solutions for small business

business planning and financial forecasting

British Columbia

Canada

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Contents

Foreword

This publication is part of the **Solutions for Small Business** series sponsored by Western Economic Diversification and the British Columbia Ministry of Competition, Science and Enterprise.

Both agencies are committed to supporting the needs of small businesses and further information about small business programs and services is available on each agency's web site (www.wd.gc.ca and www.gov.bc.ca/cse/).

The Solutions series is also available on both web sites as well as on the web site of Canada-B.C. Business Services (www.smallbusinessbc.ca). The four publications in the series are:

- Business Planning and Financial Forecasting
- Exploring Business Opportunities: a guide for entrepreneurs
- Resource Guide for British Columbia Businesses: information and guidelines
- Starting Your Home-based Business: a manual for success

Canada-B.C. Business Services is another joint partnership between Western Economic Diversification and the Ministry of Competition, Science and Enterprise. The program offers specialists who can advise on taxation, statistics and business planning as well as a wide range of business information and interactive business planning tools.

Canada-B.C. Business Services has offices in Vancouver and Victoria as well as outreach centres throughout the province in the offices of Community Futures Development Corporations and Government Agents. For locations, or for more information, check (www.smallbusinessbc.ca).

1

The Business Plan

Introduction

You want to start a business – or expand your existing business. You have a great idea, super attitude and the entrepreneurial spirit. So you head down to your local bank; you sit down in front of the credit manager and start to explain this brilliant idea when she interrupts you, *"That sounds great, but where is your business plan?"*

This scenario is played out every day in Canada. People with ideas – in many cases good ideas – who want to plunge into the business without having even done the business plan. The purpose of this publication is to explain in simple terms the concept of the business plan and to show you how to put your own plan together. There is all sorts of help available to you – including the other books in the Solution Series, courses from your local college or school board and of course the Interactive Business Planner. It is found at www.smallbusinessbc.ca.

Why do a Business Plan?

You should do a business plan for a number of important reasons. Some of those reasons include:

- **Your own thinking process is solidified through the planning process.** The planning outline leads you through a series of questions and issues that you may have forgotten about when just thinking about your business. ***Remember that you are an investor in your own business.*** You are the first person who must be convinced of the validity of your business concept.
- **Your bank will need to be convinced of the viability of your business, or your business expansion.** The business plan is a ***communications tool.*** Inform and influence the reader towards some action – providing a loan, extending credit or investing in your business.
- **Your business plan provides some guideposts in running your business.** You will set goals and then, once you are in business, you can measure those goals against the actual performance. Goals should be specific, measurable, achievable, realistic and time limited – SMART.

Your business plan has three elements.

It ***prepares*** you – the entrepreneur for starting the business.

It ***explains*** your business and ***proves*** the viability of the business to outside parties.

It spells out your business ***goals*** in clear SMART terms.

What is in a business plan?

There are as many kinds of business plans as there are kinds of businesses. There are dozens of planning guides and planning outlines, books, audio tapes, computer programs and online planning services. All of them have things in common and all have differences. (In researching this publication, the author never ran across two business planning outlines that were identical.) The business outline presented here is very simple. It has a reader friendly flow. It is not written in stone. If there are areas you need to add, then add them. If there are areas that need to be deleted, then delete them. If you are writing for a bank, then find out which sections are important to the bank. Most banks have excellent information on getting a business loan.

The reader reads what the writer writes

You cannot assume that the reader of your plan knows anything beyond what you have stated in the plan. You may know what you mean. The question is have you clearly explained it to the reader? As you go through this outline, constantly ask yourself if you are making yourself clear to a reader who is not familiar with your industry or your business. ***Your business plan is often your only representation to an outside party such as the bank!***

Here are a few tips on the actual writing of the plan:

To Do

- Try to keep it under twenty pages, exclusive of the appendix.
- Use bullet points and numbered lists wherever possible.
- Use, but do not overuse, graphs, diagrams and photographs.
- Have a neutral third party read the plan – especially someone without a background in your industry.
- Please – for the reader's sake include a table of contents and page numbers in your plan.

Avoid

- Big words and long sentences. They only serve to confuse the reader.
- Technical words and unnecessary jargon. If you need to introduce a technical term, then you should define the term.
- Using acronyms and initials to express words is another common error. You may be very familiar with the acronym but your reader might not. If an acronym has become as common as a word, such as scuba or laser, then use them. If they are still technical, such as URL then you may need to define the acronym and its meaning.

Now that you have some background on the concept of the plan, we can look at the elements of the business plan.

Introduction (Executive Summary)

Purpose: *The purpose of the executive summary is to get the readers attention by summarising the key elements of the business plan. It must be short, to the point and very well written.*

This is arguably the most important part of the business plan. The Introduction must encourage your reader to keep reading. It is a good idea to write as much of the Introduction as you can at the outset of the planning process. This initial writing will help you to focus your attentions on the goals of the plan. You should then rewrite the Introduction after you have completed the rest of the business plan. This way the specifics of the plan, and the changes made during the planning process are accounted for.

Business Concept

- Describe what your business does in general terms.
- Describe what differentiates your business from others.
- Briefly describe your business history if applicable.
- Provide any other information that will excite the reader about your business.

Plan Objective – Key Goals

- Tell the reader what you want (i.e. a business loan for a specific amount to purchase equipment.)
- State your sales, production and profit goals.
- If this is for a bank loan, comment on goals such as anticipated time to positive cash flow and the ability to service debt. (Note you cannot complete this section until the rest of the plan is complete.)

Management / Ownership

- Describe the technical qualifications of each principal in this enterprise.
- Describe the business qualifications of each principal in this enterprise.
- Tell the reader your business structure (i.e. proprietorship, partnership, and incorporation.)
- Provide a fact sheet with contact information such as name, address, telephone, e-mail etc.

Product / Service

Purpose: *The purpose of the product / service section is to detail exactly what your business does for the customer and what makes these offerings desirable to the customer.*

Key Products (Goods Businesses)

- Describe each product you sell. This is your product mix.
- If you cannot list each product, break the business down into logical categories.
- Describe the key product features, and how your products are different from those of your competition. (Functionality, durability, ease of use etc.)
- Describe product protection such as patents, copyrights and trademarks.

Key Services (Service Businesses)

- Describe each type of service you offer. (Be specific)
- Describe the service features in terms important to the customer.
- Describe any service protection such as copyrights or trademarks.

Product Risks

- If there are any risks associated with your product or service such as product liability, professional liability, or ease of duplication by competition, state them and show how you will avoid these risks.

Industry & Market Research

Purpose: *The purpose of the Industry & Market Research section is to prove that the market is large enough, in your area, given the competition to support the survival and growth of your business.*

Industry Research

- Describe your industry. The less well known the industry, the more description necessary.
- Describe the state of the industry. Is it a new industry, growth industry, competitive industry, or a stable mature industry?
- Document industry trends on a world or national size. Sales, number of customers, number of units sold, trends in related industries are all good industry indicators.
- Describe the key customers ***for your specific industry***.
- Provide other national / international economic indicators that encourage the health of your industry.
- Examine risks to the entire industry caused by legislation, technological change or any threat to the industry as a whole.

Target Market – Customer Research

The ***Target Market*** is the groupings of consumers or businesses most likely to purchase your products or services. The first group you plan to target is your *Primary Target Market*; the second is your *Secondary Target Market*. It is very important that you understand your target market – after all these are the customers you need to keep happy!

	Consumer Markets	Business Markets
Who is the customer? (Provide both the description and the information in this section.)	• Age • Gender • Income • Family Status Be sure to include how many customers there are in each grouping	• Industry Type • Size of Customer • Annual Sales Estimate the number of companies using directories or Yellow Pages.
Where is the customer?	Target the geographic radius of your customer base by city, region province or country.	The geography of business to business markets tends to be larger than consumer markets.
When do they buy?	Is there a particularly busy season for your product or service i.e. Christmas?	If you are selling to seasonal businesses, the timing can be everything i.e. wholesaling.
What do they buy?	• Necessity • Luxury Item • High involvement / Big ticket • Low involvement / consumable • Capital Item	• Inventory Item (i.e. item that is resold) • Consumable Item
Why do they buy?	How does your product or service help the consumer?	How does your product enhance the performance of this business?
How much do they buy?	Determine how much is spent on your product by your customers.	Estimate the commercial expenditure by the industries in your target area.

Note: If you are using indirect distribution, it may be necessary to describe both your customer as a target market, and the end user as a target market.

- Provide the results of any customer survey work you have done
- Provide the sources of information for any of the above

Competitive Analysis

- List the direct competitors in your local market. These are firms who offer exactly what you offer. List the current number and the number in existence for the past three-year period.
- List the indirect competitors in your local market. These are firms who offer substitute products.
- Analyse any competitors who have gone out of business in the past and if possible why.
- Explain how your firm will compete with these competitors to prove how you can survive in their markets.
- Examine risks that could occur when you enter the market. For example what if your key competitor cuts their price when you open your business?
- Show how your products / services or how your company is different from your competition. (This is called positioning your product.)

Marketing (Market Strategies)

Purpose: *The purpose of the Marketing section is to demonstrate how you plan to tap your market. This includes pricing, distribution, sales and promotional strategies.*

Price Strategy

- What are your prices for different products and services?
- How did you arrive at those prices? (Charge going rate, industry standard mark-up etc.)
- Do you have any "price packages"?
- What is your price image? (Bargain, middle of the road, high end) Is this consistent with your target market?
- How do your prices compare with your competition?
- Have you accounted for mark-downs and off price promotions?

Physical Distribution

Describe which of the following distribution systems you plan to use in your business:

- Direct Distribution – selling directly from producer / provider to the customer.
- Wholesale Distribution – selling to a retailer who sells to the customer.
- Brokers or Agents – using a third party to sell the product – usually on a commission basis. This can be done for goods (Manufacturers Agents) or for services (Speaker's Bureau).
- Hybrid Distribution – Using more than one of the above.
- Internet Sales – See Internet Strategies Section.

Location (For retail, restaurant and location dependant businesses)

- Neighbourhood Location (use map). Traffic counts and supporting information such as population radius is helpful.
- Site Location – place in mall or centre, or city block. Show the other tenants and access / egress for parking if applicable.
- Facility Location – including a diagram of the business layout.
- Signage both inside and outside the business.
- Check for location risks. A median placed in the middle of your road will cut off access to your business. Check with your city-planning department before signing a lease.

Promotion

Your promotional strategy is made up of three main areas. Not all businesses use all three so only include the parts relevant to your situation.

Advertising Plan (Paid Advertising)

- Provide a list of the media you plan to use. You may include newspapers, magazines, radio, television, direct mail or Internet advertising.
- Develop a monthly advertising schedule with planned budgeted amounts.
- If you have written any ads or brochures, include them as appendices to the business plan.

Public Relations Plan

- Include media sources you plan to use to promote your business.
- Include press releases in the appendices to the business plan.
- If you are using a Public Relations firm indicate the name of the firm in this section.

Personal Selling Plan

- Describe how you will prospect and find new customers.
- Describe how you will fulfil these prospects with information.
- If you have letters of agreement, contracts or other sales tools, it is sometimes advisable to include them as appendices to the business plan.

Internet

The Internet is becoming increasingly important to today's business world. Industry Canada uses a consumer benefit model known as ICET. You should define your Internet strategy in the same way with the following:

- Information Gathering – This includes the information provided to the consumer about your business, products and services.
- Communication – This includes more specific forms of two-way communications such as customer service and feed back mechanisms.
- Entertainment – This is the multimedia aspect approach to your site. This includes animation, sound clips and video clips.
- Transactions – This is the ability to actually order and pay for products over the Internet.

Operations

Purpose: *The purpose of the Operations section is to indicate how you plan to operate the business. That means how you provide the services or provide the products.*

Production Plan

The production plan demonstrates your ability to produce products. This section may not apply in service businesses.

Production Flow Chart (Manufacturing businesses)

- Provide a flow chart / process diagram showing the entire production process from start to finish.
- List and budget production equipment required for the business.

Procurement (Businesses that manufacture or sell products)

- Sources of supply and order lead time
- Terms & Conditions of sale
- Alternate sources of supply (this addresses procurement risk)
- Inventory control systems
- Physical space requirements (Unless covered in location sections)

Sub Contractors (These can include both goods and services)

- Provide a list of sub-contractors
- Show exactly what these sub-contractors do and where they fit into the production of the business
- Show alternative sub contractors (This addresses sub-contract risk)

Human Resources (If you have more than five staff members)

- Organizational Chart (Show reporting structure)
- Job Descriptions (Show what people do)
- Job Specifications (Show the skills and knowledge required to do each job.)
- Recruiting – Where will you find good people?
- Management – How will you treat those good people?
- Compensation – How much will you pay your people? This includes base wages, commissions, bonuses and other incentives. (Don't forget your statutory benefits of EI, CPP, WCB & Holiday pay, in addition to any benefits you plan to add.)
- Human Resources Risks. Look at contingent plans for loss of key personnel, labour shortages or strikes.

Professionals and Mentors – where the entrepreneur turns for help

- Accountant
- Lawyer
- Banking Services
- Business Advisors and Mentors (It can be helpful to provide brief one paragraph biographies on key business advisors.)

Legal & Administrative

- Legal Form (proprietorship, partnership, corporation, cooperative.)
- Share Distribution (Corporation Only)
- Directors & Officers (Corporation Only)
- Buy Sell Agreement (Corporation and Partnerships Only)
- List of key legal agreements such as contracts, leases, agreements, franchise agreements, personal loan guarantees etc. (The actual documentation is often put into the appendix of the business plan.)
- Insurance / Risk management

2

The Financial Plan

Introduction

The financial plan is critical to the success of your business plan – especially if it is for the purpose of getting a bank loan. The Cash Flow Forecast is arguably the most important part of the plan – however, each of the other documents is important from a planning perspective.

The Break-even

The break-even point in your business is the point at which your sales revenue is equal to your total expenses. At that point you neither make money, nor do you loose any. The break-even lets you know what it is going to take in sales just to survive. It provides a good indication of the viability of a business project. The break-even can also be used to evaluate a business expansion or any other business expenditure. You are simply asking how much additional revenue will be required to cover the additional cost.

There are some key definitions necessary to determine the break-even for the business. They are:

Fixed Costs (Overhead) *are costs that do not vary directly with sales. Utilities, salaries, advertising, office supplies and telephone are just a few examples. They do not have to be the same every month. What is important is that you pay them regardless of sales made.*

Variable Costs (Cost of Goods) *are the actual costs of making the product or providing the service. They can include materials, shipping and contract labour.*

Capacity *governs your output. It can be measured in units of production, billable hours, or sales volume.*

To calculate the break-even in units – we use the following formula:

$$\frac{\textit{Fixed Costs}}{\textit{(Unit Price – Variable Cost)}} = \textit{Break-even in units}$$

This method is known as ***Total Absorption Costing***, because dividing the total cost by the units sold absorbs the fixed costs. This allows us to compute the ***break-even*** for this business. Every business plan – be it for growth or for start-up – needs to establish project and business costs before proceeding.

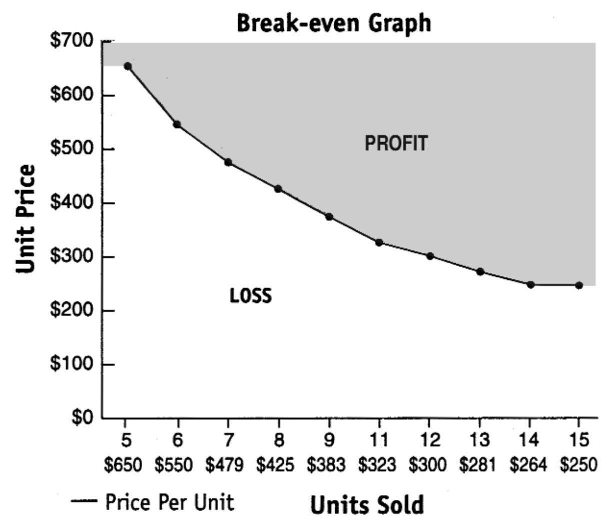
Note: For planning purposes treat the entire term loan payment, both principal and interest, as a fixed cost to the business.

Illustrative Example

Jan is a home-based potter who makes custom mugs by the case. Her ***capacity*** is no more than 15 cases of mugs per week. She has calculated the ***variable*** cost for each case, including clay, glaze and packaging to be $50 per case. It costs Jan $3,000 per week to run her business, including her wage. The cost per case, when we include the $3,000 per week ***in fixed costs***, changes depending on the number of cases produced each week. This is calculated in the table below.

Units Produced	Fixed Costs	Variable Costs	Price Per Unit
5	$3,000	$250	$650
6	$3,000	$300	$550
7	$3,000	$350	$479
8	**$3,000**	**$400**	**$425**
9	$3,000	$450	$383
10	$3,000	$500	$350
11	$3,000	$550	$323
12	$3,000	$600	$300
13	$3,000	$650	$281
14	$3,000	$700	$264
15	$3,000	$750	$250

Notice that the break-even is not a point, but it varies for each different price point. If she can get $425 per case for her mugs, she needs to be able to produce and sell eight mugs per week. We can plot this on a graph as follows:



The area above the line is profit and the area below the line represents loss.

Break Even with a Gross Profit Margin

Sometimes, a company does not sell products, if it sells so many different products that doing a break-even for each unit does not make sense. When this is the case, such as in a retail business, we calculate the break-even in revenue rather than in units. This is done with the following formula:

Where:

$$\frac{\textit{Fixed Costs}}{\textit{Gross Margin}} = \textit{Break-even Sales}$$

$$\frac{\textit{(Price – Cost)}}{\textit{Price}} = \textit{Gross Margin}$$

There are industry standard financial ratios available from Statistics Canada for many small businesses. These ratios include the gross profit margin, expressed as a percent of sales.

Illustrative Example

Sarah wants to start a retail gift store. She estimates her ***monthly fixed costs*** at $9,000 per month. She determines that the industry standard ***Gross Margin*** for a gift store is 45%. She calculates her break-even as follows:

$$\frac{\textit{Fixed Costs}}{\textit{Gross Margin}} = \textit{Break-even Sales}$$

$$\frac{\$9{,}000}{45\%} = \$20{,}000 \textit{ per month}$$

Sarah must be convinced that this location is able to sell at least $20,000 per month (or $240,000 per year) before she starts her business. Her market research, physical location, promotional plans and physical size must all support this level of sales capacity or the business will not work.

The break-even is a great first step in evaluating business opportunities. It is not that the objective is to break-even, but that the break-even is the first objective to achieve in reaching a profitable business.

The Balance Sheet

The ***Balance Sheet*** is a snap shot of the business at any point in time. In the case of a business start-up, it is often the ***starting balance sheet.*** A balance sheet is made up of three parts.

Assets:	Things a business owns
Liabilities:	Debts a business owes
Equity:	The owners' investment and re-investment in the business

Everything that the business owns, its assets have to have been paid for. Therefore we get the following formula.

$$\textit{Assets} = \textit{Liabilities} + \textit{Equity}$$

This is extremely important as it gives the reader a picture of how the business is being financed through the owners' money (equity) or through the creditors money (liabilities). In a business start-up you should look at the assets required to get the business started – and then ask yourself how you will finance that start-up. If you do not have the money to invest into the business, you will have to borrow the remainder.

X Proprietorship

Balance Sheet

December 31, 2000

Assets	
Current Assets	
Cash	$ 2,000
Inventory	15,000
Accounts Receivable	12,000
Total Current Assets	*$ 29,000*
Capital Assets	
Vehicle	$ 20,000
Less Accumulated Depreciation	(5,000)
Book Value (Vehicle)	15,000
Equipment	15,000
Less Accumulated Depreciation	(3,000)
Book Value (Equipment)	12,000
Total Capital Assets	$ 27,000
Total Assets	**$ 56,000**

Liabilities	
Current Liabilities	
Trade Payables	$ 2,000
Wages Payable	3,000
Line of Credit	4,000
Total Current Liabilities	*$ 9,000*
Long Term Debt	
Term Loan	$ 10,000
Note Payable	6,000
Total Long Term Debt	$ 16,000
Total Liabilities	$ 25,000
Equity	
Owners Equity	**$ 31,000**
Total Liabilities & Owners Equity	**$ 56,000**

The Income Statement Forecast

The purpose of the ***Income Statement Forecast*** is to project the revenues and expenses of your business over a given period of time – usually one year. Other terms for this are *budgeted income statement* or *pro forma income statement*. There are three things that need to be predicted to forecast your income statement: the sales projection, the cost of goods projection and the overhead's projection.

The Sales Forecast

The sales forecast is probably the most difficult part of the business to forecast – especially for a starting business. Sometimes, the break-even can provide a starting point for creating the sales forecast. It is important to remember that a sales forecast is not like the weather – something that you try to guess – but rather a goal you set for the business that you proactively try to achieve.

In the case of an existing business, you should look at the sales history. You should see if your sales are trending up or down, and then account for new products to be added, or old products to be taken away. ***The sales forecast must reflect your business strategies and objectives.***

Forecasting using the unit method

List all the products or services you plan to sell. You will need to forecast the number of units of each type you plan to sell. Different businesses and industries use different unit measures. (E.g., for a craftsperson, a unit may be one wooden item; for a researcher, a unit could be one hour of time.) You will have to estimate the selling price for each unit. You can then develop a sales forecast using the following equation:

$$\textit{Total Sales} = \textit{Number of units sold} \times \textit{Price per unit}$$

A business owner will do a sales forecast for each product in the business. The sum of these forecasts becomes the overall sales forecast.

Forecasting with the sales method

Sometimes a business cannot use unit sales, as it would be impossible to predict the unit sales for each of 5,000 items in a gift store. In this case, some business owners will go directly to revenue forecast. If the business is broken down into logical departments or categories, then forecast the revenue in each area for the total sales forecast.

The Cost of Goods Forecast

The cost of goods forecast relates directly to the sales forecast. The cost of producing goods varies directly with the level of sales. To calculate the cost of goods forecast, you may use either the percent to sales method, or the unit costing method.

Unit Costing Method

This method is exactly like the unit sales forecast, except instead of using price, you use cost per unit.

$$\textit{Cost of Goods} = \textit{Number of units sold} \times \textit{Cost per unit}$$

Just as in the unit forecast, you must do this for each unit sold. The sum of the cost of goods is then part of the income statement.

The percentage cost method

In retail businesses – where mark-ups and mark-downs predominate it is common to use the ***cost complement*** to calculate the cost of goods. The cost complement is the percent of the revenue, or the selling price, which represents the cost of goods. For example, if an item costs $12.00 and is priced at $20.00 then the cost complement is $12.00 / $20.00 = 60%. (If the ***cost complement*** is 60% then the ***Gross Profit Margin*** is 40%.) You can use the historical cost complement or industry standards to forecast the cost of goods and gross profit of your income statement.

The Overheads Forecast

The overheads forecast is an estimate of your ***expenses*** for the year. This list should be similar to the list developed for the fixed costs of your break-even analysis. Typical overhead expenses include:

- Advertising and Promotion
- Automobile
- Bank & Finance Charges
- Communications
- Depreciation
- Insurance
- Entertainment & Meals
- Occupancy
- Mail & Office Supplies
- Professional Fees
- Professional Development
- Wages & Benefits
- Travel & Accommodations
- Other
- Owners' Drawing or Wage

The next step is to make cost estimates for each area. You may do them monthly, or annually, however, you will eventually need to know your monthly expenditure in each area for your cash flow forecast. Some of your forecasts will be a matter of calling a supplier and asking for a quote – insurance is an example of this kind of overhead. Sometimes, you will have to make a management decision about how much you will plan to spend in order to achieve your revenue objectives.
If you have history, you should use history as a guide, making sure that increases and decreases in cost are consistent with your revenue objectives.

You should make a brief note to the reader of the plan, describing the key expense forecasted items. (i.e. you may have a quote from a broker for your insurance projection.) This is especially true if, in an existing business, there is a large change in the statement.

Sample Income Statement

X Proprietorship
Income Statement
Year Ending December 31, 2001

Sales	$84,100
Less Cost of Goods	$15,000
Gross Profit	$69,100
Expenses	
Advertising	$ 1,500
Depreciation	$ 8,000
Interest	$ 2,000
Rent	$ 4,000
Travel	$ 600
Wages	$ 7,000
Total Expenses	$23,100
Net Profit (Gross Profit – Total Expenses)	$46,000
Less Owner's Draw	$15,000
Net Profit after Draw	$31,000

Note: The term draw in a Proprietorship refers to the money that the owner takes out of the company. The profits kept in the business are known as ***retained earnings***. These earnings are reflected in the owners' equity portion of the balance sheet. It should also be noted that in a proprietorship, income tax is paid on the ***net profit – not the owner's draw***.

The Cash Flow Forecast

A *Cash Flow Forecast* is probably your most important financial tool. It is your cash flow that shows you if, and when, you will run out of cash essential to run your business. It allows you to take action before problems occur and even to do "what if" calculations before taking on new projects. The cash flow is a 12-month projection that forecasts the ***receipts*** and ***disbursements*** for your business. In a start-up situation, it is preferable to have a start-up month to specifically show the reader the costs incurred to start the business.

Why Do a Cash Flow Forecast?

Too often business owners do a cash flow forecast in their head. Putting the cash flow forecast on paper, however, will give you the following:

- A format for planning the most effective use of your cash (cash management).
- A schedule of anticipated cash receipts – follow through to see that you achieve it!
- A schedule of priorities for the payment of accounts – stick to it!
- A measure of the significance of unexpected changes in circumstances; e.g., reduction of sales, strikes, tight money situations, etc.
- A list, on paper, of all the bill paying details which have been running around in your head, keeping you awake nights. A cash flow is not an instant cure for sleeplessness but it certainly helps. It also clears your mind for more productive thinking.
- An estimate of the amount of money you need to borrow in order to finance your daytoday operations. This is perhaps the most important aspect of a completed cash flow forecast.
- An outline to show you and the lender that you have enough cash to make your loan payments on time.

Receipts

Receipts occur when cash enters the business for any reason. It is like making a deposit in your current account. The main reasons for receipts are:

- Cash sales
- Collection of accounts receivable
- Loan proceeds. This includes term loans, start-up loans, line of credit and notes.
- Owners' contributions. This includes both investments and shareholders' loans (Shareholders' loans only happen in incorporated companies.)

Disbursements

Disbursements occur when cash leaves the business for any reason. The main reasons for disbursements are:

- Cash expenses or inventory purchases
- Payments of accounts or expenses payable
- Loan repayment (Either bank or shareholders' loans)
- Owner repayment (Dividends in a corporation or drawings in a proprietorship)

In cash flow, we talk about receipts, disbursements and deficits or surpluses rather than revenue, expenses and profits or losses.

How to do your Cash Flow

The cash flow is made up of three distinctive parts. The receipts, the disbursements and the cash flow calculation. Because of the complexity of the disbursements section, this section has been broken down into a series of smaller sections. Each line is coded with a letter and a number. The letters form the following sections on your cash flow sheet:

A – Receipts

B – Disbursements for Inventory Purchases and Sub-Contracted / Piecework Labour

C– Disbursements for Overhead Expenses

D – Disbursements for Capital Purchases

E – Repayments of Bank Loans, Notes, and Investors

F – Cash Flow Calculation

In addition, there are two schedules – the monthly sales / accounts receivable forecast, and the inventory purchases forecast. These forecasts will be inserted into lines A1& A2 and B1&B2 respectively.

Start-up – For business start-ups only

The *Start-up* column is used in start-up situations only. It is used for all of the receipts and disbursements that occur as a part of starting a business. This includes purchasing fixed assets, incurring start-up expenses, the initial investment to start the business and the initial bank loans. It is helpful for the reader to separate start-up costs from on going costs. This way they will quickly see why you may have large deficits in the early stages of business development.

Using *Start-up* makes your cash flow easier for a reader to read. (You should be able to spot the starting balance sheet right off of *Start-up* in a business start –up.)

A – Receipts

The sales and accounts receivable section is forwarded directly from Schedule 1. Any owners' investments and loan proceeds are put into the appropriate row. Note that some lines of credit are forwarded in $5,000 increments. Others are treated as overdrafts. Both methods can be used in section A. One example of other receipts is sales of a fixed asset.

B – Disbursements for Inventory Purchases and Sub-Contracted / Piecework Labour

This section is forwarded directly from Schedule 2.

Sometimes you can replace all of the materials you use up in a given month. When this is the case, your purchases are equal to your cost of materials for each month. Other companies need to build up inventory. This can be caused when your productive capacity is lower than your highest sales month. You build up inventory so you can meet orders in peak periods. You will need to do an inventory forecast, based on your sales and your production.

Beginning of Month Inventory (B1.1) This is taken from either the balance sheet or from the previous month's end of period forecast.

End of Month Inventory (B1.2) This is the target inventory level for the end of the month. It is based on the seasonal needs of the business and allows you to compensate for rising and falling inventory levels.

Cost of Material (B1.2) This is the cost of the material taken from inventory and sold to customers. (Note it is accounted for at material cost only).

Purchases (B1.4) This is the amount of material required to replace material used and bring the inventory level to the end of month target.

To calculate the purchases, use the following formula:
End of Month Inventory (B1.2) + Material Used (B1.3)- Beginning of Period Inventory (B1.1) = Purchases (B1.4)

The End of month Inventory figure is then forwarded to the line Beginning of Month Inventory for the next month. This procedure is repeated for the entire 12-month cycle. If you have credit terms from your suppliers, you should then make an adjustment for your accounts payable (B1). This usually involves purchasing in one month and paying for it the next.

Piecework labour (B2) is forecast in conjunction with your monthly production.

C– Disbursements for Overhead Expenses

The C section is the cash outflow of your overhead expenses. If you pay your entire insurance in one month, then the entire amount is disbursed in that month. Some disbursements are the same every month, such as rent. Some disbursements will be similar to your sales pattern – advertising might be an example. Some disbursements are quarterly such as income tax instalments or, in some businesses, the GST. *Note: it is a good idea to disburse GST & PST into a separate holding account until they need to be remitted to government. This way the money is there when you owe it rather than having been used up in normal business operations.*

D – Disbursements for Capital Purchases

If you plan to purchase any capital assets at any time, account for these purchases in the D section. If you do not pay for the asset right away, remember to put the amount into the month in which you plan to write the cheque.

E – Repayments of Bank Loans, Notes, and Investors

The cash flow does not discriminate between principal and interest. The entire payment on term loans will be brought forward to the cash flow. If there is interest on lines of credit or on overdrafts they should be accounted for here. In the same way as some lines of credit are forwarded in $5,000 increments – they are repaid in $5,000 increments. You should also account for any repayment of shareholders' loans, owners' draws not accounted for in wages, or dividends in the appropriate row of section E.

F – The Cash Flow Calculation

The cash flow calculation (detailed on your cash flow sheet) is

Starting Cash Balance + Total Receipts – Total Disbursements = Ending Cash Balance

Now you can adjust your cash flow and your business strategies, to ensure that you do not run out of cash – or exceed pre-arranged lines of credit and overdrafts.

Financing Your Business

There are two main types of financing – equity financing and debt financing. ***Equity*** means ownership. With equity financing, an investor makes money available for use in exchange for an ownership share in the business. This could be as a silent or limited partner (not actively involved in the business) or as a shareholder. Whether equity financing is possible or a good option depends on the business structure and relationship between the borrower and lender.

With debt financing, the lender charges interest for the use or 'rental' of money loaned, but does not get a share or equity in the business. Debt financing is familiar to most people because it is the basis of most personal credit. Debt often comes from banks, but it can also come in the form of supplier credit (accounts payable) or in the form of vendor credit – for capital purchases.

Bank Financing

Many entrepreneurs will go to the bank for part of their business financing. This can be financing the start-up of the business or financing the growth of an existing business. Either way, bank financing plays a major part in the development of small business.

Banks use many different kinds of financial instruments to finance business. The two main types are Lines of Credit and Term Loans.

Line of Credit is a loan similar to a personal overdraft. It is to finance temporary shortages in cash caused by inventory and accounts receivable. They are sometimes disbursed into your chequing account in increments of $5,000. The interest rates are often variable and based on the prime lending rate. As a rule *lines of credit finance current assets.*

Term Loans are loans that are repaid over a fixed period of time – usually more than one year. A business may have several term loans at the same time – financing different projects or assets. Term loans may or may not have fixed interest rates, depending on the terms and conditions. Usually, term loans are used to finance capital assets, although sometimes term loans are taken out to increase cash levels (current assets) in the business.

Lending Criterion

Many banks use the four "C's" to evaluate loan proposals. They represent:

Cash Flow: The ability to repay the loan with cash. This is measured using the Cash Flow Forecast in your business plan.

Collateral: The value of internal and external security that may be liquidated. This is measured by taking the market value of the business assets and comparing this value to all outstanding term debts. This determines what might happen if the business defaults on the loan. Sometimes an asset outside of the business will secure a business loan. This is external security. An associated company may hold the asset or it may be a personal asset of the business owner. (See loan guarantees.)

Character: Aspects about the business owner or owners, which lead you to believe in their credit worthiness. Banks often use the business owners' personal history to determine attitudes towards credit. They will also look at the technical and business skills presented in the business plan.

Commitment: The financial commitment by the owners in this business venture. This is measured by examining the equity or shareholders loans in the business, and the retained earnings history of the business.

Statement of Personal Net Worth

A statement of personal net worth is a measure of the wealth of the owner or owners of the business. It is similar to a balance sheet – except those assets are measured at their market value. The formula for net worth is:

Net Worth = Assets (Market Value) – Liabilities

Personal Loan Guarantees

When a small corporation borrows money from a bank, the shareholders will often be required to sign what is known as a personal loan guarantee. This is like the individual co-signing a loan granted to the corporation. It means that if the corporation (business) defaults on the loan (that is banker's language for not repaying the loan) then the individual shareholders must re-pay for the corporation.

It is not unusual for the spouses of shareholders to sign guarantees as well. This prevents the guarantor (the person who signs the guarantee) from transferring their net worth to their spouse. Personal loan guarantees are required for most business loans. Always remember that the guarantee is a legal document, and it is advisable to see a lawyer before signing any such document.

Program & Financing

The program and financing is a description of the loan requirement and the asset purchase. It looks like a small balance sheet in that it states what you are going to purchase, and how you are going to pay for it.

Supposing that X Proprietorship wants to purchase a $5,000 piece of equipment. They decide to borrow $3,000 use $1,000 of the businesses cash, and invest an additional $1000 into the company. The starting balance sheet, program & financing and pro-forma balance sheet would look like this:

Initial Balance Sheet

		Program & Financing	Pro-Forma Balance Sheet
Assets			
Current Assets			
Cash	$ 2,000	-$ 1,000	$ 1,000
Inventory	$ 15,000		$ 15,000
Accounts Receivable	$ 12,000		$ 12,000
Total Current Assets	*$ 29,000*		*$ 28,000*
Capital Assets			
Book Value (Vehicle)	$ 15,000		$ 15,000
Book Value Equipment	$ 12,000	$ 5,000	$ 17,000
Total Capital Assets	*$ 27,000*		*$ 32,000*
Total Assets	**$ 56,000**		**$ 60,000**
Liabilities			
Current Liabilities			
Trade Payables	$ 2,000		$ 2,000
Wages Payable	$ 3,000		$ 3,000
Line of Credit	$ 4,000		$ 4,000
Total Current Liabilities	*$ 9,000*		*$ 9,000*
Long Term Debt			
Term Loan	$ 10,000	$ 3,000	$ 13,000
Note Payable	$ 6,000		$ 6,000
Total Long Term Debt	*$ 16,000*		*$ 19,000*
Total Liabilities	**$ 25,000**		**$ 28,000**
Equity			
Owner's Equity	**$ 31,000**	**$ 1,000**	**$ 32,000**
Total Liabilities & Owner's Equity	**$ 56,000**		**$ 60,000**

The program and financing and the statements of personal net worth must be provided along with the business plan to ensure the creditworthy nature of the business venture.

Appendices

Purpose: *The purpose of the appendices is to provide supporting documents for claims made in the business plan. They may not necessarily be read, but are there for research purposes.*

- Resume(s) of Principals
- Legal documents (including leases, insurance etc.)
- Letters of agreement / intent (potential orders, customer commitments, letters of support)
- Sample Ads and brochures
- Collation of Market Surveys
- Other

Your banker or a potential investor may request the following documents:

- Personal net worth statement (including personal property values, investments, cash, bank loans, charge accounts, mortgages, other liabilities; this will substantiate the value of your personal guarantee if required for security)
- List of inventory (type, age, value)
- List of leasehold improvements (description, when made)
- List of fixed assets (description, age, current market value of any equipment; legal description of any lands; description of any encumbrances on assets to be pledged for business purposes)
- Price lists (to support cost estimates)
- Description of insurance coverage (insurance policies, amount of coverage)
- Accounts receivable summary (include ageing schedule)
- Accounts payable summary (include schedule of payments)
- Copies of legal agreements (contracts, lease, franchise agreement, mortgage, debentures)
- Appraisals (include recent appraisals of assets such as buildings, property, and equipment or provide a market evaluation of the business and an asset list outlining the asset, the year purchased and amount paid)
- Financial statements for associated companies (where appropriate)
- Name of present lending institution (branch, type of accounts)
- Lawyer's name (include address and phone/fax number)
- Accountant's name (include address and phone/fax number)

The following information will be a specific part of a loan application:

- Name lenders, amount of financing and payment periods for short-term and long-term loans
- Term loan applied for (amount, term, when required)
- Owner's equity (your level of commitment to the program)
- Line of credit applied for (new or increased, security offered)
- Present financing including term loans outstanding and current operating line of credit
- Total all amounts from 'Owners/Investors/Shareholders' and 'Lenders' for total sources of financing.

List uses of financing with amounts and totals. These could include:

- Land
- Buildings and facilities
- Equipment and machinery
- Remodeling, renovations and Leasehold Improvements
- Initial inventory
- Working capital (for operating expenses)
- Non-liquid assets contributed by owners

Note: The total amount in uses of financing should be the same as the total for sources of financing. Most of this information should also have been determined in the financial plan, but will often need to be re-stated for the loan application.

Some final thoughts

Dwight Eisenhower once said: *"In preparing for battle, I have found that plans are useless, but planning is indispensable."* Starting a business is a great undertaking. You want to be prepared. So here are some tips to keep in mind while in the planning process:

- Keep an open mind. Do not try to make something work that cannot work, just because you like the idea.
- Be flexible – whilst developing the business plan other ideas, markets, products or services may come to mind. Explore them.
- Make your mistakes on paper – it is far cheaper than making them in real life.
- Keep planning! It can be difficult to plan when you are running your business, but it is very useful to re-examine your goals and objectives on a regular basis. Don't ever let the business squeegee out the creative entrepreneur.

This publication is part of the Solutions for Small Business series sponsored by Western Economic Diversification and the B.C. Ministry of Competition, Science and Enterprise.

Both agencies are committed to supporting the needs of small businesses and further information about small business programs and services is available on each agency's web site (www.wd.gc.ca and www.gov.bc.ca/cse/).

The Solutions series is also available on both web sites as well as on the web site of Canada-B.C. Business Services (www.smallbusinessbc.ca). The other titles in the series are:

Starting a Home-based Business
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BC Business Resource Guide
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