

**Deloitte
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Fourth Edition

Writing an Effective Business Plan



accelerator™

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INTRODUCTION

Traditionally considered an exercise in corporate discipline, today's business plans are at the heart of obtaining financing, forming alliances and recruiting executives. No longer read exclusively by insiders and traditional lenders, business plans must do more than demonstrate a sufficient level of competence. Today's plans have to withstand stiff competition in attracting funding, key employees, and other desired relationships.

Despite the enormous impact that a well developed business plan will have on a company, many executives prepare plans that poorly articulate their company and their vision.

Some executives are tempted to simplify the process by choosing from the impressive array of software products that provide interactive, menu-driven means to create a complete plan. The use of integrated business plan software products tends to result in boilerplate plans that funding sources immediately recognize as derived from a "canned" source. Others choose to employ a professional consultant. Outside advisors are useful for guidance, general advice, and to review your plan and suggest possible sources of capital. They should not, however, be your plan's original authors. Your business plan should convey your own drive and determination to succeed, and no one can better add that vital element of enthusiasm than you and your management team.

Writing a plan must be managed just as most other important business projects are managed. It requires advance preparation, delegation, refinement, and discipline. The process of preparing a business plan involves identifying likely users, gathering accurate and convincing information, and carefully outlining the plan before writing. The key sections of the business plan are as follows:

Executive Summary This is the most concise form of the business plan, covering all of the key points. Outside parties typically review the Executive Summary first to determine if your company is a potential candidate before deciding to read further. As the most important part of your business plan, this sections should be prepared last.

Company Description This first full section of the business plan covers the company's mission, history, current status, strategies, and plans for the future.

Management and Organization Many potential investors consider the management team to be the most important predictor of a successful business. This section should describe members of the management team and their backgrounds as well as needs for additional key people. Key outside advisors and consultants should also be discussed.

The Market and Competitors This section must define the company's market, the industry, current and potential buyers, and competitors. The plan should explain the key factors for the market in terms of how buying decisions are made, how the market is segmented, what kind of market position you plan, and what sort of defensive strategy you envision to fend off competitors.

The Product or Service In this section, the features, components, and quality of the product(s) or service(s) are described in detail. Issues that must be addressed are the amount of research and development remaining to be completed, how the product or service will be produced and at what cost, and how the crucial activities of quality control and after-sale service will be performed. Key regulatory considerations should also be addressed.

Marketing and Sales The business plan must describe the company's selling methods (such as direct sales or mail order), how sales staff is trained, and how support is provided. Because of the substantial expense associated with business development, the plan should consider and present the most cost-effective options. Your marketing plan should discuss the results of market research and the value proposition of your product or service. Effective marketing, often through advertising and public relations, must also be described.

Financial Information The most important elements of this section are the financial forecasts — the balance sheets and the statements of cash flow and income. They must be consistent with the discussion of the company's past performance trends and the data presented in other sections of the plan. For plans used to solicit financial backing, this section should also include a funding request that states how much money is needed, why it is needed, and how it will be used. Finally, you need to consider the likely payback for the investors and their need for an exit strategy.

Once all of these sections have been formulated, the plan is ready for final rewriting and presentation. Extensive editing is highly recommended, along with careful attention to presentation details. The plan should be tailored to the preferences and concerns of its readers, including insiders using the plan to guide the company. Given the dynamic markets within which growing businesses operate today, periodic revisions of the business plan will be necessary in order to maximize its utility as a tool for management and investors.

The purpose of this guidebook is to take the intimidation out of the business plan process and to highlight key issues worth consideration as you research, prepare, and write your plan. At the conclusion of applicable chapters, is a listing of the fundamental questions that you should ask and address as you complete each section. Add your own questions as you go along to be sure that your unique circumstances are adequately addressed.

Chapter 1

THE NEED FOR PLANNING

A successful business plan is a document that conveys the exciting prospects and growth potential of your company. It might be best viewed as a selling document. It sells the business to potential financial and other backers. By effectively selling the business as a whole, a business plan makes a strong case for specific projects. For instance, a plan may be used to seek funding to cover the expenses associated with developing and marketing a new product. Or it may be intended to secure a bank loan for additional manufacturing equipment.

Just as advertising and promotional material sell a company, so should a business plan — though in a more straightforward, organized, and detailed way. Thus, a business plan should not only emphasize the strengths of a company, but also be realistic about its problems, risks, and obstacles, while offering solutions to these issues. To accomplish its goals, a business plan must do the following:

- > Discuss the company's goals for the near-term and long-term future
- > Show how the goals can be achieved
- > Demonstrate that realization of the plan will satisfy the reader's requirements.

EXTERNAL USES FOR THE PLAN

The business plan is a company's first-line tool for obtaining funding and other types of outside support. Some examples are discussed below.

Investment Funds Private equity investors and venture capital firms will ordinarily not consider backing a company that does not have a written plan. Investors are seeking evidence of high growth. In addition, they want to know how they will realize their investment returns, whether through a public offering, sale of the company, or management buyback.

To assess the likelihood of high returns, investors look hard at the following:

- > The track records of the company, the market, and the key executives
- > The feasibility of achieving the forecasts
- > The uniqueness of the product and its technology
- > The quality of the management.

Bank Financing Bankers have traditionally focused on when and how the principal and interest will be repaid and the availability of collateral to cover any loan losses. As such, loan application packages tended to consist of little more than past and current financial statements. However, bankers are putting more emphasis on how a company would survive possible setbacks. As such many bankers are requiring business plans be included in a loan applicable package. Also, a high quality business plan can help a company stand out favorably in today's intense competition for loan funds.

Strategic Alliances These arrangements covering joint research, product development, and marketing have become increasingly vital for young, growing companies. The arrangement often includes a combination of financial backing and access to well-established distribution channels. The joint efforts may last three years or more. Major corporations invariably want to examine a company's business plan before committing themselves to such long-term arrangements.

Mergers and Acquisitions As companies increasingly look to acquisitions as a means of expansion, and to divestitures as a means of gaining liquidity, business plans become more necessary. Companies seeking acquisition candidates typically use the candidates' business plans as one of their first screening tools. Similarly, if the managers of an acquisition candidate want to stay on after an acquisition, they will probably be extremely interested in the long-term plans of the acquirer.

Customer and Distributor Relationships For many growth companies, obtaining a large customer or gaining a commitment from a major distributor can be an important milestone. Large, well-known organizations are often reluctant to enter into arrangements with companies that are an unknown entity. A convincing business plan can help to dispel doubts.

INTERNAL USES FOR THE PLAN

A business plan is an important management tool. It enables management to plan company growth and to anticipate changes in a structured way. Executives sometimes argue that it is useless to write a business plan because the marketplace is changing so rapidly that any plan is quickly outdated. While it is certainly true that change is a matter of course, the process of preparing a business plan is at least as important as the plan itself. It forces management to think through the business in detail and to set objectives. And it allows benchmarks to be set, against which the company's future performance can be measured.

Perhaps most important, the business plan commits the entire management team to the same goals. The process of working out the plan's objectives invariably forces executives to reconcile different visions of where the company stands and where it is headed.

A written business plan can be an important internal document for companies with multiple locations and operations. Top management can monitor the business plans not only to be certain that formal planning is occurring, but also to determine whether the finished plans are consistent with long-term financial and market goals.

THE FUNDAMENTAL QUESTIONS

- > What are the long-term goals of your company? The near-term?
- > What do you wish to gain from your business plan (e.g., funding, reconciled internal vision, etc.)?
- > What are the likely needs and requirements of the readers?

Chapter 2

THE PROCESS OF WRITING A BUSINESS PLAN

When it comes to business plans, one size does not fit all. Business plans take many sizes and forms. All of them, however, have certain purposes in common. They must describe the product and service to be sold, its market, and how the product will be made or the service performed. If the plan is intended for external use, it will usually describe who is involved in the company, how much money the company needs and how the funds will be spent, the form the proposed financing will take and, most important, how the investors will make a return on their investment.

All business plans must accomplish these things in a clear, concise, and convincing way. That is, the reader must come to understand the business and feel confident that the plan's objectives are achievable. Given that all plans must have these common attributes, it is important to properly prepare for the writing process. It is not advisable simply to begin writing and expect that everything will fall into place. There are four important steps for preparation: (1) gathering the right data; (2) outlining the plan; (3) determining the kind of plan; and (4) designating responsibilities.

GATHERING THE RIGHT DATA

Business plans are only as effective as the data on which they are based. One of the worst things that can happen to executives is to have prospective investors or lenders discover important information about a company's industry, market, or technology that should have been in the business plan.

The writing process becomes much easier — and quicker — if certain data is available before writing begins. Then writing does not have to be interrupted at critical points in order to gather essential information. The key data includes the following:

- > Company Description
 - Name
 - Legal form
 - Location
 - Financial highlights
 - Shareholders

- > Management and Organization
 - Organization chart
 - Key management
 - Board of Directors
 - Consultants and advisors
 - Compensation and other employee agreements
 - Other shareholders, rights and resolutions

- Market and Competitors
 - Market statistics
 - Competitor data
 - Market and customer surveys

- Product or Services
 - Product literature and technical specifications
 - Contracts and/or purchase orders
 - Competitive advantages
 - Patent, license, and trademarks
 - Regulatory approvals or industry standards
 - Operations plan
 - Research and development plans

- Marketing and Sales
 - Marketing plan
 - Marketing vehicles
 - Marketing materials

- Financial Information
 - Financial statements for up to past five years
 - Financial forecasts and projections and assumptions
 - Amount and timing of needed funding

You may choose to add other sections, depending upon the requirements of your company. A more detailed checklist of data that you will need to support the written plan is found in Appendix B.

OUTLINING THE PLAN

You should organize your business plan in clearly defined sections covering the different aspects of the company. Putting together an outline forces executives to come to some early decisions about what will be where in the business plan. For example, carelessly organized plans often describe the market for a product in the same section as the product description, or describe the product in the market section. Outlining also requires the executives to understand the necessary level of detail that should be included in the plan.

DETERMINING THE KIND OF PLAN

People writing a business plan for the first time frequently ask, “How long and how detailed should it be?” There are no fixed rules. Your plan’s length will depend to a great extent on what you want it to accomplish and how sophisticated and complex your company’s operations will be.

Broadly speaking, there are three kinds of business plans:

Summary Plan A summary plan of 10-to-15 pages works best for companies without an extensive history — a company in the early stages of development. There is not a lot of history to report, and existing operations are small. A summary plan can also be used by a more established company interested in testing the investment waters; if found to be inviting, a more complete business plan can be assembled.

A summary plan may also be appropriate for entrepreneurs with a history of success. If you are a seasoned manager with a good track record, a venture capitalist may not require as much information from you in the early stages as from an inexperienced manager.

The summary business plan should include enough information to convince potential backers that you have done your homework and understand the market — in as short a form as possible.

Full Business Plan The more traditional business plan of 20-to-40 pages — typically for financing purposes — spells out a company's operations and projections in much detail. This type of plan becomes more desirable as the amount of money being sought increases. For instance, if you want \$5 million to start a high-technology manufacturing company or are seeking new commercial lending relationships, you will probably need a highly detailed plan that contains an in-depth market analysis, five-year cost and sales forecasts, detailed research and development information, and financial data to back up your assumptions and forecasts.

Operational Business Plan For established companies, a business plan can be an important source of guidance to top managers. It serves as a blueprint for company operations. It also ensures that all managers understand the company's direction and their respective roles in achieving company goals.

Almost of necessity, an operational business plan must be lengthy — typically well in excess of 40 pages and sometimes as long as 100. The greater the detail, the more likely that individual managers will understand their roles and achieve their goals.

DESIGNATING RESPONSIBILITIES

Business plans can be prepared in several different ways. At first, a work plan detailing assignments and due dates should be prepared. A common approach is for the head of each management area — such as marketing and sales — to write the section of the plan that pertains to his/her area. Then the chief executive reviews the drafts, discusses inconsistencies with the managers, and revises the material. Another approach is for the chief executive to write a full draft of the plan and then distribute it to top management for input and revisions.

Between these two approaches are many variations. One approach is not necessarily better than the another — provided that everyone involved understands what is expected. If managers are charged with writing specific sections, they should be involved in the outlining step and be given a realistic timetable for completing the task.

An approach that should be discouraged is to engage outside consultants to write the plan. This may seem like a good way to save valuable management time, but most financial experts likely to read the plan can spot one written by a consultant and will usually disregard it or discount it heavily. Potential backers want to read management's plan, not some outsider's perception of what one should be.

T H E F U N D A M E N T A L Q U E S T I O N S

- Have you committed enough time and resources to gather and thoroughly analyze the right information?
- Are the key members of management committed to researching, writing and/or providing feedback on the plan?
- Have you identified the likely readers of the plan and chosen the appropriate type of plan to meet their needs?

Chapter 3

THE EXECUTIVE SUMMARY

The most significant single section of the business plan intended for outsiders is the Executive Summary. Venture capital and private equity investors, bankers, and corporate investment officials typically receive many business plans each week — more than could possibly be read from beginning to end. To help determine if the plans are worthy of further review, financiers invariably begin by reading the Executive Summary. If the Executive Summary suggests a promising business for investment or loan funds, then the experts will read further. If not, then they quickly reject the plan. Essential information that is buried in a later section has no value if the reader never gets that far. The primary objective of the Executive Summary is to entice investors to delve further.

KEYS TO AN EFFECTIVE SUMMARY

What makes for an enticing Executive Summary? First, it is important to remember that it is not a preface to or abstract of the business plan. Rather, it is the business plan in the most concise form possible.

An effective Executive Summary describes all of the key elements of a business plan in two to three pages. It must include the following essential information:

- > A synopsis of the company's strategy for succeeding
- > A concise account of the management team's qualifications that make the company successful (be sure to include a description of your team's contribution to previous successful business ventures)
- > A brief description of the market (along with the ingredients for success that make your company unique in that market)
- > A brief description of the product or service
- > Key historical and forecasted financial data, such as annual revenue and net income, for five years
- > An estimate of the amount of the funds you need, a statement of how you will use the money and how lenders or investors will get their money back.

This is a lot to explain clearly in two or three pages. In fact, composing an effective Executive Summary is one of the most difficult writing tasks any executive will face.

HOW THE EXECUTIVE SUMMARY HELPS TO SHAPE THE PLAN

Executives cannot realistically expect the Executive Summary that they write at this early stage of business plan preparation to be polished and ready for presentation. Indeed, they should be prepared to revise it substantially after the rest of the plan is written.

The preliminary version of the Executive Summary at the early stages of preparing a plan serves several purposes:

It provides guidance and a sense of the plan. Drafting the Executive Summary forces you to think long and hard about the factors most essential for business success. It also forces you to prioritize issues and to set aside for later consideration those of lesser importance.

It builds confidence in the plan. If you outline the key elements up front, you will be less likely to experience writer's block and other forms of procrastination later on. Getting the plan's main points down in short form will allow you to move on to the full plan with a sense of direction and vision.

It involves the management team early on. Writing a draft of the Executive Summary provides an effective way of involving all members of the management team in the analysis essential for a successful plan. This team effort secures valuable input and consensus on the main issues.

It leads to a better final product. Rewriting is the key to successful writing. An Executive Summary drafted to guide the writing of the body of the plan will need to be tackled again at the end of the process and rewritten as needed. The result will be a better business plan and a better Executive Summary than would otherwise have been achieved.

Once you have completed all of the other components of the business plan, you should go back to the draft Executive Summary. First, be sure that the Summary is consistent with all of the detailed information in the other sections of your business plan and that it addresses all of the items noted above in the Keys to an Effective Summary section of this chapter. Then ask yourself the following fundamental questions.

Does the Executive Summary demonstrate:

- that the business has been thoroughly planned and researched?
- a business proposition that makes sense?
- an accurate understanding of the value proposition of your product or service?
- that the business proposition offers real competitive advantages?
- a knowledge of the industry and target market?
- a sense of enthusiasm for the business?
- a realistic picture of the risks inherent in the business?

If it has addressed the basic content and conveyed the basic messages above, it will likely compel the reader to read further to obtain a fuller understanding of your strategies, plans, and goals.

USES FOR THE EXECUTIVE SUMMARY

An effective Executive Summary can serve two purposes for executives seeking to raise financing:

It helps preview the plan and protect the business. If your business plan is lengthy, it may be cumbersome to distribute. If you are sending your plan to financial sources who don't know you who might not be interested in what you offer, you may want to send only the Executive Summary with a cover letter. If these sources read the summary and are interested in seeing the whole plan, you can mail it or present it in person. This also will help to protect the confidential details of your plan.

It involves readers in the plan. An Executive Summary that is concise, well written, and convincing will capture attention. It makes the plan stand out from the crowd and thus will make readers eager to learn more about the company.

Chapter 4

THE COMPANY, STRATEGY, AND MANAGEMENT TEAM

Every company has a mission and a story to tell — about its past, its future and its key people. The mission must be more than just a desire to sell more products and services. It is really the core statement about why you are in business, what “valuable formula” will distinguish you from your competition, and how you relate to your customers and employees. This narrative is important information to ground you and the reader in the facts leading to the request for funding. A start-up company has a background in terms of the motivating factors that brought the management team together. Every business has members of management who are key to its success and should be introduced to the reader.

YOUR BUSINESS MISSION

The section of the business plan dealing with the company’s mission affords executives the opportunity to assess and articulate the overall driving force in the business. Invariably, the questions that must be answered in writing this section are difficult ones, but they provide important perspective for everyone involved.

This is really an assessment of the company’s overall approach to producing and selling its products or services, along with its goals for maximizing success. In order to grow, a company must have a distinctive value proposition (or “valuable formula”) for products or services that clearly meet customer needs better than the competition. Strategy can be expressed in terms of guiding principles or philosophy. The descriptive terms used are not nearly as important as the thought process and the considerations behind the ideas expressed. The strategy is the basis on which company activities — marketing, production, sales, and other functions — are organized and assessed.

THE COMPANY: PAST, PRESENT, AND FUTURE

It is important for anyone assessing a business to understand its history and current status in order to project what lies ahead. The section of the business plan on the company, then, should provide a synopsis of the company’s past, present, and future. The section can be divided into three parts:

History When was the company founded? Why was it founded? What have been its chief accomplishments? How has its direction changed? Equally important, what are the company’s failures and shortcomings? This last question is a subject executives usually prefer to avoid. While the business plan need not dwell on failures, it should acknowledge them, in the interests of balanced reporting, to give the business plan credibility. After all, every enterprise has its disappointments.

Current Status This section should summarize the company’s existing situation. What are its existing product lines? How many employees does the company have? Where does it stand in its industry and marketplace? Have there been any sales? Are sales on an upswing, level, or in a decline? Readers should have a sense of the company’s overall situation and direction as demonstrated over the previous few months.

Future This, of course, is the most difficult section to write, but it should provide a sense of where the company is headed. That is, what are its objectives and goals? Briefly, what does it plan for new markets and products?

Most important in writing about the company's future is that it makes sense in terms of the history and current status. A company that projects sales increases of 20 percent annually for the coming three years does not make a very convincing case if, during the previous 10-year history, sales have never gone up more than 10 percent in a particular year.

T H E M A N A G E M E N T T E A M

The first question venture capitalists or private equity investors tend to ask when learning about a company seeking investment funds is often, "Who are the people?" The experience, talent, and integrity of the founders and the management team are of primary concern to a professional investor. In this section you should provide a quick summary, which will lead to a more detailed description in the next section.

T H E F U N D A M E N T A L Q U E S T I O N S

- What business are you in?
- What is the purpose of your business?
- What are your products and/or services? How are they related to your mission?
- What benefits do your products and/or services provide to your customers?
- What led you to develop your business, its products or services?
- What is your vision for your business? How large do you want to become?
- Is your vision statement based in reality and is it aligned with realistic growth objectives?
- Why are you uniquely qualified to be in this business?
- How you are distinctive from your competition?
- What is the legal name of your business?
- What is your legal structure and is it appropriate for your future plans?
- Where are you located?
- What stage are you presently at? Conceptual phase? Start-up? Mature business?
- What is your current financial position?
- What are your company's weaknesses and how are you addressing them?
- Who are the key members of your management team?

Chapter 5

MANAGEMENT AND ORGANIZATION

Before agreeing to finance a company, venture capitalists, private equity investors, and lenders will often conduct a thorough reference check of each key member of the team, focusing special attention on the president. If the team does not “pass muster,” you will find it difficult to raise the funds you seek. Investors will focus on the industry and technical qualifications of your executive team, their entrepreneurial experience, and integrity among other things.

Your business plan should describe how the company is organized and what each individual’s duties and responsibilities are. An organization chart can help the reader. It is also helpful to explain how the individual talents of the management team contribute to realizing the company’s strategy.

This section of your plan should explain any shortcomings in your management team. Are there any critical skills your team lacks? If so, how and when will you recruit people possessing these skills? How will your company operate in the interim period without these skills in management? Your acknowledgement of the need for additional management talent demonstrates to the investors that you have carefully analyzed your management team’s abilities and your company’s needs.

Depending on the nature of your business, human resource issues beyond the management team are essential to successfully implementing your strategy. Your human resource strategy and your sources of other talent should be addressed.

D E S C R I B I N G T H E M A N A G E M E N T T E A M

Executives frequently wonder how to best present the management team’s qualifications. The following is one approach that allows you to explain everyone’s qualifications without cluttering up the business plan:

The Synopsis Include a paragraph or half-page synopsis of each team member’s background, including relevant employment and professional experience, significant accomplishments, and educational background.

The Resume At the end of the business plan, in an appendix, provide complete and detailed resumes, giving the information necessary to allow the prospective investor to check references. Each resume should include exact employment information (positions, places employed, dates of employment, and reasons for leaving), schools attended, degrees received, and dates. The resume should also paint a personal picture of each executive for the prospective investor. You may want, for example, to include references to industry and business affiliations, professional memberships, hobbies, and leisure time activities.

Compensation You should describe the compensation packages that you offer to the key members of the management team. Compensation packages can include salary, bonuses, profit sharing, stock ownership opportunities (options or purchase), and deferred compensation to name the most common. Be specific about the stock ownership opportunities available to each key employee. Potential investors will want to be assured that the incentives offered to key members of management are consistent with their own investment goals and are tied to increasing the long-term value of the business.

OTHER HUMAN RESOURCE ISSUES

Other necessary details in this section include the number of employees in the company and needs to expand the workforce. Your needs may range from engineers with particular skills to skilled laboratory technicians to support product development or production, or other skilled production labor. A discussion of unique human resource programs, any union contracts, and a description of pension and incentive plans should be included. If there is a shortage of skilled manpower in your area, identify this, explaining how you plan to recruit people with critical skills. If your industry is changing rapidly then your employees will need to continue to develop their technical skills. Management should discuss which development programs are critical to the company's success.

OUTSIDE ADVISORS

Your outside advisors may include a formal Board of Directors or an informal group of counselors. You may have some key consultants that can provide added credibility for your product or service in the marketplace. Your potential investors will want to understand these relationships and the depth and quality of these advisors.

THE FUNDAMENTAL QUESTIONS

- > Why is the CEO qualified to lead the company?
- > Do the strengths and experience of the management team match the goals and strategies of the business?
- > Does the management team have both technical and business acumen?
- > Are your compensation arrangements aligned with the goals and objectives of the business?
- > Do you have any strategic alliances that give you access to talent that is not resident in your management team?

- If your management team is not complete, what is your action plan to add the necessary talent? What impact is this having on current operations?
- Are your compensation programs competitive enough to attract and retain the right human resources?
- How will you address the ongoing development needs of your workforce?
- Who are your outside experts and what will it cost to retain them?
- Does your Board of Directors or advisors bring relevant experience to your management team?

Chapter 6

THE MARKET AND COMPETITORS

Every day, brilliant and innovative people come up with ideas for “fantastic” products. The ideas are worthless, however, unless there is a market for these items. Consequently, the market section of your business plan is often the one that potential financial backers will turn to next, after the Executive Summary.

This section of your business plan must convince potential backers that a market exists for your product or service and that you understand the market forces affecting your company. The results of your research will form the foundation of the marketing and sales plan that is discussed in Chapter 8.

IDENTIFYING YOUR MARKET

The market and competition section of the business plan should begin by describing your company’s market. Essentially, this means answering several basic questions, including:

What are the trends in your industry? The market section of your business plan should begin with an assessment of the industry in which you will operate, including a description, an analysis of trends, and an assessment of the business opportunities. Our economy is typically divided into six general categories: service; manufacturing; technology; commerce; energy, and healthcare. There is further segmentation by industry. Many businesses are formed around the intersection of several industries making an analysis of trends that would impact future growth dependent on several variables. The research you do here will support your financial projections so it should be well documented. If you will be affected significantly by regulation, you should be asking questions about the risks of increased regulation or the opportunities that may be created by deregulation. Changes in technology have affected all businesses and are expected to continue to do so. However these changes vary among industries. The typical distribution channels in your industry will influence the course of your marketing and sales plans.

What is the target market? This question is usually answered in terms of a particular category of buyer. That is, the market may be consumers between the ages of 28 and 40, or it may be upscale restaurants, or process manufacturers. Beyond that, each market has characteristics that determine customer location, and purchase and payment preferences. These should be described as they pertain to your product or service. Although you may be tempted to define your market very broadly it is usually best to be as specific as possible.

How large is the market? You need to provide some data as to how many individuals or businesses make up the market you are trying to reach. Getting the information may require extrapolating from various sources. For instance, if you are selling a pesticide designed for use with peach trees, you may need to determine the number of farmers cultivating peaches as well as the number of peach trees in order to estimate the size of the market for the pesticide. Moreover, you must decide whether to extend your calculations from the United States to Mexico and Central America, or limit them to your immediate region, such as the southeastern

United States. Your assessment of the size of the market should also take into account market trends, demographics, geography and other key variables. You must assure the readers of your plan that the potential market will be large enough to support your business proposition. On the other hand, if your target market is too large it may be too costly to effectively serve it.

What is the competition? Executives often neglect this question. They tend to feel that their product or service is so superior that competition won't be significant. Underestimating the competition can be fatal. Competitors that are well established and prospering are doing so for very good reasons, and it is up to you to determine those reasons. Readers of the business plan are likely to be concerned about the competition, so this issue must be addressed directly by listing the companies that will be your primary competitors and assessing their respective strengths and weaknesses. Describe how you intend to compete with them and what you expect their response to your market plans will be. New ideas are often pursued by multiple companies simultaneously vying for first-to-market advantage. Many may also boast strong financial backing. Be sure to elucidate why you believe *you* will claim the edge. You should also address future competition, particularly if you believe that there are relatively low barriers to entry for potential new competitors. A concise and honest appraisal of your competition will lend a great deal of credibility to your business plan.

UNDERSTANDING THE MARKET

Beyond providing an overview of the market's composition and organization, executives must demonstrate an understanding of key market dynamics. Shifts in markets or customer behavior can leave you vulnerable. These, too, can be considered in terms of several key questions:

What motivates buying decisions? Individuals invariably purchase benefits rather than specific products or services. They buy convenience, status, and savings of time or money. They may buy a luxury car to impress friends or a computer to avoid adding personnel. Executives must be aware of the factors that determine how buying decisions are made and describe this decision-making process for the company's product or service in the business plan.

How is the market segmented? Market segmentation is very important and frequently overlooked. You cannot assume that because a product's price varies over a wide range, its customers are distributed evenly over that range. For example, if the price of a basic product varies among competing manufacturers from \$50 to \$100 per unit, you cannot assume that if you sell your product for \$75, you will get one-half of the customers. Upon a closer look, you may discover that the higher-priced product (\$90 - \$100) accounts for only 10 percent of all sales and that the basic model with lesser capabilities and fewer enhancements (\$50 - \$60) accounts for the bulk of the sales. In this case, your \$75 version may have very few customers. Your understanding of this principle and your description of your product's place in its market are essential to getting financial backing.

How will your product or service be positioned in the market? Positioning begins with the crucial issue of pricing. Your price should be set according to how much the market will pay for your product or service, not how much it will cost you to manufacture, deliver or sell it. If you determine the maximum selling price of your product and then find you cannot make and distribute it at a profit, you will have to modify the product concept (e.g., Is your product so “cutting edge” that it is unclear how to price?). You will need to find a way either to sell your product for more money or to manufacture it at a lower cost. Other positioning considerations include:

- **Technology Leadership** Is your company perceived as a technological leader or follower?
- **Management Style** Is your company aggressive and not averse to risk, or do you plan to grow carefully and slowly?
- **Service Philosophy** Have you acquired a reputation for stable and reliable service or do you expand your business only as quickly as your service organization can support it?
- **Product Quality** Do you aim for the high-priced, high-quality end of the market, or does your company try to make an adequate product that can capture a large market share by selling at a low price?

What is your defensive strategy? If your product or service threatens any of your competitors, you must consider how they might fight back and what your reaction will be. If your product represents a significant advance in technology or application, your competitors may seek to divert or at least delay your efforts until they can catch up. Many people expect large, entrenched companies to react slowly to changes in the marketplace. When their primary market is seriously threatened, however, such companies can act swiftly and commit substantial financial resources to a competitive effort.

THE NEED FOR MARKET RESEARCH

Analysis and description of the market as recommended in this chapter require complete, detailed information. That information comes from market research.

The term *market research* suggests complex matters such as regression analysis and academic studies. More often, it is a straightforward accumulation of data available from published sources such as government or industry-association statistics and news articles, as well as from executives' inquiries.

Needed information can also come from the experience that management team members have had in working for other companies in the market. If your executives have held management positions elsewhere in your industry, they will know which companies are the key players and how buying decisions are made.

The most important aspect of market research, however, is feedback from current and prospective buyers. How do they feel about the product or service you are offering? What do

they like, and what do they dislike? How likely are they to buy under various conditions and at different prices?

Getting such information, of course, requires that you speak with these customers and prospects or get them to fill out questionnaires. If you have an established business and are in contact with your customers, gathering the information you need will be easier than if you are starting a new business.

In any case, the more hard data you have from current and potential buyers about their needs and preferences, the more convincing the marketing section of your business plan will be. Too often, executives avoid this part of market research and simply extrapolate from raw data to arrive at market projections. They take the total number of prospective customers, estimate that their company can secure some percentage, say 3 or 5%, as customers, and then calculate sales. This is not only unconvincing to outside readers of the plan; it is dangerous for internal planning purposes as well.

THE FUNDAMENTAL QUESTIONS

- > In which industry or industries do you operate?
- > How are these industries changing? How fast?
- > What changes will affect the need for your product or service?
- > Are there changes in the political or regulatory landscape, or social values, that affect the need for your product or service?
- > How will changes in technology change your industry?
- > What is/are your specific target market(s)?
- > Who are your customers today and are they in the identified target market(s)?
- > What market trends/changes may affect your customers' ability to afford your product or service?
- > What is the approximate size and geographic spread of your target market(s)?
- > What is the approximate growth rate of your target market(s)?
- > Which companies and which types of companies make up your competition?
- > What are the barriers to entry for your competition?
- > Have you honestly analyzed your competitors' strengths and weaknesses?

THE FUNDAMENTAL QUESTIONS (cont.)

- What are the key factors motivating customers to buy your product or service?
- How does your product or service integrate with other products or services? Does the sale of your product or service depend on the sale of another product or service?
- Is it costly for your customer to change product or service providers? Are they loyal to your competitors?
- Is your product or service vulnerable to substitution?
- How is your product or service differentiated from the competition's on a basis other than price?
- Is your market price sensitive? If so, where is your product or service positioned on the price curve?
- Is there perceived value in higher prices?
- How are you pricing related items such as service and support? What are your credit terms?
- How will your competition respond to your pricing strategy?

Chapter 7

THE PRODUCT OR SERVICE

Your business plan should completely, yet concisely, describe your products or services and explain how they are produced or delivered. You need not describe every nut and bolt or service provision, but you should explain what your product or service is and what need it fills. Your description should give the potential investor some idea of how your product or service differs from that of the competition. The potential investor must be convinced that your offering is more effective or efficient than that of the competition.

The challenge in this section of the business plan is not so much describing the product or service in positive terms — most company executives can easily do that — as truly analyzing it in terms of features and the cost of those features. This means developing a list of the key features and making some judgments about their importance. This list often raises important questions. For example, it could be that including a newly developed electronic component in the specialty equipment you sell will improve performance slightly, but not enough to justify the increased cost and potential for breakdown.

In addition, this section of the business plan must convince potential backers that you can do what you say you can do with regard to production or service delivery. They must feel confident that your company can produce the product or service described, on schedule, with high quality, and at the cost anticipated.

P R E S E N T I N G T H E P R O D U C T

If you have already built a working model or a prototype of your product, you may want to include a photograph of it. If it is small or inexpensive enough — such as a type of food or other consumer product — you might even consider including a sample or sending one as a follow up to receipt of the business plan.

If you have not built the product, it could be helpful to include an artist's rendering or at least a conceptual diagram. Furthermore, if your product or service is derived from a new technology or an innovative application of an existing technology, you should explain this fully.

In describing your product or service, keep in mind that most investors and bankers are not scientists. You should endeavor to explain your technology in lay terms. The financial backer may want to employ a consultant to examine your product, so you should have sufficient information available for this purpose or be prepared to provide it.

P R O D U C T D E V E L O P M E N T I S S U E S

The following are some ways to address the subject of product development in your business plan:

Describe the R&D requirements fully. If you intend to use funding to complete research & development of your product, your plan should clearly explain this. You should include an

R&D plan, budget, key development goals and milestones, and list your schedule for meeting them. The technical risks inherent in your R&D should also be fully explained and, as many new products use recent technological innovations as the cornerstone of their design, describe your reliance on any other “leading edge” technologies.

Assess competing technologies. You should discuss other technologies that will affect your product, and consider new technologies being developed by others as well as existing technologies. Many executives make the mistake of assuming that their company is the only one working on a new technology.

Explain where the product or service will lead the company. An important area is product evolution. Investors seldom like to back “one-product” companies. You should explain your existing products and what new products or services may evolve from your technology, how you will decide which of them you plan to develop, and when you expect to introduce them.

Explain what is proprietary. Investors are especially interested in knowing how you can delay or even prevent competitors from jumping in once your product or service has shown signs of success. Your business plan should discuss how you propose to protect your idea while it is in the development stage. Is your product or your technology capable of being patented, or can it be protected by copyright? If not, how do you plan to ensure the secrecy of your product or service until it can be developed and marketed? If your product can be patented, how comprehensive will these patents be?

M A N U F A C T U R I N G A N D O P E R A T I O N S

You must explain how you will manufacture the product or perform the service. This means answering a number of essential questions about site selection, capacity, manufacturing processes, and suppliers. The reader will want to know how much of the process you will do yourself and how much will be contracted out to others. If your product is complex, you may need to describe key processes, the impact that technology may have on those processes or other investment needs to support production. You may also want to address how you will package and ship your product and what level of inventory you will need to carry in order to meet customer needs and expectations.

Your discussion of manufacturing and operations should also cover manufacturing costs including any plans you have to reduce or control manufacturing costs.

At some point, the backers will ask to see a detailed manufacturing cost breakdown. Although this information need not be included in the business plan, it should be available.

QUALITY CONTROL AND ONGOING SERVICE

The business plan should describe your philosophy and approach to quality control. You need not go into great detail, but you should indicate how you intend to avoid defects and what monitoring or inspection is built into the production process.

Then, you should explain how your company will deal with products that develop defects or that require further attention to make them operate as the customer requires. This means addressing the questions of whether you will have an in-house service department or outsource the function.

RISKS AND REGULATIONS

Your business plan should explain fully any government regulations that may affect your business, such as those concerning waste disposal and worker safety. You should include copies, or at least synopses, of such regulations and describe the steps you will take to get your product or service approved for sale. If the Environmental Protection Agency requirements are applicable to your business, historical compliance records should be reviewed.

In addition to federal regulations, you may also have to comply with state and local regulations and laws that affect the manufacture of your product. If the manufacturing process will be subject to health restrictions, safety regulations, special permits, or government inspections, you should explain the steps you intend to take to meet these requirements.

Finally, insurance questions should be addressed. What steps have you taken to cover buildings and valuable machinery and other equipment? Are there product liability contingencies that call for special insurance?

IDENTIFYING COSTS

As suggested at several points in this section, costs associated with such activities as research and development, manufacturing, quality control, insurance, and other aspects of production should be assembled. They can be noted briefly in this section, and they will become especially important in putting together the financial section of the plan.

THE FUNDAMENTAL QUESTIONS

- What are the key milestones in the research and development process? At what stage are you in that process? When will your product be ready to sell?
- What are costs to complete the development of the current product? What are the ongoing costs?
- Are you capable of monitoring the need for product improvements and changing the production cost structure as the industry, competitor products, and customer needs change?
- How much are you spending on research and development? How much is the competition spending?
- How do you select new products for research and development?
- Do you have any intellectual property?
- Is your product or product name registered with appropriate governmental bodies? If your business is expected to be global, have you taken into account international patent, intellectual property and other legal influences?
- How much manufacturing space will you need?
- What type of capital equipment will you require? What impact will changing technology have on your equipment needs?
- Will you build all of the product in house or subcontract out a portion of the production process?
- Are there any critical processes that have not been developed?
- Are any parts or supplies difficult to get, or do they require long-lead times? How reliable are key suppliers?
- Are there any parts that can be obtained only from a single source or only from overseas?
- What are the backup sources for these materials?
- How will you monitor quality? How can customers contact you if they have comments or problems?
- Have you identified business risks and developed a risk management strategy to address them?

Chapter 8

MARKETING AND SALES

Marketing and sales are two distinct but related activities.

Marketing involves increasing customer awareness, delivering a message about your product or service, and identifying customer prospects. Selling involves various efforts to convince those potential customers to buy.

THE MARKETING PLAN

Your marketing plan should be built on the results of your market research and the specific value proposition of your product or service. The key factors you should consider about the market and your competitors are summarized in Chapter 6. Armed with the research, you can then devise a plan to reach that market and deliver a targeted message to your key prospects.

First you must position your product or service. A clear understanding of how your product or service is positioned will help keep all your messages strategically focused on your unique value proposition.

There are many marketing vehicles that you can use, ranging from simple product brochures to complex broadcast media advertising to get your message across. The choice of marketing vehicles must be consistent with your image and must be effective in reaching your targets. Choosing the right marketing vehicles and the appropriate mix will help you stay within an affordable budget. Marketing vehicles include:

- > Descriptive product or service brochures
- > Advertising in print, broadcast or electronic media
- > Direct mail
- > Premiums and advertising specialties
(e.g., items imprinted with your company name and/or message)
- > Sampling programs
- > Public relations

Advertising The most costly marketing vehicle is often advertising. It is the primary means used by companies to create a public image for themselves in the marketplace. For most growing companies, promotion is a challenge and an opportunity. It is a challenge because the traditional means of promotion are expensive. Advertising, in particular, is quite costly, especially when growing companies are competing with major corporations with multi-million-dollar ad budgets.

Certain products and services, such as automobiles, must be advertised. If yours is one of these, the business plan should explain your advertising approach. The advertising philosophy and program should reflect your positioning in the market. If you are aiming at the high end

of the market with an expensive, high-quality product, this should be clearly expressed in your advertising.

Your advertising plan should also take into account the availability of your product. Some companies make the mistake of advertising their products long before they become available. Customers may then become disappointed when they cannot get the product right away. Premature advertising also serves to notify your competitors of your intentions and gives them more time to react to your entry into the market.

Public Relations Many companies overlook the value of public and press relations (“PR”) in spreading news about their products. The attractive part of PR is that it can often be obtained at little or no out-of-pocket cost. Editors and news directors are always looking for stories about new companies and innovative products. If you explain your idea and describe your product in ways that are likely to be interesting to your readers, they may decide to publish stories about your company. Depending on your product or service, this “free advertising” can produce more sales than paid advertising. What appears in the press can be very valuable in positioning your company, your product, and your service.

Consideration should be given to getting assistance from advertising and public relations agencies. Keep in mind that the press exposure that a public relations agency gains for your company will be fairly expensive. The agencies should be carefully selected. Look for those that have done work for other companies in your industry and have a solid reputation.

Other Marketing Vehicles Effective marketing vehicles differ from industry to industry. If your product or service needs to be replaced or can be expanded from add-on or follow-on products or services, your plan should address customer-based marketing strategies. Licensing or cooperative advertising may be critically important in your industry. There may be key trade shows that you will need to include in your marketing plan to cost effectively reach your target audience. You should not overlook these other types of marketing.

SALES STRATEGIES

Without sales, there is no business, no matter how well production, marketing research, and other functions are handled. Your business plan must explain in detail how you will sell your product or service. The description of the selling process should cover two aspects: selling methods and serving the sellers.

Selling Methods Executives must first address the question of exactly how their product or service will be sold — the distribution channels and methods. For example, will you sell through independent distributors? If so, what kind? If you plan to use the company’s own sales force, how many salespeople will it take to achieve your sales goals? What is your expected sales efficiency (that is, how many sales calls will it take to get one order, on average)? How large will the average order be? How will the customer pay for it — on receipt or some time after being billed?

Answering these questions will lay the groundwork for determining your selling costs and will help you prepare a sales plan. The sales plan is a key component in the determination of how much financing you require. If you elect to use sales agents or distributors for your product, you will have to include sales commissions or distributor sales discounts in your planning. In the latter case, you should also indicate how you will identify distributors.

Your business plan should also address international sales, if appropriate. If there is a market for your product outside the United States, do you plan to sell to this market? If so, you should explain how you will reach it. Do you plan to use foreign agents and distributors, or will you set up your own organization? Many services to help companies new to the export market are available through the Department of Commerce, whose field officers are located in most major cities. Customs brokers and freight forwarders can often supply import and export services that would be too costly to provide in house before your company is large enough to support them.

Executives should pay close attention to selling costs, determining what is appropriate for their particular operation. One way to establish an appropriate range is to look at the financial statements of publicly held competitors, analyze their selling-cost percentages, and compare them with your own.

For some businesses, the costs associated with sales may be 10 % of revenues, but for others they may be as much as 30%. Keeping selling costs at or below the level appropriate for a particular industry has become increasingly difficult, and many companies have explored alternatives to the traditional in-house sales force. There is increasing reliance on direct mail, telemarketing, the Internet, and seminars to sell products and services.

Serving the Sellers However you sell your product or service, those doing the selling need help. An in-house sales force needs training, descriptive materials, and other selling aids. Manufacturer's representatives need these plus demonstration models. Telemarketers need training and approved answers to commonly asked questions and objections.

Perhaps most important, everyone involved in selling needs incentives. The incentives must be properly structured and clearly explained if they are to be effective. They can consist of both monetary awards and nonmonetary inducements. If the incentive packages are not clearly defined or are weighted too heavily toward the company, your sellers will not be at their most effective. Selling is one of the most difficult tasks in business, and the work can be very demoralizing without the proper incentives. The business plan must spell out in convincing detail the nature of the support program and exactly what will make it succeed as expected.

Although your written business plan will not go into the level of detail discussed above, your financial projections will need to carefully take into account the details of your marketing plan and your expected sales activity. You will need to assure potential investors that there is an adequate return on the marketing investments that you are making. In addition, as you think about your human capital needs you will want a clear picture of your marketing and sales efforts.

THE FUNDAMENTAL QUESTIONS

- How are you positioning your product or service?
- What are the key messages that you want to convey in your marketing materials?
- What types of marketing media will you use to promote your product or service?
- What is your marketing plan? What mix of media will you use? How much will you spend? How do these compare to similar efforts deployed by the competition?
- How will you use public relations to help promote your product or service?
- What distribution channels are you using and what selling methods are appropriate for each channel?
- Do you need your own sales force? Dealers? Representatives?
- What is your commission structure?
- Do you have any strategic alliances that will allow you to reach your target market(s) efficiently and cost effectively?

Chapter 9

THE FINANCIAL INFORMATION

The financial section of the business plan is written last, after key data on costs and potential revenues have been assembled. The amount and type of financial information necessary for your business plan depend in large measure on the company's stage of development and what the plan's objectives are. The more mature the company, the more historical data it will have available, and the more complete its financial statements are expected to be. For a company seeking financing, the plan should describe in general terms the type and amount of funding being requested.

The financial planning of the sort used in a business plan is essential for all companies. The process of putting together financial forecasts enables executives to spot both potential shortfalls and opportunities much sooner than they might otherwise be identified.

THE FINANCIAL STATEMENTS

The company's financial statements are the core of the business plan's financial information section. They present both the company's past results and its forecasts for the future. For a company seeking a subsequent round of financing, the prospective investors will want to see the balance sheets, income statements, and cash-flow statements for the previous three years, along with five-year cash flow, income statements, and balance sheet forecasts. For new companies seeking seed capital, sales forecasting along with information on cost of operations, selling and administrative costs, and cash flow may be sufficient. In other situations, more financial information may be desirable. For example, if significant amounts will be invested in capital assets, you may want to provide a list of your anticipated purchases.

Preparing these statements requires expertise in finance and accounting. [Note: Preparing your financial statements using the accrual method of accounting is generally preferable to using the cash method since it is the preferred method of financial statement preparation.] The following are the main considerations in putting the forecasts together:

Time Frame The typical business-plan forecast covers five years. At a minimum, your forecast should be for three years. Anything less will be insufficient for evaluation by investors and lenders of your company's potential. Forecasting beyond five years is considered too speculative to be of much use.

Cash flow and income statements should be shown on a monthly basis for the first two years; thereafter, they can be shown on a quarterly basis. The prospective balance sheets should be prepared on at least a quarterly basis for the first two years and annually thereafter.

Forecast Assumptions A forecast should represent your best estimate of future operations. To enable the investor or lender to evaluate the reliability of that estimate, you must provide the assumptions used in preparing the forecast. You should be conservative. All businesses have certain risks and projecting future results using the most favorable assumptions can lead to missed targets and undermined credibility with investors. Do not be creative; stick with industry accounting practices and assumptions widely accepted as standard.

A key aspect of the forecast is internal consistency. The cash flow statements, income statements, and balance sheets must be based on the same assumptions. For example, your sales forecasts will appear on your income statement. Cash receipts, as shown on your cash-flow statement, must be a function of those sales forecasts and of your estimate of the collection period. Outstanding accounts receivable, as shown on the balance sheets, must be a function of those sales and cash receipts, as well as of your assumption as to the level of bad debt.

Therefore, the first step in preparing a forecast is to establish the necessary assumptions. To the extent possible, your assumptions should be supported by facts, market surveys, or detailed analyses, and reflect past performance. This is based on the same information that was gathered to support other portions of the business plan. The forecast should include a brief description of the major assumptions used:

Sales Sales assumptions are generally the most critical in a forecast, as they establish the volume of activity. You should explain the basis used for forecasting sales. The sales forecast should conform to your description of the market, your marketing strategy, and anticipated position in the market as described in the marketing section of the business plan. For example, your market share should be consistent with your estimate of the total market and your competitive advantage over others.

Sales may be forecast on either a unit or a percentage-of-volume basis. If you forecast sales by unit, you should also describe your assumptions as to the unit sales growth, initial unit sales price, and the timing of subsequent price changes. Since many products have distinct seasonal patterns, it is important to make specific assumptions and assure that the pattern is followed consistently throughout the forecast. This method is usually used to forecast sales in the earlier years.

You may also forecast sales as a percentage increase in dollar volume each month. In this case, describe the percentages used and state your reasons for using them. This method is more common for the later years of the forecast.

If you will have more than one product line or service offering and the composition of sales by product line will change over time, show separate forecasting and assumptions for each line. Similarly, if you have a product designed for more than one market segment, show sales to each segment separately. Depending on the nature of your product you may need to make provisions for sales returns. If you use distributors you will need to consider the likelihood of their return of unsold products.

Cost of Sales Rather than merely assuming costs to be a percentage of sales, you should analyze the material, labor, and overhead elements that go into making the product. Your forecast should be based on the production plans that you have developed and should take into account all cost components.

Develop detailed product bills of materials based on engineering estimates and on vendor quotations. Labor costs should be prepared on the basis of an assumed production time and an estimated hourly wage. Overhead costs require an analysis of estimated annual costs; these costs are usually applied to product costs as a percentage of direct labor amounts.

If you have several product lines, indicate the unit of cost for each. Explain the factors that will affect unit costs. For example, materials costs may decline as increased production allows for volume purchases.

Marketing Expense For the first two years, marketing expenses should be based on a detailed marketing plan that builds on the marketing section of the business plan. This plan should include a personnel forecast and the related costs, sales commission arrangements, trade-show costs, promotional campaigns, and overall advertising costs. For subsequent years, you can estimate marketing expense as a percentage of sales if your distribution channels and marketing activity is expected to be similar.

Research and Development Costs Investors view research and development costs as an investment in the future. These costs, while highly discretionary, are critical to the long-term healthy growth of your business. If your product carries a high margin and a short life, significant research and development costs should be expected in order to maintain continuous development of new products. In such a situation, your cost forecasts should be based on a detailed plan that includes the types of products you expect to develop, personnel requirements, and other expenditures.

If research and development will not be a substantial activity once your initial product is developed, your cost assumptions at that point can be established as a percentage of sales. Remember that research and development expenditures are also important to many service businesses.

General and Administrative Expenses To forecast these costs, prepare a detailed schedule of the major general and administrative expenses, such as salaries for administrative and support personnel, communications, rent, and supplies. While it is not necessary to include this schedule in the assumptions, you should provide a brief description of the method used to forecast these expenses and indicate the total number of personnel for each time period.

Taxes on Income Estimate each year's effective tax rate. Include federal, state, and local taxes as well as available tax credits. Apply this tax rate to each month's income before taxes.

If certain years generate losses, subsequent years' effective tax rates should be adjusted for available federal net-operating-loss carryforwards.

Because of the complexity of the current tax laws, you may want to seek some assistance in calculating the appropriate taxes on income and in estimating quarterly tax payments.

Inventories Estimate the level of inventory needed to support your estimated sales volume. This will depend on the length of the manufacturing process and can be expressed either as a turnover rate (for example, inventory turns over four times a year) or a production cycle (three months). The timing of your inventory purchases will be a major factor in forecasting your cash needs.

Accounts Receivable Estimate the length of time between a sale and collection of the related receivable. This can be expressed as an average collection period (such as 60 days) or a turnover rate per year (a turnover rate of six times is an average collection period of 60 days). Industry statistics may provide a good indication of the typical duration you might expect.

Cash Estimate a minimum amount of cash to be maintained over the forecast period. This will affect the amount of cash you need to raise through either borrowings or the sale of stock. Most business owners prefer to maintain enough cash (including cash investments) to cover three month's disbursements, to allow some cushion for unexpected problems and costs. This cushion will also provide time to negotiate a good funding package when you are ready for a subsequent round of financing.

Investments If you raise capital by selling stock, your investors will expect you to invest any idle funds in low-risk money-market funds or certificates of deposit. The level of investment will depend on your monthly cash needs. Indicate the rate of interest you expect to earn on excess funds. A good rule of thumb is to assume that interest will be earned at the current money-market fund rate.

Property and Depreciation Describe the major assets you plan to buy and when you will buy them. Indicate the useful lives of the equipment and the method you are using to depreciate them. If you are planning to lease equipment, be sure to take into account lease payments when developing cost of sales and other income statement items.

Accounts Payable Estimate the period over which you expect to pay your bills. A business may initially have to pay promptly to establish a good credit history. Therefore, you should assure that your payment period will generally be shorter than the industry average during the early years. In forecasting accounts payable, payment terms are usually expressed in number of days (for example, payables are assumed paid within 30 days). If payroll is your major expenditure, be sure to use the appropriate payroll period to forecast cash flow requirements.

Debt and Interest Expense You should indicate the expected sources of borrowed funds and the assumed interest rate. Be realistic in setting the interest rate, and use one commensurate with the risk in your business.

Common and Preferred Stock Describe your anticipated sources of capital. If common stock has been issued, indicate the number of shares issued and the issue price. If you expect multiple rounds of venture-capital investment, indicate the total amount needed and the timing of each round. The number of shares and the price per share will be determined as each round is funded, on the basis of the company's progress.

Sensitivity Analysis The reliability of your forecast is dependent upon how accurate your assumptions turn out to be. Investors, in particular, may want to see a sensitivity analysis included in your forecast discussion. In preparing this analysis, you should identify the most critical assumptions that you used and then determine what the impact would be if those assumptions were changed.

The sales assumptions are critical to most forecasts. If you projected a 50% annual growth rate each year, what would the results be with a 30% growth rate? Or, what if costs are 5% higher than anticipated? For start-up companies, another critical assumption is milestone dates. What would happen if the initial shipment or launch were delayed three months?

You need not include prospective financial statements that use the changed assumptions. Instead, provide a general discussion of the most critical assumptions used in preparing your forecast and, in discussing the alternative results, focus on whether additional financing will be required and on what income and return on equity will be at the end of the forecast period.

Preparing your initial financial forecast is a time-consuming process. Properly done, however, it will give a reader sufficient financial information to evaluate your company's potential.

The forecast is a tool for the financial management of your business. Use it as a budget. Assess the accuracy of your assumptions as you progress, and update or review your forecasts as necessary. Then, when you are ready for the next round of financing, updating your financial forecast will be a relatively simple matter.

HOW FINANCIAL EXPERTS EVALUATE FORECASTS

One of the first things potential investors examine is whether a plan's forecasts and assumptions are reasonable. Experienced investors can usually determine this fairly quickly. If they think the figures are reasonable, they will perform analytical review procedures, which may include the following:

Operating Margins Investors calculate your operating margins (gross profit and pretax profit) and research and development, marketing, and general and administrative expenses as a percentage of sales, and compare these percentages with those of other companies in your industry. If you forecast a gross margin of 65% in an industry where other companies are realizing only 50%, prospective investors will question your assumptions and your rationale. If you feel that your figures are correct, you should be prepared to defend them with supporting data.

Asset Management This is an area that many executives overlook. Your forecasted balance sheets should demonstrate that you understand how to manage cash, receivables, and inventory. Such evidence is extremely important to potential investors and bankers alike.

Your forecasts and ratios should be generally comparable to those of other companies in your industry. Various industry guides and studies are available for making these comparisons.

Company Valuation Investors will often “ballpark” a company’s value by looking at your forecasted earnings at the end of a certain period (usually three to five years) and multiplying those earnings by a factor that is relevant to your industry. No general standards exist. If yours is a growth industry, investors may use an earnings multiple of 10 to 20. If yours is a consumer-oriented business, investors may use a multiple of 5 to 10. This multiple helps estimate the future value of your company. The investors discount this future value using a risk-adjusted rate of return to arrive at their estimate of the current valuation.

For example, if you forecast annual sales of \$40 million at the end of five years with a 15% after-tax profit, and you are in a growth industry, investors might multiply your forecasted profit (\$6 million) by 10 and come up with a value of \$60 million. This is the value one could assume for your company if it went public or were sold to a third party. Investors, in particular, need to know this figure for two reasons: (1) they want to be sure that your company will be large enough someday to make their investment worthwhile, and (2) they use this figure to help determine the percentage of ownership in the company they require in exchange for the amount of cash you are trying to raise.

THE FUNDING REQUEST

Companies seeking financial backing are expected to include a funding request in the financial section of the business plan. It should state how much money you need, why you need it, and what you will do with it. Here are some general points to keep in mind:

Be consistent. Make your explanation of how you plan to use any financing consistent with your financial forecasts. If you state that you want seed capital to develop the product or service and set up a marketing organization, your financial forecast should illustrate these expenditures. If you are seeking a second or third round of financing, you can refer the reader to your financial forecasts for details, but explain briefly how much of the money will be used for R&D, marketing, manufacturing, capital equipment, and so forth.

Provide for slippage. When considering how much money to ask for, allow some room for flexibility, so that small deviations from your plan don’t put the company in a cash squeeze.

Show how the capital structure will be affected. If your business is already in operation, explain the company’s capital structure and what effect the anticipated funding will have on it. If you are a new company, explain how you have been capitalized, who the stockholders are, what their positions in the company are, how much stock they own, and how much they paid for it.

Describe additional financing plans. You should explain any plans for obtaining financing besides the venture capital, private equity or loan funds described in the immediate funding request. Many companies arrange a bank line of credit, or a bank-term loan or equipment lease to finance their short-term working-capital needs and capital-equipment expenditures, respectively. Your accountant or lawyer will usually have numerous contacts in the banking community and can introduce you to the institutions most likely to be interested in arranging short-term credit.

Monitor debt. In deciding on the mix of debt and equity capital, many trade-offs must be considered. Debt capital may be cheaper, but obtaining such capital depends on your ability to repay and perhaps your ability to provide adequate security for the loan. Be careful not to become too leveraged (that is, don't plan for a very high debt-to-equity ratio), as this makes your company less attractive to prospective investors and lenders. Using up much of your debt capacity will translate into lost flexibility and will likely inhibit your ability to borrow additional funds down the road. Your accountant can help you develop an appropriate balance between debt and equity funding.

Describe future needs. You should explain, clearly and concisely, anticipated future funding needs. If your project will take several years to develop, you may be able to obtain capital investment only in stages. When will you require the next round of funding, and what are the milestones for reaching that point? Will you use debt financing? If so, when, how much, and on what expected terms?

PAYBACK AND EXIT STRATEGY

Investors will want to know what kind of a return they can expect for their investment. Different investors have different goals. Returns that are acceptable to lending institutions will not excite venture capitalists or private equity investors to commit to some businesses. Different investors also have different time frames. A venture capitalist will generally want to liquidate their investment in a reasonably short period of time, while a lending institution may want a longer-term relationship. You should think carefully about your long-term plans and be explicit about your intended exit strategy.

THE FUNDAMENTAL QUESTIONS

- > Have you carefully analyzed your current and historical financial statements in order to explain your results to investors and to form the foundation for your projections?
- > Are your assumptions consistent with the results of your market analysis and the other sections of the business plan?

THE FUNDAMENTAL QUESTIONS (cont.)

- Have you completed several different financial projections to understand the impact of different scenarios on the key financial metrics of your business?
- How much capital do you need and over what period of time?
- What form of investment are you seeking?
- How will you use the funds obtained?
- How do you plan to finance further company growth?
- What is the exit/payback strategy for lenders and investors?

Chapter 10

PUTTING IT ALL TOGETHER

At this point in the process of preparing the business plan, you should be ready to put it in its final form. You and your team will have assembled the essential information and presumably organized the data in the form of notes and drafts. The following are pointers to keep in mind:

Write clearly. Choose your words carefully. Maintaining a professional, confident, and enthusiastic tone is important. However, don't get carried away with claims that can't be supported or purely subjective comments. Don't assume that your readers will know your product, market, or industry. Avoid jargon or industry slang and use layman's terms wherever possible. If this can't be done, include a glossary of terms as an appendix.

Many executives are frustrated by the writing process because their initial drafts are badly organized and poorly stated. Try to think of your first draft as getting the information down. Then, think of your subsequent drafts as cleaning things up. Remember, the best writing comes from extensive rewriting; even experienced professionals suffer numerous rewrites before satisfied with finished articles and books.

A common approach is to put the written material aside for a week or two. When next you pick it up, inconsistencies and other problems may appear more obvious.

Address the readers' key concerns. Your potential investors, lenders, or business partners likely receive many plans each week. They do not read every plan cover to cover. If you have a comprehensive and compelling Executive Summary they will likely read more, often moving next to the Market and Financial information sections. The questions that will need to be answered to get their continued attention are:

- Is the business concept solid and feasible? Can it be implemented in a reasonable time frame?
- Is your product or service viable? Does it add significant value to the customer?
- Does a real market exist?
- Are your strategies consistent with your evaluation of the marketplace and your capabilities?
- Is your strategy ethical and legal?
- Have you thoroughly evaluated different strategies? Can you defend your choices among the alternatives identified?
- What are the target markets and are they large enough to support the business plan?
- Is the target market growth potential high?
- Have you thoroughly and honestly evaluated your competition?
- Are your goals focused, tied to the strategy, measurable, specific, and understandable?

- Is the financial plan realistic?
- Does the funding request match the investors' criteria?
- Is management experienced and capable?
- Do you have a detailed and realistic timetable and set of benchmarks by which to measure progress?
- How and when will the investors get their investment back?

Get an outsider's perspective. When you have a completed draft of your business plan, you should ask at least two independent parties to review it before you distribute it to its intended readers. Your reviewers should understand how the financiers or others are likely to react, so they can give you constructive suggestions. Good potential reviewers include other executives, your accountants, and your attorneys. They will probably provide specific ideas and suggestions for rewriting. You might even want to consult a professional editor or writer. Executives within the company should also review the plan and offer reactions and suggestions.

Tend to the details. Your plan should make it easy for readers to locate information in which they are most likely to be interested. It should have a table of contents, with sections listed by page number. You might also consider placing title tabs on the first page of each section. Many investor and other financial groups are made up of three or four people, each with a different specialty. After reading the Executive Summary, one person may want to look at the marketing section first, while another may want to examine the financial information.

Also consider adding an appendix or even creating a second document to provide supporting documentation. This might include the full resumes of management team members, sample advertisements, and complimentary letters from customers. Because these documents can take up a lot of space, they should not be allowed to clutter the plan's flow, but they should be available to interested parties.

Don't become obsessed with the cover and other presentation matters to the point of excessive spending. Offset printing and expensive binding are unnecessary. Expensive, lavishly prepared plans may make bankers and investors question your priorities. They may also wonder how many copies were made and how many financiers other than themselves have seen the plan. Investors who suspect that your plan has been widely distributed may be less interested, so be careful to make only enough copies for each member of your founding team and for a reasonable number of prospective investors or others.

Tailor the plan. The plan should be written and organized with the primary readers in mind. If the plan is being used to secure a bank loan, it should emphasize such matters as collateral, previous borrowing history, cash flow, receivables, and other matters of principal interest to bankers. If the plan is intended to raise investment funds, it should concentrate more heavily

on long-term market trends and other issues affecting growth prospects. If the plan is to be shown principally to potential acquirers of the company, it should emphasize the company's accomplishments within its industry, along with its ability to continue long-term growth and improve cash flow over the coming five years.

Of course, many of these matters are interrelated and must be emphasized regardless of who is expected to read the plan, but different groups react in different ways to specific factors. For instance, it may be a mistake to emphasize balance-sheet ratios to venture capitalists, because they understand that the ratios of fast-growing and service companies can be easily distorted. It may also be a mistake to emphasize explosive market growth to bankers, who many then worry about whether cash flow will be sufficient to cover debt service requirements.

Consider more than one version of the plan. If you are looking for both loan and investment funds, you may want to consider preparing two versions of the plan. This may sound harder than it really is. As noted in the previous paragraph, different readers may have different concerns. A second version of the plan (or more, if there are more classes of intended readers) allows the plan to be customized.

In some cases, executives may want a plan available to potential acquirers to be also available to senior-level employees — but minus sensitive data about salaries and other costs. Or they may want an operating plan that is filled with production and sales details for the benefit of the managers to be presented in a more summary fashion to bankers.

Prepare an oral presentation. If your business plan is successful in convincing outsiders that your business has a solid future, they will want to know more. They will want to meet the key executives and be able to ask questions raised by the plan. You should be prepared for the additional scrutiny that is stimulated by a well-done business plan. That means preparing a brief presentation — usually 15 to 30 minutes — to summarize the plan and introduce the management team. This presentation should be carefully structured. Outlines of talks or even full scripts should be prepared. Overhead or slide displays should also be included to illustrate important points.

The banking, investment, acquisition, and other relationships that develop from business plans are not unlike marriages. In that context, the business plan is like a first date, and the presentation and ongoing meetings are part of the continuing courtship. Potential investors will still need to conduct due diligence on your business after this initial stage. If you present your business as fairly and attractively as possible during the courtship, your prospects for a happy and productive relationship are significantly increased.

APPENDICES

GROWTH COMPANY SERVICES

APPENDIX A: PLANNING INFORMATION CHECKLIST

Company Description

- Name
- Date of incorporation
- Legal form
- Subsidiaries
- Location(s)
- Security given to current lenders
- Shareholders
- Brand and trade names

Management and Organization

- Organization chart
- Key management
 - Roles
 - Age, experience, and expertise
 - Track record and achievements
 - Long-term objectives
 - Resume
- Board of Directors
 - Roles
 - Age, experience, and expertise
 - Track record and achievements
 - Long-term objectives
 - Resume
- Consultants and advisors
- Compensation plans and policies
- Staffing plan by department
- Culture

Market and Competitors

- General description
- Market statistics
 - Size
 - Growth projections
 - Segmentation
 - Seasonality
 - Economic factor vulnerability
- Customer data
 - Demographics
 - Needs
 - Loyalty
 - Buying behavior and purchasing criteria

Competitor data

- Type and number
- Location
- Strengths and weaknesses
- Turnover
- Barriers to entry
- Strategy
- Potential future competitors

Market and customer surveys

- Pricing
- Sensitivity
- Segmentation

Product or Services

- Product literature and technical specifications
- Competitive advantages
- Current development stage
- Product life span information
- Impact of technology
- Patent, license, and trademarks
- Regulatory approvals or industry standards
- Business risks
- Operations plan
 - Description of production process
 - Facilities
 - Capacity — present and future
 - Security of supply channels
 - Inventory requirements
- Research and development plans
- Quality control plans
- Customer service plans

Marketing and Sales

- Marketing plan
- Marketing vehicles
- Marketing materials
- Strategic alliances
- Distribution channels
- Sales force

Financial Information

- Financial statements from the past five years
- Financial forecasts, projections, and assumptions
- Amount and timing of needed funding

APPENDIX B: ANALYZING FINANCIAL PERFORMANCE

When analyzing financial statements it is easy to be overwhelmed by the volume of data available for analysis. For this reason many analysts use ratio analysis to help with the task. As noted in Chapter 9, using ratios is a good way to spot trends and raise issues for further analysis but is never a substitute for thorough analysis. Company performance should not be looked at in a vacuum; rather, it should be compared with similar companies operating in the same industry as there are significant variations in typical performance, as well as differences in what measures are most relevant. Also, be careful when looking at financial statements of foreign companies, since accounting standards vary from country to country.

The first step in ratio analysis is to prepare “common size” financial statements. Each line of the financial statement is presented as a percentage of the total. On the income statement, all amounts are presented as a percentage of sales. On the balance sheet, all amounts are presented as a percentage of total assets. Looking at these common-size financial statements should be a useful tool for analysis even before calculating any ratios. The most commonly used ratios are summarized below, by category.

Finally, when comparing ratios with industry comparables be sure to check which method was used for the industry tables since there are variations on the way the statistics are computed that could make comparisons impossible.

RETURN ON EQUITY (ROE)

This is the most commonly used measure of financial performance. Generally this ratio is computed using average common shareholder equity as a basis. We also recommend that you calculate this ratio on an **after-tax** basis. In some situations you may need to calculate this ratio on a **pre-tax** basis, but in those circumstances you should clearly indicate which basis you are using.

$$\frac{\text{Net Income}}{\text{Average common shareholders' equity}}$$

We will divide the remaining ratios into four different categories. Three of them – Profit Margin, Asset Turnover, and Financial Leverage – can be directly related to Return on Equity. Following the equations below you can see the relationships.

$$\text{ROE} = \text{Profit Margin} \times \text{Asset Turnover} \times \text{Financial Leverage}$$

$$\frac{\text{Net Income}}{\text{Shareholders' equity}} = \frac{\text{Net Income}}{\text{Sales}} \times \frac{\text{Sales}}{\text{Assets}} \times \frac{\text{Assets}}{\text{Shareholders' Equity}}$$

Here are other related comprehensive return measures that can also be of use.

RETURN ON INVESTMENT (ROI)

This measures return on total invested capital, rather than just common shareholder equity. Although this measure takes into account some industry differences related to different capital structures, it might not fully explain differences between industries that typically have very different capital structures. Since total invested capital includes only long-term debt, be sure to include interest on that debt only. You should also be sure that debt is properly classified between long-term and short-term.

$$\frac{\text{Net Income} + \text{Interest (1-tax rate)}}{\left[\begin{array}{cc} \text{(Beginning shareholders' equity} & \text{(Ending shareholders' equity)} \\ + & + \\ \text{Long-term debt)} & \text{Long-term debt)} \end{array} \right] / 2}$$

RETURN ON TOTAL ASSETS

$$\frac{\text{Net Income} + \text{Interest (1-tax rate)}}{\left[\begin{array}{c} \text{Beginning total assets} + \text{Ending total assets} \end{array} \right] / 2}$$

PROFITABILITY RATIOS

Profitability ratios are a good measure of operational parameters. It can help you understand a company's product or service pricing strategy as well as its operating costs.

PROFIT MARGIN

$$\frac{\text{Net Income}}{\text{Sales}}$$

GROSS MARGIN

$$\frac{\text{Gross profit}}{\text{Sales}}$$

ASSET TURNOVER RATIOS

Short-Term Liquidity Measures

Liquidity ratios measure the company's ability to meet its current obligations as they come due. The *quick ratio* eliminates inventory since it is generally the least liquid current asset. You should consider calculating this ratio after stating current investments at market value.

CURRENT RATIO

$$\frac{\text{Current assets}}{\text{Current liabilities}}$$

QUICK RATIO OR ACID TEST

$$\frac{\text{Cash} + \text{Cash equivalents} + \text{Marketable investments} + \text{Receivables}}{\text{Current liabilities}}$$

Activity Ratios

Activity ratios measure how efficiently a company uses its assets.

Accounts Receivable Turnover – This ratio is either expressed as the number of times per year that receivables turn over on average or as the average number of days required to collect accounts. If you are evaluating a business with seasonal characteristics you should compute this ratio over shorter periods of time, such as quarters. Be sure to exclude cash sales from the calculation if material.

$$\frac{199X \text{ Sales}}{\left[\frac{\text{Accounts receivable EOY } 199(X-1) + \text{Accounts receivable EOY}}{2} \right]}$$

To determine days required collecting accounts, divide the above turnover amount by 365 days.

Inventory Turnover – When comparing inventory turnover between companies, be sure you know which basis was used to value the inventory. If you are evaluating a business with seasonal characteristics, you should compute this ratio over shorter periods of time, such as quarters.

$$\frac{199X \text{ Cost of Goods Sold}}{\left[\frac{\text{Inventory EOY } 199(X-1) + \text{Inventory EOY}}{2} \right]}$$

To determine average days in inventory, divide the above turnover amount by 365 days.

Sales to Net Working Capital – Working capital is defined as current assets less current liabilities. A high ratio can result from favorable turnover in accounts receivable and inventory, indicating an efficient use of working capital. It can also indicate a potential short-term liquidity problem.

$$\frac{\text{Sales}}{\left[\frac{\text{Working Capital EOY } 199(X-1) + \text{Working Capital EOY } 1999X}{2} \right]}$$

Sales to Fixed Assets and Total Assets

These measures show how efficient a company's assets are at generating sales. Over a period of time they can be seen as a measure of productivity. These measures can be made using average total assets or average fixed assets (or for shorter periods if the business is seasonal). You should use these ratios carefully since fully depreciated can make the company look more efficient when it should have been increasing its investment to improve productivity.

$$\frac{\text{Sales}}{\text{Fixed assets}} \qquad \frac{\text{Sales}}{\text{Total assets}}$$

Financial Leverage Ratios

These ratios measure the long-term solvency of the business and its ability to deal with the opportunities and challenges that may arise in the future.

Total debt to total assets. This ratio measures the long-term adequacy of the company's capital structure.

$$\frac{\text{Total liabilities}}{\text{Total assets}}$$

Equity to total assets. This ratio is also called the equity ratio.

$$\frac{\text{Total equity}}{\text{Total assets}}$$

Long-term debt to total capital.

$$\frac{\text{Long-term debt}}{\text{Total assets} - \text{Current liabilities}}$$

Equity to total capital

$$\frac{\text{Total equity}}{\text{Long-term debt} + \text{Equity}}$$

Fixed assets to equity

$$\frac{\text{Net fixed assets}}{\text{Total equity}}$$

Debt to equity

$$\frac{\text{Total liabilities}}{\text{Total equity} - \text{Intangible assets}}$$

Income Statement Coverage Ratios

Times Interest Earned – This ratio is also known as the interest coverage ratio. It measures the company's ability to meet its interest payments.

$$\frac{\text{Earnings before interest and taxes (EBIT)}}{\text{Interest expense}}$$

Coverage of Fixed charges – This ratio is more comprehensive than the Times Interest Earned ratio. It takes into account other debt service and financing items that require short-term funding such as annual lease payments and principal due within one year.

$$\frac{\text{Earnings before interest and taxes (EBIT) + Lease payments}}{\text{Interest + Current portion of long-term debt + Lease Payments}}$$

Risk Analysis

Business risk is the uncertainty in net income that results from fluctuations in either sales or fixed operating costs. For businesses for which sales volatility is of prime concern, the business risk ratio is most meaningful.

$$\frac{\text{Standard deviation of net income}}{\text{Mean of net income}}$$

For businesses where high fixed operating costs are of concern, the measure known as operating leverage is most important to measure.

$$\frac{\text{Percentage change in operating earnings}}{\text{Percentage change in sales}}$$

Financial risk is results from businesses incurring fixed financing costs (interest and other debt service) compared to earnings. The most common measure is the degree of financial leverage. The higher the degree of financial leverage, the more risk exists for common shareholders.

$$\frac{\text{Percentage change in income to common shareholders}}{\text{Percentage change in earnings before interest and taxes (EBIT)}}$$

GLOSSARY OF BUSINESS TERMS

Accounts Payable A current liability representing the amount owed by an individual or a business to a creditor for merchandise or services purchased on an open account or short-term loan.

Accounts Payable Days This is the number of days, on average, that you take to pay your suppliers. One method to estimate this is to divide your accounts payable balance at the end of the year by your total cost of goods sold for the year.

Accounts Receivable Money owed to a business enterprise for merchandise bought on open account.

Accounts Receivable Days This is the number of days, on average, that it takes to collect payment for your sales. Also referred to as the Days of Sales Outstanding.

Accrual Method A way of determining when income and expenses are computed for financial statement and tax purposes. This method recognizes income and expenses when they actually occurred or were rendered, rather than when the payment was made.

Asset An item of value owned by a business or individual, whether or not there is another claim on the item.

Balance Sheet The Balance Sheet statement presents a projection of your financial position at the end of each month, quarter and/or year. This encompasses everything a company owns (Assets), owes (Liabilities), and the equity of the owner(s).

Bankers A source of loans for equipment and expansion. Bankers lend money deposited from people who have been guaranteed to get it back with interest. Since the money was deposited with the idea that there is little risk, bankers are generally conservative with it.

Barriers to Entry Those conditions that make it difficult or impossible for new competitors to enter the market. Two barriers to entry are patents and high start-up costs.

Board of Directors The members of the governing body of an incorporated company.

Budget The Budget presents a projection of revenues, cost of goods sold, and detailed operating expenses for future periods.

Business Plan A business plan is a written document used to describe the operational and financial situation of your business. People write business plans for a number of reasons, most often to obtain funding for the business. There are three commonly used types of business plans: (a) a complete plan, (b) a summary plan, and (c) an operational plan.

Capacity The ability of your present facility to produce your product or deliver your service, and how your product plans affect manufacturing schedules or affect the way productions is currently done.

Capital The funds necessary to establish or operate a business.

Cash Method A way of determining when income and expenses are computed for financial statement and tax purposes. Recognizes income and expenses when the payment was made, rather than when the items occurred or were rendered.

Cash Flow The movement of money into and out of a company; actual income received and actual payments made out.

Cash Flow Statement The Cash Flow statement, formerly called a Statement of Changes in Financial Position, presents a projection of your sources and applications of cash. It categorizes sources and applications of cash by operations, investments and financing.

Collateral Assets pledged in return for loans.

Company Description A section in a business plan that describes the company's current situation and overall big picture. Describes your business, its name, legal organization, location and sites, and type of business you are in. It also describes the current state of your business — new, existing, etc.

Corporation A business incorporated under the laws of a state or other jurisdiction. Corporations are recognized as entities unto themselves, separate and distinct from the owners. They have limited liability so owners cannot be sued for the debts of the business unless they have personally guaranteed those debts. Therefore, the only potential loss to owners is the investment. An S-Corporation has the same legal liability properties as a C-Corporation and the shareholders must vote or elect to become an S-Corporation. S-Corporations are owned by shareholders, shares may be sold or transferred. They are separate legal entities and organized under state law. An S-Corporation differs from a C-Corporation in regard to tax considerations.

Cost of Goods Sold (“COGS”) The various costs to the manufacturer/service provider in order to produce the finished good/service. These costs include Labor (the human effort required in productions and operation), Material (the physical materials used in production), and Fixed Costs (those production factors whose price does not change).

Conventional Financing Financing from established lenders, such as banks, rather than from investors; also known as debt financing.

Cover Letter The cover letter asks permission to introduce yourself, your business, and your plan to the prospective evaluator of your business plan.

Debt Financing Raising funds for a business by borrowing, often in the form of bank loans.

Debt to Net Worth Ratio Also called Debt to Owners' Equity, this ratio compares the total liabilities of your business to your net worth.

Debt Service Money being paid on a loan including principal and interest; the amount necessary to keep a loan from going into default.

Deferred Compensation Salary delayed until a future date; often taken by principal employees as a method of reducing expenditures in early years of operation.

Distributor Company or individual that arranges for the sale of products from manufacturer to retail outlets; the proverbial “middle man.”

Due Diligence The process undertaken by venture capitalists, investment bankers, or others to thoroughly investigate a company before financing; required by law before offering securities for sale.

Equity Money you personally invested in the company plus profits. Also defined as the value that is left after liabilities are subtracted from assets.

Executive Summary A brief and generalized synopsis of the entire business plan.

Exit/Payback Strategy Tells your investors how and when you will be able to pay them back. It must be backed up by your financial projections. Informs your potential investors how they can turn their investment back into cash.

Financial Plan The section of a business plan that states business assumptions, points to and highlights projections, and provides data on overall financial picture. Summarizes all the financial data from financial statements. Includes analysis and supporting spreadsheets or other suitable descriptions of the business and its capital requirements.

Financial Projection Conclusions based on future business assumptions and research rather than on actual historical data generated by your business. Also called pro forma statements.

Goals The necessary levels of achievement that must be met to achieve a company’s mission.

Gross Profit Margin The dollar difference between net sales and the net cost of goods sold during a stated time frame. Gross margin percentage is calculated by dividing net sales into this figure.

Income Statement The income statement presents a projection of revenues, cost of goods sold, and summarized operating expenses.

Inventory An asset of a business. Inventory is of two general types: (a) direct inventory, which consists of raw materials, work in process, and finished goods; and (b) indirect inventories, which in general are all supplies used to carry on the business and not purchased for resale.

Investor An individual whose principal concerns in the purchase of a security are regular dividend income, safety of the original investment, and, if possible, capital appreciation.

Legal Form of Business A description of how a business is owned, its legal liability with regard to creditors and taxes, and by what agencies or regulations it is governed. Forms of business include proprietorship, partnership, corporations, and others.

Licensing The granting of permission by one company to another to use its products, trademark, or name in a limited, particular manner.

Limited Partnership An investment method whereby investors have limited liability and exercise no control over a company or enterprise; the general Partner(s) maintain control and liability.

Limited Liability Company (“LLC”) LLCs are a hybrid form of business. They provide the equivalent tax benefits of a Limited Partnership and equivalent protection of a C-Corporation or an S-Corporation. LLCs can only be privately held companies.

Liquidity The ability to turn assets into cash quickly and easily; widely traded stocks are usually a liquid asset.

Management Team Provides the leadership for your business and must include combined strength in both management and technical areas. The management team should be selected for complementary talents rather than overlapping or duplicate skills.

Manufacturing Companies Businesses that make products from raw or unfinished materials, generally to be sold to intermediaries (such as stores and dealers) rather than the end-user.

Market Analysis Explains what market you are targeting and the characteristics of that market, what segment you may focus on, its size, its potential, its projected growth, and current and future competition.

Market Share The percentage of the total available customer base captured by a company.

Milestone A particular business achievement by which a company can be judged.

Net Income The remains from earnings and profits after all costs, expenses, and allowances for depreciation and probable losses and taxes have been deducted.

Objectives Those specific and measurable actions that result in the attainment of a particular goal. You may have one or many goals, each of which requires the completion of objectives.

Options The right to buy stock in a company at a later date, usually at a preset price; if the stock rises higher than the original price, an option holder is likely to exercise these options.

Partnership A legal form of business defined as an association of two or more persons to carry on as co-owners of the business for profit.

Personal Financial Statement A balance sheet summarizing your personal financial position. It may also present specific information about your savings accounts, credit accounts, securities and other personal financial details. Often requested of the CEO and possibly other top management of a company by investors.

Product and Service Strategy Section A section of your business plan that describes what you sell, your products and services, both in the present and in the future. Includes information such as why your product and/or services will be successful, who your customers are, who your competition is, and research and development requirements or accomplishments to date.

Product Selection Criteria The set of factors or parameters you use to decide what ideas to turn into a product or service based on market need, competition, uniqueness, and other factors.

Profit The excess of the selling price over all costs and expenses incurred in making a sale; the money remaining after a company has paid all of its bills.

Profit Margin The amount of money earned after the cost of goods (gross profit margin) or all operating expenses (net profit margin) are deducted; usually expressed in percentage terms.

Profitability The ability of a business to generate cash.

Proprietary Technology or Information Technology or information belonging to a company; private information not to be disseminated to others.

Ratio Analysis The Ratio Analysis presents annual projections of 11 common financial ratios. These ratios cannot be judged as good, bad, or average just based on their value. What the values for these ratios indicate is dependent upon the nature of your company, comparisons to your company's historical ratio values (if available), and comparisons to competitive companies in the same industry. (Standard ratios for many industries are available from on-line database services, and are also published in various reference books available at most libraries.)

Receipts Funds coming in to the company; the actual money paid to the company for its products or services. Not necessarily the same as a company's actual revenues.

Research & Development ("R&D") Activities that a company undertakes to turn a product concept into a prototype, and a prototype into a final product. Applies the findings of science and technology in creating a firm's products or services.

Return on Investment ("ROI") The net profit (after taxes) generated by your product or service divided by the total amount invested in the business. In short, $ROI = \text{profit} \div \text{investment}$.

Stock Offerings A way of selling shares of your company to the public in accordance with the registration requirement of the Securities and Exchange Commission. They are presented in a document called a prospectus and represent a certain amount of ownership in a business that corresponds to a given cash value for each share.

Strategic Partnerships Two or more businesses joining forces for collaborative work. An agreement with another company to undertake business endeavors together or on each other's behalf; can be for financing, sales, marketing, distribution, or other activities.

Supporting Documents Includes example materials and operational details for your business such as copies of your advertising or detailed spreadsheets summarized in your financial section. These are usually attached to your business plan to provide depth and backup to the concepts discussed in your plan.

Venture Capitalists Investors who typically invest between \$500,000 and \$3,000,000 in companies having a potential for fast growth. Generally a venture-capital firm will tend to invest in an industry or industries in which it has some specific knowledge, or will focus on early-stage (not typically start-up) investment in a company.

Vision and Mission Describes your company's personality. It is the way the business thinks about itself. Explains to your reader why you are in business and what you hope to achieve.

Working Capital The excess of current assets over current liabilities.