Writing a Business Plan: The Basics

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Writing a Business Plan

The Basics

Key Topics Covered in This Chapter

- *why you need a business plan*
- *a format that tells readers what they want to know*
- *the importance of the executive summary*
- *how to handle each section of the plan*
- *style features that will make your message stand out*

A *BUSINESS PLAN* IS a document that explains a business opportunity, identifies the market to be served, and provides details about how the entrepreneurial organization plans to pursue it. Ideally, the business plan describes the unique qualifications that the management team brings to the effort, explains the resources required for success, and provides a forecast of results over a reasonable time horizon.

Every entrepreneur is encouraged to write a business plan, and most take that good advice; those who don't quickly learn that obtaining outside funding is almost impossible without it. Lenders and investors want to see a logical and coherent plan before putting their money at risk. Who wouldn't?

Few entrepreneurs, unfortunately, are skilled at creating a written document that simultaneously (1) makes the best case for the venture, (2) avoids burying the exciting opportunity under a mountain of data, (3) is engaging to read, and (4) gives prospective financiers the information they need to make a decision.

There are plenty of business plan services available, both in major cities and online, that can help you develop a document. For $1,200 and up, these consultants will take your information and work with you to produce a complete, eye-catching plan. There is also plenty of do-it-yourself software available for the business plan writer. These plans, however, are only as good as the ideas and forecasts you put into them. They are no substitute for the substantial thinking on which good plans are based, and that is why some experts suggest that the entrepreneur take control of the entire job.

This short chapter cannot impart all the information you need to write an investment-winning plan, nor can it offer details of what every plan section should contain. You'll find those details in the books and articles mentioned in the "For Further Reading" section of this volume. This chapter aims to impart the serious purposes of a business plan and explain the key points that readers look for in the many plans that cross their desks. If you are not a skillful writer, the final section on style will help you get those points across.

The Purposes of a Business Plan

Ask any entrepreneur why he or she needs a good business plan and you are likely to receive this answer: "You can't get funding without one." This is true, and it explains why many books, advisory services, software, and even M.B.A. courses have been developed to help people write bulletproof, knock-'em-dead business plans. Many leading M.B.A. programs and venture capitalists even sponsor contests that offer funding to whoever writes the most compelling plan. The best and brightest students flock to these contests, hoping to leave campus with a degree *and* financial backing for a start-up company.

Yes, a solid business plan is essential for any business that seeks outside funding from banks, "angels," venture capitalists—even relatives. Absent a good plan, creditors and investors won't take you seriously. They will conclude (perhaps correctly) that you haven't identified your customers or figured out how you will deal profitably with them. The most tolerant funders will say, "Come back and see us when you've put together a complete business plan." The less tolerant will not give your business a second look.

But seeking funding is not the only reason to develop a solid plan. There are several others:

- The act of writing the plan will force you and your team to think through all key elements of your business.
- Trusted and experienced outsiders who review your initial plan will help you identify weaknesses, missed opportunities,

unsupportable assumptions, and overly optimistic projections. Finding and fixing these problems on paper will improve your prospects with funders and will reduce the chance of future operational failure.

- A solid plan can be a blueprint for operating your business over the first one or two years, increasing the likelihood of success. The plan will tell you how much you can afford for personnel, advertising, and other expenses. It will specify target customers and success factors.
- The plan's financial projections can be used as a budget. Actual results that fall short of planned results will prompt you to investigate and take corrective action.

These various purposes for the business plan suggest that you tailor plans for different purposes. The intended audience should determine how the plan is written and presented.

Suggested Format

Many venture capital firms review more than a thousand business plans every year—and fund only a few. This means that they don't have time to figure out what you're trying to say. Nor do they have time to deal with people who haven't given them the information they need. The same is true of banks and angel investors. Assuming that you have a worthy idea, you will improve the odds of success if you can grab the reader's attention and keep it. To do this, you must address readers' concerns in a well-organized way.

Figure 5-1 contains a prototype format for a company we will call Lo-Carbo Foods Company, a manufacturer of packaged breakfast and snack foods having low carbohydrate levels. It aims to capitalize on the growing popularity in North America and Europe of low-carb diets. The company's research estimates that twenty-nine million Americans and eight million Europeans are now following low-carb diets, which U.S. government studies have confirmed to be effective in weight reduction and weight control.

FIGURE 5-1

Prototype Business Plan Format

Lo-Carbo Incorporated Business Plan

There is nothing sacred about the format shown here. In fact, you would be wise to tailor your plan format to the likely interests of your readers, just as you would customize the résumé you develop when seeking employment. Thus, you should follow the first rule of every form of writing: Know your audience. The goal in every case is to give readers the information they need to make a decision. (For another format and tips on plan writing, see the CIT/SBA tutorial at www.smallbizlending.com/resources/workshop/sba.htm, or consult the appropriate publications cited in the "For Further Reading" section of this book.)

Let's consider each major section of this document in greater detail.

Contents and Executive Summary

The Contents section (or table of contents) makes it easy for readers to see at a glance what the plan has to offer and where it can be located.

The contents should be followed by an *executive summary*, a short section of two to three pages. In terms of selling your plan to financial backers, this is the most important part of the entire document, so take the time to get it right. The executive summary is not a preface or an introduction; instead, it is a snapshot of the entire plan, something that explains your business to an intelligent reader in only a few minutes. A well-written executive summary captures the interest and attention of readers and prepares them for what follows.

The Opportunity

There is no point in starting or expanding a business unless the entrepreneur has identified a lucrative opportunity. Use this section to describe that opportunity: the market factors driving it, its current size, and its projected size in the years ahead. The point is to get readers to see and appreciate the business opportunity you have identified. So describe the opportunity in terms that are clear and compelling.

For the Lo-Carbo Foods Company, for example, you would use this section to describe the latest findings about rampant obesity in the United States and signs of the same in Western Europe. You would point to research estimating that twenty-nine million Americans and eight million Europeans are now following low-carb diets, and you would cite independent scientific studies that confirm the effectiveness of low-carbohydrate diets. An overview of consumer spending on health foods and weight control foods might also be provided here.

Use this section also to highlight the economics underlying the opportunity and the factors that will drive its success, such as market penetration, product innovation, and so on. But don't get carried away. Keep it brief, focused, and upbeat.

This is also a suitable place to cite the magnitude of the funding being sought and to explain how it will be used in pursuing the opportunity. For example, the Lo-Carbo plan might include something like this:

> *Lo-Carbo is seeking $2.75 million in funding to pursue this opportunity. The bulk of those funds will be used to exploit its current success*

and growing interest in the company's existing products by a national vendor of high-protein/low-carbohydrate foods.

Although it is important to document the opportunity with objective data, don't turn this section into a boring "data dump." Don't allow your compelling story to be buried under a mountain of facts. Instead, summarize the data and explain its implications for investors. Put the actual documentation in an appendix.

The Company, Its Products (or Services), and Strategy

Use this section to describe the company, explain how it is organized, and state its essential purpose. Here is an example:

Lo-Carbo is a Colorado-based corporation. It was founded in 2001 with the goal of serving a growing interest in a high-protein and low-carbohydrate diet. Its experienced management team has developed and test-marketed several low-carbohydrate products, primarily breakfast and snack foods. These products are not merely low in carbohydrates; tests have confirmed that they are also tasty and satisfying—qualities that differentiate them from other low-carb foods. The products are as follows:

- *Mellow Morning, a whole wheat and barley breakfast cereal with 48 percent fewer carbohydrates than leading conventional breakfast cereals. Mellow Morning meets the specifications of the leading low-carb diets.*
- *Crackle Brackle, a crisped, steel-cut oatmeal product for breakfast eating and for baking. Like Mellow Morning, Crackle Brackle meets the specifications of leading low-carb diets.*
- *Compadre Lo-Carb Chips, the company's tortilla chip. It too meets low-carb diet requirements while being flavorful and satisfying.*

Each of these products was well received in market tests (see the Appendix for details) and is currently being sold through two regional health food stores: Nutrimarket Stores, Inc., and Pleasant Valley Farms, Inc. Other products are in development.

GOALS. Don't forget to include a subsection about the goals of the company and its business strategy. Investors will want to know how you plan to grow. If there is a chance that the company will become a tempting acquisition target for a larger, less innovative competitor, mention this possibility. Here is an example:

Lo-Carbo has three goals:

1. *To broaden its product line*

2. *To expand market penetration through stores and through a private labeling agreement with one of the major diet companies (currently in negotiations)*

3. *To expand the business to the point where it either becomes a dominant player in the low-carbohydrate food niche* or *is acquired by one of the packaged food industry giants. In this industry, small companies with one or two successful products are often bought out at premium prices.*

If your company's products are not yet market-ready, you should reveal your plans for product rollouts. Also include an artist's rendering of the final physical product. If your products are market-ready, go beyond the written description; include high-quality photographs.

YOUR STRATEGY. Include in this or a separate section a discussion of the company's strategy. Strategy is about differentiation and competitive advantage. Explain what is different about your company's approach to the marketplace and how that difference will give it a sustainable competitive advantage. Differentiation may reside in the product or service—for example, a technically superior semiconductor that provides greater value to customers. On the other hand, differentiation may reside in your approach to customers, as in Dell's initial decision to sell custom-configured personal computers directly to users, bypassing the retail channel.

What makes your product or service, or means of delivery, different—and more desirable—in the eyes of customers? How will that difference translate into a competitive advantage that will produce profits and growing equity value? Investors want clear answers to these questions. Spell them out here.

OWNERSHIP. This "Company" section is also a fitting location for ownership information:

- Who are the current owners, and what percentages do they control?
- How is ownership evidenced—for example, in terms of common and preferred stock?
- Have any options, warrants, or convertible bonds that could expand ownership been issued?
- Which owners are involved in the day-to-day workings of the business?

The Management Team

Investors are keen to know about the people behind the business, whom they see as key assets. Specifically, what experiences or qual-

About Intellectual Property

Is your competitive advantage based on a proprietary technology or process? Is that technology or process patented or "patentable"? Does the company own patents, copyrights, or valuable trademarks? If it does, when will they expire?

Many businesses are formed around one or another piece of intellectual property. Some are key assets that impact competitive advantage over a period of time. Readers of your plan will want to know what steps you've taken to protect that property and to keep technical and market know-how within the organization, where it will produce revenues and profits for investors.

ifications do they bring to the enterprise? "When I receive a business plan," writes professor-practitioner Bill Sahlman, "I always read the résumé section first. Not because the people part of the new venture is the most important, but because without the right team, none of the other parts really matter."[1]

Fourteen Personnel Questions Every Business Plan Should Answer

- Where are the founders from?
- Where have they been educated?
- Where have they worked—and for whom?
- What have they accomplished—professionally and personally—in the past?
- What is their reputation within the business community?
- What experience do they have that is directly relevant to the opportunity they are pursuing?
- What skills, abilities, and knowledge do they have?
- How realistic are they about the venture's chances for success and the tribulations it will face?
- Who else needs to be on the team?
- Are they prepared to recruit high-quality people?
- How will they respond to adversity?
- Do they have the mettle to make the inevitable hard choices that must be made?
- How committed are they to this venture?
- What are their motivations?

SOURCE: William A. Sahlman, "How to Write a Great Business Plan," *Harvard Business Review,* July–August 1997, 101. Used with permission.

Here's how Lo-Carbo's business plan describes its people:

The management team is made up of Joanne Galloway, Dr. Philip Lindstrom, Gunter Schwartz, and Carlos Talavera. Together, they bring exceptional technical expertise and business experience to the enterprise.

- *Joanne Galloway has fifteen years of product and general management experience with packaged food companies, most recently with Gigantic Foods Corporation.*
- *Philip Lindstrom has a Ph.D. in nutrition. He joined the company in 2002 after working for ten years in product development for Behemoth Foods.*
- *Gunther Schwartz, the team's manufacturing expert, has been in the processed foods business for twelve years with both Behemoth Foods and Food Science Laboratories, a contract food research organization. Among Mr. Schwartz's accomplishments is the extrusion process used to manufacture Snackarinos and Caloritos, two highly successful packaged snack brands owned by Behemoth Foods.*
- *Carlos Talavera left his position as vice president of marketing at Healthtone, a leading packaged foods company, to join Galloway and Lindstrom in founding Lo-Carbo.*

Note: Complete résumés can be found in the appendix.

Most plans use an organization chart to indicate the reporting relationships among key personnel. A table indicating names, titles, and salaries is also useful, as in table 5-1.

Assuming that your company is a corporation, this is also an appropriate place to identify the board of directors. You should indicate the names of board members, their positions on the board, their professional backgrounds, and their history of involvement with the company.

Marketing Plan

If the "people" section of your business plan gets the most attention from readers, the marketing plan runs a close second. Investors know

TABLE 5-1

Lo-Carbo Inc., Key Personnel

	Position	Salary
Joanne Galloway	CEO	$85,000
Philip Lindstrom	VP Product Development	$75,000
Gunther Schwartz	VP Manufacturing	$75,000
Carlos Talavera	VP Sales & Marketing	$75,000
Edward Johnson	Financial consultant	Day rate
Diane Wolfe	Adminstrative assistant	$40,000

that marketing is the activity most associated with success or failure. An attractive product or service is essential, but a company will fail if it cannot connect with customers. A sound and realistic marketing plan is the best assurance that a solid customer connection will be made. The plan should be clear about all aspects of marketing, including the following:

- Identification of customers
- The number of potential customers and potential sales revenues
- The requirements of various customer segments
- The importance of purchase convenience, rapid delivery, product customization, and so on for these segments
- Ways to effectively access each segment—through distributors, a captive sales force, direct mail, e-commerce, or whatever
- Appropriate sales and promotion approaches
- An analysis of how purchase decisions are made
- Customer price sensitivity
- The cost of acquiring and retaining customers
- The strengths and weaknesses of competitors and ways that competitors are likely to react when the company enters the market

The Board of Directors

Every corporation must, by law, have a board of directors. But the entrepreneur should go beyond the requirements of the law in enlisting members. A board shouldn't be just a bunch of warm bodies. Instead, it should be an effective sounding board for ideas and a source of sage advice.

Recruiting board members should be a matter of the highest importance. You want people who have abundant business experience and, if technology is essential to the business, considerable scientific or engineering know-how. Board members should also be respected in the broader business community. Their capabilities and integrity will speak volumes to whoever reads your business plan, financiers in particular.

For your plan to be credible, these issues should be supported with solid market intelligence. Summarize that supporting intelligence here, and refer readers to whatever market research you've provided in the appendix.

Operating Plan

Whether you're in the business of designing products, manufacturing them, acting as a distributor, or running an e-commerce site, you are faced with a host of operational issues. What supplier relationships do you have or envision? How much inventory will be required? If you are a manufacturer, will you follow a job shop or continuous flow operation? Which day-to-day operating chores will be handled internally, and which will be outsourced?

An operations plan considers the many details of converting inputs to outputs that customers value. What is your plan?

Financial Plan

If a company is already operating, it will have (or should have) a set of financial statements: a *balance sheet*, an *income statement*, and a *cash flow* *statement*.[2] In a nutshell, the balance sheet describes what the company owns—its assets—and how those assets have been financed (through liabilities and the funds of the current owners) as of a particular date.

The income statement reveals the company's revenues, what it spent to gain those revenues, and the interest and taxes it paid over a specified period. Finally, the cash flow statement tells readers the sources and uses of cash during the same period. Together, these three financial statements reveal much to the trained eye of potential investors. (Note: If you are not familiar with these statements, see appendix A for an explanation of the basics.)

Generally, it's best to place the full financial statements in the appendix to your business plan. Use this space for key data from those statements—data that will give readers the big picture of your business and its intended future. Key among these data are your sales and expense projections, described earlier in this book as a pro forma income statement. For a company such as Lo-Carbo, readers would be interested in a breakout of key items in the statement, such as the anticipated revenues from various channels of distribution, as shown in table 5-2. Here we see anticipated sales and sales growth by channel and the percentage of sales represented by each.

TABLE 5-2

Forecast Revenues by Distribution Channel (in $000 and % of Sales)

	2005	%	2006	%	2007	%
Net sales						
Health food stores	112	*100*	160	*80*	200	*38*
Supermarkets	0	*0*	40	*20*	80	*15*
Private label business	0	*0*	0	*0*	240	*46*
Total Sales	112	*100*	200	*100*	520	*99*

TABLE 5-3

Forecast Marketing Expenses (in $000 and % of Sales)

	2005	%	2006	%	2007	%
Marketing expenses						
Sales commissions	11	*10*	20	*9*	52	*9*
Research	70	*63*	80	*36*	85	*15*
Promotion	20	*18*	32	*15*	50	*9*
Total expense	101	*91*	132	*60*	187	*33*

Consider doing the same for key categories of operating expenses, such as marketing cost, as shown in table 5-3.

Naturally, sales projections and other items in these pro forma statements are based on assumptions. Experienced investors are keenly aware of this and will want to know what those assumptions are and why you made them. Make that part of your discussion.

Style

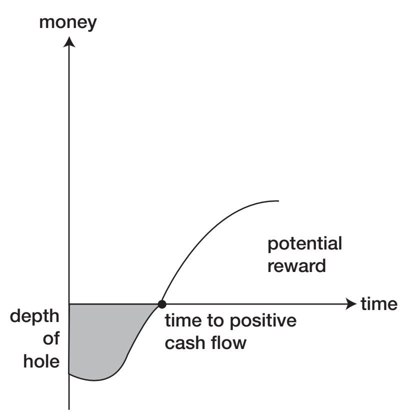
Every business plan is a combination of style and substance. Not being wordsmiths, most entrepreneurs concentrate on the substance and shortchange the style. That's unfortunate, because inattention to style makes a plan dull and difficult to read.

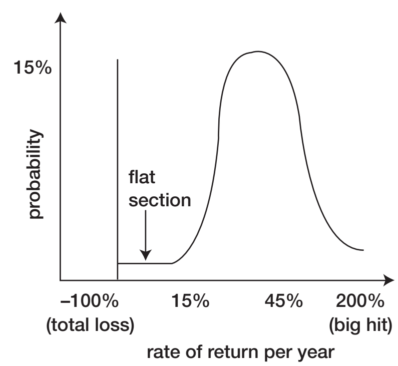
One remedy is to work with a writer who has experience in business plan writing. Another is to be your own wordsmith and observe the rules of good writing: Use words sparingly, keep sentences simple, make the most of design elements, and use graphics judiciously.

Visualizing the Bottom Line

Some people learn best from written material. Others are more receptive to the spoken word. Still others—and that includes most of us—learn from pictures and graphic representations of numerical data. So it's a good idea to use graphics to summarize your financial data.

Harvard professor Bill Sahlman suggests a "time to positive cash flow" graph like the one shown here. This image helps the investor see at a glance the expected depth and duration of negative cash flow, as well as the relationship between the investment and the potential return. "The ideal, needless to say," says Sahlman, "is to have cash flow early and often. But most investors are intrigued by the picture even when the cash outflow is high and long—as long as the cash inflow is more so."





SOURCE: William A. Sahlman, "How to Write a Great Business Plan," *Harvard Business Review,* July–August 1997, 104.

Use Words Sparingly

In the business world, shorter is always better if it communicates the required information. So heed Rule 17 in Strunk and White's timeless *Elements of Style*, and omit needless words.

> *Vigorous writing is concise. A sentence should contain no unnecessary words; a paragraph no unnecessary sentences; for the same reason that a drawing should have no unnecessary lines and a machine no unnecessary parts. This requires not that the writer make all his sentences short, or that he avoid all detail and treat his subjects only in outline, but that every word tells.*[3]

This quote from Strunk and White is itself a perfect model of their rule. They use no unnecessary words; every word makes a contribution. Economy of words has two big benefits for the business plan writer: Your key messages will stand out, and economy of words saves your reader's valuable time.

Use Simple Sentences

The sentence is the basic unit of written expression. Most sentences make a statement. The statement can be simple or complex. Consider these:

1. The growing popularity of low-carbohydrate diets has created a business opportunity for makers of low-carb foods.
2. On the one hand we witness rising levels of obesity among children and adults, both in North America and in Western Europe, which in turn have increased the popularity of low-carb diets, which in turn have created a business opportunity for Lo-Carb Company and other makers of low-carb foods.

The first sentence, unlike the second, is spare and to the point. It will more likely register with readers. It does not contain all the information found in the second. If that information is important, it should be provided in a separate sentence.

Packing more information into each sentence is not necessarily bad, nor does it violate rules of grammar if done properly. However, complex sentences make the reader work harder and may create confusion. As a writer, your challenge is to know when a sentence has reached its optimal carrying capacity.

Use Design Elements to Lighten the Reader's Load

Readers of your business plan are busy people who have learned to skim; they drill down only to relevant details. You can facilitate their skimming through the use of design elements. Design elements include headings, subheads, and short blocks of text. Even white space can be used as a design element. All are useful in long documents. Used judiciously, they can

- make your written documents more inviting to the reader
- improve reader comprehension
- help speed the reader through your material

USE HEADINGS AND SUBHEADS. Headings and subheads signal that a new or related topic is about to begin. They give your work greater eye appeal and "skimmability." You can also use headings and subheads to impart key ideas. For example, our heading "Use Headings and Subheads" is also a key idea. A time-constrained reader can gather the key points of any section in your business plan by simply reading these headings and subheads.

BREAK UP LONG BLOCKS OF TEXT. Long, uninterrupted blocks of text are off-putting to readers and are difficult to skim. Headings and subheads can help you break those blocks into identifiable small bites. So can short paragraphs. Some experts recommend that paragraphs average no more than two hundred words—about five sentences, or 1.5 inches of single-spaced typing.

Numbered lists are another effective way to break up long, intimidating blocks of text and to increase the impact. You can use numbered lists to summarize key points or to get your ideas across quickly, as in the following example:

Our study of the market for low-carb foods uncovered four primary channels for reaching end-use customers:

1. *Health food retail stores (currently 34,000 in the U.S. alone)*
2. *Stand-alone low-carb food stores (currently only 43, but growing quickly in numbers)*
3. *Traditional grocery stores (health food section)*
4. *Private labeling of products sold through one or more of the low-carb diet plans*

Notice how the numbered list breaks up the page and gets conclusions across in a way that they cannot be missed.

Bullets can serve the same purposes as numbered lists. Bullets are sometimes the best way to get information across clearly and succinctly—if not elegantly. For example, you might use a bulleted list when you

- want to highlight a sequence of actions
- need to organize a list of items
- need to list parts of a whole

Bullets (or numbers) are not needed when your list has only one or two elements. In these cases you can usually get by saying something like this:

Focus groups identified two problems with our competitor's low-carb tortilla chips: They taste like cardboard and cause gastric distress.

Let Graphics Tell Part of the Story

Business plans inevitably contain lots of numerical data. When it comes to transmitting numerical data quickly, bar charts and pie charts are hard to beat. Readers can see at a glance what they would otherwise have to extract from many tedious lines of verbiage and numbers. Which of the following would you rather read? Which of the following would make a more memorable impression?

Text-only example:

> *Our survey found that 2 percent of the people who come downtown in a typical day do so by bicycle. Some 9 percent arrive by public transportation. Thirty-five percent respond that they walk to the downtown, while the largest single group—54 percent—arrive by automobile.*

Text and graphics example (see figure 5-2):

> *According to our survey, people arrive downtown by various means, most by automobile.*

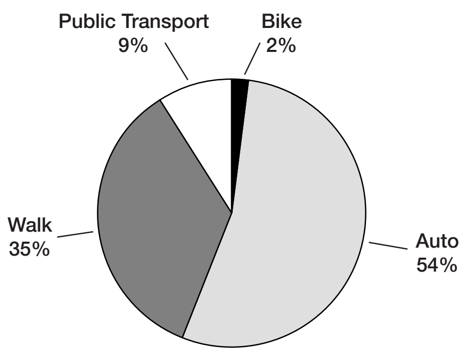
A Caution on Design Elements

Don't get carried away with design elements. Word processing software gives you an arsenal of design features: boldface, italics, dozens of font sizes and styles, clip art, chart-making tools, and so forth. Used judiciously, these add to the appearance and readability of your text. Overuse them, however, and you will create the opposite effect and make your work appear amateurish. So keep it simple.

There is no general rule about the appropriateness and inappropriateness of design features. Every piece is unique. When in doubt, obtain a professionally produced business plan of another company and use it as a model.

FIGURE 5-2

How People Reach the Downtown



Notice that telling the story with a graphic doesn't necessarily save space, but it gives your audience a break from reading text, and it generally has more impact.

Final Thoughts

As you develop your business plan, always keep the interests of your readers in mind. Put yourself in their place. Your audience is looking for convincing evidence that you have found a real business opportunity—one with substantial growth possibilities. Considering the risks they will be taking with their money, they want to see major upside potential.

Your plan's readers will also be looking for clear indications that you have done your homework—that you understand the market, have targeted the right customers, and have developed a sound strategy for profitably transacting business with them. Prospective investors want assurance that you and the management team have the knowledge, experience, and drive to turn an opportunity into a profitable business. And what is important to potential lenders and

The Software Solution

Business plan software programs are available for $200 or less. Business PlanPro is one example. Some matchmaker firms even offer downloadable templates that provide the basic structure of the plan and ask you to "fill in the blanks" for the component parts, including cash flow and sales projections. For software and templates, search the Internet using "business plan" and "business plan software" as keywords.

investors should be just as important to you. So as you write your plan, stop periodically and ask yourself, Is this a real opportunity? Do I understand the market and the customers I hope to attract? Can we really make this thing work?

Finally, tell your readers how they will get their money out of the company.

Investors want an exit strategy: a buyout by management, an acquisition by another company, an initial public offering of shares, and so on. Even if you plan to be in the business for the long haul, your investors want liquidity at some point—and the sooner the better.

Summing Up

- Keep the audience foremost in your mind as you develop your business plan.
- Your business plan should tell readers in a compelling way everything they need to know to make a decision.
- Although the principal reason for writing a business plan is to obtain outside funding, the act of writing it will force the management team to think through all key elements of the business.

- The executive summary should, in compelling terms, explain the opportunity, tell why it is timely, show how your company plans to pursue it, describe your expected results, and provide a thumbnail sketch of the company and the management team.
- Among other things, the plan should state the company's goals and explain how investors will eventually cash out.
- Pay attention to style. Use as few words as necessary to get your points across. Avoid long, complex sentences when possible. Make your document easy to skim by using headings, sub-heads, white space, and numbered and bulleted lists to break up blocks of text.

APPENDIX A

Understanding Financial Statements

A Primer

What does your company own, and what does it owe to others? What are its sources of revenue, and how has it spent its money? How much profit has it made? What is the state of your company's financial health? This appendix helps you answer those questions by explaining the three essential financial statements: the balance sheet, the income statement, and the cash flow statement. The appendix also helps you understand some of the managerial issues implicit in these statements and broadens your financial know-how through discussion of two important concepts: financial leverage and the financial structure of the firm.

If you have a business degree or senior management experience, you may already know as much as you need to know about these topics. But many entrepreneurs have neither. For example, Ken Olsen, the legendary founder of Digital Equipment Corporation in the late 1950s, knew all about electrical engineering and programming, and he had terrific ideas for building a new generation of computers. But he knew next to nothing about financial statements, which the venture capitalists wanted him to include in his business plan. According to entrepreneurial lore, Olsen went to the public library, borrowed a copy of Paul Samuelson's famous economics textbook, found an example of a balance sheet and income statement, and used them as models for his projected figures. The venture capitalists were impressed and gave him the money he needed to develop his business.

If you're already knowledgeable about financial statements, you can probably skip this appendix. But if you're more like novice entrepreneur Ken Olsen (and we hope you are, since he made lots of money and accomplished great things), then continue reading. The ability to read and interpret financial statements is essential for the enterprising businessperson. When the conversation turns to "current liabilities," "profit margin," and "working capital," the meaning of these terms must be understood.

Why Financial Statements?

Financial statements are the essential documents of business. Managers use them to assess performance and identify areas in which intervention is required. Shareholders use them to keep tabs on how well their capital is being managed. Outside investors use them to identify opportunities. And lenders and suppliers routinely examine financial statements to determine the creditworthiness of the companies with which they deal.

Publicly traded companies are required by the Securities and Exchange Commission (SEC) to produce financial statements and make them available to everyone as part of the full-disclosure requirement the SEC places on publicly owned and traded companies. Companies not publicly traded are under no such requirement, but their private owners and bankers expect financial statements nevertheless.

Financial statements—the balance sheet, the income statement, and the cash flow statement—follow the same general format from company to company. And even though specific line items may vary with the nature of a company's business, the statements are usually similar enough to allow you to compare one business's performance against another's.

The Balance Sheet

Many people go to a doctor once a year to get a checkup—a snapshot of their physical well-being at a particular time. Similarly, companies prepare balance sheets as a way of summarizing their financial positions at a given point in time, usually at the end of the month, the quarter, or the fiscal year.

In effect, the balance sheet describes the assets controlled by the business and shows how those assets are financed—with the funds of creditors (liabilities), with the capital of the owners, or with both. A balance sheet reflects the following basic accounting equation:

Assets = Liabilities + Owners' Equity

Assets in this equation are the things in which a company invests so that it can conduct business. Examples include cash and financial instruments, inventories of raw materials and finished goods, land, buildings, and equipment. Assets also include money owed to the company by customers and others—an asset category referred to as *accounts receivable*.

Now look at the other side of the equation, starting with liabilities. To acquire its necessary assets, a company often borrows money or promises to pay suppliers for various goods and services. Moneys owed to creditors are called *liabilities*. For example, a computer company may acquire $1 million worth of motherboards from an electronic parts supplier, with payment due in thirty days. In doing so, the computer company increases its inventory assets by $1 million and increases its liabilities—in the form of *accounts payable*—by an equal amount. The equation stays in balance. Similarly, if the same company were to borrow $100,000 from a bank, the cash infusion would increase its assets by $100,000 and its liabilities by the same amount.

Owners' equity, also known as shareholders' or stockholders' equity, is what is left after total liabilities are deducted from total assets. Thus, a company that has $3 million in total assets and $2 million in liabilities would have owners' equity of $1 million.

Assets – Liabilities = Owners' Equity
$3,000,000 – $2,000,000 = $1,000,000

If $500,000 of this same company's uninsured assets burned up in a fire, its liabilities would remain the same, but its owners' equity—what's left after all claims against assets are satisfied—would be reduced to \$500,000:

Assets – Liabilities = Owners' Equity
\$2,500,000 – \$2,000,000 = \$500,000

Thus, the balance sheet "balances" a company's assets and liabilities. Notice, for example, that the total assets equal total liabilities and owners' equity in the balance sheet of Amalgamated Hat Rack, our sample company (table A-1). The balance sheet also describes how much the company has invested in assets and shows where the money is invested. Further, the balance sheet indicates how much of those monetary investments in assets comes from creditors (liabilities) and how much comes from owners (equity). Analysis of the balance sheet can give you an idea of how efficiently a company is using its assets and how well it is managing its liabilities.

Balance sheet data is most helpful when compared with the same information from one or more previous years. Consider the balance sheet of Amalgamated Hat Rack. First, this statement represents the company's financial position at a moment in time: December 31, 2002. A comparison of the figures for 2001 against those for 2002 shows that Amalgamated is moving in a positive direction: It has increased its owner's equity by \$100,000.

Assets

You should understand some details about this particular financial statement. The balance sheet begins by listing the assets most easily converted to cash: cash on hand and marketable securities, receivables, and inventory. These are called *current assets*. Generally, current assets are those that can be converted into cash within one year.

Next, the balance sheet tallies other assets that are tougher to convert to cash—for example, buildings and equipment. These are called plant assets or, more commonly, *fixed assets* (because it is hard to change them into cash).

Because most fixed assets, except land, depreciate—or become less valuable—over time, the company must reduce the stated value of

TABLE A-1

Amalgamated Hat Rack Balance Sheet as of December 31, 2002

	2002	2001	Increase (Decrease)
Assets			
Cash and marketable securities	$355,000	$430,000	$(75,000)
Accounts receivable	$555,000	$512,000	$43,000
Inventory	$835,000	$755,000	$80,000
Prepaid expenses	$123,000	$98,000	$25,000
Total current assets	$1,868,000	$1,795,000	$73,000
Gross property, plant, and equipment	$2,100,000	$1,900,000	$200,000
Less: accumulated depreciation	$333,000	$234,000	$99,000
Net property, plant, and equipment	$1,767,000	$1,666,000	$101,000
Total assets	$3,635,000	$3,461,000	$174,000
Liabilities and Owner's Equity			
Accounts payable	$450,000	$430,000	$20,000
Accrued expenses	$98,000	$77,000	$21,000
Income tax payable	$17,000	$9,000	$8,000
Short-term debt	$435,000	$500,000	$65,000
Total current liabilities	$1,000,000	$1,016,000	$(16,000)
Long-term debt	$750,000	$660,000	$90,000
Total liabilities	$1,750,000	$1,676,000	$74,000
Contributed capital	$900,000	$850,000	$50,000
Retained earnings	$985,000	$935,000	$50,000
Total owner's equity	$1,885,000	$1,785,000	$100,000
Total liabilities and owner's equity	$3,635,000	$3,461,000	$174,000

Source: HMM Finance.

these fixed assets by something called accumulated depreciation. Gross property, plant, and equipment minus accumulated depreciation equals the current book value of property, plant, and equipment.

Some companies list *goodwill* among their assets. If a company has purchased another company for a price above the fair market value of its assets, that so-called goodwill is recorded as an asset. This is, however, strictly an accounting fiction. Goodwill may also represent intangible things such as brand names or the acquired company's excellent reputation. These may have real value. So too can other intangible assets, such as patents.

Finally, we come to the last line of the asset section of the balance sheet: total assets. Total assets represents the sum of current and fixed assets.

Liabilities and Owners' Equity

Now let's consider the claims against those assets, beginning with a category called current liabilities. *Current liabilities* represent the claims of creditors and others that typically must be paid within a year; they include short-term IOUs, accrued salaries, accrued income taxes, and accounts payable. This year's repayment obligation on a long-term loan is also listed under current liabilities.

Subtracting current liabilities from current assets gives you the company's net working capital. *Net working capital* is the amount of money the company has tied up in its current (short-term) operating activities. Just how much is adequate for the company depends on the industry and the company's plans. In the balance sheet shown in table A-1, Amalgamated has $868,000 in net working capital.

Long-term liabilities are typically bonds and mortgages—debts that the company is contractually obliged to repay, with respect to both interest and principal.

According to the aforementioned accounting equation, total assets must equal total liabilities plus owners' equity. Thus, subtracting total liabilities from total assets, the balance sheet arrives at a figure for the owners' equity. Owners' equity comprises *retained earnings* (net profits that accumulate on a company's balance sheet after any dividends are paid) and contributed capital (capital received in exchange for shares)

Historical Values

The values represented in many balance-sheet categories may not correspond to their actual market values. Except for items such as cash, accounts receivable, and accounts payable, the measurement of each classification will rarely be equal to the actual current value or cash value shown. This is because accountants must record most items at their historic cost. If, for example, XYZ's balance sheet indicated land worth $700,000, that figure would represent what XYZ paid for the land way back when. If the land was purchased in downtown San Francisco in 1960, you can bet that it is now worth immensely more than the value stated on the balance sheet.

So why do accountants use historic instead of market values? The short answer is that it represents the lesser of two evils. If market values were mandated, then every public company would be required to get a professional appraisal of every one of its properties, warehouse inventories, and so forth—and would have to do so every year. And how many people would trust those appraisals? So we're stuck with historic values on the balance sheet.

Managerial Issues

Although the balance sheet is prepared by accountants, it represents a number of important issues for managers.

WORKING CAPITAL. Business owners give substantial attention to the level of working capital, which naturally expands and contracts with sales activities. Too little working capital can put a company in a bad position: The company may be unable to pay its bills or to take advantage of profitable opportunities. Too much working capital, on the other hand, reduces profitability, because that capital has a carrying cost; it must be financed in some way, usually through interest-bearing loans.

Inventory is one component of working capital—unless yours is a service business that has no inventory. Like working capital in general, inventory must be balanced between too much and too little. Having lots of inventory on hand allows a company to fill customer orders without delay and provides a buffer against potential production stoppages and strikes. The flip side of plentiful inventory is the cost of financing and the risk of deterioration in the market value of the inventory itself. Every excess widget in the stockroom adds to the company's financing costs, and that reduces profits. And every item that sits on the shelf may become obsolete or less salable as time goes by—again, with a negative impact on profitability.

The personal computer business provides a clear example of how excess inventory can wreck the bottom line. Some analysts estimate that the value of finished-goods inventory melts away at a rate of approximately 2 percent *per day* because of technical obsolescence in this fast-moving industry.

FINANCIAL LEVERAGE. You have probably heard someone say, "It's a highly leveraged situation." Do you know what "leveraged" means in the financial sense? *Financial leverage* refers to the use of borrowed money in acquiring an asset. We say that a company is highly leveraged when the percentage of debt on its balance sheet is high relative to the capital invested by the owners. For example, suppose that you paid $400,000 for an asset, using $100,000 of your own money and $300,000 in borrowed funds. For simplicity, we'll ignore loan payments, taxes, and any cash flow you might get from the investment. Four years go by, and your asset has appreciated to $500,000. You decide to sell. After paying off the $300,000 loan, you end up with $200,000 in your pocket (your original $100,000 plus a $100,000 profit). That's a gain of 100 percent on your personal capital, even though the asset increased in value by only 25 percent. Financial leverage made this possible. In contrast, if you had financed the purchase entirely with your own funds ($400,000), then you would have ended up with only a 25 percent gain.

Financial leverage creates an opportunity for a company to gain a higher return on the capital invested by its owners. In the United

States and most other countries, tax policy makes financial leverage even more attractive by allowing businesses to deduct the interest paid on loans. But leverage can cut both ways. If the value of an asset drops (or fails to produce the anticipated level of revenue), then leverage works against its owner. Consider what would have happened in our example if the asset's value had dropped by \$100,000, that is, to \$300,000. The owner would have lost the entire \$100,000 investment after repaying the initial loan of \$300,000.

FINANCIAL STRUCTURE OF THE FIRM. The negative potential of financial leverage is what keeps CEOs from maximizing their debt financing. Instead, they seek a financial structure that creates a realistic balance between debt and equity on the balance sheet. Although leverage enhances a company's potential profitability as long as things go right, managers know that every dollar of debt increases the riskiness of the business—both because of the danger just cited and because high debt results in high interest payments, which must be paid in good times and bad. Many companies have failed when business reversals or recessions reduced their ability to make timely payments on their loans.

When creditors and investors examine corporate balance sheets, they look carefully at the debt-to-equity ratio. They factor the riskiness of the balance sheet into the interest they charge on loans and the return they demand from a company's bonds. Thus, a highly leveraged company may have to pay 14 percent on borrowed funds instead of the 10 to 12 percent paid by a less leveraged competitor. Investors also demand a higher rate of return for their stock investments in highly leveraged companies. They will not accept high risks without an expectation of commensurately large returns.

The Income Statement

The income statement indicates the results of operations over a specified period. Those last two words are important. Unlike the balance sheet, which is a snapshot of the enterprise's position at a point in time, the *income statement* indicates cumulative business results within a defined time frame. It tells you whether the company is making a profit—that is, whether it has positive or negative net income (net earnings). This is why the income statement is often referred to as the *profit-and-loss statement,* or P&L. It shows a company's profitability at the end of a particular time—typically at the end of the month, the quarter, or the company's fiscal year. In addition, the income statement tells you how much money the company spent to make that profit—from which you can determine the company's *profit margin.*

As we did with the balance sheet, we can represent the contents of the income statement with a simple equation:

Revenues – Expenses = Net Income (or Net Loss)

An income statement starts with the company's *revenues:* the amount of money that results from selling products or services to customers. A company may have other revenues as well. In many cases, these are from investments or interest income from its cash holdings.

Various costs and expenses—from the costs of making and storing goods, to depreciation of plant and equipment, to interest expense and taxes—are then deducted from revenues. The bottom line—what's left over—is the *net income,* or net profit or net earnings, for the period of the statement.

Consider the meaning of various line items on the income statement for Amalgamated Hat Rack (table A-2). The *cost of goods sold* is what it cost Amalgamated to manufacture its hat racks. This figure includes the cost of raw materials, such as lumber, as well as the cost of turning them into finished goods, including direct labor costs. By deducting the cost of goods sold from sales revenue, we get a company's *gross profit*—the roughest estimation of the company's profitability.

The next major category of cost is *operating expenses*. Operating expenses include administrative employee salaries, rents, and sales and marketing costs, as well as other costs of business not directly attributed to the cost of manufacturing a product. The lumber for making hat racks would *not* be included here; the cost of the advertising and the salaries of Amalgamated administrative employees would be included.

TABLE A-2

Amalgamated Hat Rack Income Statement for the Fiscal Year Ending December 31, 2002

Retail Sales	$2,200,000
Corporate Sales	$1,000,000
Total Sales Revenue	$3,200,000
Less: Cost of Goods Sold	$1,600,000
Gross Profit	$1,600,000
Less: Operating Expenses	$800,000
Depreciation Expense	$42,500
Earnings before Interest and Taxes	$757,500
Less: Interest Expense	$110,000
Earnings before Income Tax	$647,500
Less: Income Tax	$300,000
Net Income	$347,500

Source: HMM Finance.

Depreciation is counted on the income statement as an expense, even though it involves no out-of-pocket payments. As described earlier, depreciation is a way of estimating the "consumption" of an asset, or the diminishing value of equipment, over time. A computer, for example, loses about one-third of its value each year. Thus, the company would not expense the full value of a computer in the first year of its purchase but rather would decrease its value as it is actually used over a span of three years. The idea behind depreciation is to recognize the diminished value of certain assets.

By subtracting operating expenses and depreciation from the gross profit, we get *operating earnings.* These earnings are often called earnings before interest and taxes, or EBIT.

We're now down to the last reductions in the path that revenues follow on their way to the bottom line. Interest expense is the interest charged on loans a company has taken out. Income tax, tax levied by the government on corporate income, is the final charge.

What revenues are left are referred to as net income, or earnings. If net income is positive—as it is in the case of Amalgamated—we have a profit, what the for-profit company lives for.

Making Sense of the Income Statement

As with the balance sheet, our analysis of a company's income statement is greatly aided when presented in a multiperiod format. This allows us to spot trends and turnarounds. Most annual reports make multiperiod data available, often going back five or more years. Amalgamated's income statement in multiperiod form is depicted in table A-3.

TABLE A-3

Amalgamated Hat Rack Multiperiod Income Statement

	For the Period Ending December 31			
	2002	**2001**	**2000**	**1999**
Retail Sales	$2,200,000	$2,000,000	$1,720,000	$1,500,000
Corporate Sales	$1,000,000	$1,000,000	$1,100,000	$1,200,000
Total Sales Revenue	$3,200,000	$3,000,000	$2,820,000	$2,700,000
Less: Cost of Goods Sold	$1,600,000	$1,550,000	$1,400,000	$1,300,000
Gross Profit	$1,600,000	$1,450,000	$1,420,000	$1,400,000
Less: Operating Expenses	$800,000	$810,000	$812,000	$805,000
Depreciation Expense	$42,500	$44,500	$45,500	$42,500
Earnings before Interest and Taxes	$757,500	$595,500	$562,500	$552,500
Less: Interest Expense	$110,000	$110,000	$150,000	$150,000
Earnings before Income Tax	$647,500	$485,500	$412,500	$402,500
Less: Income Tax	$300,000	$194,200	$165,000	$161,000
Net Income	$347,500	$291,300	$247,500	$241,500

In this multiyear format, we observe that Amalgamated's annual retail sales have grown steadily, and its corporate sales have stagnated and even declined slightly. Operating expenses have stayed about the same, however, even as total sales have expanded. That's a good sign that management is holding the line on the cost of doing business. The company's interest expense has also declined, perhaps because it has paid off one of its loans. The bottom line, net income, has shown healthy growth.

The Cash Flow Statement

The *cash flow statement,* the last of the three essential financial statements, is the least used and understood. This statement details the reasons that the amount of cash (and cash equivalents) changed during the accounting period. More specifically, it reflects all changes in cash as affected by operating activities, investments, and financing activities. Like the bank statement you receive for your checking account, the cash flow statement tells how much cash was on hand at the beginning of the period and how much was on hand at the end. It then describes how the company acquired and spent cash in a particular period. The uses of cash are recorded as negative figures, and sources of cash are recorded as positive figures.

If you're a manager in a large corporation, changes in the company's cash flow typically don't have an impact on your day-to-day functioning. Nevertheless, it's a good idea to stay up-to-date with your company's cash flow projections, because they may come into play when you prepare your budget for the upcoming year. For example, if cash is tight, you will probably want to be conservative in your spending. Alternatively, if the company is flush with cash, you may have opportunities to make new investments. If you're a manager in a small company (or its owner), you're probably keenly aware of your cash flow situation and feel its impact almost every day.

The cash flow statement is useful because it indicates whether your company is turning accounts receivable into cash—and that ability is ultimately what will keep your company solvent. *Solvency* is the ability to pay bills as they come due.

As we did with the other statements, we can conceptualize the cash flow statement in terms of a simple equation:

Cash Flow from Profit + Other Sources of Cash – Uses of Cash = Change in Cash

Again using the Amalgamated Hat Rack example, we see that in its year 2002 cash flow statement, the company generated a positive cash flow of $377,900 (table A-4). The statement shows that cash

TABLE A-4

Amalgamated Hat Rack Cash Flow Statement, 2002

Net Income	$347,500
Operating Assets and Liabilities	
Accounts receivable	$(75,600)
Finished-goods inventory	$(125,000)
Prepaid expenses	$(37,000)
Accounts payable	$83,000
Accrued expenses	$25,000
Income tax payable	$(23,000)
Depreciation expense	$89,000
Total changes in operating assets and liabilities	$(63,600)
Cash flow from operations	$283,900
Investing Activities	
Sale of property, plant, and equipment	$267,000
Capital expenditures	$(175,000)
Cash flow from investing activities	$92,000
Financing Activities	
Short-term debt increase	$27,000
Long-term borrowing	$112,000
Capital stock	$50,000
Cash dividends to stockholders	$(187,000)
Cash flow from financing activities	$2,000
Increase in cash during year	$377,900

Source: HMM Finance.

flows from operations ($283,900) plus those from investing activities ($92,000) and from financing ($2,000) produced $377,900 in additional cash.

The cash flow statement doesn't measure the same thing as the income statement. If there is no cash transaction, then it cannot be reflected on a cash flow statement. Notice, however, that net income at the top of the cash flow statement is the same as the bottom line of the income statement; it's the company's profit. Through a series of adjustments, the cash flow statement translates this net income into a cash basis.

The statement's format reflects the three categories of activities that affect cash. Cash can be increased or decreased because of (1) operations, (2) the acquisition or sale of assets, that is, investments, or (3) changes in debt or stock or other financing activities. Let's consider each in turn, starting with operations:

- Accounts receivable and finished-goods inventory represent items the company has produced but for which it hasn't yet received payment. Prepaid expenses represent items the company has paid for but has not yet consumed. These items are all subtracted from cash flow.

- Accounts payable and accrued expenses represent items the company has already received or used but for which it hasn't yet paid. Consequently, these items add to cash flow.

Now consider investments. Investment activities include the following:

- Gains realized from the sale of plant, property, and equipment—in other words, gains realized from converting investments into cash

- Cash that the company uses to invest in financial instruments and plant, property, and equipment (the latter investments are often shown as capital expenditures)

The cash flow statement shows that Amalgamated has sold a building for $267,000 and has made capital expenditures of $175,000, for a net addition to cash flow of $92,000.

Cash Flow Versus Profit

Many people think of profits as cash flow. Don't make this mistake. For a particular period, profit may or may not contribute positively to cash flow. For example, if this year's profit derives from a huge sale made in November, the sale may be booked as revenues in the fiscal period, thus adding to profit. But if payment for that sale is not received until the next accounting period, it goes on the books as an account receivable, and that reduces cash flow.

Finally, we come to cash flow changes from financing activities. Amalgamated has raised money by increasing its short-term debt, by borrowing in the capital markets, and by issuing capital stock, thereby increasing its available cash flow. The dividends that Amalgamated pays, however ($187,000), must be paid out of cash flow and thus represent a decrease in cash flow.

There's a lot more to financial statements and their interpretation than we can provide in this short primer, but you now have a basis for learning more. The statements generated by your small start-up will be fairly simple in any case, and you can learn more as you work with your accountant or financial officer, and as your company grows.

Notes

Chapter 5

1. William A. Sahlman, "How to Write a Great Business Plan," *Harvard Business Review*, July-August 1997, 100–101.

2. The Harvard Business Essentials Web site contains a free, downloadable computer spreadsheet template you can use to develop a pro forma balance sheet, an income statement, and a cash flow statement for your business plan. It will also produce several charts that readers of your plan will find useful. This piece of software comes with complete instructions. To access it, go to www.elearning.hbsp.org/businesstools.

3. William Strunk Jr. and E. B. White, *The Elements of Style,* 3rd edition (New York: Macmillan Publishing Company, 1979), 23.

Harvard Business Essentials

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The Harvard Business Essentials series is designed to provide comprehensive advice, personal coaching, background information, and guidance on the most relevant topics in business. Drawing on rich content from Harvard Business School Publishing and other sources, these concise guides are carefully crafted to provide a highly practical resource for readers with all levels of experience, and will prove especially valuable for the new manager. To assure quality and accuracy, each volume is closely reviewed by a specialized content adviser from a world-class business school. Whether you are a new manager seeking to expand your skills or a seasoned professional looking to broaden your knowledge base, these solution-oriented books put reliable answers at your fingertips.

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