Why EntreQuick?

Starting a new business is risky.
Before diving into your new business, you need to ask yourself:

- What is the profit potential of my idea?
- How much cash do I need to get my business off the ground?
- How much of my own money should I invest, and how much should I borrow?
- What return rate can I expect from my investment, and is this return worth the risk I am taking?
- What if my sales are 50% less than I expected? How will this affect my cash flow and rate of return?

Why leave these answers to guesswork? EntreQuick can help you arrive at intelligent answers, and to develop valuable insights into your new business idea, before you invest your own money.

- quickly test the financial feasibility
- forecast start-up funding requirements
- project cashflow, Return on Total Investment, Return on Equity, and other key indicators
- create professional looking financial statements for investors

What is EntreQuick?

EntreQuick is a web-based application. With Internet access you have the convenience of accessing and updating EntreQuick anywhere, anytime.

You are able to document, analyze, and store up to 1000 new business ideas in EntreQuick.

EntreQuick is fully menu-driven and easy to use. EntreQuick does not use or require a spreadsheet.

All you do is follow EntreQuick's simple format for inputting assumptions, and EntreQuick simulates key financial statements for your new business covering a three year planning horizon. EntreQuick quickly generates for you:

- An Income statement that you know, month-by-month for the entire three year period, whether you'll make enough profit and whether your revenue and expense estimates are realistic.

- A Balance sheet showing your new business' forecasted growth in assets, liabilities, and net worth for each month in your three year horizon.

- A Cash flow statement that details your sources and uses of cash over the 36 month period, and tells you whether you have enough financing to keep your business afloat. It will show you why healthy profits do not always equal a healthy cash flow.

- A Key financial indicators report which shows you, at a glance, important indicators like your new business' profit before taxes, rate of return, and lowest ending cash balance.

EntreQuick's projected income statement, balance sheet, cash flow statement, and key financial indicators are fully linked and integrated. A change in your data or assumptions in, say, your income statement will automatically be reflected in your other three statements.

These pro forma financial statements are essential for a new business. You need to understand the long-term financial aspects of your business, not just how much money you'll make in the first month. Research has shown that many start-up failures could have been prevented had the owners made proper financial projections of their new business ideas.

How to Start EntreQuick

After successfully signing-up, and subscribing to EntreQuick, from the home page (entrequick.com), click the “my ideas” link from the top menu navigation bar.

Add your first new business idea, by clicking “Add Idea”.

Each new business idea has the following fields:
- Idea Name
- Idea Description and Notes
- What is good or promising about this idea?
- What obstacles need to be overcome?
- What are the next steps?
- Edit Financial Forecast <— this link will take you to Financial Forecast Module
- Rate this idea (1 to 5 stars)
- Add this idea to "Short List”
- Save button

General Steps to Evaluating Your New Business Idea

EntreQuick, when used correctly, can provide you with valuable insights into which of your ideas belong in the fore-front of your mind, which you should keep in the back of your mind, and which you are better off erasing completely from your mind. It does this by analyzing your business opportunities specifically from a financial standpoint. These are the five easy steps to determining which of your business ideas are worth pursuing:

STEP 1. Think of a Great Idea for a New Business

Chances are you already have one, if not several, business ideas you'd like to try out. If you're still waiting for the light-bulb to go off in your head, or your idea didn't pan out the way you thought it would, we can only recommend you keep trying. Remember to keep your eyes open, your ears to the ground, and the left and right sides of your brain fully operational.

STEP 2. Research Your New Business Idea

If you think your idea is a winner, then do some preliminary research to back up your gut feelings. For example, before opening an ice-cream shop you'd want to know how much it would cost to rent the shop, how many people walk by, and how many other ice-cream shops are already located on the street.

STEP 3. Use EntreQuick to Financially Analyze Your New Business Idea

Start EntreQuick, and enter your data.

STEP 4. Review Your Financial Statements

View and evaluate your projected financial statements. If necessary, make revisions to your data.

STEP 5. Create Multiple Scenarios

It's almost impossible for you to predict 100% how well your new business idea will do. All businesses, some more than others, are vulnerable to outside factors completely beyond their control. A good example is the vulnerability fruit-growers have to weather conditions, transportation links, and market demand. An unusually cold winter could ruin a farmer's peach crop, while a problem like pesticide in imported peaches could mean bigger-than-usual sales for local crops. To get a complete picture of all your business prospects we suggest you make multiple scenarios--pessimistic, most likely, and optimistic--so you can be prepared for anything.

EntreQuick - Data Inputs

This section gives you some background on the data EntreQuick needs to accurately analyze your new business opportunity. The following is a list of what you need to know:

1. product price and cost information
2. forecast of how many products you expect to sell
3. forecast of sales expenses
4. forecast of general and administrative expenses
5. fixed asset expenditure and asset life expectancy
6. debt financing--term loan
7. equity financing
8. expected taxes and dividend pay out
9. general assumptions: cash sales, account receivable, accounts payable, and inventory policy

Before going on to discuss EntreQuick's data input requirements in more depth, we advise you to use only reliable data--based on the way things are, not on how you'd like them to be. The quality of your research is directly reflected in the accuracy of your projected financial statements. If your data differs from the normal industry guidelines or averages, it may raise the eyebrows of bankers or venture capitalists, who will likely ask you for reasonable explanations, or send you back to take a second look at your numbers.

For a simple example of a Financial Forecast see EntreQuick - Financial Forecast - An Example

1.   Product Price and Cost Information

The data you provide in this step has a crucial impact on your new business' revenue forecast, cost of goods sold, and gross profit margin.

In order to complete this step you must be able to answer these questions:

* What product or service do I plan to sell?

* At what price do I want to sell my product or service?

* How much will my product cost me to either produce myself or purchase from a wholesaler/distributor/manufacturer?

What product or service do I plan to sell?

We assume at this point you have already done your preliminary product research and know what product you want to sell. If you are selling an established product in the marketplace, you may already have some idea of its demand. However, if you are introducing a new product you may need to do some market research. This type of research usually involves a user needs study to determine whether there is a need for the product, and a competitive analysis study to find out what similar products are already available on the market.

At what price do I want to sell my product or service?

Pricing your product correctly is important to your business' success. Your pricing strategies are set mostly by the type of product you are selling and the type of market you are selling to. If you are selling a low price, low profit margin product, you will likely emphasize high volume sales and a low overhead operation with less customer service. On the other hand, if you have a high priced, high profit margined product, your operation will probably be geared to lower volume sales, and a more select market emphasizing personal service and support.

Consider how your competitors price their products--if they are marking-up their product at cost plus 100%, it doesn't make sense for you to sell your product at cost plus 15%--unless you don't mind leaving "money on the table," or you're confident in weathering a price war should your established competitors choose to meet and beat your price.

How much will my product cost me to either produce myself or purchase from a wholesaler/manufacturer?

Equally as important as pricing your product is costing your product accurately. The cost you forecast for your product directly affects your cost of goods sold on your income statement.

Your product's cost depends on the type of business you are planning to start: a retail/wholesale, manufacturing, or service oriented business. Each of these has special considerations:

Retail/wholesale--typically these businesses are not involved in making a product, but rather in re-distributing products to either consumers or other retailers. Consequently, your product cost is fairly easy to forecast: whatever you pay the manufacturer or wholesaler to buy the product.

Manufacturing--calculating product costs for this type of business is more complicated. It typically involves estimating costs such as direct labor usage, materials, and allocations for factory overhead (see Appendix 2 for an example). Unfortunately, this costing method is quite laborious. Many entrepreneurs instead use the simpler method of taking a percentage of their product's selling price as an estimate of their product's cost. For example, if you know from experience that the average product cost in your line of business is 50%, and your selling price is $100, then you can estimate your product cost at $50. However, caution should be taken in using this "quick and dirty" method, as most cost percentages are averages that pertain to established manufacturers. You may risk serious error in applying it to a new manufacturing business.

Service--estimating a product cost for a service oriented business is usually the simplest of all. Costs normally equal whatever you plan on paying your employees. For example, the biggest cost in running an escort service would be what the escorts are paid. Service oriented businesses typically do not sell inventories, and therefore do not have a cost of goods sold.

2. Forecasting Product Sales

Your product sales forecast is the main driver in projecting all three of your financial statements (income statement, balance sheet, and cash flow statement). Therefore it's worth your while to spend some time developing a realistic forecast. Try to keep the following guidelines in mind:

* Sales volumes are critical to all businesses. In general, most businesses have a basic level of costs (inventory, administrative expenses, finance charges, etc.), which form the minimum level of sales required to

sustain operations. If this volume is not met, the business can quickly get into financial trouble.

* Be realistic in your sales forecast. Some entrepreneurs prepare grandiose forecasts with amazing sales growth potential, mostly to impress bankers and investors. Unfortunately, building a business on exaggerated expectations paves the way to business failure. In addition, bankers and investors know what a reasonable forecast looks like, and a rose-tinted one will do little to boost your credibility.

* Allow sufficient time in your forecast for product development and marketing activities to start rolling. Your sales should show a gradual increase; sky-rocketing does not happen often.

* If it applies, incorporate a seasonal factor into your sales forecast. For example, you can expect to sell more Christmas cards in December than in June.

* Prepare more than one sales forecast. We recommend doing a pessimistic, a most likely, and an optimistic forecast. This enables you to plan for risk and cash flow contingencies, in case your sales are less than or more than you expected.

* As a final step, to ensure your projections are reasonable, you should verify the projected sales volume of your business with someone knowledgeable in the industry.

3. Sales Expenses

In this step you enter all the costs associated with selling and marketing your product. These costs usually include salespersons' salaries, commissions, advertising, promotional supplies, and so on. In general, sales expenses are not fixed, but tend to vary directly with sales revenue.

4. General and Administrative Expenses

General and administrative expenses (G&A) are overhead costs, relatively fixed to sales revenue (remain constant regardless of how many sales you make), and they are generally unrelated to any specific activity

like sales or manufacturing. Examples of G&A expenses are office and executive salaries, telecommunication expenses, accounting, and legal costs.

5. Fixed Asset

In this step you enter information about the fixed asset you need to get your business started. Fixed assets (also referred to as capital assets) are operating assets having a useful life of more than one year, which are needed to support and run a business. Examples of fixed assets might be machinery, trucks, buildings, ovens, printing presses, and computers.

Although every business has to buy some fixed assets to support their operations, some businesses are more capital intensive than others. Service businesses are often the least capital intensive, because they only involve purchasing equipment such as a photocopier, fax machine, and furniture. Retail operations, on the other hand, are more capital intensive; since they entail fixed assets such as store-fronts, display units, and fixtures. Finally, manufacturing start-ups are the most capital intensive, because they require large purchases such as trucks, lathes, conveyors, and drills.

As fixed assets have a useful life of more than one year, their purchase costs are not expensed entirely in one year, but rather over the time they remain useful. This expensing of a fixed asset over a number of years is known as taking depreciation. Depreciation is an important consideration in your business, because it affects all three financial statements and their subsequent interpretations.

For example: you have a brainstorm idea to set up a gourmet hot dog stand at a strategic downtown sidewalk location. Your only major fixed asset purchase is the hot dog stand itself. How much will it cost? You do some comparative shopping around town and find a Deluxe hot dog stand, fully equipped with gas stove, mag wheels, and a polished mahogany finish, for the rock-bottom price of $15,000. The dealer gives you his personal guarantee--the stand will last at least three years before it needs replacing.

There are many methods you can use to depreciate the Deluxo hot dog stand. EntreQuick uses the simplest, the straight-line method. The

straight-line method calculates yearly depreciation expenses by dividing the purchase cost of the fixed asset by its useful life expectancy. For example, the depreciation on your Deluxo hot dog stand would look like this:

Purchase cost of asset = $ 15,000
Useful life expectancy = 3 yrs
Depreciation method =straight-line
Depreciation expense per year = $ 5,000

Financing Your New Business

You need money to get your business up and running, plain and simple. It takes money to do things like buy or lease a site, hire people, carry accounts receivable, and purchase inventory.

A new business typically has three sources of financing to draw from:

* Debt financing--loans from friends, family, banks.

* Equity investment--investing your own money or money from others. Investors gain ownership rights in your business.

* Cash receipts from operations--cash generated through your business' sales activity.

For a new business, cash receipts from operations are quite often negative for at least the first year. This leaves debt financing and equity investment as the only two sources of money open to entrepreneurs for covering losses until their cash receipts from operations reach a self-financing level.

*Many entrepreneurs like to over capitalize--that is, ask for more money than their projections suggest they need. ~~A good rule of thumb for determining your capitalization requirements is to take your best revenue projection and divide by two; and your best expense projection and multiply by two.~~ Overcapitalization enables you to prepare ahead of time for a worst-case revenue performance. This is better than being caught off-guard with an unexpected downturn in your business, and then having

to scramble around for more money. Investors aren't eager to throw more money at what appears to be a sinking ship.

6. Debt financing--Term loan

Debt financing refers to raising new venture cash from debt resources such as loans, mortgages, bonds, a line of credit, or any other means whereby the borrower is obligated to repay funds at a later date. You can think of it as renting cash for a specified period: you don't own the money, and you must pay for the right to use it. Your interest payments are like monthly rental payments, and eventually you must return the entire principal amount to the lender.

Debt financing has a direct effect on your income statement, balance sheet, and cash flow statement. On your income statement, interest payments are regarded as a legitimate expense deduction from your revenue. Repayments of loan principal, however, are not an operating expense and therefore do not appear on your income statement. Because debt eventually has to be repaid to the creditor, the outstanding principal is shown on your balance sheet as a liability. Since interest payments and repayments of loan principal affect cash, both these items appear on your cash flow statement.

EntreQuick allows for term loan financing:

Term loan financing

Term loan financing is usually an intermediate (1-4 years) to long-term (over 5 years) debt financing instrument. Borrowers acquire a fixed sum of money, and pay back the principal plus interest in blended monthly payments over a defined period of time (called the loan term). The loan amount is often secured by the borrower's collateral (e.g. a personal asset such as a house or an automobile).

EntreQuick provides you with one term loan. This term loan requires the following information:

* the loan start date (any month of your 36 month forecast horizon)

* the loan amount

* the annual interest rate

* the loan term (amortization period, in months)

Determining how much money you need to borrow is usually a step-by-step process, dependent on how much you think it will cost you to buy equipment, inventory, etc. As EntreQuick allows you to revise your loan financing assumptions easily at any time, you may want to enter your loan amount as the amount you anticipate being able to borrow. If necessary, you can revise this amount later, after you have reviewed your cash flow statement.

7. Equity Investment

Equity investment is any investment that you, your friends, or venture capitalists make, which represents ownership rights in your business. If your business is incorporated, ownership rights will likely take the form of common shares. Investors normally don't invest their money without some benefit or return, such as a share in your business' decision-making and profits (e.g. dividends).

How does equity investment fit into your projection?

Income statement--as equity investment is not a revenue or expense activity, it does not appear on this statement.

Balance sheet--the amount of equity investment appears on your balance sheet under Paid-in Capital.

Cash flow statement--as equity investment affects your cash balance, it appears on this statement as a Source of Cash.

EntreQuick lets you inject equity investment into your new business model in any or all of your 36 month forecast horizon.

Optimal mix of debt and equity

Keep these two points in mind when you're figuring out the optimal mix of debt and equity financing for your forecast:

1. Most lenders require a significant contribution of an entrepreneur's own money. Don't make the mistake of thinking you can fund your business entirely through debt. This is like attempting to buy a house with "no money down"...any lender agreeing to this type of arrangement would not stay in business long. By investing some of your own money, you are telling lenders that you think your idea is a good one, and you are committed to its success. At the same time you are also reducing their risk in your business.

2. Different industries have different acceptable levels of debt and equity. An industry which is highly leveraged usually has $3 to $4 of debt for every $1 of equity. Highly leveraged businesses normally have high success rates and good collateral behind their debt; therefore the risk of loss to the lender is lessened. On the other hand, industries with lower levels of leveraging typically have higher failure rates and less dependable collateral. You can get an idea of the common debt to equity ratios in your industry from Dun & Bradstreet.

8. Taxes and Dividends

Taxes and dividends are both complex matters, which go beyond the scope of EntreQuick's financial projection model. For instance, it takes literally hundreds of pages in government tax rules to define taxable income and taxes payable. Unless you have special knowledge in these areas, we recommend you consult a qualified accountant before entering this data into your forecast.

Taxes

Although EntreQuick does not provide an automatic tax calculation, it does enable you to directly enter manually calculated taxes directly into your income statement.

Dividends

Dividends (also called owner's withdrawals) are slices of your business' profits shared amongst its owners. In a new business you may want to plow back (re-invest) all your profits into your business; however, you also

have the option of taking some or even all your profits out of your business.

As with taxes, EntreQuick allows you to insert manually calculated dividend pay outs directly into your income statement.

9. General Assumptions

To complete this step, you need to answer these five questions:

Cash sales - what percentage of your total sales are made on a cash basis?

Accounts receivable - what percentage of your total sales are made on credit, collectible 30 days from the date of sale? 60 days from the date of sale? 90 days from the date of sale?

Accounts payable - what payment terms will your suppliers extend to you--0 days (cash only basis) or 30 days to pay for your purchases?

Inventory policy - how many days in advance of expected sales—0, 30, 60, or 90 days--will you purchase or produce your inventory?

Cash sales/Accounts receivable

When you sell a product, it will be either on a cash or a credit basis. Some customers prefer to pay cash up front, while others want to pay on credit. For example, if your business sells to large corporate customers, you'll likely have to extend them credit terms, such as giving them 30 days to pay. Large corporate customers rarely pay cash right up front. However, if you are selling low priced items such as candy bars to the general public, you’ll want cash only.

EntreQuick allows you to build a customized collection pattern, based on your expected cash sales and accounts receivable policy. For example, EntreQuick gives you the flexibility to assume 50% of your total sales are for cash, 35% of your total sales are collectible in 30 days, 10% are collectible in 60 days, and the remaining 5% are collectible in 90 days.

Accounts payable terms

You must also consider the payment terms suppliers extend you in buying their goods. If they demand cash at the time of your purchase, enter 0 days in your forecast; or if they give you 30 days to pay your invoice, enter 30 days.

Inventory policy

If you are a retailer, the number of days between the time you buy your product from a wholesaler and expect to sell it depends, to a large extent, on your wholesaler's stocking levels and delivery times. It could be 0, 30, 60, or 90 days in advance of your expected sales. The ideal situation for you is to buy the product only when you have a sale (and therefore you only need to carry minimal inventory). However, you must also keep in mind that wholesalers may need a set time to deliver their product, or order it, if they don't have it in stock.

In the case of service start-ups, you are typically not selling a product; you are selling labor, so you don't have to worry about inventory purchases (enter 0 in your forecast).

For a manufacturing business, your inventory depends on how much you produce, and how much you produce depends on how much you expect to sell. The decision you have to make is whether to produce your product 0, 30, 60, or 90 days in advance of your forecasted sales.

EntreQuick Outputs: Pro Forma Financial Statements

Now that you've entered your data, EntreQuick can help you decide if your new business idea is a good one. EntreQuick provides you with four pro forma financial statements covering a three year period:

Income statement

Balance sheet

Cash flow statement

Key financial indicators

This chapter discusses each of these financial statements.

Income Statement

The proforma income statement (also known as the Profit and Loss, or just plain P&L statement) captures the profitability of your new business start-up over a specific period of time (EntreQuick uses monthly statements). The income statement is the most common, although not the most critical statement, for demonstrating a new business' financial performance. It predicts how much money you expect to earn (revenue), and how much you expect to spend (expenses) over a set period of time.

EntreQuick uses the following format for the income statement:

Income Statement Year 1

	month 1	month 2
Revenue	5,250	5,250
- Cost of goods sold	1,575	1,575
Gross Profit	3,675	3,675
- Selling expenses	250	25
- General/Admin. expenses	700	50
Net operating profit	2,725	3,600
- Int. expense (term loan)	19	18
- Depreciation expense	167	167
Profit before tax	2,540	3,415
- Taxes	0	0
Net Income	2,540	3,415
- Dividends	0	0
To Retained Earnings	2,540	3,415

Revenue reflects your total sales revenue from all your products and/or services. Revenue is a function of how many products you sell, and at what price you sell them. Remember, this revenue is earned revenue only. It does not necessarily equal cash in your hands, as some of your sales may have been made on a credit basis.

Cost of goods sold is the total cost of products sold in a month. It depends on how many products you sell and how much they cost.

Gross profit is the difference between your sales revenue and your cost of goods sold. This margin, commonly expressed as a percentage of total sales revenue, is one of the most widely used indicators for presenting and comparing product profitability. Gross profit margin is what is left over to cover your indirect expenses and overhead costs.

*Sales expense*s are what you spend to sell and market your product.

General and administrative expenses are overhead costs independent of any specific business activity like sales or marketing (i.e. salaries, telecommunication expenses, and legal costs).

Net operating profit is the amount of money remaining after sales expenses and G&A expenses have been subtracted from the gross profit margin.

I*nterest expense (term loan)* is the cost of borrowing funds on a term loan basis.

Depreciation expense shows the gradual expensing of a fixed asset over its life expectancy. Depreciation is a non-cash expense that reflects a continuing accounting allocation for a fixed asset purchase that may have occurred years earlier.

Profit before taxes is the amount remaining after interest expense and depreciation expense have been deducted from the net operating profit.

Taxes are payments made on profits to local, state, and federal authorities.

Net income is the net profit after taxes have been subtracted. The net income may be distributed to the business owners in the form of dividends, or it may be kept in the business by adding it to the *Retained Earnings* Account of the balance sheet.

Don't be fooled into misinterpreting the profit figures on your projected income statement as cash in the bank. A company can have a rosy income statement, but still not be able to pay its bills. ~~Appendix 3 gives~~

~~you a more detailed explanation on why profit may not necessarily equal cash.~~

Balance Sheet

The balance sheet is a standardized financial statement that outlines the assets of your business (what your business owns in the way of inventory, cash, equipment), the liabilities of your business (what you owe to others--your accounts payable and loans), and your equity or net worth (what you own minus what you owe to others).

While the income statement reflects your business' operating performance over a period of time (month or year), the balance sheet is a snapshot of your business' strengths, weaknesses, and subsequent wealth. As an analogy, your personal income tax return is similar to a business' income statement. Your tax return lists the income or revenue you made for the year. When you subtract your deductions and taxes you are left with your disposable income for the year. From your disposable income you subtract your living expenses, leaving you with your net savings for the year. These savings are then added to your net worth.

You could also develop a balance sheet that shows your personal wealth or net worth by listing your assets (house, car, cash, stocks), liabilities (mortgage, loans, outstanding credit card balances), and your net worth (assets minus liabilities).

EntreQuick uses the following format for its balance sheet:

Balance Sheet Year 1

	month 1	month 2
Cash	5,632	9,139
Accounts receivable	0	0
Inventory	0	0
Equipment	8,000	8,000
Accum. depreciation	167	333
Total Assets	13,465	16,805
Accounts payable	0	0
Term loan	4,926	4,851
Paid-in capital	6,000	6,000
Retained earnings	2,540	5,954
Liabilities and Equity	13,465	16,805

The golden rule of balance sheet accounting is that assets must always equal liabilities plus owner's equity--otherwise it won't be a balance sheet!

ASSETS = LIABILITIES + OWNER'S EQUITY

or, by re-arranging this equation we get,

ASSETS - LIABILITIES = OWNER'S EQUITY

In other words, what your business owns, less what it owes to creditors, equals its net worth or equity. If your liabilities exceed your assets, you're in the red. Profits you make in each period are added to this net worth as they are carried from your income statement to your retained earnings.

Here is a closer look at the balance sheet:

Current assets are generally assets that can be easily converted into cash--money held in banks, accounts receivable, and inventory are three examples.

Cash refers to money or liquid securities held in banks, savings and loans, and other financial institutions.

Accounts receivable are payments owing to your business from customers who purchased your product or service on credit.

Inventory includes all products you presently have in stock.

Equipment/Fixed assets, also known as capital assets, are operating assets purchased by a business, which have a useful life of more than one year.

Accumulated depreciation reflects the cumulative amount of your fixed asset cost that has been used up as depreciation expense since the date you bought your fixed asset.

Liabilities include all your business' liabilities that must be paid. This category includes accounts payable and term loan.

Accounts payable are payments owed by your business to suppliers for merchandise, raw materials, or inventory you purchased on credit.

Term loan financing is usually an intermediate (1-4 years) to long-term (over 5 years) debt financing instrument

Paid-in capital reflects the amount of money you invested in your business.

Retained earnings are the cumulative amounts of your business' net income that you chose to leave in your business.

Cash Flow Statement

Once you have perused your income statement and balance sheet, you can turn to your cash flow statement. By combining the information from your income statement and balance sheet, your cash flow statement details the changes in your business' cash balance.

The cash flow statement for a new or growing business is probably your most critical forecasting tool. In your business' early years, cash position is more critical than profitability, because it mirrors your company's viability. You can't pay bills with profits, only with cash... and if you don't have enough cash to pay your bills, sooner or later you will go out of business. Your cash flow statement helps you identify in advance how large your negative cash flows will be, and how long they will last, so you can arrange for additional funding when necessary.

EntreQuick uses the following format for the cash flow statement:

Cash Flow Statement Year 1

	month 1	month 2
Net Income	2,540	3,415
Add: depreciation expense	167	167
Add: change in A/P	0	0
Deduct: change in A/R	0	0
Deduct: change in Inventory	0	0
Net Cash Flow from Operations	2,706	3,582
Investment by owners	6,000	0
Loan proceeds (term loan)	5,000	0
Total Sources of Cash	13,706	3,582
Capital equipment	8,000	0
Dividends	0	0
Term loan principal repayment	74	75
Total Uses of Cash	8,074	75
Net Increase / Decrease in Cash	5,632	3,507
End-of-period Cash Balance	5,632	9,139

As you can see, the cash flow statement separates your sources of cash into two main categories: Cash Flow from Operations, and Other Sources of Cash, which are basically financing activities. Separating your sources of cash this way enables you to zero in on cash flow provided by operations. In the long run, your cash flow from operations will be the lifeblood of your business. Without a positive cash flow from operations it will be difficult for you to stay in business.

EntreQuick uses the following steps to derive cash flow:

1. Start with net income from your income statement.

2. Add depreciation expense back to net income, as depreciation expense is a non-cash expense on your income statement.

At this point, we have what is sometimes referred to as cash flow from net income, which is simply the net income amount plus depreciation expense. However, this is not the same as cash flow from operations, as some entrepreneurs mistakenly interpret it to be. To derive your cash flow from operations, you must also look at the changes in operating assets and operating liabilities affecting your net income (steps 3, 4, and 5).

3. Add increases or subtract decreases in accounts payable since your last accounting period. An increase in accounts payable indicates that cash equalling the amount of the increase was not paid out to your suppliers. For example, your income statement may show $1,000 of expenses incurred during a one-month period. If, however, these expenses were made on credit, no cash would have been paid and your accounts payable would increase by $1,000.

4. Deduct increases or add decreases in accounts receivable since your last accounting period. An increase in your accounts receivable for the period indicates that cash equalling the amount of the increase was not received by you from customers buying your goods. For example, your income statement may show a sales revenue of $10,000 for the period. If, however, all $10,000 of your sales were made on credit by your customers, you will not have received any cash, increasing your accounts receivable by $10,000.

5. Deduct increases or add decreases in inventory since your last accounting period. An increase in your inventory for the period indicates that more cash was spent on inventory purchases than received for inventory sold. For example, your income statement may show $5,000 as the cost of goods sold during the period. However, if inventory purchases of $10,000 were also made, an additional demand on cash of $5,000 would be created, and your inventory would increase by $5,000.

6. The net figure is net cash flow from operations.

7. Add other sources of cash for the month:
   equity investment
   term loan proceeds.

8. Total all sources of cash.

9. Total all uses of cash:
   fixed asset purchases during the month
   dividends paid out to owners
   term loan principal repayments.

10. Total sources of cash minus total uses of cash gives you the net increase or decrease in cash for the month.

11. Add this net increase or decrease in cash for the month to your previous month's ending balance and you'll have your present month's cash ending balance.

Your end-of-period cash balance is an important indicator. If you have not yet included funding (debt/equity investment) in your analysis, then your ending cash balance will likely go negative quickly. This cash balance should, however, increase as your revenues increase. Your largest negative ending cash balance over your three year forecast horizon is, in theory, the amount of funding you will need.

Key Financial Indicators

EntreQuick's key financial indicators report shows, at a glance, important information you will need to evaluate your new business idea.

Financial Indicators

	Year 1	Year 2	Year 3
Revenue	63,000	66,156	69,456
Profit before taxes	40,119	43,136	45,339
Return on equity (pretax)	146.8%	62.1%	39.8%
Return on total investment (pretax)	126.7%	59.3%	39.1%
Return on assets (pretax)	126.0%	59.0%	38.9%
Lowest monthly cash flow	3,507	3,682	3,862
Lowest ending cash balance	5,632	47,888	92,250
Gross profit margin	70.0%	70.0%	70.0%
Net income margin	63.7%	65.2%	65.3%

*Revenu*e = total sales revenue from all your products and/or services.

Profit before taxes = the dollar amount of profit after all expenses except taxes have been deducted from sales. It is taken from the income statement.

Return on equity (pretax) = profit before taxes divided by average total owner equity.

This is a profitability indicator that shows what your new business is capable of earning (profit before taxes) on your total owner equity investment (paid in capital plus retained earnings). You can compare this indicator to rates of return on similar risk investments to see if your return on equity is enough.

Note: the owner equity figure appearing on your balance sheet in a yearly summary format is the owner equity figure at the end of the year. The end-

of-year owner equity figure will differ from your average total owner equity figure.

Return on total investment (pretax) = profit before taxes, plus interest expense, divided by average owner investment (paid in capital plus retained earnings) and investment by lenders (short- and long-term debt).

This is a variation of the return on equity indicator. It shows the return on investment from capital invested by all sources, both owners and lenders.

Note: the total investment figure appearing on your balance sheet in a yearly summary format is the total investment figure at the end of the year. The end-of-year total investment figure will differ from your average total investment figure.

Return on assets (pretax) = profit before taxes divided by average total assets.

The return on assets indicator measures how much profit you are generating with each dollar of your assets.

Note: the total assets figure appearing on your balance sheet in a yearly summary format is the total assets figure at the end of the year. The end-of-year total assets figure will differ from your average total assets figure.

Net income added to retained earnings = the net profit, less any dividends added to the retained earnings account of the balance sheet. If there is a loss for the period, it is subtracted from the previous period's retained earnings account.

Lowest monthly cash flow = the lowest monthly cash flow for the year, as shown on the cash flow statement.

Lowest ending cash balance = the lowest ending cash balance for the year, as shown on the cash flow statement.

Gross profit margin = gross profit divided by total sales revenue.

This ratio is called gross profit, because no expenses other than the cost of goods sold have been deducted. This popular ratio is often used when comparing how products are priced.

Net profit margin = net profit before taxes divided by total sales revenue.

The net profit margin indicates the relative profitability of a business after taking into account its expenses.

We have endeavoured to include the most widely used definitions of the above indicators. In some cases there is variability as to how specific ratios are computed and how the values substituted in the formulas are determined. Our formulas are generic. Make sure, in other words, you're comparing "apples to apples" when you look at ratios from different sources.

EVALUATING YOUR NEW BUSINESS

This chapter looks at how you can effectively analyze and interpret your projected financial statements by answering these crucial questions:

1. How much funding do I need to get my business up and running to the point where I can finance it internally through operations? How will I raise these funds--through debt financing or equity investment?

2. How much profit can I realistically expect to make from my venture? How much rate of return can I expect from my investment? Is my expected rate of return worth the risk I am taking?

How Much Funding Do I Need?

Your business is not going to make it, unless you have enough cash to support your operations until your business reaches a self-financing level through sales activity. You can find out how much cash you will need by reviewing your projected cash flow statement. Take a look at your month-end cash balances over your three year forecast horizon and find the largest negative cash balance. This is the minimum amount you must have in your bank account. Preferably, to this amount you will add enough money to cover a contingency reserve factor.

When will you need this cash funding? Your cash flow statement answers this question by showing you, month-by-month, how much cash is coming in and how much cash is going out of your business. This prepares you ahead of time for those months when more cash is going out than coming in.

Many entrepreneurs are optimists--they have to be, otherwise they wouldn't be trying to start a new business. And they wouldn't be trying the venture they chose unless they were convinced it had promise. It's easy, however, to see more promise in your business idea than what is really there. For this reason you should keep a contingency reserve of cash on hand, in case your business does not go over the way you thought it would.

You can get a good idea of your contingency requirements by projecting multiple scenarios--an optimistic scenario, a most likely scenario, and a

pessimistic scenario. By forecasting three different outcomes of your new business, you will be prepared for a range of situations, each having its own maximum negative cash balance, cash contingency reserve, and profit outcome. For example, say you project your maximum negative cash balance under the following three scenarios:

Maximum negative cash balance:

Optimistic forecast scenario $-70,000

Most likely forecast scenario $-55,000

Pessimistic forecast scenario $-48,000

From this example, you can see that you'll need at least $55,000 in additional funding to finance the most likely scenario. But if, by chance, you meet your optimistic forecast you will need at least $70,000 in additional funding. You should therefore plan to obtain funding of at least $55,000, plus a contingency reserve of another $15,000 (total $70,000), just in case you meet your optimistic forecast.

If you're wondering why the optimistic scenario requires the most cash--the answer is, it takes money to make money. More sales mean more working capital to carry additional accounts receivable and additional inventory.

How Much Profit can I Realistically Expect to Make from My New Venture?

You do not need to specify an upper limit on how much profit you'd like to make--we assume it's as much as possible. However, you should have an idea of how much profit, as a bare minimum, your business must have to survive. You can determine your minimum acceptable profit by looking at your key financial indicator, rate of return on equity (ROE), which shows you how much return you will earn on the amount of money you invest in your business.

What is an acceptable return on your equity? Your rate of return should be commensurate with the risk you are taking. If you put your money into a bank account, for example, the risk to your money is minimal, therefore

your return will not be huge--maybe 4% interest. Most new businesses require an ROE of at least 20%, to compensate for the risk involved.

If your predicted ROE is not high enough, go back to your data input section and make adjustments to save money or increase your revenues. You may want to consider money-saving options like buying used fixed assets rather than new equipment, subcontracting production, renting smaller premises, or increasing collections on credit sales.

Starting a new business will take up almost all of your time. In the first years a small business owner may have to work 12-hour days, seven days a week! Therefore, even if the numbers look good, consider whether your new business idea is suited to your personality. Can you remain committed and enthusiastic over the long haul?

Profit Versus Cash

Many entrepreneurs are disappointed when they learn that even though their income statement is rosy, they are still consistently short of cash. Cash, not profit, is the life-blood of a business in its early stages, because if you can't pay your bills, you will eventually go out of business. If your income statement looks healthy, but your cash situation is dismal, consider these variables:

Increases in inventory

Increases in inventory do not immediately affect your income statement. You may make a large inventory purchase one month, and pay cash for it, but this inventory purchase will not impact your income statement until it is sold, and then it appears as a cost of goods sold expense.

Customer purchases on credit

Every time a customer makes a purchase on credit an accounts receivable is created. This purchase is shown on the income statement as revenue, but no cash is received from the customer until a later period, maybe one to two months after the sale. You can see how a small business can quickly become strapped for cash if there is a long time between when their inventory is purchased and when they actually receive cash from their customers.

Large loan payments

This is another situation where a cash outflow does not appear on the income statement. Loan payments usually consist of an interest component and a principal repayment component. For example, a monthly loan payment of $1,000 may consist of $100 interest and $900 principal repayment. Because the principal repayment portion is merely repaying money given to you earlier, it does not appear on the income statement as an expense. The interest portion, however, is a legitimate expense and does appear on the income statement. Thus, if you are making large principal repayments, it is possible for you to be short of cash, even though your income statement shows a profit.

Unprofitable, but cash rich

It is also possible for you to be cash rich even though your income statement looks dismal. This can arise when you have a large depreciation expense on your income statement. Since depreciation expense is a non-cash expense (no cheque is written for this expense), you may have cash to spend even though your large depreciation expense makes your business appear unprofitable.

~ End of EntreQuick - A Primer ~