# FINANCIAL INTRODUCTION

In earlier sections you calculated your cost of goods sold, overhead expenses and capital cost in order to help you determine the sales price of your product. In your business plan, however, the marketing section will not be as detailed – it will state what you will charge customers and then describe your marketing and distribution. The financials used to support your pricing decision will be included in the financial section of your business plan. For the feasibility analysis the only necessary financial information is a report of how much money you need to start your business, a description of what that money will be used for and your businesses revenue projections in the form of an income statement[1]. The final business plan will include more figures and financial statements, such as a balance sheet and cash flow statement, which will be explained in Chapter 4. In addition, **Annex E** offers an introduction to basic financial terms and concepts.

***How much money do I need?***

After completing the marketing and operations section it should be clearer what capital goods need to be secured and what people need to be hired to start the business. Put together a list of the items to be purchased and their costs as well as a figure for operating expenses, employee salaries, professional fees, and taxes per month. If you used the suggested format in the schedule section it can also be used here. Remember, planning and pre-operations need to be covered by invested capital, whereas the operating expenses need to be covered by revenue.

There is a relatively simple way to determine how much capital you need. First you need to estimate all of your costs before you will receive cash from customers. That will include the payment of salaries and contractors and the purchase of goods needed in the planning of your enterprise, in the Pre-operations or Construction Phase of your enterprise and during the Operating Phase of the enterprise up until revenues cover the daily-weekly-monthly expenses. You will borrow some of this money and you will put some of this money in as equity. But you need to know how much is required. Too often entrepreneurs just estimate the cost of buying their product and equipping their facilities and forget that bills need to be paid until cash comes from customers. The amount of this "working capital" requirement can be crucial in the success or failure of a business. Keep in mind you must have enough funds to pay your bills until the customers pay you, which may be thirty, sixty or even ninety days after you bill them. For instance, perhaps you will order equipment, furnish your office, and market your product for 6 months before your first sale. Then it will take another 8 months to sell enough products to break-even. Furthermore, when you borrow funds you are required to at least begin paying interest within about 6 months. It is possible to use borrowed funds to cover initial operating costs.

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[1] If your business sells several types of products or services a revenue section should be included in addition to an income statement to clearly present where you generate your revenues from and over what schedule.

| Phase | Costs |
| --- | --- |
| ❑ **Planning:** | |
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| ❑ **Pre-operations/construction:** | |
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| ❑ **Operations:** | |
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| | |
| **Total:** | |

There is a simple way to see if you are borrowing enough. In the next chapter, you will learn how to complete a cash flow statement, which is basically like a checkbook. This will show your business' profit or loss. It is possible to play with the figure and see the effect on your payments, and profit or loss.

Financial reports, of which the income statement is most important, are not as complicated as they seem at first glance. They are designed to give managers and investors a clear summary of what is happening at the company. Although at first they can be intimidating, you will soon see that they are straightforward.

***Income Statement:***
The purpose of an income statement is to present, in an organized fashion, the business' performance during a given time period. To do this, the income statement lists the company's total revenue as its first line and then subtracts different expenses until arriving at profits, or 'the bottom line.' If profits are negative, than the business generated a loss during the period.

On the way from the top of the income statement to the bottom (from total revenue to profit), you will find your gross margin (which is the same as what you computed earlier in the chapter), and 'Operating Income,' which is another important measure of a company's health. The income statement contains the following information defined below:

Gross Revenues: defined as all of your business' dollar sales for the listed period of time. It is also referred to as gross sales, total revenue or total sales.

Returns: the cost to your business for any damaged or returned products.

Net Revenues: difference between gross revenues and returns. Sometimes called net sales.

Cost of Goods Sold: refers to the cost to you to purchase materials or products from suppliers for resale or manufacturing. Commonly referred to as cost of sales.

Gross Profit: this is calculated by subtracting cost of goods sold from net revenues.

Gross Margin: calculated by dividing your gross profit by net revenues.

Operating Expenses: all of your business' costs including labor, capital equipment expenses, overhead, professional services, promotional costs, etc. (see example below).

Net Operating Income: subtract operating expenses from gross profit to calculate. This is your earnings before you deduct interest, taxes and depreciation. It is a number investors will be looking at to see if your business' core costs are paid for by revenue. .

Depreciation: Even though this gets listed on your income statement like a regular expense, depreciation is not an expense in the way that salaries or rent is. Depreciation is a method for re-valuing your capital goods (machines, vehicles, buildings, etc.) as they lose value as they age. The way you determine the dollar-amount of depreciation is to take the original cost of the asset, spread out that cost over a number of years (see below), and each year list that amount as your depreciation expense. One benefit of depreciation is that it reduces the profit your business ends up reporting, which reduces the amount that the business has to pay for income taxes.

The number of years for which you should depreciate your capital assets is up to you, but generally is between ten and thirty. The number of years should be the same as your estimate of the 'useful life' of the asset. For solar powered water pumps this could be 10-20 years. For a co-generation business it could be 15-30 years.

Interest: calculate the interest paid on loans over the given period of time. When putting together a forecast, this estimate is rather rough, but it

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|---|---|
| | should be finalized before presenting to a potential lender or investor. |
| Taxes: | calculate all taxes the business must pay including employee and income taxes. At the business start-up level it is therefore only important to provide an “allowance” for income taxes from the business on a simplified basis. |
| Net Profit (or Loss): | Also called net earnings or net income, this is the total profit after interest, taxes and depreciation are subtracted from Operating Profit. |
| Net Margin: | divide the net profit by net revenues to understand how much profit you are making in comparison to your sales. This is expressed as a percentage. |

**Example of an Income Statement:**

Company Name
Income Statement
For the period from DATE to DATE

| | |
|---|---|
| **Gross Revenues:** | |
| Returns | |
| **Net Revenues** | |
| Cost of Goods Sold: | |
| **Gross Profit:** | |
| Gross Margin: (percentage) | |
| | |
| **Operating Expenses:** | |
| Labor: | |
| | |
| | |
| Professional Services: | |
| | |
| Overhead: | |
| Rent | |
| Utilities | |
| Vehicle | |
| Travel and Entertainment | |
| Maintenance and Repair | |
| Equipment leases | |
| Supplies | |
| Packaging and Shipping | |
| Insurance | |
| Licenses and Permits | |
| Other | |
| **Total Operating Expenses:** | |
| **Net Operating Income** | |
| Depreciation | |
| Net Profit Before Interest | |
| Interest | |
| Net Profit Before Taxes | |
| Taxes | |
| **Net Profit (or Loss)** | |
| **Net Margin: (percentage)** | |

The above income statement is for the first year of operations. An income statement for what you expect, or project, to achieve in the coming years must also be completed. Such a statement is often called a pro-forma income statement. The pro-forma statement should be presented in the same format but with additional columns for each year. Title the column according to the year.

Preparing financial projections is tricky because you must make assumptions about the future. Lenders and investors usually want to see your business grow, but typically that is not as simple as increasing your revenues each year. You must ask yourself what will be the ratio of increased expenses to increased revenues. For example, if you want to sell 150 units in year 1 and 250 units in year 2 how many more employees will you have to hire or how many additional vehicles will you need to purchase? Perhaps, your business will get more efficient in the future so you will not need to increase your expenses the same each year.

| Task: Complete a worksheet detailing how much funds you require, an Income Statement for your business for year 1 and a Pro-forma Income Statement for years 2 through 5 and include in your Feasibility Analysis. |
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