WRITING A BUSINESS PLAN[1]

by Harry A. Carpenter

Chances are great that writing a business plan will be a tough job. There are any number of formats that are being circulated, but, in general, there is no one business plan outline that will work everywhere, every time. For example, they may be as brief as 15 pages to as long as 250 pages. The major criteria are that the contents are substantive, concise, and in the case of a loan, promotional (of your operation). All projections should be based on a five-year time period. This may be hard to envision for companies with miniscule or no revenue, or no previous performance record, or no product. Yet every figure should be defensible in some way. What may work with one bank or one source of financing, or one time, may not work again. Or, just because it doesn't work one place doesn't mean it won't work somewhere else. Hence, when it comes to business plans, about the only rule is, there are no rules.

Why should you go to the trouble of creating a written business plan? There are three major reasons: 1) The process of putting a business plan together, including the thought you put in before beginning to write it, forces you to take an objective, critical, unemotional look at your business project in its entirety. 2) The finished product—your business plan—is an operating tool which, properly used, will help you manage your business and work toward its success. 3) The completed business plan is the means for communicating your ideas to others and provides the basis for your financing proposal.

The importance of planning cannot be overemphasized. By taking an objective look at your business, you can identify areas of weakness and strength, pinpoint needs you might otherwise overlook, spot problems before they arise, and begin planning how you can best achieve your business goals. As an operating tool, your business plan helps you to establish reasonable objectives and figure out how to best accomplish them. It also helps you to red-flag problems as they arise and aids you in identifying their source, thus suggesting ways to solve them. It may even help you avoid some problems altogether.

In order for the business plan to work, it is important that *you* do as much of the work as possible. A professionally prepared business plan won't do you any good if you don't understand it thoroughly. This understanding comes from being involved with its development from the very start.

No business plan, no matter how carefully constructed and no matter how thoroughly understood, will be of any use at all *unless you use it*. Going into business is rough—over half of all new businesses fail within the first two years of operation; over 90 percent fail within the first 10 years. *A major reason for failure is lack of planning.* The best way to enhance your chances of success is to plan and follow through on your planning.

Your business plan can help you avoid going into a business venture that is doomed to failure. If your proposed venture is marginal at best, the business plan will show you why and may help you avoid paying the high tuition of business failure. It is far cheaper *not* to begin an ill-fated business than to learn by experience what your business plan could have taught you at a cost of several hours of concentrated work.

Finally, your business plan provides the information needed by others to evaluate your venture, especially if you will need to seek outside financing. A thorough business plan automatically becomes a financing proposal (usually with lenders' application forms) which will meet the requirements of most lenders.

Suggested Business Plan

Cover sheet. The cover sheet should identify the business and the document; identify the loca-

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tion and telephone numbers of the business, where the principals can be reached, and identify the person who wrote the business plan. The cover sheet should not be elaborate. It should be neat, attractive, and short. If you have a logo, use it. If the plan is to be used as a financing proposal, use a separate cover sheet for each bank or capital source you submit it to with their name on the sheet (for example: submitted to Capital Bancorp).

Statement of purpose. The first page of your plan should state the objectives of the plan or proposal as simply as possible. If the plan is for your sole use, the statement should be a brief description of how you intend to use the plan once it has been developed. For example: This plan is an operating and policy guide for XYZ Company.

If the plan is also to be used as a financing proposal, the statement of purpose becomes more complex. It should include responses to at least the following questions: 1) Who is asking for money? 2) What is the business structure (i.e., sole proprietorship, partnership, corporation)? 3) How much money is needed? And when? 4) What is the money needed for? 5) How will the funds benefit the business? 6) Why does the loan make sense? 7) How will the funds be repaid? And when?

The loan you are requesting, its use and expected effects on the business, and how you will repay it will be supported and clarified by and within the rest of your plan. If you are not seeking a loan, the plan should still support and justify the investment of your time and money (or that of your partner, friends, or family).

Keep the statement of purpose clear, concise, readable, businesslike, and depending on the purpose, short. Usually it will be one page or less but some complex funding instances may require more. It should cover the purpose of the business, significant product and/or service features, market potential, capital required, and technical and operational aspects. Give financial projections, when you expect to break even and the profit potential. It should end with a phrase including a positive statement such as ". . . funding and principals capital will be sufficient to make XYZ Company, a viable, on-going, profitable enterprise."

The statement of purpose cannot be completed until much of the plan has been developed because of the need for the information included within the other parts of the plan, particularly financial data.

Table of contents. The table of contents should follow your statement of purpose. It helps the reader find his or her way through a lengthy proposal. Your reader may want to turn immediately to specifics, or you may want to do the same if the business plan is for your sole use. The table of contents can be used as a guide to writing the plan. The order of the items may be changed. Again look to the use of the plan. Sometimes it is recommended that the strengths of the company be discussed first, working toward the weaknesses. In some plans, markets and marketing strategy may be a separate section.

I. The business. The objective of this section is to make clear: 1) What is the business? (Or what will it be?). 2) What market do you intend to service? What is the size of the market? And what is your expected share? 3) Why can you service that market better than your competition? 4) Why have you chosen your particular location? 5) What management and other personnel are available and required for the operation? 6) And why (if appropriate) debt money or someone's equity investment will make your business more profitable?

These six critical considerations will form the written policy of your business, rules you should not deviate from without compelling reasons. Policy gives direction and stability to your business. It will require a great deal of thought and planning. The business will be a reflection of your personality and ideas. In describing your business, and hence your policy, keep it clear and simple. The technical support for your idea will be in the financial data and the supporting documents. Avoid too much detail and reference with supporting data as needed.

A. Description of business. In this section you will deal with what your business is, how you are going to run it, and why you think your business will be successful.

Deciding what business you are in and what business it will be in five years is the most important decision you will have to make. You may be involved in more than one activity. If so, you will have to decide what is the central activity. Your

entire planning effort is based on your perception of what business you are in.

The description of your business should answer the following: 1) What is the type of business? Merchandising? Manufacturing? Or service? 2) What is the status of the business? Is it a start-up? A take-over? Or an expansion of a going business? 3) What is the business form? Sole proprietorship? Corporation? Or partnership? 4) Why is your business going to be profitable? 5) When did the business open? 6) What hours of the day and days of the week are you open? 7) Is yours a seasonable business? Or are the hours adjusted seasonably? (Make sure they are referred to in the other areas of the business plan.)

Knowing exactly what your business does and how it operates enables you to plan for profits effectively. Before you begin to consider profitmaking, you must be able to clearly identify the aims and goals of your business. As the business progresses, the question of how to make profits must continually be asked and answered. Attention to this will help you identify what is special about your business and why it won't be one of the 50% that fail during the first two years. You will not be able to completely answer the profitability question until the financial data section is complete.

The market. In order to generate a consistent and increasing sales flow, you must become knowledgeable about your market—the people who will be buying your service, product, or merchandise.

Basic marketing considerations are: 1) Who is your market? 2) What is the present size of the market? 3) What percent of the market will you have? 4) What is the market's growth potential? 5) As the market grows, does your share increase? Or decrease? 6) How are you going to satisfy your market? 7) How are you going to price your service, product, or merchandise, to make a fair profit and at the same time be competitive?

In marketing terminology, define your *target* market. Defining the target market is done in a logical fashion by considering who needs and who buys what you offer. It may be necessary to change your service, product, or merchandise mix to meet the needs of the market you have targeted.

Your market may be defined by any number of factors such as geographical location, socioeconomical factors, age, sex, or any of a thousand other conditions. Whatever they are make sure you identify them. One way to do this is to list all of the important characteristics of the market and then, using available data and information, find out to what extent these characteristics are present in different areas.

Your target market, the market you have selected to serve, must be measured. Having too few customers puts you out of business. Ultimately you rely on sales as the main source of money. If there are no sales, there is no business. Good marketing strategy must be planned and it must be based on good information.

After you have a feel for the market you will need to consider how you will attract and keep this market, and how you can expand your market. Also, as a part of your marketing strategy, you will show the price you anticipate getting for your service, product, or merchandise. Is this price competitive? Why will someone pay your price? How did you arrive at the price? Is it profitable? Is there something special that you can offer (consider service or higher quality) that will justify a higher price?

In order to make a profit, a business must make more on sales than it spends (both directly, as in cost of goods sold, and indirectly, as in overhead and selling cost). Many businesses flounder because they lose sight of this simple truth. There is no point in pricing yourself out of the market, nor is there anything to be gained from a price which puts your business in the red. Keep in mind that pricing reflects a total package of product and service and expenses.

C. Competition. If you have decided on your target market and it is large enough to be profitable and contains reasonable expansion possibilities, the next step is to check out your competition, both direct (similar operations) and indirect.

Some considerations are: 1) Who are your nearest five competitors? (List them.) 2) How will your operation be better than theirs? 3) How is their business? Steady? Increasing? Decreasing? Why? How much? 4) How are their operations similar? Different? 5) What are their strengths? Their weaknesses? 6) What have you learned

from watching their operations? Your objective here is to make your business more profitable by picking up your competitors' good practices and avoiding their errors. A common error is opening a business in a market that is already more than adequately serviced. Also, you should analyze your competition as an on-going practice because markets shift and success attracts competition. A good practice is to identify an underserved or undersatisfied market and go after it.

D. Location of business. Proper site location can help your business make money. If you are going into business, first define, then try to locate the ideal site. If you can't find the ideal site, see how close you can come to it. Remember, rent is the combination of space and advertising. Do not go into business in a given spot simply because the rent or the building price is low. Rents and purchase prices are usually fixed by market forces, and a low price can reflect low desirability. The key to correct site selection is to keep in mind that a bad site can put you out of business, while a good site can increase your profits. Once you get started or if you are already located, keep a constant eye on changes in and around your location: new roads get built; populations shift from one class to another; people move; zoning ordinances change; and your business needs may change.

Some considerations are: 1) What is your business address? Is a good address a factor? 2) What are the physical features of your building? 3) Is your building leased or owned? State the terms (include copy of the lease in the appendix.) 4) Are renovations needed? What are they? What is the expected cost? 5) What is the neighborhood like? Does zoning permit your kind of business? 6) What kinds of businesses are in the area? Are they compatible? 7) Have you considered another area? Why is this site the *one* desirable site for your business? 8) Why is this the right building and the right location for your business? 9) How does (or will) this location affect your operating cost?

This section can be fairly short. Notations in this section on what you think would be most desirable will help keep you targeted for more profitability from your business location.

E. Management. According to various studies of factors involved in the failures of small business, roughly 98% of the businesses fail because of managerial weakness; less than 2% of the failures are due to factors beyond the control of the persons involved. Of the 98% failures, managerial incompetence accounts for 45% of business failures. Your business plan must take this fact into account by analyzing management personnel. In preparing this section, there are five areas to be considered.

Personal history of principals. This would include your business background and management experience. Include education, both formal and informal, which has a bearing on the managerial abilities. Personal data as to age, where you live and have lived, along with special abilities and interests leading into the *motivation* for going into the business and why you are going to be successful at this venture. Be sure to indicate if you are physically able to handle the job. Owning and operating a business requires considerable stamina. Do you have the support of your family?

A personal financial statement must be included as a supporting document in your business plan, especially if it is a proposal for financing. Bankers and other lending sources want to see as much collateral as possible to secure their loan. Be forewarned: under most circumstances, the personal creditworthiness of the principals will be a major concern of the banker. Also, you will undoubtedly be expected to *sign personally* for the loan. This means that your personal assets may be taken if the business fails—even if the business is a corporation.

Related work experience will be more detailed than mentioned previously. Direct operational experience and managerial experience in this type of business should be documented. Managerial experience outside the type of business should be noted whether it is from work or public service but try to correlate that experience with the needs of the business.

Duties and responsibilities of the proposed management should be written down relating: Who does what? Who reports to whom? And where do the final decisions get made? Include time for planning and reviewing plans. List major operating duties and allocate these duties and responsibilities so they are clear to you and to

your employees.

Salaries should be defined. Many deals never get going because bankers feel the principals are getting paid more than they should. Include a cost of living budget to help justify your salary requirements. One sure way to damage a small business is to bleed it for family necessities. If your business cannot afford to pay you a living wage, and you have no other income or savings, you had better think your deal over again.

Resources available to the business include your accountant, lawyer, and insurance broker in addition to your banker. Your banker will have a vested interest in your business if you have a loan from them. He will want to know what is happening with the business on a continuing basis. Get to know not only these people but any others that you may need, before you need them. There are numerous other resources which should be noted, especially if they fill the gaps in on-board expertise. Keep in mind the necessity of managing your business rather than letting the business manage you.

F. Personnel. Businesses stand or fall on the strength of their personnel. Good employees can make a marginal deal go; poor employees can destroy the best business. Here are some questions to think about in determining your hiring needs: What are your personnel needs now? In the near future? In three years? In five years? What skills must they have? Are the people you need available? Do you need full or part-time or a mix? Are you going to use salaries or hourly wages? Or both? What will your fringe benefits be? What will they cost? Are you planning on overtime? Will you train the people? If so, what will it cost? How often will you have to train? Or retrain?

One excellent personnel control is the job description. Hire people only when it will result in added profitability to your business. Think before hiring whether or not the job is really necessary. If it is, then careful selection of a person to fill the job will more than repay the time and effort involved in hiring the *best* person for that job.

G. Application and expected effect of loan. Whether you are seeking a loan or planning to finance the deal yourself it is important to use this section. In determining how much money you'll need and for what purposes it will be used, do not rely on guesses when exact prices or firm estimates are available.

Make sure that this section contains responses to the following: How is the loan or investment to be spent? What is (are) the item (or items) to be bought? Who is the supplier? What is the price? What is the specific model, name and/or number of your purchase(s)? How much did you (or will you) pay in sales tax? For installation charges? For freight charges? How will the loan make your business more profitable?

Your banker may be interested in using whatever it is that you are buying as collateral for the loan. By having a list, your loan can be processed faster. You may want to consider the leasing of capital equipment and renting instead of buying a building.

Interest is an expense which reduces profits. If you propose borrowing money or investing your own, you must know how the money is going to work for you. Make sure it earns more than it costs.

Be guided by your judgment in this section. Hard figures will appear in the financial data section to support any loan proposal. The objective is to give the reader—either you or your banker—an insight into the effect of the loan on the business that is expressed qualitatively.

Consider in your loan application a reserve loan (not disbursed) available to take advantage of opportunities which may arise in the future. Frequently a small business grows too fast and when it turns to the bank for additional financing the funds are denied. In this way, the funds will be available when needed but, because they are not disbursed, will not incur additional interest expense. This looking ahead to forestall problems is a good example of careful planning and will be noted by the banker.

H. Summary. The purpose of this section is to summarize the ideas you have developed in the preceding sections. This summary will help you make sure that the different parts of the analysis make sense, that they support each other logically and coherently, and that it leaves the reader with a concise, convincing statement that the project is feasible *and profitable*.

II. Financial Data

Policy and control are the key ingredients of any successful business. Policy is establishing what your business will do. Control is measuring the accomplishment of policy goals.

The heart of the operation is in the accounting system. Before you start your business, it is essential that you have a competent public accountant set up a paperwork system that will give you adequate accounting records. If you can't afford this, you are simply too undercapitalized to be in business. If you don't understand the need for this, you don't have enough management experience to be starting a business. This is a typical problem area for the vast majority of small businesses.

The overriding policy of a business is to find out what the market wants, provide satisfaction of those wants, and to do so while making a profit. The implementation of your policy depends on planning and using your plan as a means of controlling your business. The first step towards managing your business for profits is to establish a bookkeeping system that provides you with the raw data for the five control documents: balance sheet, break-even analysis, income statement, cash flow, and deviation analysis.

Your bookkeeping system should be simple enough for you or an employee to keep up-to-date on a daily basis with provisions made for weekly, monthly, quarterly, and yearly summaries. The system must contain cash controls (a checkbook and a tape cash register are part of your bookkeeping system). Beyond this, your method of bookkeeping should be suited to your specific needs.

There are some good bookkeeping systems available, and they fall under three general categories: do-it-yourself, business service firms, and accountants (public, CPA, and in house). Each category has definite advantages and disadvantages. You should decide which suits your needs best. The do-it-yourself systems are lowest in cost but require more time and often provide less information than professional business service firms and accountants. Business service firms and accountants do cost considerably more. Your best bet is to check out all three before making your decision. Keep in mind that business service firms and accountants can frequently act as outside staff (consultants). This extra service might justify their higher cost.

The five control documents (balance sheet, break-even analysis, income statement, cash flow, and deviation analysis) mentioned earlier are the backbone of your planning efforts. Properly used, they act as a budgeting tool, an early warning system, a problem identifier, and a solution finder. Used inconsistently or not at all, they are worthless. Used incorrectly they are dangerous. Misleading financial information can lead to bad, often disastrous, decisions. These documents needn't be very complicated. Develop your financial statements with an eye on your information needs, using your common sense as guide to the level of detail that is required for your business. It is possible to suffer from too much information. These statements are to be used systematically. Make it a policy to spend at least several hours each month checking them over. By doing so the data will be of maximum use to you; it will help you plan your profits, make good business decisions, and set reasonable objectives for the future.

Ultimately, your accounting system should be a working model of your business. A business manager has two concurrent objectives: to make a profit and to pay bills as they come due. These objectives are reflected in the two main financial statements, the income statement and the cash flow. The income statement, also called the profit and loss statement, is designed to show how well the company is managing its cash (liquidity) by subtracting disbursements from receipts.

The break-even analysis is based on the income statement and cash flow. It is a technique that no business, no matter how small, can afford to ignore. Basically, a break-even analysis shows the volume of revenue from sales that is necessary to exactly balance fixed and variable expenses. This document can be used to help make information available for decision making in such critical areas as setting prices, purchasing or leasing equipment, projecting profit (or loss) at different volumes, and even hiring a new worker.

The balance sheet records the past effect of such decisions. More to the point, it records what the cash position (liquidity) of the business is and what the owner's equity is, at a given time: these are directly affected by the cash flow and the in-

come statement.

Together, the income statement, cash flow, break-even analysis, and balance sheet afford a comprehensive model of the operations, liquidity, and the past and near future of your business. If there is only a single statement that is available, most accountants advise that it be the cash flow since a business that cannot pay its bills cannot stay in business for long, even though the business may be operating at a profit. Remember: cash-in flows must equal or be greater than cash-out flows.

Projections or forecasts are an integral part of your financial data and are critical to accurately evaluating the feasibility of your deal and to planning just how large an investment is required to get the business to a stable level of operation. Your assumptions must be carefully thought out and explained. Be honest for your own benefit. Over-optimism can lead to failure.

A. Sources and applications of funding. This must be included if your business plan will also serve as a financing proposal. It is a restatement of the information in part "G. Application and Expected Effect of Loan or Investment." Major anticipated expenditures should be supported by copies of contracts, lease and/or purchase agreements, or similar documents and included in the appendix.

Sources of funds could include mortgage loan; term loan; reserved loan; and owners investment. Applications could be for purchase of building; equipment; renovations; inventory; working capital; and a reserve for contingencies. *The sources and the applications must be equal.*

B. Capital equipment list. The capital equipment list is used to maintain control over depreciable assets, insure against letting your reserve for replacement of capital equipment become too low (or be used as a slush fund), and to assist in the creation of a cost budget.

Capital equipment is that equipment which you use to manufacture a product, provide a service, or use to sell, store, and deliver merchandise. It is not equipment that you will sell in the normal course of business, but rather it is equipment that you will use and wear out or consume as you do business (this does not include items that are expected to need replacement annually or more frequently). These goods are depreciable, and their cost is expressed as "depreciation" expense on the income statement.

These items should be listed by name, model number, and cost or list price at least. The more information used the more valuable the list. Be sure to include sales tax, installation fees, and freight charges.

C. Balance sheet. Balance sheets are designed to show how assets, liabilities, and net worth of a company are distributed at a given time. The format is standardized to facilitate analysis and comparison—do not deviate from it.

Balance sheets for all companies, great and small, contain the same categories. The difference is one of detail. Your balance sheet should be designed with your business information needs in mind. These will differ according to the kind of business you are in, the size of your business, and the amount of information that your accounting system makes available.

The order of sub-categories is important and should be followed. They are arranged in order of decreasing liquidity (for assets) and decreasing liquidity immediacy (for liabilities).

The following is a brief explanation of each principal category.

(1) *Current assets*: Cash, government securities, marketable securities, notes receivable (other than from officers or employees), accounts receivable, inventories, prepaid expenses, and any other item that will or could be converted into cash in the normal course of business within one year.

(2) *Fixed assets.* Land, plant, equipment, leasehold improvements, and other items that have an expected useful business life measured in years. Depreciation is applied to those fixed assets that (unlike land) will wear out. The fixed asset value of a depreciable item is shown as the net cost minus accumulated depreciation.

(3) *Other assets.* Intangible assets such as patents, copyrights, royalty arrangements, exclusive use contracts, and notes receivable from officers or employees.

(4) *Current liabilities.* Accounts payable, notes payable, accrued expenses (wages, salaries), taxes payable, current portion of long-term debt, and any other obligations coming due within the

year.

(5) *Long-term liabilities.* Mortgages, trust deeds, intermediate and long-term bank loans, and equipment loans.

(6) *Net worth.* Owner's equity and retained earnings.

(7) *Footnotes.* You should provide displays on any extraordinary item (for example, a schedule of payables). Contingent liabilities (such as a pending lawsuit) should be included in the footnotes.

If you need to provide more detail, do so, but remember to follow the standard format. If your balance sheet is assembled by an accountant, he will specify that it was done with or without audit. If you do it yourself, it is without audit. The decision to use (or not use) an accountant (and if so, to what extent) should be made carefully. This may be important for tax purposes or other legal reasons.

D. Break-even analysis. A break-even analysis provides you with a sales objective that is expressed in either the number of dollars or units of production at which your business will be breaking even, that is, where it is neither making a profit nor losing money. If you know your break-even point, you have a definite target that you can plan to reach by carefully reasoned steps. Many businesses have destroyed themselves by ignoring the need for a break-even analysis. It is essential to remember: *INCREASED SALES DO NOT NECESSARILY MEAN INCREASED PROFITS.*

Calculating the break-even point can be simple (for a one product business) or complex (for a multi-line business), but whatever the complexity, the basic technique is the same. Some of the figures you need to calculate the break-even point will have to be estimates. It is a good idea to make your estimates conservative by using somewhat pessimistic sales and margin figures and by slightly overstating your expected cost figures. The basic break-even formula is: **S = FC + VC**, where **S** = break-even level of sales in dollars; **FC** = fixed cost in dollars; **VC** = variable cost in dollars.

Fixed costs are those costs that remain constant no matter what your sales volume may be, those costs which must be met even if you make no sales at all. These include overhead (rent, office, and administrative costs, salaries, etc.) and "hidden costs" such as interest and depreciation. Variable costs are those costs associated with sales including cost of goods sold, variable labor costs, and sales commissions. These cost figures are further developed in the Pro Forma Income Statements.

When you want to calculate a projected break-even and you therefore do not know what your total variable cost will be, it is necessary to use a variation of the "S = FC + VC" formula. If you know what Gross Margin (profit on sales) you expect as a percent of sales, the following formula can be used: **S = FC : GM**, where **GM** = Gross Margin as a % of sales.

If, instead of calculating a dollar break-even, you want to determine how many units (or hours for a service company) you will need to sell to break even, you simply divide the break-even derived above in dollars by the unit price (or charge per hour) to get the number of units (or hours) to be sold to reach the break-even point.

E. Pro forma income statement. Income statements, also called profit and loss statements, are complementary to balance sheets. The balance sheet gives a static picture of the company at a given point in time. An income statement provides a moving picture of the company during a particular period of time. Income statements that are cast into the future are called Income Projections. Income projections are forecasting and budgeting tools, estimating income and anticipating expenses, in the near to middle range future. For most small businesses, income projections covering the next five years are adequate.

You do not need a crystal ball to make your own projections. While no set of predictions will be 100% accurate, experience and practice tend to make your projections more precise. Even if your projections are not accurate, they will provide you with a set of benchmarks to test your progress toward short-term goals. They become your budget.

There is nothing sacred about income projections. If they are not exact, correct them to make a more realistic guide. However, at what point you should do this is a matter for your judgment. Do not change your predictions more than *quarterly* or even semi-annually. In a short period, certain trends will be magnified, and these distortions will

usually even out in the long run. Of course, if you omit a major expense item or a new source of revenue you ought to make immediate corrections, but use your common sense.

The reasoning behind income projection is this: since most expenses are predictable and income doesn't fluctuate too drastically, the future will be much like the past. If, for example, your gross margin has historically been 30% of net sales, it will (unless there is strong evidence to the contrary) continue to be 30% of net sales. If you are in a start-up situation, you can find income ratios for businesses similar to yours (Dun & Bradstreet and Robert Morris Associates, for example). This will improve the accuracy of your financial forecast.

It is important to be systematic and thorough when you list your expenses. The expense that makes your business illiquid is often one which is overlooked, and therefore unplanned for. There are some expenses that simply cannot be foreseen, and the best way to allow for them is to be conservative in your estimates and document your assumptions. Try to slightly understate your expected sales and slightly overstate your expected expenses.

It is far better to exceed a conservative projection than to budget optimistically and then fall below the projected margins. However, being *too far under* can also create problems—such as not having adequate cash to finance growth. Basing income projections on hopes is a frequent cause of business failure. Be realistic; your budget is intimately tied to your forecasted sales and expense figures.

Income statements and projections are standardized to facilitate comparison and analysis. They must be *dated* to indicate the period of time they cover and should also contain notes to explain any unusual items such as windfall profits, litigation expense and judgments, changes in depreciation schedules, and so forth. Any assumptions you make must be footnoted.

Income statements should be reviewed at least once a quarter (or more frequently) to check their validity and, if necessary, to make adjustments. As a budget tool, the actual progress of the business should be compared against the projections on a monthly basis. You need to detect deviations as soon as possible so that you can correct problems before they become disasters, and to identify new opportunities for growth. Remember, the purpose of the financial statements and forecasts is to provide you with a maximum amount of usable information, not to dazzle a prospective investor. For the most useful projections, state your assumptions clearly. Do not put down numbers that you cannot rationally substantiate. Do not puff your gross sales figures to make the net profit figure positive. BE REALISTIC.

Businesses, for both planning purposes and for loan proposal requirements, should project income and cash flow for five years. The proper sequence of projection pages in your business plan for both income and cash flow would be as follows: 1) Five year summary. 2) First year projected by month. If the business does not break even in the first year, continue projections through the year that shows a break even. 3) Years II, III, IV, and V projections by quarter (provided break even was achieved in year I).

If you are already in business or are considering taking over an existing business, historical statements (income statements and balance sheets) should be included for at least the three previous years. Tax returns help to substantiate the validity of unaudited statements.

F. Pro forma cash flow. The cash flow is the most critical planning tool for a new or growing business. Businesses need cash for start-up or growth. The cash flow analysis: 1) shows how much cash will be needed, 2) when it will be needed, 3) and where it will come from.

The cash flow attempts to budget the cash needs of a business and shows the flow of cash into and out of the business over a period of time. Cash flows into the business from sales, collection of receivables, capital injections, etc. and flows out through cash payments for expenses.

This financial tool emphasizes the points in the calendar when money will be coming into and going out of the business. The advantage of knowing when cash outlays will be made is the ability to plan for those outlays and not be forced to resort to unexpected borrowing to fulfill cash needs. By constructing a cash flow for the near to immediate future, you can see the effect of a loan on your

business more clearly than you can from an income statement. Often, you can find different ways to finance your business operations or to only borrow a specific amount needed which will help you to keep your interest expense as low as possible.

Cash is generated primarily by sales. However, not all sales are cash sales. Perhaps this does not apply in your business, but if you offer any credit (charge accounts, term payments, trade credit, etc.) to your customers, you may want to have a means of telling when your sales turn into cash-in-hand. Unlike the income projection, the cash flow can indicate this. Your business may be subject to some seasonal bills, and again, cash flow makes the liquidity problems attending such large, occasional expenses clear.

A cash flow deals only with actual cash transactions. Depreciation, a non-cash expense, does not appear on a cash flow. Loan repayments (including interest), on the other hand, do since they represent a cash disbursement.

After it has been developed, the cash flow should be used as a budget. If the expenses for a given item increase over the amount allotted for a given month, you should find out why and take corrective action as soon as possible; if the figure is less, then also find out why. By reviewing the movement of your cash position you can better control your business. If expenses are lower than anticipated, it is not necessarily a good sign; it may be that a bill wasn't paid.

On the other hand, the lowered expense may alert you to a new way of economizing. Discrepancies between expected expenses and revenues and the actual flow of cash are indicators of problem or opportunity areas. If the sales figures don't follow the cash flow, look for the cause. Perhaps the projections are too low. Your cash flow is not a universal cure that will make your job as manager or owner superfluous. It is a tool that you must use and use consistently.

G. Deviation analysis. For most small businesses, the pro forma cash flow for one year provides an operating budget. You may wish to break down some of the expense items (disbursements) more finely to insure greater control, but the cash flow is a basic framework for your budget. Budget deviation analysis is a direct control on your business. It can help you minimize expenses and increase profits at a time cost of approximately one evening per month. It is an essential part of your business even when things are going well.

Budget deviation analysis must be performed periodically, at least on a monthly basis, if it is to be effective. If you are engaged in a business with several projects going on concurrently, it may be more helpful to devise separate budgets and deviation analyses for each job or division. Budget deviation analysis provides one of the most valuable sources of current information available to you, and it is a task no manager can afford to let slide. At a glance, if done properly, it will tell you which parts of your business are going out of control and which are exceeding expectations.

Year to date budget deviation analysis is another instrument of financial control. If more expenditures fall in one month than were expected, you will often find a corresponding lowering of expenditures for the preceding or following month. The year to date budget deviation analysis helps to level out these swings. Used with the monthly budget deviation analysis, this form will save you some unnecessary arithmetic and worry as well as check the accuracy and effectiveness of your projections. With experience, your budgeting will become more exact, affording you ever greater control over your business and enhancing your profitability.

As in the case with other control documents, you should adapt the formats to your own particular needs. Your accountant can help here, but you must be the one to decide what information will be reflected by the budget deviation analysis.

H. Historical financial reports. An integral part of your business plan is a record of what has happened in the past. For most business deals, balance sheets and income statements for the past three years are sufficient, though it may be necessary to go further back if you are trying to raise capital (especially venture capital). The third major component of your past financial condition is your tax statement. Since this must be filed on at least an annual basis, it provides a summary of what you earned, how you earned it, and what your deductible expenses were. If you decide to sell your business, these tax reports will be the

first substantiation of your asking price that will be requested. If you don't have these financial records, or if you have lied to minimize your tax liabilities, you have only cheated yourself. In the first instance, you have demonstrated your incompetence by not keeping records. In the second case, you have simply lowered the performance level of the business, thus making it a worse risk for a lender and more difficult to sell, should you have to sell. Either way, it just isn't worth it.

Finally, various tax records can be used as an additional source of data. For example, exact copies of wage and deduction statements are helpful in preparing projections for the future. Financial data from the past is an important planning aid.

III. Supporting Documents

Any additional supporting documents should be included in the last section of the business plan. If it is for an application for funding, it is very important to substantiate as much of the information contained in the business plan as possible. If not used for funding, it may help to remind you of where you started, where you were headed, how you got to where you are, if you are still on course, or if you need to change the course.

Summary

Budgeting, balancing objectives with reality, then guiding the business to achieve the goals within the budget constraints, is the real test of management ability.

With the exception of historical financial reports, which reflect past managerial decisions, the financial data section stresses the importance of making careful assumptions about the objectives of your business as the first step in preparing financial documents. These documents, particularly the income and cash flow projections, give you the basis for your planning efforts. They set up a systematic range of objectives to be met. The most critical is: how long to the break-even point. Through deviation analysis, they establish your principal control system, a system that will serve as an early warning network when consistently used and that will contain built-in suggestions for remedying weaknesses in your operation.

The financial records discussed here are not intended to be straitjackets. They are meant to free you from the number one problem most small business owners/managers face: how do you find time for planning when there are so many brushfires to be put out? Your single most important asset is your time. To make the most effective use of your time, early planning is not a luxury, it is a necessity.

It cannot be overstressed that the control over your business is only as strong as the decisions on which those controls are based. You *must* take the time to think your business objectives through and in careful detail.

You *must* make your assumptions as clear and as well defined as possible. And you *must* be prepared to constantly review and reevaluate those assumptions and make appropriate corrections to your projections on a periodic basis.

Financial data is the heart of your planning efforts once the business has been fully articulated. The financial documents will provide you with the information to manage your business, and that information should be timely—not a month or two months too late—to avert a full-blown problem.

Solve problems before they occur, not after. This requires that you set aside time to review the information your system provides. Budget your time as well as the activities of the business. An excellent practice followed by many managers is to set aside one afternoon or evening a week, away from the office and the telephone, for planning and review. If you have the feeling that you cannot afford the time, this is the clearest indication that you need to plan and that you *must* plan, and that you *must* take the time *NOW. PLANNING IS THE KEY TO BUSINESS SUCCESS.*

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