note and deed of trust you owe. State the property by which it is secured and the terms of payment, including any balloon payment and when the note will be paid in full, as well as the unpaid balance.

Loans Secured by Personal Property: List any loans secured by equipment, vehicles, business inventory, or anything other than real estate. Show the payee, unpaid balance, security, terms of payment, including any balloon payment, and when the note will be paid in full.

Loans Against Life Insurance Policies: If you borrowed against a whole life insurance policy, list the insurance company, terms, and outstanding balance.

Other Liabilities: List whatever else you currently owe. This may include unpaid medical bills, tax liabilities, unpaid lawyer bills, unpaid alimony or child support, and debts to bookies.

Total Liabilities: Add up all the amounts you owe others. The result is your total liabilities.

CAUTION

Check for consistency. Before you go on, carefully compare the information on your assets and liabilities lists. Make sure they are consistent. For instance, make sure that you show assets for which you show liabilities and vice versa.

Determine Your Net Worth

To calculate your net worth, simply subtract your total liabilities from your total assets. (If you are using the Personal Financial Statement form included on the CD-ROM, the spreadsheet program will automatically calculate this amount.)

In the last blank, add together your total liabilities and net worth. This figure should match your total assets. If it doesn't, you've made a mathematical error.

CAUTION

If your total liabilities are more than your total assets, your net worth will be a negative figure and you'll need to place brackets around the number. Of course, people with a negative net worth frequently have difficulty borrowing money and may have to consider another form of financing, such as selling equity in the business. (See Chapter 4 for information about raising money.)

Determine Your Annual Income

The next part of the Personal Financial Statement shows your income from all sources. These figures show the annual total of each income source, so don't confuse this with the asset section completed earlier. However, if you show any income from an asset in this section, make sure you also list that asset in the asset section. This form should reflect your current situation and show your present salary, even if you'll quit your job to start the new business.

TIP

Note about cosigners: If someone else will guarantee the loan with you—such as your spouse—fill in the requested information for that person as well.

Gross Salary and Wages: List all the sources of your income, including wages, earnings from your business, and independent contractor work.

Income From Receivables and Loan Repayments: If anyone owes you money, list the annual payments you receive. If you have substantial income from loans, you may list interest income and principal repayments separately. Otherwise show the entire repayment amount.

Rental Property Income: If you rent out real property or valuable personal property like a truck or piano, list the annual rental payments here. Include relevant details, such as your plans to raise the rent in six months.

Dividends and Interest: List the source and annual amount you expect to receive. Make sure that the information shown here corresponds to information you have shown in the Assets portion of your Personal Financial Statement. For example, if you list dividend income from several stocks and bank accounts here, they must be listed in the Assets portion.

Income From Business or Profession: If you already own a business, list the annual income.

Other Income: Describe any other source of income, such as payments from judgments, payments from business investments other than your main business, trust fund payments, and so forth. It's generally a good idea to list alimony and child support payments you receive, since it increases your ability to repay any loan.

Total Annual Income: Add up the income you receive from all sources and fill in the total.

Personal Financial Statement

ANNUAL INCOME

Gross Salary and Wages

Source	Annual Amount
Consolidated Console, Inc.	$ 35,000
Primavera Community College	4,500
Pine Tree Unified School District	20,000
Total Gross Salary and Wages	$ 59,500

Income From Receivables and Loan Repayments

Person Owing	Terms	Annual Amount
Jack Sprate, nephew	8% interest; unsecured, $106.25/mo.	$ 1,275
	Total Receivable and Loan Repayment Income	$ 1,275

Rental Property Income

Source	Annual Amount
27 Fruitvale St., New City, IL	$ 3,600
Total Rental Property Income	$ 3,600

Dividends and Interest

Source	Annual Amount
General Computer (50 shares)	$ 780
Thrift Savings (interest on savings account—$3,000 at 5%)	150
Total Dividends and Interest	$ 930

Income From Business or Profession

Description	Annual Amount
N/A	$
Total Income From Business or Profession	$ 0

Other Income

Description	Annual Amount
Child Support (former husband)	$ 2,500
Total Other Income	$ 2,500

Total Annual Income	**$** 67,805

Determine Your Annual Living Expenses

The goal of this part of the form is to make an accurate estimate of how much it costs you to live. Business expenses should be covered under a separate profit and loss statement for the business.

Real Estate Loan Payments or Rent: List your mortgage holder or landlord and your monthly payment. Indicate whether you rent or own. Fill in the annual total of all your rental or real estate loan payments, including principal and interest.

Property Taxes and Assessments: List your yearly liabilities if you own real property. Also list business non-real-estate property, such as inventory or equipment, if it is taxed every year and the taxes are not shown on statements for your business.

Federal and State Income Taxes: Show your totals from last year's income tax forms. If this year's taxes will be very different from last year's, make an estimate. Especially if you're an independent contractor, you may want an accountant to help you prepare your estimated taxes for the year.

Other Loan Payments: List payments for all of the non-real-estate loans, notes, charge accounts, and credit cards you listed in the Liabilities part of the form. Use last year's numbers unless they have changed substantially; if they have, append a sheet and explain.

Insurance Premiums: List everything you expect to pay for the year that won't be covered through your job. Common types of insurance include life, health, disability, property, and automobile.

Living Expenses: Estimate your other regular personal living expenses that weren't covered earlier, such as utilities, child care, medical and dental costs, transportation, food, clothing, entertainment, and travel. Either provide an itemized list or a general category of expenses.

Other Expenses: List child and/or spousal support obligations and any other expense not listed above, like art collection purchases or vacation trips. Include professional associations that have continuing education expenses and club membership fees.

Total Annual Expenses: Now add up all your expenses. (If you are using the Personal Financial Statement form included on the CD-ROM, the spreadsheet program will automatically calculate your expenses.) If your total is greater than your annual income total above, examine the information carefully before you consider borrowing money with a fixed repayment schedule.

Personal Financial Statement

ANNUAL EXPENSES

Real Estate Loan Payments or Rent

Mortgage Holder/Landlord	Rent or Own?	Annual Payment
Bank of Centerville, 1st deed on residence, monthly payment $895	Own	$ 10,740
Abner Small, 1st deed on unimproved lot, split $380 monthly payment with my mother, co-owner	Own	2,280
	Total Real Estate Loan Payments or Rent	$ 13,020

Property Taxes and Assessments

Property Taxes/Assessments	Annual Payment
Winchester County real estate taxes	$ 1,250
Total Property Taxes and Assessments	$ 1,250

Federal and State Income Taxes

Description	Annual Payment
IRS	$ 3,000
State	898
Total Income Taxes	$ 3,898

Other Loan Payments

Creditor	Annual Payment
VISA (Bank of Centerville)	$ 1,600
American Local	290
Total Other Loan Payments	$ 1,890

Insurance Premiums

Insurance Company	Type of Policy	Annual Payment
Reliable Insurance	Whole life	$ 1,164
	Total Insurance Premiums	$ 1,164

Living Expenses

Description	Annual Payment
Food, clothing, entertainment, etc.	$ 22,000
Total Living Expenses	$ 22,000

Other Expenses

Description	Annual Payment
Child support payments per year	$ 3,150
Total Other Expenses	$ 3,150
Total Annual Expenses	**$ 46,372**

Date: ____________________ Signature: ______________________________

Complete Your Personal Financial Statement

If you have not already done so, print out your spreadsheet. Make sure you sign and date your completed form; you'll be surprised at how fast things change.

As noted above, many financial institutions prefer their own form, which they will supply you. However, chances are that you won't have to redo your Personal Financial Statement or, if you do, it will be easy.

Verifying the Accuracy of Your Financial Statement

Potential lenders probably will want to verify your financial statements. Tax returns for the last two or three years are normally adequate to back up your income and expense statements. If your actual income is somewhat greater than your tax returns show, be ready to verify your assets in some other way. But don't worry too much about this sort of disparity unless it is large. In an age of overly high taxation, your lender will not be surprised if your actual income is a shade higher than your reported income. His probably is, too.

In addition, lenders usually obtain a personal credit check from a credit information agency on your track record in making payments. That shows what bills you pay and when, as well as any unpaid bills. Credit reports also list your current employment, lawsuits in which you're involved, and bankruptcies filed in the last ten years. It's a good idea to request your own copy of your credit report before you meet with any prospective lenders. That way, you'll know what they will see and will be prepared to discuss it. If your credit file contains some inaccurate or misleading information, you have the right to challenge that information. (For information on how to go about this, see *Solve Your Money Troubles: Debt, Credit & Bankruptcy,* by Robin Leonard (Nolo).)

Most of the time, lenders will accept your estimates of your personal assets and liabilities on your Personal Financial Statement, since it is a crime to knowingly make false financial statements.

Banks will also verify your cash deposits by contacting the relevant institutions. Also, lenders will want evidence of your title to property they take as security for a loan.

CHAPTER

6

Your Profit and Loss Forecast

QUICK PLAN

If you've chosen the quick plan method to prepare a business plan (see Introduction), you need to read and complete the section "Complete Your Profit and Loss Forecast," below.

If you have any difficulties completing your Profit and Loss Forecast, go back to Chapter 3 and read the section entitled "Break-Even Analysis: Will Your Business Make Money?" before completing this step. If you've chosen a quick plan, you should be able to complete this step easily.

Introduction

Your next job is to forecast how much money you'll need. You can't make realistic financial projections in a vacuum; they must be integrated into a thought-through plan. As a result, you'll need to make a number of decisions about how your business will operate and forecasts of financial results. But don't let this intimidate you. You've probably been thinking about the financial side of your business for some time. You will inevitably need to make some assumptions and even a guess or two. Of course, you should make your projections as accurate as possible; shoot for an accuracy rate of plus or minus 10%.

TIP

Project development note: If you plan to do a project development, skip the rest of this chapter and go on to Chapter 7. Then turn to Appendix C, where you will find a project development example.

As you begin dealing with all the details inherent in financial projections, it is easy to lose perspective and forget the larger picture—that is, what all your work is supposed to prove. If this happens, pause for a moment and remember that, for yourself and your potential backers, you're simply figuring out:

- how much money you need
- what you will spend it on, and
- how you will pay it back.

What Is a Profit and Loss Forecast?

A profit and loss forecast is a projection of how much you will sell and how much profit you will make. This is the foundation of your business plan. It gives you and your potential backers the basic information necessary to decide whether your business will succeed. Basically, a profit and loss forecast forces you to estimate how many dollars you will take in and how many dollars you will spend for some future period. While other extremely important factors affect your business, such as your cash flow (Chapter 7), you'll be in good shape if you can confidently predict that the money coming in will exceed the money going out by a healthy margin.

In Chapter 3, you completed a rough break-even analysis for your business. That analysis helped you decide whether you chose the right business. Now we are going to take a closer look at those numbers and develop them into a comprehensive forecast of your business's future profits. (If you did not complete or don't remember the work you did then, review the section in Chapter 3 entitled "Break-Even Analysis: Will Your Business Make Money?")

Your business's profits result from three specific dollar figures:

- **Sales revenue.** This is all the money you take into your business each month, week, or year. It is also called "gross sales," "sales income," or simply "sales."
- **Cost of sales.** This is your direct cost of the product or service you sell. Sometimes it is called "direct product cost," "variable cost," "incremental cost," or "direct cost."
- **Fixed expenses.** These are sometimes called "overhead," and you must pay them regardless of how well you do. Fixed expenses don't vary much from month to month. They include rent, insurance, and other set expenses. They are also called "fixed costs," "operating expenses," "expenses," or "discretionary costs" (discussed in the section in Chapter 3 entitled "Break-Even Analysis: Will Your Business Make Money?").

In a given period, you make profits when sales revenues exceed your total cost of sales and fixed expenses. To put it another way, sales revenue minus both cost of sales and fixed expenses equals profits or losses for a given time period.

Our job here is to examine closely all the above numbers and, once you are convinced they are right, to present them on a month-by-month basis for two years. Two years is enough time to see if any short-term problems or long-range trends begin developing. Of course, you can change the time frame if necessary. For instance, if you are starting a beer stand for the annual county fair or a vineyard with a five-year growing cycle, a different time frame will make sense for you.

CD-ROM

A copy of the Profit and Loss Forecast is included on the CD-ROM in *Excel* spreadsheet format. You can find it under the filename ProfitForecast.xls. Note that formulas have been embedded in the spreadsheet document so that it will automatically calculate relevant totals.

Determine Your Average Cost of Sales

Your first step in your profit and loss projection is to determine your average cost of sales—that is, your direct cost of the products or services you sell. You'll use the Sales Revenue Forecast you completed in Chapter 3 to make this estimate.

One way to derive your average cost of sales is to estimate your annual sales revenue for each product or service. Then calculate each product's annual cost of sales. Finally, add up the numbers to get an annual average.

More Detailed Method to Determine Average Cost of Sales

Another way to calculate your average cost of sales is to make a separate monthly sales revenue and cost of sales forecast for each of your major product or service lines. If you complete a separate monthly forecast for each of your product or service lines, you will have a very detailed forecast. However, many people balk at this level of detail in forecasting and wish to proceed with the less-detailed method demonstrated in this section. Either way is acceptable.

CAUTION

Whether you make one annual cost of sales forecast or a number of detailed forecasts, don't forget about the inevitable percentage of merchandise you will have to move at marked-down prices. Whether you're in the book business, bake cookies, or are a child psychologist, chances are you will commonly sell some of your product or services for less than standard prices. This may be because you need to move out last year's styles or because you need to sell broken cookies or because you provide counseling cheaper to low-income groups.

EXAMPLE:

Antoinette Gorzak plans to sell dresses for an average price of $250, and her research shows they will cost $125 each. Her cost of each sale for dresses before she allows for labor and other overhead will be 50% of the selling price. If she plans to give her customers anything with the purchase, say a specially printed shopping bag and an imprinted dress box, she should include the cost of these items as part of her cost of sales. Maybe this will make her cost of each sale 51% or 52% instead of 50%. Since Antoinette sells accessories in addition to dresses she needs to allow for different gross profit margins for the additional merchandise.

A cost-of-sales averaging chart for Antoinette's Dress Shop might look like this:

Annual Average Cost of Sales Chart: Antoinette's Dress Shop

Item	Forecast Sales Revenue	Cost per Sale*	Total Cost of Sales
Dresses	$ 200,000	50.4%	$ 100,800
Accessories & Sale Items	200,000	73.3%	146,600
TOTAL	$ 400,000		$ 247,400

Total Average Cost of Sales = 61.8% ($247,400 ÷ $400,000)

*These percentages come from Chapter 3, where she calculated gross profit. To get cost of sales percentage, simply subtract gross profit percentage from 100%. The remainder is cost of sales.

Here's how Antoinette completed this chart. First, she estimated how much sales revenue for each of the product categories the shop would receive in the first year; that enabled her to complete the first column of the chart.

Next, she obtained her cost of sales percentage by using the figure she developed in Chapter 3. She then multiplied the sales revenue for each product category by the cost of sales percentage for that category; that enabled her to complete the total cost of sales column of the chart.

The average total cost of sales figure (61.8% in Antoinette's example) is not an average of the cost per sale percentages. Instead, it is weighted according to the amount of expected sales revenue and is derived by dividing the total cost of sales by the expected sales revenue ($247,400 ÷ $400,000).

An average cost of sales of 60% is reasonable for many profitable retailers. Even though it is wise to be a little conservative, Antoinette uses 60% as her cost of sales when forecasting profits.

You can use the procedure in the example above to estimate your average cost of sales if you're in the retail, manufacturing, or wholesale businesses. Simply modify the item categories to fit your business. For example, a restaurant would have categories for food, non-alcoholic drinks, liquor, beer/wine, and possibly take-out orders. Another example, for a bar and restaurant, is shown below.

Annual Average Cost of Sales Chart: Bar and Restaurant

Item	Forecast Sales Revenue	Cost per Sale	Total Cost of Sales
Food	$ 300,000	38%	$ 114,000
Liquor	60,000	29%	17,400
Beer/Wine	40,000	75%	30,000
TOTAL	$ 400,000		$ 161,400

Total Average Cost of Sales = 40% ($161,400 ÷ $400,000)

By definition, service businesses sell services or labor and do not sell merchandise. Occasionally they may bill a client for a service they purchase outside the firm or bill for a service that has some incidental costs. The cost of sales portion of a service business's total costs will be low. For example, a consulting firm may incur outside typing, photocopying, and report binding expenses that will vary somewhat with every sale. Most expenses, such as salaries and rent, will be fixed costs and won't appear on this chart. Service businesses should follow the example below of the consulting business.

Annual Average Cost of Sales Chart: Consulting Firm

Item	Forecast Sales Revenue	Cost per Sale	Total Cost of Sales
Publications, phone, travel	$ 100,000	20%	$ 20,000
Contract services (typing, etc.)	50,000	75%	37,500
Studies, Consultations	527,000	0%	0
TOTAL	$ 677,000		$ 57,500

Total Average Cost of Sales = 8.5%
($57,500 ÷ $677,000)

CAUTION

Include piece-rate and commission costs. Note that some businesses pay workers on a piece-rate or commission basis. All your costs that vary with each sale should be in cost of sales instead of fixed expenses.

When you've completed your cost of sales calculations, you are ready to prepare your Profit and Loss Forecast.

Complete Your Profit and Loss Forecast

Follow the line-by-line instructions below to complete your form.

CD-ROM

Note for computer users: A formatted copy of the Profit and Loss Forecast is provided on the CD-ROM at the back of this book in Microsoft *Excel* format under the filename ProfitForecast.xls.

1. **Sales Revenue.** You have completed this estimate already. Simply enter the total sales revenue dollars for each month for two years from the Sales Revenue Forecast you completed in Chapter 3.

CAUTION

Here's another chance to revise the sales revenue numbers in case you think they need work. However, be sure you really believe that you can generate all the revenues you forecast. Make sure you don't do it backwards by writing down enough sales revenue to show the profits you want. Otherwise, you'll have to explain to your backers each month why things aren't as good as you said they would be.

2. **Cost of Sales.** Enter your monthly dollar cost of sales. To get these figures, multiply your monthly sales revenue forecast by the average cost of sales percentage. Returning to our dress shop example, Antoinette would multiply her monthly sales figure estimate by 60% (or 0.6). For example, if March sales are forecast at $30,000, the cost of sales for March would be $18,000 (0.6 × $30,000 = $18,000).

CD-ROM

If you are using the Profit & Loss Forecast form on the CD-ROM, you can enter the Cost of Sales percentage in Column B in the spreadsheet (where it is marked "(%here)" in red). Then enter the relevant Sales Revenue in Column C. The spreadsheet program will automatically calculate your Gross Profits. Note, if a series of #### symbols appear in a box in a spreadsheet that means that you need to widen the column in order to display the numbers.

CAUTION

If you made separate forecasts of sales revenue, cost of sales, and gross profit for each product line, then add together all the gross profit numbers and enter them on a summary form line 3. You will have prepared separate forms for each product line for the first three lines (sales revenue, cost of sales, and gross profit) and a summary sheet showing total gross profit, operating expenses, and profit.

3. **Gross Profit.** Subtract cost of sales (line 2) from sales revenue (line 1) to get gross profit. It's the amount of money that remains after you've paid your direct costs of the products sold. This money is available to pay the business's fixed expenses and your profits. If gross profit is larger than fixed expenses for that month, you will have a profit. But if gross profit is smaller than fixed expenses, you will have a loss that month.

   For example, looking at the dress shop example for March, Antoinette arrives at gross profit by subtracting the cost of sales of $18,000 from the forecast sales revenue of $30,000 and entering the result of $12,000. She'll do the same thing for each subsequent month.
4. **Fixed Expenses.** The categories listed on the form are the most common fixed expenses, but feel free to add or modify items to suit your business. All fixed expense items reduce your profit so that you pay less business income tax.

4a. Wages/Salaries. Most small businesses keep some employees on a fixed weekly or monthly work schedule regardless of how business fluctuates. Many

Profit and Loss Forecast: Year One

for Antoinette's Dress Shop

Month	1	2	3	4	5
	Mar	Apr	May	Jun	Jul
1. Sales Revenue	$30,000	$33,800	$45,000	$ 37,500	$33,800
2. *Less:* Cost of Sales (60 %)	(18,000)	(20,300)	(27,000)	(22,500)	(20,300)
3. Gross Profit (40 %)	12,000	13,500	18,000	15,000	13,500
4. Fixed Expenses:					
a. Wages/Salaries	3,168	3,168	3,168	3,168	3,168
b. Payroll Tax	432	432	432	432	432
c. Rent/Lease	3,850	3,850	3,850	3,850	3,850
d. Marketing & Advertising	1,000	1,000	1,000	1,000	1,000
e. Insurance	500	500	500	500	500
f. Accounting/Books	200	200	200	200	200
g. Interest Expense	0	0	0	0	0
h. Depreciation	0	0	0	0	0
i. Utilities	800	800	800	800	800
j. Telephone	600	600	600	600	600
k. Supplies	200	200	200	200	200
l. Bad Debts	100	100	100	100	100
m. Freight	200	200	200	200	200
n. Miscellaneous	1,000	1,000	1,000	1,000	1,000
5. *Less:* Total Fixed Expenses	(12,050)	(12,050)	(12,050)	(12,050)	(12,050)
6. Profit/(Loss)	$ (50)	$ 1,450	$ 5,950	$ 2,950	$ 1,450

Date Completed: 1/25/xx

6	7	8	9	10	11	12	Year Total
Aug	Sept	Oct	Nov	Dec	Jan	Feb	
$33,800	$ 41,200	$ 41,200	$45,000	$ 52,500	$26,200	$30,000	$450,000
(20,300)	(24,700)	(24,700)	(27,000)	(31,500)	(15,700)	(18,000)	(270,000)
13,500	16,500	16,500	18,000	21,000	10,500	12,000	180,000
3,168	3,168	3,168	3,168	3,168	3,168	3,168	38,016
432	432	432	432	432	432	432	5,184
3,850	3,850	3,850	3,850	3,850	3,850	3,850	46,200
1,000	1,000	1,000	1,000	1,000	1,000	1,000	12,000
500	500	500	500	500	500	500	6,000
200	200	200	200	200	200	200	2,400
0	0	0	0	0	0	0	0
0	0	0	0	0	0	0	0
800	800	800	800	800	800	800	9,600
600	600	600	600	600	600	600	7,200
200	200	200	200	200	200	200	2,400
100	100	100	100	100	100	100	1,200
200	200	200	200	200	200	200	2,400
1,000	1,000	1,000	1,000	1,000	1,000	1,000	12,000
(12,050)	(12,050)	(12,050)	(12,050)	(12,050)	(12,050)	(12,050)	(144,600)
$ 1,450	$ 4,450	$ 4,450	$ 5,950	$ 8,950	$ (155)	$ (50)	$ 35,400

businesses call in some temporary employees as needed. All such wages are a fixed expense. To fill out line 4a, you'll need to know how many people you'll hire, how many hours per month each will work, and how much you'll pay each person. If you plan to pay yourself a regular wage, regardless of how profitable the business is, include your salary as well.

Fill in the gross amount, before employee withholding deductions, you will pay every month for wages and salaries. (If you don't know, or aren't sure how this works, turn to Chapter 8 for a complete discussion.)

CAUTION

Certain wages aren't fixed expenses. Some small manufacturing businesses pay workers on a piece-rate basis or hire employees when orders are high and lay them off when business is slow. Others don't pay a salary at all, but compensate workers with a commission for each sale. In all of these situations, the portion of the wages that changes with each additional unit of production should be considered a variable cost of sale. Those costs belong in the cost-of-sales category and not the fixed-expense category.

4b. Payroll Tax. As an employer, you'll pay the federal government taxes of approximately 14% of your employees' wages and salaries. It is your contribution to your employees' Social Security program. Multiply each month's dollar figure for wages and salaries by 14% (0.14). For example, if employees receive $4,560 in wages and salaries in May, the payroll tax is $638 ($4,560 × 0.14 = $638). In other words, the employees in this example cost the employer $5,198 in May ($4,560 + $638 = $5,198) even though the employees' gross pay is only $4,560.

These tax rates change from time to time. You can call the IRS for current rates. Most states have additional taxes not included here that vary from state to state. (Workers' compensation insurance is covered in line 4e, below.)

4c. Rent/Lease. Rent is the next major item to consider, unless you plan to operate out of your home or some other space that will not result in additional out-of-pocket costs. If you're not renting commercial space, however, bear in mind that local zoning laws may affect you. You'll want to check out zoning ordinances before going ahead with your plans.

If you don't already have a spot in mind, check building availability and costs by talking to a commercial real estate broker and people who occupy space similar to the one you have in mind. You should know what kind of location you want by now—for instance whether you need high visibility or whether an obscure, low-cost location is just as good. You should also know how large a space you need, what plumbing, electrical, and lighting you want, and how much storage you need. Sometimes cheap rent doesn't turn out to be such a bargain if you have to build walls or install a bathroom and a loading area, or if a poor location means you get few customers.

TIP

Leasehold improvements note: Any time you build something like a wall or a bathroom, it is considered a capital outlay, not a fixed expense. (Capital expenses are covered in Chapter 7.) Do not show the expenditure as a current operating expense. Only the depreciation is a fixed expense. You can write off or depreciate leasehold improvements over the term of the lease in most cases. (If you don't know what depreciation is, look at line 4h, below. For more help, check with your CPA.)

Normally you will want to sign a lease for a business space rather than to accept a month-to-month tenancy. Business leases generally protect the tenant more than the landlord, although it may not seem so if you read all those fine print clauses. You'll be sure that you can stay at the location long enough to build your business around it, and you'll know what your rental costs will be. But what happens if your business fails or you discover the location is poor? You'll be responsible for paying the rent until the space is rented to someone else, which could take a long time in some areas. Assuming someone else will pay at least as much as you do, you'll have no further obligation once the new tenant begins paying rent.

Be sure you know exactly what your rent will include. Commercial leases often require the tenant to pay for a number of things that a landlord commonly pays for in residential rentals. For example, some shopping center leases require you to pay a pro rata share of property taxes, building maintenance, and fire insurance on the building, as well as a pro rata share of the parking and common area charges. A friend of mine who rented a small building for a retail nursery business put it this way: "That blankety-blank landlord sold me the building; he just kept the title." So, as part of making your financial projection, be sure you know exactly what charges, if any, the realtor or landlord expects you to pay in addition to the rent. By the way, no matter what you determine the rent to be, expect to put up the first and last month's rent and often a security deposit when you sign the lease. Don't include those deposits here. (See Chapter 7 for treatment of preopening expenses.)

Many leases that last longer than a year contain a method to protect the landlord from inflation. Some are tied to a cost-of-living index, which means your rent goes up each year at the same amount as the inflation rate. Others contain a percentage of sales clause, where you pay a set rent or a percentage of your gross sales, whichever is higher.

EXAMPLE:

Bob Smith signed a shopping center lease for his optometry office. His lease called for a base rent of $2,400 or 6% of monthly sales, whichever was more, plus a set charge of $400 for taxes, maintenance, and insurance. If sales exceeded $40,000 per month ($2,400 ÷ 0.06), he would be obligated to pay the landlord more rent. Bob was pleased to sign the lease because his sales projections ($32,000 per month) indicated he would be making a healthy profit if his sales volume reached $40,000 a month, so he would not mind paying a higher rent. Of course, this sort of lease is not a good idea if the amount of sales needed to trigger a substantially higher rent is too low. In Bob's situation, for example, if he was required to pay more rent if monthly sales reached $28,000, he probably would have looked elsewhere.

When you have figured out your total monthly rent from a lease quotation from your expected landlord or from a survey of market rents, fill in that amount.

4d. Marketing and Advertising. Here's a story about advertising. Back in the early 1930s, John Axelrod opened a hot dog stand on the main road into Pine Valley. Business was fair. When he put up a small sign, business got a little better. Then he added several more signs and things got a lot better. Finally, he put up a dozen big signs. Business became so good, he had to expand his seating area and hire more cooks. He was feeling pretty happy about life when his son, whom he thought was a positive wizard, came home from college. The son, an economics major, was appalled at all the new signs and seating.

"Dad, what are you doing spending so much on advertising? Don't you know there's a depression going on and everybody's going broke? If you don't pull in your horns a bit, you will never make it."

"No kidding," John replied, and took down the signs and stopped the construction program. Soon business dwindled away to nothing and John went broke.

The lesson of this story is simple: When the signs went up, business improved. When they came down, there wasn't enough income to buy ketchup. One way or another, successful businesses get the word out. (Incidentally, the son went on to get his degree and opened his own business consulting firm.)

There are small libraries full of books about how to market a business or product. I recommend especially *Marketing Without Advertising*, by Michael Phillips and Salli Rasberry (Nolo). Such books used to focus almost exclusively on paid advertising. More recently, broader concepts of marketing have come into prominence. Network marketing, or selling to friends and acquaintances, has become an identified alternative to more traditional selling strategies. Guerrilla marketing involves getting the word out to the people and groups who are most apt to need your goods or services, rather than advertising your product or service to the community as a whole. "Guerrilla" refers to the use of unconventional methods to spread product or service information. For example, guerrilla marketers may pay students or part-time workers to hang out in bars or coffee houses and talk about their product in a favorable way.

If you get creative, there are all sorts of ways you can reach the people most likely to want your product or service, for little or no cost. For example, if you invent a better software program (or develop a consulting business in your special field), you could advertise on the radio—or you could target your market by finding a computer bulletin board of people who need your product. Your next step might be to get someone to write about your business for a computer magazine or newsletter. Similar opportunities exist in every business. If you open an oboe repair shop, for example, one of the first jobs is to figure out inexpensive ways to let every oboist within a hundred-mile radius know of your existence. One way might be to contact every wind instrument instructor, school band leader, and music store in the area and supply them with free literature on oboe cleaning.

Many successful businesses allow a set percentage of gross sales for promotion, often 3% to 5% of sales revenue as a budget figure. They allocate half that amount for a continuing, low-level effort to let people know about their product or service and schedule the other half to advertise sales and special events.

Think about what you will need to do to tell people about your business. Will your business need cards? Flyers? Newspaper ads? A good-sized ad in the yellow pages? Sample merchandise sent to media outlets so they can review your product? Window displays? Mailings? A part-time marketing expert to help you pull this together? Avoid expensive promotions that you haven't tried before. For example, if you get an idea that involves mailing out 100,000 flyers, plan for a test by mailing only 5,000. If it works, go for the rest. If not, use the money you saved for something else.

A great deal of money spent on conventional advertising is wasted. New businesses especially are prone to spend too much in the wrong places. So use your common sense. Talk with friends in business. Check with trade associations to see what they suggest as a good budget number for telling potential customers about your business. Once you've set a budget for special promotions and continuing low-level advertising, write both amounts in the Profit and Loss Forecast.

RELATED TOPIC

For more help, look ahead to Chapter 8. In that chapter, you'll write a detailed marketing plan for your business that includes both preopening promotions and continuing marketing costs.

4e. Insurance. You must have at least some insurance in this litigation-happy society. Your lease may require you to keep fire, flood, or earthquake insurance on the building. If the public comes into your business, public liability and property damage insurance is a necessity. This will protect you from the person who slips and falls on your floor mat. If you employ anyone, you also need workers' compensation insurance, since you are absolutely liable if one of your employees injures herself while at work. You will probably also want to carry insurance on your valuable inventory and fixtures. And if you manufacture any product that could possibly harm anyone, such as food or machinery, you will want to consider product liability insurance.

Talk to an independent insurance broker who specializes in business insurance to get an idea of what coverage you'll need and how much it will cost. Then shop around warily. Lots of over-enthusiastic insurance people will try to sell you far more insurance than you need. Although you need some insurance to protect against obvious risks, you don't need to starve to death trying to raise enough to pay your premiums.

CAUTION

Some people try to avoid the responsibility of paying workers' compensation insurance or payroll taxes by calling their employees "independent contractors." This can cause serious problems with back taxes if the IRS rules against you. Also, if the independent contractor is injured while working for you, the workers' compensation appeals board will almost always rule in favor of the employee and against independent contractor status, unless your worker genuinely has her own business. This means you may end up paying huge sums if one of your workers becomes disabled while you don't have insurance. In other words, trying to save a few pennies on this insurance is just not worth the risk.

Once you arrive at a good estimate for your total insurance bill, inquire about deferred payment programs. Most companies that offer them often require that you pay 20% of the total premium up front each year and the balance in ten payments. For purposes of your Profit and Loss Forecast, divide the total annual insurance payment by 12 and enter those figures.

4f. Accounting/Books. You can do your own books if you like working with numbers. Chances are, however, you'll be so busy with the business, you won't have time.

One good approach is to budget for a CPA to set up your books initially and to hire a part-time bookkeeper to do day to day upkeep. If you are starting small, your initial cost should be under $500 and your monthly cost under $200 to keep the records up to date and to prepare routine employee withholding tax returns, statements, etc., assuming you close the register each day. Once a year you will pay the CPA another few hundred dollars to review this work and help you prepare your yearly returns. If your business is going to be fairly good-sized from the start, your figures will be larger.

If you're interested in keeping your own books, you'll probably want to look into reliable accounting software such as Intuit's *QuickBooks* (www.intuit.com), or *M.Y.O.B. Plus* (www.myob.com). The program you need depends on how big your business might grow to be, what extra features like statements or payroll you want the computer to provide, and so forth. You can research the different programs yourself, but remember to keep in mind the features you may need later on after your business has grown. Or you can look into an outside service, which may recommend a program to fit your business and computer, set up the books, and run parallel for a month or two to make sure that you don't lose any data. The systems can be very handy and timesaving if you have no strong attachment to a paper record, or are willing to print out the documents you may want.

When designing a bookkeeping system for your business, remember that it costs a lot of time and money to change it—make sure it really fits you and your business. (See Chapter 12 for a further discussion of computers in business.)

Make as good an estimate as you can and enter this figure on your Profit and Loss Forecast. You can take the year total and divide it by 12, or you can enter the amounts when you think they will be paid.

4g. Interest. This line of your Profit and Loss Forecast concerns the interest portion of the payments you make on any money you borrow. Unless you have an interest-only loan with a balloon payment at the end, your interest payment will vary from month to month even though you pay the same monthly amount.

EXAMPLE:

Joanie Ricardo borrows $50,000 from the bank to open a Gelato's Ice Cream store in Providence, Rhode Island. She agrees to repay it in 36 equal monthly installments of $1,660.80, including 12% interest on the unpaid balance. While Joanie's monthly payments remain equal, the portion of the payment that is credited to principal increases every month, while the portion of her payment going toward interest decreases.

But, let's say that you don't know how much money you'll borrow at this time. After all, one of the main reasons for doing a business plan is to decide how much money you'll need to finance your business. In that case you have three choices:

- You can complete the Profit and Loss Forecast in this chapter, and the Cash Flow Forecast in the next chapter, making your best guess about how much you'll borrow and what your payments will be.
- You can complete the forecasts without showing any loans or payments. Then use the results to decide how much money you'll borrow and revise the forecasts to include loan payments.
- You can complete both forecasts without showing any loans at all. Then you can include a discussion about how much money you'll need to borrow and the cash flow available to make repayments. (See your Plan Summary discussion in Chapter 9.)

There are loan progress charts and computer programs that show approximately how much of any payment is interest and how much is principal.

CD-ROM

Nolo, the publisher of this book, provides a calculator that will create a chart similar to the one shown below. You can access it at www.nolo.com/legal-calculators. Enter the information in the form and the program will calculate interest payments over the loan period.

Loan Interest Calculation Chart

A	B	C	D	E	F
Month	Balance (from column F above)	Monthly payment	Interest paid (B × __% ÷ 12)	Principal Paid (C – D)	New balance (B – E)
				Starting amount:	$ 50,000.00
June 20xx	$ 50,000.00	$ 1,660.80	$ 500.00	$ 1,160.80	$ 48,839.20
July 20xx	48,839.20	1,660.80	488.39	1,172.41	47,666.79
Aug 20xx	47,666.79	1,660.80	476.67	1,184.13	46,482.66

CAUTION

You can't write in the entire loan payment amount on your Profit and Loss Forecast, because the IRS does not consider principal repayments fixed expenses that can reduce your taxable income.

TIP

Note of sanity: You don't need to be perfect in forecasting your interest costs. Just make your best informed guess. You can also check with your banker, CPA, realtor, or bookstore for loan repayment tables. Make sure the sum of your interest payments here and the principal payments from Chapter 7 equal the total loan payment.

4h. Depreciation. Depreciation is a gift to the businessperson from Uncle Sam. Ask not what your country can do for you—this is it. Depreciation is an amount you can subtract from your profits when you pay taxes. It compensates you for the fact that your business equipment and buildings are wearing out. The government allows you to assume that your fixed assets wear out over some period of years, meaning that for tax purposes, your assets are worth less at the end of that period. Your depreciation allowance simply lets you show a percentage of this wear as an expense on your tax return each year. In a sense, it is a sinking fund for equipment replacement, or would be if you put the depreciation amount in the bank. In actuality, the stuff usually lasts longer than your depreciation shows, which is why depreciation can be seen as a friendly federal gesture.

Often, equipment is depreciated over three to five years and buildings over 15 to 30 years for tax purposes. It's not your choice, however; the IRS publishes very explicit rules and lists of what can be depreciated and how fast. These lists and rules change frequently, so you'll probably need to check with your tax advisor about depreciation and fixed assets.

You can depreciate all fixed assets that last longer than one year. Remember, you don't show the purchase price as an expense on the Profit and Loss Statement if you depreciate an item.

If the asset will last less than one year, you simply show the entire purchase price in the expense column for the year you bought the equipment and do not depreciate it. Inventory of goods available for resale and consumable supplies are examples of purchases that are expensed immediately because they last less than one year.

EXAMPLE:

Chuck Leong expects to spend $20,000 for fixed assets to open his business. Items include a new toilet, several new walls, a cash register, a small computer, and store fixtures. Assuming Chuck's accountant agrees that five years is the proper time frame to use for depreciation, he can take $333 as an expense for depreciation each month ($20,000 ÷ 60 months).

4i.–4n. Other Expenses. Inevitably, you will encounter a number of other expenses, depending on your business. Spend some time thinking about these using the accompanying list as a starting point. Then list all the other costs you expect to incur on Lines 4i to 4n. If you expect any of these to be recurring expenses, include your monthly estimate for each. For expenses that occur once or twice a year, divide the annual total by 12 and enter an amount each month.

Total Fixed Expenses. Add up lines 4a through 4n and fill in the total for each month.

Profit/(Loss). From the Gross Profit (line 3), subtract the Total Fixed Expenses (line 5) and fill in the result. Make sure that you place brackets around each negative number—that will identify it as a loss.

Year Total. Finally, add up each of the rows (lines 1 through 6). Enter the yearly totals under the Year Total column. Check your arithmetic by seeing if the monthly profit figures add up to the same figure you get for your yearly total. If they don't match, double-check your addition to find the error. If they match, congratulations!

Common Expenses

Here are some of the more common expenses that businesses incur on a regular basis:

- Attorneys, consultants, tax advisors
- Auto and truck expenses
- Bad debts
- Commissions (probably should be placed in cost of sales or as a deduction from sales revenue if commissions are paid regularly; if paid only occasionally, include them in fixed expenses)
- Dues and publications
- Employee benefit programs
- Equipment rental
- Freight in on merchandise acquired (also sometimes placed in cost of sales; freight out to customers is usually paid for by the customer)
- Janitorial
- Laundry
- Licenses and taxes including permit fees (not income taxes, which are calculated after profits are known)
- Office supplies
- Payments to investors
- Postage, fax, telephone
- Repairs and maintenance
- Security and alarm systems
- Travel and entertainment
- Utilities.

Review Your Profit and Loss Forecast

You've now completed your first run through a Profit and Loss Forecast. Date it so you won't get confused if you do another draft. I hope it looks positive. However, if like many people you find you need to increase profitability to make the business a good economic idea, go back through all your assumptions. How can you realistically reduce costs or increase volume? Incorporate into your forecast only those changes you're sure are sound. Now look at the profit figures again. Do they show enough profit to make a good living, pay back your money source, and leave some margin for error? If they do, and you're sure the figures are right, you will want to go ahead with your business idea. If the adjusted figures still do not show enough profit, it may be wise to look for another business idea or change your basic business assumptions.

Notice that Antoinette's business looks more profitable in her Profit and Loss Forecast than it did in her preliminary analyses in Chapter 3. That's because she increased her first year's sales estimate from $400,000 to $450,000 and reduced her fixed costs from $16,050 to $12,050 per month. The net effect of these changes was a slight increase in profit. She knows these numbers will be hard to achieve, but she is confident that she can make her goals.

How much profitability is enough to justify going ahead with your business? That's both a good question and a touchy one. Or, put another way, there are almost as many answers as there are business-people. My personal response is, I look for a yearly profit (including my wages and return on investment) equal to the amount of cash needed to start the business. If I need $40,000 to start a business, a conservative profit forecast would show a yearly profit of at least $40,000.

One way to approach the issue of profitability is to look at your profit forecast from an investor's viewpoint. A $35,400 profit for the dress shop won't seem like much to them. They will be concerned that the dress shop owner will have a difficult time earning a living and making it through the inevitable slow times. An investor or lender will probably want her to be able to convincingly demonstrate she has a plan to increase sales enough to raise the profit forecast to a more respectable level—say, the $46,200 she shows in the second year.

Your Profit and Loss Forecast and Income Tax Return

Figuring out your business's income tax return involves more calculations than we have shown so far. One major difference involves cost of sales, which we have viewed as a simple percentage of sales for forecasting purposes. You'll need to follow more complicated rules when computing your business income tax return. Read below to learn how to spot employee theft. You can skip this discussion if your business has no inventory.

Here's how to do it the right way. First, take a physical count of all your merchandise for resale every year or every few months. Even if you have a computerized inventory system that can tell you how much inventory you have at any time, it's a good idea to take a physical inventory every six or 12 months to reconcile the real inventory with the computer inventory. Once you have a complete listing of the description and count of all the goods in your store at a particular date, then you apply the best figures you have for what the merchandise cost you when you bought. Multiplying the unit cost of each item on your shelves by the number of items you have and adding purchases during the period gives you the cost of the goods available for sale. While there are a number of different theories on which cost figure to use (the latest or the earliest), the critical thing is to make sure you do it the same way every time. Then, you can make accurate comparisons from year to year. Of course, if you have a service business or business with no inventory, the inventory valuation discussion is moot.

After you have developed a total dollar value of the goods you have on hand, you can calculate your real cost of sales this way:

1. Add together the goods you purchased during the period and the inventory amount at the beginning of the period. (This total represents the dollar value of the goods you had available to sell during the period.)
2. From that amount, subtract the dollar value of the inventory at the end of the period.
3. The difference is the cost of sales for the period.

Here's an example that demonstrates how you do this:

Cost of Sales

Beginning Inventory from physical count		$ 10,000
Add: Purchases during period	+	30,000
Subtotal: Goods available for sale		40,000
Less: Ending Inventory from physical count	–	15,000
Cost of Goods Sold during period		$ 25,000

This calculation has more use than merely filling out IRS forms: It can let you know when someone is stealing from you. Suppose you have a good estimate of what the cost of sales percentage should be, either from past statements or from a good understanding of your business. Suppose further that you expect a cost of sales of 61.5% and that you actually had a cost of sales of 77.3%. What does that mean? It could mean that some of the merchandise you buy for resale is leaving the store without any money entering your register. At any rate, it means that you need to do some serious research to find out what is really happening.

CHAPTER

7

Your Cash Flow Forecast and Capital Spending Plan

QUICK PLAN

If you've chosen the quick plan method to prepare a business plan (see Introduction), you need to read and complete these sections of Chapter 7:

- "Prepare Your Capital Spending Plan"
- "Prepare Your Cash Flow Forecast"
- "Required Investment for Your Business."

Introduction

In Chapter 6, you drafted your estimated Profit and Loss Forecast. While it tells you a lot about the big financial picture, it leaves you ignorant of many details. If you overlook one critical detail, you may go broke, even though your business seems profitable viewed from afar.

The crucial detail a business owner must manage is called "cash flow." Cash flow is another term for the money coming into and going out of your business. Positive cash flow occurs when the money coming into your business exceeds the money flowing out, and negative cash flow is the opposite. In the day-to-day world of starting and operating your business, you will be at least as concerned about short-term cash flow as you will be about long-term profitability. After all, you don't want your creditors to sue you because you can't pay your bills even though your sales are increasing rapidly. One new business owner I know even wears a T-shirt that says: "Happiness is positive cash flow."

Your Cash Flow Forecast is different from your Profit and Loss Forecast because money comes into and flows out of your business at different times than your Profit and Loss Forecast shows. A formal Cash Flow Forecast is required by most potential backers, who want to know that you understand and can manage that time difference.

EXAMPLE:

Rita Singh plans to open a small tie-dye manufacturing business. Since several of her likely customers are chain stores, Rita knows that she will have to sell and ship their orders before the stores pay her. The stores often can take several months to pay their bills. Wisely, Rita carefully prepares a Cash Flow Forecast to make sure she can afford to sell on credit.

In your Cash Flow Forecast, you'll refine any guesses you've made about how much money you need to start or expand your business. You'll develop an amount of money you are comfortable with—an amount you can explain to prospective investors. In other words, you need to be as accurate as you can be in this forecast.

The money you need to start or expand your business can be separated into two categories:

- **Capital investment.** This is the cash you need to spend before you begin or expand your business.

- **Initial working capital.** This consists of the cash reserves you need to keep your business afloat before you begin to show profits every month.

Commonly, cash flow from monthly sales is not enough to cover monthly expenses for the first few months after a new business opens. If your Cash Flow Forecast shows a negative picture for this period, you need to have extra money set aside for initial working capital. Your initial working capital keeps the doors open until cash flow from monthly business becomes positive. If your Cash Flow Forecast shows you'll run a cash deficit for several months, don't be too concerned. Just be sure you have enough initial working capital to cover it. But if your Cash Flow Forecast shows a continuing cash deficit, or a deficit that rises over time, your business may have some fatal flaw and you should reexamine the whole idea before making any commitments.

Growth, too, can create problems. Many businesses that grow quickly suffer severe cash flow shortages because money from sales does not come in fast enough to cover the investment needed to expand. If you find yourself in this situation, you will need to reduce your growth rate or find extra sources of money. (See the cash flow discussion below.)

So, let's put a close-up lens on our camera and focus on cash forecasting. Here again, it's necessary to get out your calculator or computer and play with some numbers.

Prepare Your Capital Spending Plan

Your capital spending plan includes all the things you have to buy before your business begins bringing in sales revenue, including opening inventory, fixtures and equipment, business licenses, deposits for the building lease, and whatever else you need.

Open a computer file or take out a clean sheet of paper and write "CAPITAL SPENDING PLAN" at the top. Now, make a list of all the things you'll have to buy before you open. This will enable you to make a good estimate of the cash you need to open your doors.

The list shown below sets out many common items businesses need to purchase before they are ready to open. Some of the items you'll buy will be considered capital items, which depreciate over their useful lives. All preopening expenses represent your capital investment in the business, regardless of whether they are treated as capital items or expense items. If you have doubts about whether an item can be depreciated, ask your accountant.

Now assign specific dollar amounts to each item on this list. If you're unsure about the cost of an item, ask the person from whom you'll buy the item for an estimate or a quote. Try for plus or minus 10%. Remember that you're trying for an accurate estimate here, so use the numbers you think are right. Most experienced

Common Items in a Capital Spending Plan

Here's a list of common items businesses need to buy before opening. Note that they fall into two categories—capital items and expense items.

Capital items generally have a useful life of more than one year and can be depreciated for tax purposes. They include:

- permanent signs, heaters, air conditioners, cooking and refrigeration equipment
- equipment, including machinery, large tools, and other expensive items
- racks and display fixtures for retail selling areas
- office furniture
- leasehold improvements or any alterations you make to the building, including walls, bathrooms, and carpeting
- computers, typewriters, fax machines, adding machines, cash registers, phone systems, and other small equipment you purchase.

Expense items generally are shown as either fixed expenses or costs of sale at the time they are purchased because they last less than one year. They include:

- opening inventory (sometimes you can get a deferred payment schedule from suppliers, but you will usually have to pay for many, if not most, goods before you sell them)
- lease deposits
- tax deposits
- business licenses and permits
- opening marketing and promotion
- insurance
- telephone installation
- utility deposits
- office supplies and stationery
- legal fees, costs to incorporate, and CPA fees to establish your business
- contingency reserve.

businesspeople will add another 10% to 20% of the total as a contingency to allow for poor guesses and other foul-ups. If you think you need such a contingency and haven't included it already, add it in now. Add up all the items you've listed to get an estimate of the cash you need to open your business.

Your capital spending plan should reflect the exact amounts you will spend as accurately as possible. For example, it was okay for Antoinette to use estimates of costs when she thought about her business in general terms, but now she needs to be precise. She should have shopped around for the best deals by now and know them. If a potential lender asks her why she's spending $3,000 each for dress racks, she can say, "The used ones from the auctioneer are terminally rusty and the discount ones are shoddy. I want my image to be high quality, and this is the best deal on good racks." As the accompanying example shows, Antoinette knows the business she is about to open.

Although she doesn't include an itemized list of fixtures, office equipment, and leasehold improvements in her summary, she has detailed lists available.

Capital Spending Plan: Antoinette's Dress Shop

Item	Amount
Fixtures in selling area include cash registers, sewing machines, dress racks (see list)	$ 30,000
Leasehold improvements, bid from Jones Construction includes signs, lights, decorations	80,000
Rent deposit, two months' rent	7,500
Opening inventory	30,000
Contingency	15,000
Total capital required to open	**$ 162,500**

For a second example, here's a one-man consulting firm's opening cash needs. As you can see, he plans to start with extra cash; he has allocated $10,000 for working capital.

Capital Spending Plan: Jeffer's Associates Consulting

Item	Amount
Desk, conference tables, chairs	$ 6,000
Fax machine	1,000
Computer system: PC, laser printer, software	4,000
Copy machine	2,000
Typewriter	700
Telephone system	1,000
Misc. decorative accessories	500
Misc. deposits for utilities, business license	2,000
Opening marketing and advertising	2,000
Supplies, stationery	1,000
Working capital estimate	10,000
Total capital required to open	**$ 30,200**

Prepare Your Cash Flow Forecast

Once you complete your capital spending plan, you'll know how much money you need to open your doors. The next step is to estimate how much additional money you'll need to survive the first lean months.

The basic process we'll use to make a Cash Flow Forecast is to start with the monthly profit (or loss) figures you developed in your Profit and Loss Forecast in Chapter 6. You'll then make adjustments each month to the monthly profits to account for the time differences in collecting and spending money.

Cash Flow Forecast: Year One

for Antoinette's Dress Shop

Cash In/(Out)

Month	1	2	3	4	5
	Mar	Apr	May	Jun	Jul
1. Profit/(Loss) [P & L line 6]	$ (50)	$ 1,450	$ 5,950	$ 2,950	$ 1,450
2. *Less:* Credit Sales—25% on credit × Sales Revenue [P & L line 1]	(7,500)	(8,450)	(11,250)	(9,375)	(8,450)
3. *Plus:* Collections of Credit Sales 2 months after sale	0	0	7,500	8,450	11,250
4. *Plus:* Credit Purchases—50% of purchases on credit × Cost of Sales [P & L line 2]	9,000	10,150	13,500	11,250	10,150
5. *Less:* Payments for Credit Purchases 2 months after purchase	(0)	(0)	(9,000)	(10,150)	(13,500)
6. *Plus:* Withholding ____% of total wages (if paying taxes quarterly)	0	0	0	0	0
7. *Less:* Quarterly withholding payments (if paying taxes quarterly)	(0)	(0)	(0)	(0)	(0)
8. *Plus:* Depreciation	0	0	0	0	0
9. *Less:* Principal Payments	(0)	(0)	(0)	(0)	(0)
10. *Less:* Extra Purchases	(0)	(0)	(0)	(0)	(0)
11. Other Cash Items in/(out)	0	0	0	0	0
12. Monthly Net Cash	1,450	3,150	6,700	3,125	900
13. Cumulative Net Cash	$ 1,450	$ 4,600	$ 11,300	$ 14,425	$ 15,325

Date Completed: 1/25/xx

6	7	8	9	10	11	12	Year Total
Aug	Sept	Oct	Nov	Dec	Jan	Feb	
$ 1,450	$ 4,450	$ 4,450	$ 5,950	$ 8,950	$ (1,550)	$ (50)	$ 35,400
(8,450)	(10,300)	(10,300)	(11,250)	(13,125)	(6,550)	(7,500)	(112,500)
9,375	8,450	8,450	10,300	10,300	11,250	13,125	98,450
10,150	12,350	12,350	13,500	15,750	7,850	9,000	135,000
(11,250)	(10,150)	(10,150)	(12,350)	(12,350)	(13,500)	(15,750)	(118,150)
0	0	0	0	0	0	0	0
(0)	(0)	(0)	(0)	(0)	(0)	(0)	(0)
0	0	0	0	0	0	0	0
(0)	(0)	(0)	(0)	(0)	(0)	(0)	(0)
(0)	(0)	(0)	(0)	(0)	(0)	(0)	(0)
0	0	0	0	0	0	0	0
1,275	4,800	4,800	6,150	9,525	(2,500)	(1,175)	$ 38,200
$ 16,600	$ 21,400	$ 26,200	$ 32,350	$ 41,875	$ 39,375	$ 38,200	

Open the blank Cash Flow Forecast forms included on the CD-ROM and follow the step-by-step instructions below. You'll be completing a forecast for the first two years of your business. Complete every line for each of the 24 months before going on to the next line.

CD-ROM

A formatted copy of the Cash Flow Forecast is provided on the CD-ROM at the back of this book in Microsoft *Excel* format under the filename CashFlow.xls. The spreadsheet program will automatically calculate your Monthly Net Cash, Cumulative Net Cash, and Yearly Totals. Note, if a series of #### symbols appear in a box in a spreadsheet that means that you need to widen the column in order to display the numbers. If you use a spreadsheet program that cannot convert the *Excel* format, you set up the form in your program using the same categories as the completed Cash Flow Forecast in this chapter. (Make sure that the column and row headings are the same.)

1. **Profit/(Loss).** To begin, take out the Profit and Loss Forecast you completed in Chapter 6 and copy the monthly profit/(loss) from line 6 onto the first line of the Cash Flow Forecast form. The profits or losses you show have already taken into account the normal expenses of running a business like rent, wages and salaries, and so forth. You won't have to worry about those costs in this forecast.

CAUTION

If any of your figures are losses, place brackets around them. Otherwise, your entire Cash Flow Forecast will be seriously inaccurate.

2. **Credit Sales.** Skip ahead to line 4 if you don't plan to sell merchandise or services on credit. If you sell merchandise or services on credit, the customer receives the goods or services right away. Even though you incur costs, you don't get paid right away. Credit sales create bills people owe you; they are called your "accounts receivable" because you will receive the money soon. (When you buy goods on credit, you create bills you owe others. These are called your "accounts payable" because you will pay them soon.)

   Most businesses that sell to other businesses should plan for some sales on credit. Most businesses that sell only or primarily to retail consumers can plan to sell mostly for cash, including checks and credit cards.

TIP

Credit card note: For purposes of this discussion, sales on credit cards are the same as cash sales, except for the processing fees the bank charges you. If you use an electronic terminal, the money is credited to your bank account right away, and if you use a paper imprinter, the money is deposited to your account in a few days.

It takes more money to start and run your business if you offer credit to your customers than it would if you received cash for every sale. Here's how to figure out how much cash you'll need. First, estimate what portion of your total sales will be for credit. For example, if you think that about one-third of your sales will be for credit, that means that about 33% of your monthly sales dollars will not be collected in the month in which the sale is made. Make a note of that percentage now on the Cash Flow Forecast form in the heading for line 2.

Look at the Profit and Loss Forecast you completed in Chapter 6. Multiply each month's Sales Revenue dollars (line 1 of the Profit and Loss Forecast) by the credit percentage that you forecast for your business. Then enter each of those monthly figures on line 2 of your Cash Flow Forecast.

EXAMPLE:

Mickey and Michele run a photocopy and fax service. They estimate that about 40% of their total sales revenue will be on credit and the remaining 60% will be for cash. On line 2 of the Cash Flow Forecast, they'll enter these credit sales: $4,400 for January; $4,400 for February; and so forth throughout the forecast.

M & M Copy Shop Cash Flow Forecast
Credit Sales Calculation, Six Months ($000s)

	Jan	Feb	Mar	Apr	May	Jun
Forecast sales revenue	$ 11.0	$ 10.9	$ 12.6	$ 13.1	$ 15.6	$ 16.8
% sales on credit	40%	40%	40%	40%	40%	40%
Forecast credit sales	$ 4.4	$ 4.4	$ 5.0	$ 5.2	$ 6.2	$ 6.7

3. **Collections of Credit Sales.** Skip this item if you don't plan to sell merchandise or services on credit. Your cash receipts are reduced when a sale is made for credit instead of cash. On the other hand, your cash receipts increase when you collect the money from a credit sale you made earlier. This Cash Flow Forecast shows you exactly how much your receipts will be reduced and increased as a result of your credit policies. Even though your customers don't pay you right away, they eventually pay you. Your job is to figure out when they'll do so. If you grant your customer your normal 30-day terms, it usually takes 60 days to get paid. Here's why. You make a sale on day one, then write a statement at the end of the month and mail it to the customer. He pays it 30 days after he gets the statement. Of course, some people pay sooner and some people pay later. In a well-run business with good paying customers that grants 30 days to pay bills, the average turnaround will be 45 to 60 days.

Make an estimate of the number of months you anticipate as an average lag time between a sale and the collection of the bill. Most businesses use two months. It's easier to use whole months for this purpose than to use portions of months. If you think 45 days is the likely answer, use two months—don't use one and one-half months. Enter the number of months in the heading for line 3.

EXAMPLE:

If Mickey and Michele collect bills in an average of two months, the credit sales that were just subtracted from monthly sales will be added back two months later. In this example, the business starts up in January and there are no outstanding accounts from the previous year. As you can see, the delay in collections means that the M & M Copy Shop will have an $8,800 cash flow reduction in January and February. This means they need at least $9,000 in working capital to sustain them during the first two months.

M & M Copy Shop Cash Flow Forecast
Credit Sales and Collections, Six Months ($000s)

	Jan	Feb	Mar	Apr	May	Jun
Credit Sales	$ 4.4	$ 4.4	$ 5.0	$ 5.2	$ 6.2	$ 6.7
Collections of credit sales	0	0	4.4	4.4	5.0	5.2

Now that you see how it works, complete your monthly Cash Flow Forecast for two years, writing in the cash collections in the month you collect the money on line 3.

4. **Credit Purchases.** Make an estimate of how the timing of your purchases will affect your cash flow. Most businesses buy merchandise from their suppliers on credit and delay paying them for a time. Most suppliers will grant you 30 days to pay your bills on a fairly routine basis, if they approve your credit application. That way, you get to use their money for a while, just like your customers use your money if you sell on credit.

Here's how to complete this section of the Cash Flow Forecast. First, make an estimate of the percentage of your total goods and services you expect to buy on credit. (See the section entitled "Break-Even Analysis: Will Your Business Make Money?" in Chapter 3, on how to make educated guesses, or SWAGs.) Write the percentage figure in the heading for line 4.

Next you'll calculate the dollar costs of purchases your business will buy on credit each month. To derive that figure, multiply each month's cost of sales by the estimated percentage of credit purchases. And write the answer on line 4. Note that they increase cash flow.

EXAMPLE:

Mickey and Michele estimated that they'd buy approximately 60% of their purchases on credit. Their January cost of sales is $3,600, so the credit purchases come to $2,160 ($3,600 × 0.6 = $2,160). They round this figure to $2,200. Here's how it looks for a few months at the M & M Copy Shop. On line 4 of their Cash Flow Forecast, they'll enter their credit purchases: $2,200 for January; $2,200 for February; $2,500 for March; and so forth.

M & M Copy Shop Cash Flow Forecast
Credit Purchases, Six Months ($000s)

	Jan	Feb	Mar	Apr	May	Jun
Forecast cost of sales	$ 3.6	$ 3.6	$ 4.2	$ 4.3	$ 5.1	$ 5.5
% brought on credit	60%	60%	60%	60%	60%	60%
Credit purchases	$ 2.2	$ 2.2	$ 2.5	$ 2.6	$ 3.1	$ 3.3

5. Payments for Credit Purchases. Here you show when you pay for the purchases you've made on credit. These payments are subtracted from profits on the Cash Flow Forecast. Make an estimate of how long you will take between the time you sell merchandise and the time it is reordered and paid for. Write your estimate of how many months will elapse between selling your merchandise and paying for the replacement in the heading for line 5.

If you're in doubt, figure it this way: It usually takes about 60 days to make an inventory of what you've sold, reorder the merchandise, receive and restock the merchandise, and pay the invoice or statement. If that's true for you, then the merchandise you sell in January will be reordered and paid for by March. Here's a word of caution, though: Many suppliers have tightened their terms considerably. It is not unusual for suppliers to expect payment within ten days of the date you receive the merchandise.

CAUTION

Know suppliers' credit policies. If you're not sure of your suppliers' policies, it's a good idea to check them out before you complete this forecast. A mistake here can result in a dramatically incorrect cash forecast.

EXAMPLE:

Here's how it works for the M & M Copy Shop, which expects a two-month delay between ordering and paying for merchandise:

M & M Copy Shop Cash Flow Forecast
Credit Sales and Collections, Six Months ($000s)

	Jan	Feb	Mar	Apr	May	Jun
Line 4: Credit purchases	$ 2.2	$ 2.2	$ 2.5	$ 5.2	$ 3.1	$ 3.3
Line 5: Paying for credit purchases	0	0	2.2	2.2	2.5	2.6

Now, enter the dollar amount of credit purchases you entered on line 4, but in a later month, in a similar fashion to the M & M Copy Shop.

6. **Withholding Taxes.** Most businesses must pay their employees' taxes every month. That means that every month you send the IRS the amount of wages you've withheld from your employees' paychecks plus the amount you're required to contribute to their Social Security. If you make these tax payments every month, they don't affect your cash flow, so they won't show up on your Cash Flow Forecast.

   Some businesses qualify to pay withholding taxes every three months rather than every month. To qualify for the quarterly payment program, you must owe the IRS less than $2,500 every quarter. If you do not qualify for the quarterly option or wish to pay every month, skip ahead to line 8. If you wish to explore the quarterly option, read the following discussion of withholding taxes.

   When you completed the Profit and Loss Forecast, you added at least 14% to the total wages and salaries you pay each month as an additional expense (Profit and Loss Forecast, line 4b, Withholding Taxes). That's your approximate mandatory contribution to your employees' Social Security fund and federal unemployment insurance. You'll write a check to the government to pay that amount.

RESOURCE

These are approximate tax figures, for your planning purposes. Later, you'll need to learn more about the tax rules. Some good information resources include *Tax Savvy for Small Business*, by Frederick W. Daily (Nolo), and IRS Publication 15 Circular E, *Employer's Tax Guide*, available, along with other publications, at the IRS website (www.irs.gov).

In addition, the government also expects you to collect money from your employees for their portion of income and Social Security taxes and pay the government directly. While every employee is different because of their individual tax situations, the average employee has about 15% of their total wages or salary withheld from every paycheck for federal withholding. This is money that belongs to the employee that you must mail to the IRS.

If you will pay a total withholding of less than $2,500 every quarter, you may choose to pay taxes quarterly rather than monthly. Make sure you verify your employees' actual withholding rates before deciding on this option.

EXAMPLE:

Let's say that you plan to hire one full-time sales clerk in your business for a total salary of $1,500 per month or $4,500 per quarter. Multiplying 29% by the quarterly salary (0.29 × $4,500 = $1,300) gives an answer of $1,300, which is less than $2,500. In that