Chapter 7: The Financial Plan

Tab 1: Introduction

The **financial plan** demonstrates how much money you will spend and how much money you hope to make in your new business. It shows you have enough money to run your business, and that you have thought about how you will manage your business finances. VR agencies, lenders, and investors use the financial plan to help decide if they want to give you a loan or invest in your business.

Business owners use the financial plan as a working document to compare their actual financials against their predicted growth. When there are differences between the financial plan predictions and the actual financials, you need to make some changes in your pricing, sales, or other areas.

The financial plan includes several sections:

- Up-front cash needs
- Break-even analysis and pricing
- Sales forecast
- Cash flow statement
- Income statement
- Balance sheet

These sections build on one another, so if something in one section changes, you might have to go back and change the other sections too.

Cash Needs

Up-front cash is the money needed to get a new business up and running. This includes the money you need to set up the business before it can open, and the money you need to run the business and cover expenses until your business earns a profit.

Up-front cash needs are estimated for two types of costs:

- Pre-opening expenses
- Post-opening expenses

Pre-Opening Expenses

Pre-opening expenses are things you pay for while you're getting your business set up and ready to open. They include:

- Inventory – your finished product, or the things you need to make your product
- Capital equipment – major equipment or fixtures that have a shelf life of over one year
- General Supplies – things you use in day-to-day business operations, but are not direct inputs for making your product
- Property – buying or renting your building space
- Renovations – changing or getting your workspace ready for business
- Marketing – advertisements, promotions, and creating marketing materials
- Other pre-opening expenses – such as costs for licenses, permits, insurance, or utilities

Use your Start-up Costs Worksheet from Chapter 3: Business Feasibility to estimate your pre-opening expenses.

Post-Opening Expenses
Post-opening expenses are things you pay for once your business is open. They are the costs for running your business. They include:

- Inventory and wages
- Rent and utilities
- Capital equipment replacement or expansion
- Marketing
- Ongoing expenses such as tax and bookkeeping services
- Unforeseen costs

Funding
When you have enough money to pay for your pre- and post-opening expenses, with some money set aside for emergencies, your business is capitalized. Your business is capitalized when you have enough money to run your business until you start making a profit.

It can be hard to figure out how much up-front funding you need, but it is important to know this information. You need to know how much money you will have to use of your own savings, and how much you'll need to get from other funding sources.

Sources of Cash
You can get funds to start your business from different places, such as:

- Personal savings
- Loans – bank loans, bank lines of credit, and loans from friends or family
- Investors – angel investors, venture capitalists, VR, friends, or family
- Grants – small business incubators and government grant programs
- Gifts – crowdfunding, friends, and family

Trade or Barter
One way to keep down expenses is to trade, or barter, with other businesses or people. Think about what things other people could help you with, and what skills or talents you have to offer in exchange. These could be professional skills related to your business, or other things that you're good at but not necessarily related to your business.

For example, if you are skilled at graphic design, you could offer to design some advertisements for another person's small business in exchange for their help with transporting and setting up your shelving units. Or, you could ask a friend to help you catalogue your inventory in exchange for a fancy home-cooked meal or an evening of babysitting their children.

Tab 2: Break-Even Analysis

A **break-even analysis** helps you figure out how much product or service you have to sell in order to break-even, or to cover all of your costs. Then, it helps you figure out how many additional units you have to sell to reach profit goals. A break-even analysis can show you how changing different parts of your financial plan, like increasing your price or reducing expenses, can affect your profit.

To start your break-even analysis, first estimate your fixed and variable operating costs. These are what you use to estimate gross profit per unit and the break-even point for different prices. This, in turn, helps you develop sales goals.

Conducting a Break-Even Analysis

Fixed and Variable Operating Costs

The first step in a break-even analysis is to figure out your monthly variable and fixed operating expenses.

- **Fixed operating costs** are costs you always pay, even if you don't sell anything. They are generally recurring costs, such as rent, utilities, or insurance.
- **Variable operating costs** are how much it costs for you to produce your product or service. These costs are higher if you make a lot of your product, and lower if you make less. For this reason, they need to be estimated on a monthly, quarterly, or per project basis.

If you are unsure about what these costs include, refer to the Inputs section of Chapter 6: Operations Plan.

Gross Profit per Unit

To figure out your gross profit per unit, subtract your variable costs per unit from your price per unit. Gross profit covers your fixed operating costs.

price per unit – variable costs per unit = gross profit per unit

When you sell enough units of your product to exactly cover your fixed operating costs, this is called your break-even point.

When you sell more than your break-even point, this means your business is earning a profit.

Break-Even Point

To figure out your **break-even point**, divide your fixed operating costs by your gross profit per unit.

fixed costs ÷ gross profit per unit = break-even point

Your business will break-even when the money you bring in from sales covers your fixed and variable operating costs.

Example: Jean's Variable Operating Costs

Jean is starting a jewelry making business. She is starting with earrings, since they are relatively easy and inexpensive to make. Jean made this table to estimate her per unit variable costs to produce a pair of earrings. She included per unit labor, materials, packaging, and shipping costs. She added these costs together and found that her variable costs per pair of earrings is $13.50.

Variable Costs (for producing one pair of earrings)	
Labor = .33 @ $9.00/hour	$3.00
Materials	
Silver	$5.75
Semi-precious stone	$3.75
Shipping	$0.75
Box/packaging	$0.25
Total variable costs per unit	**$13.50**

Jean's Fixed Operating Costs

Next, Jean estimated her fixed monthly costs. These include her rent, utilities, insurance, taxes, and other costs that she has to pay each month even if she doesn't sell any of her earrings. Jean estimated her fixed monthly costs at $945.

Monthly Fixed Costs	
Rent	$335.00
Utilities	$50.00
Phone	$50.00
Office supplies	$30.00
Insurance	$25.00
Advertising/promotion	$40.00
Taxes	$40.00
Owner's Draw	$300.00
Craft fair expenses	$75.00
Total fixed costs per month	**$945.00**

Jean's Gross Profit per Unit

Jean's variable costs per pair of earrings is $13.50. In order to earn a profit, she will need to charge more than her variable costs per unit. Jean estimated her gross profit per unit for three different price points ($20, $25, and $30 per pair of earrings) using this formula:

price per unit – variable costs per unit = gross profit per unit

Gross Profit per unit			
Sales price per unit	$20	$25	$30
Variable costs per unit	$13.50	$13.50	$13.50
Gross profit per unit	$6.50	$11.50	$16.50

Jean's Break-even Point

Jean's break-even point is how many pairs of earrings she must sell per month to cover both her variable and fixed costs. Depending on the price she charges and the gross profit she earns, Jean will have to

make different amounts of earrings to cover her monthly fixed costs. She uses this calculation to figure out the break-even point for her three different price points:

fixed costs ÷ gross profit per unit = break-even point

Break-Even Point			
Sales price options	**@ $20**	**@ $25**	**@ $30**
Monthly fixed costs	$945.00	$945.00	$945.00
Gross profit per unit	$6.50	$11.50	$16.50
Break-even point (number of units to sell)	**146**	**83**	**58**

Jean's Pricing Considerations

If she sells her earrings for $20, Jean must sell 146 pairs each month to break even. At $25 per pair, she must sell 83 pairs, and at $30 per pair, she must sell 58. In a month when Jean sells more than the break-even number, she makes a profit. In a month when she sells below her break-even number, she loses money.

How you price your product or service will affect how many units you sell. When you charge more, you often sell less. Research about your industry can help you figure out how much customers will pay. The next two slides have more information about other things to think about when setting your prices.

Jean's Profit Sales Goals

If you want your business to grow, you can't just break-even each month. You need to think about personal and long-term business goals, like earning money to reinvest in your business.

Jean wants to earn $150 in profit per month to buy a van and upgrade her equipment. She uses this calculation to figure out how many additional pairs of earrings she must sell.

profit goal ÷ gross profit per unit = profit sales goal

Profit Sales Goals			
Sales price options	**@ $20**	**@ $25**	**@ $30**
Profit goal per month	$150.00	$150.00	$150.00
Gross profit per unit	$6.50	$11.50	$16.50
Profit sales goal (additional units to sell)	**24**	**14**	**10**

Pricing

Once you calculate your fixed costs, variable costs, gross profit, break-even point, and sales goals, you can decide what to charge. The numbers alone will not dictate the right price. You will also need to consider things like how much your competition charges, and how much customers are willing to pay for your product or service.

Check out How to Price Your Small-Business Products and Services (www.sba.gov/blogs/how-price-your-small-business-products-and-services) from the Small Business Association How to Price Your Products (www.inc.com/guides/price-your-products.html) from *Inc.com* to get some ideas.

Pricing a Service
Figuring out how to price a service is not always as easy as pricing a product. For example, it might be hard to calculate how much you spend on materials, labor, and overhead for a home-based accounting business. Instead, you can calculate price for a unit of time, such as by the hour or by the project. To do this, research your industry for:

- Rates for comparable services
- Method of billing – per hour or per project
- Who pays for materials – the customer or the business owner

To calculate break-even points and sales goals for a service business, pick two or three different rates to figure out the number of billable hours needed to cover fixed costs.

Check out 5 Tips for Pricing Your Services When You're Self-Employed (www.theselfemployed.com/start_ups/5-tips-for-pricing-your-services-when-youre-self-employed/) from *theselfemployed.com* and What is Your Time Worth? How to Figure Out Your Hourly Rate (www.handymanstartup.com/figure-hourly-rate/) from *Handyman Startup* for more tips on how to price a service.

Quiz Yourself

Scenario: Parker's Gourmet Cat Treats
Parker is starting a business making gourmet cat treats. He plans to sell them in local pet shops and directly to individual pet owners. He is trying to figure out his gross profit per unit, break-even point, profit sales goals, and total units to sell for three different price points.
Download the Quiz Yourself Worksheet: Break-Even Analysis (http://vrselfemployment.org/sites/default/files/PDFs/Quiz-Yourself-Worksheet-Break-Even-Analysis.pdf) and help Parker make these calculations.

You will need the following information:

- Variable costs for producing one package of cat treats are $5, which includes labor and materials.
- Fixed costs per month are $900.00, which includes his rent, utilities, insurance, advertising, taxes, and owner's draw.
- Parker is exploring selling his product for three prices ($8, $10, and $13 per bag).
- Parker's profit goal per month is $100.00.

Gross Profit per Unit
Parker first wants to figure out his gross profit per unit. Use the formula below and the Quiz Yourself Worksheet: Break-Even Analysis to figure out Parker's gross profit per unit for his three different price options ($8, $10, and $13 per unit). Parker's variable costs per unit are $5.

price per unit – variable costs per unit = gross profit per unit

Check your answer next.

Parker's Gross Profit per Unit
For each price point, Parker subtracted his variable costs per unit and figured out his gross profit per unit. At a sales price of $8, his gross profit per unit is $3. If he charges $10, his gross profit per unit is $5, and if he charges $13, his gross profit per units is $8.

Gross Profit per Unit			
Sales price per unit	$8.00	$10.00	$13.00
Variable costs per unit	$5.00	$5.00	$5.00
Gross profit per unit	$3.00	$5.00	$8.00

Break-Even Point
Next, Parker needs to figure out his break-even point. Use the formula below and figure out how many bags of cat treats Parker needs to sell each month to reach his break-even point for his three price points ($8, $10, and $13 per bag). Parker's fixed costs each month are $900.00.

fixed costs ÷ gross profit per unit = break-even point (number of units to sell each month)

Check your answer next.

Parker's Break-Even Point
For each price point, Parker divided his fixed costs by gross profit per unit to arrive at the number of bags of cat treats he needs to sell to break-even. At a sales price of $8, he needs to sell 300 bags of cat treats to break-even. If he charges $10, he needs to sell 180 bags, and if he charges $13, he needs to sell 113 bags.

Break-Even Point			
Sales price options	**@ $8.00**	**@ $10.00**	**@ $13.00**
Monthly fixed costs	$900.00	$900.00	$900.00
Gross profit per unit	$3.00	$5.00	$8.00
Break-even point (number of units to sell)	**300**	**180**	**113**

Profit Sales Goal
Next, Parker needs to figure out his profit sales goal. This will tell him how many additional bags of cat treats over the break-even point he'll need to sell each month to make a profit. Use the formula below to figure out Parker's profit sales goal for his three price points ($8, $10, and $13 per bag). Parker's monthly profit goal is $100.00.

profit goal ÷ gross profit per unit = profit sales goal (additional units to sell)

Check your answer next.

Parker's Profit Sales Goal
For each price point, Parker divided his profit sales goal by gross profit per unit to arrive at the number of additional cat treat bags he needs to sell to reach his profit goal. At a sales price of $8, he needs to sell an additional 34 bags of cat treats to meet his profit sales goal. If he charges $10, he needs to sell an additional 20 bags, and if he charges $13, he needs to sell an additional 13 bags.

Profit Sales Goals			
Sales price options	**@ $8.00**	**@ $10.00**	**@ $13.00**
Profit goal	$100.00	$100.00	$100.00
Gross profit per unit	$3.00	$5.00	$8.00
Profit sales goal (additional units to sell)	**34**	**20**	**13**

Total Units to Sell
Using your answers from the previous questions, how many bags of cat treats must Parker sell each month to break-even and reach his profit goal? Use this formula to figure out how many bags of cat treats Parker needs to sell each month for each price point.

break-even point + profit sales goal= total units to sell

Check your answer next.

Parker's Total Units to Sell
Parker added the number of units he needs to sell to break-even with the number of units he needs to reach his profit goal and figured out the total number of bags of cat treats he needs to sell each month at each price point. At a sales price of $8, he needs to sell 334 bags of cat treats to break-even and meet his profit sales goal. If he charges $10, he needs to sell 200 bags, and if he charges $13, he needs to sell 126 bags.

Total Units to Sell			
Sales price options	**@ $8.00**	**@ $10.00**	**@ $13.00**
Units sold to break-even	300	180	113
Units sold to reach profit goal	34	20	13
Total units to sell	**334**	**200**	**126**

Tab 3: Sales Forecast

The break-even analysis helps you set pricing and sales goals. The **sales forecast**, on the other hand, describes what you think you will sell over a given period of time (typically 1 to 3 years).

For a new business, the sales forecast is an estimate based on:

- Market share - the portion of customers that will go to your business versus the competition
- Expected growth in sales over the business start-up phase
- Seasonal fluctuations

Once your business is up and running, your sales forecast becomes more accurate based on the past year's actual sales.

Forecasting Sales

You can figure out your sales forecast using several different strategies:

- You can use average sales for similar businesses in similar locations to give you a ballpark idea about expected sales.
- You can figure out your market share, or how much business you will attract compared to your competitors.
- You can break down sales into months for specific products and services and account for variations in sales during business start-up or to account for seasonal fluctuations.

These strategies should be used together to come up with your best estimate of future sales. The more information you gather to estimate sales, the better!

Average Sales

When you start a new business, you may not have a clear idea of what kind of sales to expect. Use average sales for similar businesses in similar locations as a benchmark for expected sales. However, don't assume you will have average sales right off the bat. Make sure to account for lower sales during the start-up phase.

Check out this University of Minnesota Extension fact sheet: How can I assess demand for a proposed business in my community? (www.extension.umn.edu/community/retail/analysis/assess-demand-business) for more information and instructions on how to use the Economic Census to estimate your potential sales.

Estimating the Market

A business' market share is the portion of the total sales, units, or customers that goes to the business instead of competing businesses. One way to figure out market share is to divide the total sales for all businesses in your area by how many sales your business made (or expects to make) for the same time period.

For example, all of the businesses that sell bath products in an area sell 1,000 handmade soaps per year. Kerry estimates she could sell 100 of her soaps per year, which means her market share is 10% (100 ÷ 1,000 = 0.10).

Market Share

There are three ways to figure out your business's potential market share. You can calculate the:

- Share of unit sales
- Share of customers served
- Share of sales in dollars

Which measure to use will depend on what product or service your business offers and what information you can find out about competing businesses in your area.

See How to Calculate Market Share for Your Business Marketing Plan (www.dummies.com/business/start-a-business/business-plans/how-to-calculate-market-share-for-your-business-marketing-plan) and Calculate Your Small Business Market Share (www.dummies.com/business/sales/calculate-your-small-business-market-share) from *dummies.com* for more information on how to figure out your business's market share.

Sales Breakdown

When you are figuring out your sales forecast, it's useful to break down sales by month during your start-up phase. You also should account for seasonal fluctuations in sales. For instance, a small craft business that makes mittens out of recycled sweaters will have much higher sales in winter months and before Christmas than in the spring and summer months.

You can also break down sales by specific products or services to get estimates that are more accurate.

Example: Carl's Lawn and Grounds Services

Carl is starting a lawn and grounds keeping business. He plans to offer services including lawn mowing, snow removal, raking/grounds clean-up, and fertilizing. He researched other lawn and grounds keeping businesses to come up with an average price for each of these services.

- Lawn mowing - $40 per job
- Snow removal - $25 per job
- Raking/ grounds clean-up - $90 per job
- Fertilizing - $75 per job

He expects that demand for his different services will change based on the season and initial business growth.

Snow Removal – 1st quarter

Carl plans to start his business in November. The only service he expects to provide during the first three months is snow removal. He has 10 clients lined up for November, but expects to attract additional clients in December and January. Based on discussions with other snow removal contractors in the area, he estimates 3 snow removal jobs per client in November and 5 per customer in December and January.

The table below shows his sales forecast for snow removal services in November, December, and January.

Snow Removal Sales Forecast

	Nov	Dec	Jan
Price per snow removal	$25	$25	$25
Number of clients	10	15	18
Units sold per month per client	3	5	5
Monthly snow removal sales	$750	$1,875	$2,250

Notice that:

- Monthly sales = price × number of clients × units sold to each client per month.
- The number of clients increases over time, reflecting business growth.
- The units sold vary across months to adjust for changes in snowfall and seasonal fluctuations.

Carl's 12-month Sales Forecast
Carl completed sales estimates for all his services for each month of the year using a sales forecast spreadsheet.

First, Carl created a spreadsheet that includes rows for each of the services he offers and columns for each month of business. For each service and month, he entered the price for each service, number of clients, expected units sold per client, and monthly sales. Click here to view Carl's 12-month Sales Forecast Worksheet (http://vrselfemployment.org/sites/default/files/PDFs/Carl-12-Month-Sales-Forecast-Example.pdf).

Notice that:

- Carl added mowing sales, removal sales, clean-up sales, and fertilizing sales to arrive at monthly sales totals.
- Carl added all of these monthly sales totals to arrive at his total sales estimate of $29,680 for the year.

Sales Forecast Spreadsheet
Use Carl's sales forecast spreadsheet as a guide to help you complete your own sales forecast. It's best to use spreadsheet software, like Microsoft Excel, which can be set up to make mathematical calculations for monthly and total sales. If you don't have Microsoft Office installed on your computer, you can access a version of Excel for free using Google Drive (www.google.com/drive).

For each of your products or services:

- Enter your sales price.
- Estimate the number of customers you will have each month.
- Estimate the number of units sold to each customer each month.
- Calculate your monthly sales using this equation:

price × number of customers × units sold per month = monthly sales

Tab 4 – Cash Flow

Cash, or the amount of money your business has at any given time, is as important to business operations as profit. While your business may be profitable overall when sales are averaged over several months, that doesn't mean you made a profit each month. This is important to note because you need to cover your bills and other fixed costs when they are due each month.

The **cash flow statement** is a monthly record of your revenue and expenses. It is calculated based on estimates of your fixed costs, variable costs, and sales. It shows when your business will receive cash (receipts) and when you need cash to pay bills (disbursements).

Each month you start with a cash reserve. During the month, you increase your cash reserve by adding payments from customers, and lower your cash reserve by deducting your costs and expenses, or disbursements. The ending cash balance is the money you have to start the next month.

Cash Flow Statement

Constructing your Cash Flow Statement

The cash flow statement usually covers a one-year timeframe. For each month, you estimate your receipts, cost of sales (or variable operating costs), expenses, and disbursements to figure out if you are operating at a surplus or deficit. The surplus or deficit amount is either added to or deducted from your cash reserve to estimate ending cash for the month. Each month's ending cash estimate is the next month's cash reserve.

Cash Reserve

The starting point for a cash flow statement is the **cash reserve**. It is important to have a large cash reserve when you first start your business. Not only will you use your cash reserve to cover start-up costs, but you will also use it to cover your fixed and variable costs until your business breaks-even.

If ending cash falls below zero, it means you have depleted your cash reserve and your business will not have enough cash on hand to pay current bills.

Receipts

Receipts are money your business receives from sales or other sources such as grants or short term operating loans. You might not always get paid right away when you sell your product or service. For instance, businesses that invoice for sales and services are generally not paid until the following month. This delay must be accounted for in the cash flow statement and can get complicated to figure out across multiple months.

Check out the following example of making receipt estimates.

Receipts Calculations – Green Grass Sprinkler

The following information was used to calculate receipts for a sprinkler installation business for May, June, and July.

- Sales for the first three months are $5,000 for May, $6,000 for June, and $7,000 for July.
- Based on estimates from owners of similar businesses, 50% of customers pay bills in the same month, 40% pay bills the following month, and 10% pay within two months. That means each month of sales will be received over three months.

	May receipts	June receipts	July receipts	Aug receipts	Sept receipts
May Sales = $5,000	$2,500	$2,000	$500		
June Sales = $6,000		$3,000	$2,400	$600	
July Sales = $7,000			$3,500	$2,800	$700
Etc....				...	...
Total Receipts	$2,500	$5,000	$6,400		

Total Disbursements

Total disbursements are made up of three types of costs:

- **Cost of Sales** are the variable operating costs, or the cost of the supplies and labor required to produce your product or service.
- **Expenses** are fixed operating costs, or costs paid each month whether or not you sell any product or service. They are things like rent, utilities, and insurance.

- **Other Expenses** cover things like loan repayments, capital expenditures, owners draw, and taxes, which are not variable or fixed operating costs.

The cash flow statement should show when you actually pay these costs of sales, expenses, and other expenses. Some of these are paid every month, such as rent and materials, and others may be only once or twice a year, such as insurance and license fees.

Surplus or Deficit
The cash flow statement shows if your business is operating at a surplus or deficit each month. If you are operating at a surplus, this means your receipts are larger than your disbursements, and your business is making a profit. If your business is operating at a deficit, your total disbursements are larger than your receipts for that month.

However, having a surplus does not mean your business is doing well. If your surplus is declining from month to month, your business is not profitable and you are using up your cash reserve. For example, if your cash reserve is $300 in January, $250 in February, and $100 in March, you are still operating at a surplus, but your business is not making money, and eventually you will be operating at a deficit once your money runs out.

Putting it Together
Use the following formula to figure out if you are operating at a deficit or surplus. If your answer is negative, it is a deficit. If your answer is positive, it is a surplus.

receipts – total disbursements = surplus (+) or deficit (-)

To figure out the ending cash balance, use the formula below.

cash reserve + receipts – total disbursements = ending cash balance

Remember that the ending cash balance for one month becomes the starting cash reserve for the following month.

Example: Gustav's Gutter - November
Download Gustav's Cash Flow Statement (http://vrselfemployment.org/sites/default/files/PDFs/Gustav-Cash-Flow-Statement.pdf) to follow along with the example.

Gustav started his gutter installation business in November.

- His beginning cash reserve was $10,000.
- His receipts for November were $0.
    - Although his sales for the month were $5,000, he projects he will not be paid for these jobs until December (50% of November sales, which equals $2,500), January (25% of November sales, $1,250), and February (25% of November sales, $1,250).
- His costs of sales, or variable operating costs, for November are $2,225.
- His expenses, or fixed operating costs, for November are $1,036.
- His other expenses for November are $4,909.
- Added together, his total disbursements for November equal $8,170. He found this number by adding his costs of sales, expenses, and other expenses.

- Because Gustav has no receipts in November, he is operating at a deficit of $8,170.
    - $0 (receipts) - $8,170 (total disbursements) = -$8,170 (deficit, because his total disbursements are more than his receipts).
- If he subtracts this deficit from his starting cash ($10,000 - $8,170) that leaves $1,830 left in cash reserve to start the next month, December.

Gustav's Gutter – December

With the first month under his belt, Gustav does these same calculations for December.

- His beginning cash reserve for December is $1,830 (this was his ending cash balance from November).
- His receipts for December are $2,500.
    - He receives $2,500 in December from jobs he completed in November.
    - His December sales of $5,000 will not be paid until January (50% of December sales), February (25% of December sales), and March (25% of December sales).
- His costs of sales for December are $2,225.
- His expenses for December are $288.
- His other expenses for December are $659.
- Adding up his December costs of sales, expenses, and other expenses, his total disbursements are $3,172.
- To figure out if he is operating at a surplus or deficit, he takes his receipts and subtracts his total disbursements ($2,500 - $3,172 = -$672). He is operating at a deficit this month, because his total disbursements are more than his receipts.
- Now, he plugs these numbers into the ending cash balance equation.
    - $1,830 (cash reserve) + $2,500 (receipts) – $3,172 (total disbursements) = $1,158 (ending cash balance)
- From this, Gustav determines he has $1,158 in cash reserve to start the next month, January.

Gustav's Gutter – January

Here is one more month.

- His beginning cash reserve for January is $1,158 (his ending cash balance for December).
- His receipts for January are $3,750.
    - He receives $1,250 in January from jobs he completed in November.
    - He receives $2,500 in December from jobs he completed in December.
    - His January sales of $5,000 will not be paid until February (50% of January sales), March (25% of January sales), and April (25% of January sales).
- His costs of sales for January are $2,225.
- His expenses for January are $288.
- His other expenses for January are $659.
- Adding January costs, his total expenses are $3,172.
- To figure out if he is operating at a surplus or deficit, he takes his receipts and subtracts his total disbursements ($3,750 - $3,172 = $578). He is operating at a surplus this month, because his total disbursements are less than his receipts.
- Again, he plugs these numbers into the ending cash balance equation.
    - $1,158 (cash reserve) + $3,750 (receipts) – $3,172 (total disbursements) = $,1,736 (ending cash balance)
- Gustav calculates he has $1,736 in cash reserve to start the next month, February.

Final Pointers

Here are some things to keep in mind as you put together your cash flow statement:

- Ending cash is carried forward to the next month as cash reserve.
- Make sure you take into account seasonal fluctuations and business growth in your sales and costs of sales, because they affect monthly receipts.
- Expenses should be recorded when they are actually paid.
    - If you use invoicing, sometimes payment is delayed. Make sure you take this into account in your cash flow statement.
- To be safe, it is best to overestimate expenses and underestimate income or receipts.
- All costs should be estimated as accurately as possible.
    - Call utilities providers for installation prices, monthly fees, and projected expenses.
    - Call suppliers for prices and credit procedures.
    - Interview owners of similar businesses to project sales volume, collection delays, and bad debt.

Quiz Yourself

Question 1

Use Gustav's Gutter Cash Flow Statement (http://vrselfemployment.org/sites/default/files/PDFs/Gustav-Cash-Flow-Statement.pdf) to answer the following questions.

What months does Gustav operate at a deficit (meaning his costs are greater than his receipts)?

Answer 1

Gustav operates at a deficit in November, December, and February.

In November and December he had large fixed operating costs and other expenses as he paid for initial business start-up costs. He also did not have many receipts coming in ($0 in November, and $2,500 in December).

Although he operated at a surplus in January and his business grew from January to February, he was unable to cover February costs due to a large quarterly tax payment that was due (see **Taxes** in the Other Expenses section of Gustav's cash flow statement).

Question 2

If Gustav were to start a cash flow statement for his second year of business, what amount would he use for his beginning cash reserve?

Answer 2

Gustav's beginning cash reserve for Year 2 would be the ending cash balance on the last month of Year 1. His final month for his existing cash flow statement is October, which has an ending cash balance of $17,494. This means his beginning cash reserve for his second year of business is $17,494.

Question 3

What is Gustav's profit for the entire year?

Answer 3
Gustav's profit for the entire year is $7,494, which equals total receipts ($66,875) minus total disbursements ($59,381).

$66,875 (total receipts) –$59,381 (total disbursements) = $7,494 (total profit)

Tab 5: The Income Statement

The **income statement** shows a business's financial activity over a specific period of time, usually one year. It shows:

- Total sales
- Costs of goods sold
- Gross profit
- Fixed operating and other expenses
- Pre-tax profit
- Net profit

These estimates will be very similar to the yearly totals generated on the cash flow statement. However, the income statement is different from the cash flow statement because it is not broken down month-by-month. Instead, it shows your total revenue and costs for the entire year. The income statement compares business expenses with revenues so you can figure out if your business overall made or lost money in that year.

In your business plan, the income statement shows your best estimates of revenue and costs. Once your business is up and running, the income statement uses real numbers to determine business profit or loss.

Income Statement Parts

Getting Started
Download the Sample Income Statement (http://vrselfemployment.org/sites/default/files/PDFs/Sample-Income-Statement.pdf). Then, follow along with the subsection information including:

- Total sales
- Total costs of goods sold
- Gross profit
- Total operating and other expenses
- Pre-tax profit
- Net profit

Notice the sample statement covers a specific time period for measuring income: January 1, 2016 – December 31, 2017.

Total Sales
Most financial planning begins with projecting sales over a specific period of time. To project sales, you should do some market research, such as:

- Surveying similar businesses in other locations about their average sales

- Reviewing industry publications for average sales of similar sized businesses
- Searching Small Business Administration (SBA) publications on business start-up

This information was covered in the **Break-Even Analysis and Pricing** and **Sales Forecast** sections earlier in this chapter.

Costs of Goods Sold
Costs of goods sold are the direct costs to produce your products or services. You can use estimates from your cash flow statement to estimate your total costs of goods sold for the year. Here are some examples of costs of goods sold for retail, manufacturing, and service businesses.

- Retail business: the difference between the cost of the beginning and ending inventory, costs for shipping and packaging, and costs of labor directly related to sales.
- Manufacturing business: the costs of raw materials, parts, and labor to manufacture one item, multiplied by the amount of units sold.
- Service business: expenses for providing the service, such as direct labor costs and any supplies. For instance, a lawn mowing business might include labor, gas costs, and lawn waste disposal costs.

Notice, the sample income statement shows total costs of goods sold as $7,000, which includes the difference between beginning and ending inventory, materials, and labor costs.

Gross Profit or Loss
Gross profit is the difference between total sales and costs of goods sold. Here is the formula:

total sales – costs of goods sold = gross profit or loss

If sales are more than costs, there is a gross profit. If costs are more than sales, the business is operating at a loss.

Notice that the sample income statement reports $18,000 in gross profit. This was calculated by taking the total sales ($25,000) and subtracting the total costs of goods sold ($7,000).

Total Operating and Other Expenses
Total operating and other expenses are made up of:

- **Operating expenses** - the costs of running a business that are not directly linked to the production of your product or service. These are things like rent, utilities, salaries, payroll taxes, advertising, insurance, office supplies, repairs and maintenance, and depreciation. They are the same as fixed operating costs.
- **Other expenses -** costs that are not part of operating the business or creating the good or service. These are things like interest payments on loans or capital equipment purchases.

You can use estimates from your cash flow statement to estimate your operating and other expenses.

Pre-Tax Profit or Loss
Pre-tax profit is the difference between gross profit and total expenses. Pre-tax profit is used to figure out how much your business will owe in taxes. Here is the formula:

gross profit – total operating and other expenses = pre-tax profit

Notice that the sample income statement reports $2,320 in pre-tax profit, which is gross profit of $18,000 minus total operating and other expenses of $15,680.

Note: Most businesses hire an accountant to determine the taxes they owe.

Net Profit or Loss
Net profit or loss shows if your business is profitable. A business owner can increase net profit by increasing gross profit, decreasing their total expenses, or by doing both. Net profit is calculated with the following formula:

pre-tax profit – taxes = net profit

Tab 6: Balance Sheet

The **balance sheet** shows how much a business is worth at a specific point in time. The balance sheet records the total assets, total liabilities, and equity of your business.

Total assets include:

- Current assets, such as cash, inventory, accounts receivable, and prepaid expenses (like insurance).
- Fixed assets, such as land, buildings, and equipment, minus depreciation.

Total liabilities include:

- Current liabilities, such as accounts payable and accrued expenses.
- Long-term liabilities, such as long-term loans or a mortgage.

Equity is the difference between the total assets and the total liabilities of your company, or, how much your business is worth. You can figure out your business's equity by using this equation:

total assets – total liabilities = equity

Generally, a new business develops a balance sheet every year. This way you can compare balance sheets over time to see if your equity is growing, falling, or staying the same.

Download the Sample Balance Sheet (http://vrselfemployment.org/sites/default/files/PDFs/Sample-Balance-Sheet.pdf) to see how it is set up. To learn more, check out Balance Sheet Definition and Example (www.thebalance.com/balance-sheet-definition-2946947) from *thebalance.com*.

Tab 7: Review

The **financial plan** is an overview of your anticipated costs and revenues. It shows how you will manage your business to be profitable. It includes several sections:

- Up-front cash needs
- Break-even analysis
- Sales forecast
- Cash flow statement
- Income statement
- Balance sheet

Developing your financial plan is one of the harder parts of writing your business plan. But if you've made it this far, you have some good tools for getting started. There are also business development resources to help develop a financial plan. Chapter 8 lists some of these resources.

After you finish your business description, marketing plan, operations plan, and financial plan, go back to the executive summary section to write an overview of your full business plan.

The business plan provides a guide for getting your business up and running. It is also a document to share with potential funders.

Prepare

First, take a deep breath—developing your financial plan can seem scary, but with some research and planning you can do it! Refer to some of the business development resources listed in Chapter 8 to help you. Think about working with a bookkeeper or accountant to help you figure out your financials, or invest in bookkeeping software like Quickbooks (https://quickbooks.intuit.com).

Start pulling your financial plan together by figuring out your up-front cash needs. How much money will you need to start your business and keep it going until you make a profit? Make a list of different sources of funds, such as loans or grants. In order to secure loans you will probably need a full business plan, so keep working through all the sections in this chapter.

Figure out your break-even point. How much will it cost to produce your product or service, and how much do you have to sell in order to cover these costs? Don't forget to include both your variable and fixed expenses in this calculation. After that, move on to pricing.

Work with your counselor, a mentor, or other expert to help you keep going!

Counselor Review

Sources of Cash

It is important for the client to know how much money they need to start their business. It is also important they know how much of their own money they can invest in their business, and how much they will need from other funding sources.

Keep in mind that some funding sources will only cover certain expenses. For example, VR funds will usually not pay for outside services, like bookkeeping or legal services. If these services are used, the

client may need to pay for those with non-VR funds. Other grants also may have strict guidelines for how the funds can be used. Make sure you and the client are aware of funding source restrictions.

Pricing and Break-even Analysis
Pricing a product or service can be tricky. The price needs to be high enough that the client can reasonably meet their break-even point, but not too high that it deters customers from buying. Sometimes, however, a higher price conveys better quality. In these cases higher-priced products may actually sell better than lower-priced ones.

A break-even analysis is a more-detailed version of the napkin math exercise, completed in Chapter 3. Once the client settles on a reasonable price, they can figure out how much product or service needs to be sold each month to clear a profit. This sales benchmark could be used as an indicator for VR case closure.

Sales Forecast & Cash Flow
Many new business owners are undercapitalized, meaning they do not have enough cash to meet their monthly expenses. The **sales forecast** and **cash flow statement** work together to help the client understand:

- How much funding is needed to cover costs during the business start-up phase
- How much sales are required to achieve a profit.

The cash flow statement also shows trends in cash reserve. If ending cash is getting smaller over time, the business is struggling.

As a general rule of thumb, it is a good idea to have a cash reserve to cover six months of fixed and variable operating costs when starting a business. This will allow the client to pay bills when sales are slow and allow enough time to build a customer base.

Business Plan
Once the client's business plan is complete, you will be one of the first people to review it critically. Evaluate answers through the eyes of VR and other potential funders. Should VR fund this business? If not, what are the reasons? Help connect the client with outside assistance if parts of the plan need improvement.

If the agency will support the business:

- Determine how much VR will contribute
- Assist the client with exploring additional funding sources
- Amend the Individualized Plan of Employment (IPE)
- Determine what needs to be achieved before VR closes the case

Wrap up
The Business Plan provides a working document to help develop, manage and grow a new business. It is the blueprint for gauging success. It helps both you and the client track the business and determine if plans are working out as expected.

If costs, sales, and profit are drifting from the business plan estimates, what changes need to be made?

- Does the client need more assistance with some aspects of the business?

- Does the client need to adjust prices, marketing, or some other business management practices to gain more customers?
- Could a business advisor help address resolvable issues?
- Should the client explore other employment options?

Our hope is that through the process of assessing readiness, business feasibility, and developing a solid business plan, clients who pursue self-employment will be primed for success.

Check Your Understanding

This section helps you check your understanding of the material covered in this chapter. Go through the questions and write down your answers on a separate piece of paper. Check your answers in the Review Your Answers section.

Check Your Understanding

Up-Front Cash
What is up-front cash? What are the two costs included in your up-front cash needs?

Sources of Cash
What are some different places to get funds to start your business?

Break-Even Analysis
What does a break-even analysis help you figure out?

Sales Forecast
What are some things you should think about when you are putting together your sales forecast?

Cash Flow vs. Business Profit
Why is cash flow more important than business profit over a year?

Cash Flow vs. Income Statement
How is the cash flow statement different than the income statement?

Review Your Answers

Up-Front Cash
Question: What is up-front cash? What are the two costs included in your up-front cash needs?

Answer: Up-front cash is the money you need to get your business up and running. It includes pre-opening expenses and post-opening expenses.

Sources of Cash
Question: What are some different places to get funds to start your business?

Answer: Some sources of cash include:

- Personal savings - your own and/or a business partners
- Loans - bank loans, bank lines of credit, and loans from friends or family

- Investors - angel investors, venture capitalists, VR, friends, or family
- Grants - small business incubators and government grant programs
- Gifts - crowdfunding, friends, and family
- Bartering

Break-even Analysis
Question: What does a break-even analysis help you figure out?

Answer: A break-even analysis helps the business owner determine how many units of a product or hours of service must be sold to break-even and start making a profit. A break-even analysis can also show how changing a product's price or reducing expenses affects profit.

Sales Forecast
Question: What are some things you should think about when you are putting together your sales forecast?

Answer: You should consider:

- Average sales for similar businesses in similar locations. Use this information as a point of reference for what your sales will be as you get established.
- How sales might change over the year based on seasonal demand for your product or service.
- Lower sales during start-up as your business gains market share.

Cash Flow vs Business Profit
Question: Why is cash flow more important than business profit over a year?

Answer: While your business may be profitable when sales are averaged over a year, that doesn't mean you made a profit every month. This is important to know because you need to be able to pay your bills and other fixed costs each month.

For example, think about a business that makes knitted wool scarves. Most of their business is in the winter holiday season. They might need to use up-front cash reserves from February to October to cover business costs until they sell more scarves in November, December, and January.

Cash Flow Statement vs Income Statement
Question: How is the cash flow statement different than the income statement?

Answer: The cash flow statement is a monthly record of your revenue and expenses. It is calculated based on estimates of your fixed costs, variable costs, and sales. It shows when your business will receive cash (receipts) and when you need cash to pay bills (disbursements).

The income statement shows a business's financial activity over a specific period of time, usually one year. It shows total sales, costs of goods sold, gross profit, fixed operating and other expenses, pre-tax profit, and net profit. These estimates will be very similar to the yearly totals generated on the cash flow statement.

The income statement is different from the cash flow statement because it is not broken down month-by-month. Instead, it shows your total revenue and costs for the entire year. The income statement

compares business expenses with revenues so you can see if your business made or lost money each year.