



A Guide to Creating Financial Statements for Entrepreneurs

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The creation of financial projections in the feasibility stage of entrepreneurship can help you think about the financial consequences of the work you have done so far to develop your opportunity. Projections are useful for anticipating cash needs and when you will need to secure financing. They can also help you determine whether the business model is viable and potentially profitable, whether effort and money should be invested in developing it further, and which aspects may need to be rethought.

The financials that are common in the business world are those that track past performance. With these statements, if we know past performance, we can better predict future performance. For a prospective business that has not previously existed, on the other hand, preparing financial statements is much more difficult. There is no past history to build on, there are no real numbers to start with, and it is not certain how the venture will materialize. It is not likely the numbers will be correct, so why do this?

The main reasons for creating financials fall into internal and external arguments:

1. Your numbers reflect your positioning and business model. They can inform you about the viability of your business and help you determine whether and how to move forward. While some numbers are likely to be wrong, your initial approach to the business is also likely to be wrong in some aspects. If these numbers can help put you on a more viable path (sooner rather than later), this information is undeniably valuable.
2. Investors and other stakeholders will want to understand the viability of your business and how you intend to pursue the opportunity. They want to know that you have thought through the economic representation of your business model and that you have done your homework in crafting logical financials. While most sophisticated investors and

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A Guide to Creating Financial Statements for Entrepreneurs

BAB466- November 2018

other experts often believe entrepreneurs are overly optimistic with financial projections, they also want to see how ambitious you are in your thinking about launching the business.

Most business people have at least a basic understanding of financial statements, but creating them from scratch is a difficult task. The complexity of the exercise increases when entrepreneurs feel they need to create detailed, comprehensive statements with items such as unearned revenue, prepaid rent, and allocated overhead. Don't do this. Start simple, at least for the first pass. Get the basics down and, more importantly, understand the relationships between the numbers on the statements and how they link to your business model.

Using Templates

A template can serve as an easy solution for an entrepreneur who does not have substantial finance expertise and has little time to devote to this task. Working with a template can be better than ending up with no financials at all, or with poorly constructed ones. However, be aware of the limitations.

First, plugging in numbers and having the statements generate on their own can limit your understanding of the relationships between elements within and across the different statements. In addition, you want to have in-depth knowledge of your financials when dealing with sophisticated investors and other financially savvy stakeholders. In many ways, templates can help you do this. However, you need to understand the reasoning behind your inputs to the statements and what the results tell you. Similarly, if you have a team member with financial expertise or an accountant working with you on this, make sure you know the numbers and their implications.

Second, every business is unique, and generic templates are often limited in their ability to help specific types of business, or they are overly complex in an attempt to be relevant to all businesses. A similar issue arises with adapting financials from an established company in your industry. This latter exercise is very useful and will be discussed later in this note. But financials from an ongoing business may have more detail than you need to consider early on. Also, adapting financials needs to be done with careful consideration of the startup context and how your business differs. With regard to templates, if you can find a template that serves your industry well, and if these templates allow for adaptation to your unique business model, this can be very helpful, especially in establishing a base-level set of financials.

This note will guide you through the process of building basic financials that reflect the approach of your prospective business. This will provide a foundation for you to evaluate the viability of, and make changes to, the business model, and communicate the opportunity to key stakeholders. This early set of financials can then serve as a launching pad for identifying metrics and for ongoing assessment of the venture startup and growth process.

Understanding the Relationship Between the Three Statements

Let's first take a basic look at the financial statements and their interrelationships. Each serves a critical role in exhibiting particular dimensions of your business. The income statement tells you about the profitability of your business, while your cash flow statement indicates how cash will



A Guide to Creating Financial Statements for Entrepreneurs

BAB466- November 2018

flow into and out of the business (like a checking account register). The balance sheet shows assets and liabilities and, by subtracting the liabilities from the assets, it reflects your equity in the business.

Here is an oversimplified example, meant to illustrate in very basic terms the differences, and relationships, between the three statements. Let's assume you decide to start a business called Orthopawdic, selling orthopedic dog beds.

Month 1: You paid your supplier for your first shipment of 10 dog beds at \$50 each. Your grandmother gave you a loan of \$500 to cover this inventory. Your statements would look like this below. Look at these for a few minutes before you read further. Think about the activities that have taken place and how they are represented in the numbers below.

Income Statement Month 1		Cash Flows Month 1		Balance Sheet Month 1	
Revenues	0	Operating activities	-500	Accounts Receivable	
less: COGS ²	0	Investing activities		Inventory	500
Gross Margin	0	Financing activities	500	Total Assets	500
		Net Cash Flow	0		
less: SG&A ³	0	Beginning balance	0	Liabilities	500
Net Income	0	Ending balance	0	Equity	
				Total Liabilities and Equity	500

You've probably noticed a few things:

1. There is a lot of cash and product changing hands, but no sales, so the income statement shows nothing (for simplicity, we're assuming no SG&A).
2. On the cash flow statement, the cash paid for the inventory is reflected in operating activities. The money from Grandma shows up in financing activities on the balance sheet. You now have inventory, which is an asset that will create value when you sell it. But you owe Grandma \$500, and that shows up as a liability on the other side, balancing out the statement.

Month 2: Congratulations! You made your first sale. Kiki has bought a bed for \$125 for her dog Max and will pay you next month. Your statements below reflect this month's activities. Again, look at this before you read further, and think about how this month's activities are reflected in the three statements, especially compared to the first month. What has changed?

² Cost of Goods Sold

³ Selling, General and Administrative Expenses



A Guide to Creating Financial Statements for Entrepreneurs

BAB466- November 2018

Income Statement Month 2		Cash Flows Month 2		Balance Sheet Month 2	
Revenues	125	Operating activities	0	Accounts Receivable	125
less: COGS	50	Investing activities		Inventory	450
Gross Margin	75	Financing activities	0	Total Assets	575
		Net Cash Flow	0		
less: SG&A	0	Beginning balance	0	Liabilities	500
Net Income	75	Ending balance	0	Equity	75
				Total Liabilities and Equity	575

Some observations you've made probably include the following:

1. You've made a sale, so the income statement shows revenue. One dog bed comes out of inventory and goes into COGS on the income statement. You'll notice that inventory on the balance sheet is now \$450.
2. You've also made a profit of \$75 (the amount that Kiki paid, less the cost of the bed) which shows up in the income statement as net income and also in equity on the balance sheet. Essentially, you've added \$75 of value to the business.
3. You'll notice that no cash changed hands. Kiki will not pay you until next month, and you already paid for the inventory last month. So the \$125 sale is recorded as an account receivable on the balance sheet, and there is no activity recorded on the cash flow statement.

Now, before reading further, recall the purpose of each of the three financial statements. What does each tell you about your business?

The **income statement** tracks your business activities (regardless of the flow of cash). There are two main categories of expenses: (1) COGS is tied to sales. So when Orthopawdic made a sale to Kiki, one bed came out of inventory and went into COGS;⁴ (2) SG&A are expensed in the period in which they are incurred; they are not costs associated with a particular sale. If, for example, Orthopawdic did some advertising in Month 1, that expense would go under SG&A.

Your income statement thus tells you about the flow of business activities and whether the enterprise can be profitable. It should reflect your business model. For example, if you are introducing an innovative or otherwise highly differentiated product, you should expect higher margins, particularly to cover expenses associated with communicating its unique advantages, and perhaps other costs like product development. With this example, you will likely project losses for the first year or more, given that you are incurring expenses such as marketing and product development⁵ that you expect will generate substantial future sales.

⁴ Notice how the dog bed went from being classified as an asset on the balance sheet, to an expense on the income statement. Before it was sold, the bed was sitting in inventory, offering future economic value for your business. That value was created when the bed was sold, and it then became an expense (COGS) associated with the revenue generated on the income statement.

⁵ R&D/product development costs are expensed when incurred, under SG&A on the income statement. If you have a patent, however, the cost associated with applying for, or acquiring, the patent will become an asset on the balance sheet that is expensed over time on the income statement (as amortization).



The **cash flow statement** tracks your flow of cash. Cash flows fall into three categories:

1. Operations: actual cash received and paid out for items on the income statement.
2. Investing: assets that go on the balance sheet. For example, equipment, property, or temporary investments in stocks of other companies.
3. Financing: money that comes in or is paid out to finance the business, whether debt or equity. This includes dividends, but interest is typically an operating cash flow.

You may already recognize the importance of the cash flow statement for entrepreneurs, particularly when considering that what happens in the income statement does not necessarily match what's going on relative to cash flows. You can be hugely profitable but cash poor; cash flow projections can therefore help you determine when you will be short on funds.

The **balance sheet** essentially shows the asset base you are leveraging and the capitalization of your business. It can provide a lens into how you are building and managing your asset base, and how you are choosing to finance your business.

While the income statement is a financial representation of the business activities that have taken place over time, and the cash flow statement reflects cash flows over a period, the balance sheet is unique in providing a snapshot of your financial picture. The balance sheet is akin to a still photo, while the income statement and cash flow statement are like videos.

Making Informed Assumptions

Given the high uncertainty characterizing the early stages of planning a venture, financial projections are often seen as unreliable, like pulling numbers out of thin air. What is more important than arriving at precise figures, however, is the set of assumptions and reasoning applied to derive the numbers.

There are three basic sources you can use to determine your inputs to the financials:

1. Published (secondary) sources. These are cheap and plentiful. You can access a range of information such as company and industry data, trade and business information, media articles and so forth. Secondary data is compiled for a particular purpose, not all of which is relevant to your needs. And what is relevant often needs to be adapted somehow. The overall challenge is to sort through all of this, and to figure out what applies to your business and how. Be selective in what you use to support your numbers and the reasoning you use in applying this data to your business. Then, continue your search through the vast amount of information out there, and incorporate new information into your financials as they evolve.
2. Advice and feedback from experts or customers you contact. It is increasingly critical to talk to people about your business and use their feedback to adjust your approach. You will impress your audience when you show evidence of having reached out to experts and customers.
3. Results of experiments and primary research you conduct. This will surely wow an investor or other interested party—stating that you stood at an intersection for two hours



A Guide to Creating Financial Statements for Entrepreneurs

BAB466- November 2018

at a time over each day of the week for one week and counted how many cyclists there were, and how many wore helmets. Or, you rented a table at a farmer's market, and 50% of the people who stopped in front of your table bought your brownies.

When using any of these sources, make sure you sound as objective as possible. Avoid biased information, like saying you told 50 people about your new cat-tracking device and 90% said they loved it, even if they didn't have a cat. Seeing how passionate you are, or neither understanding it nor feeling invested in what you're doing, they may just say what you want to hear.

Think deeply about how you can gather and present information in the most objective way. For example, you talked with 60 men and women aged 45-65 in the Boston area, and 30% are currently members of a health club, but of these, half have not visited their club at all in the prior two weeks. In the early stages of building an opportunity, particularly an innovative one, actual behavior is much more reliable than expressed intentions.

Your numbers may represent a guess, an informed estimate, or an exact number. As you move forward with your business, you'll have some exact numbers (financing raised, sales orders received, marketing costs incurred). In the beginning, it may seem that you have mostly guesses. Nonetheless, you want to move quickly toward informed estimates. Continually refine your numbers as you collect more information and steer your venture onto more viable paths. Keep a running list of the sources used to develop your assumptions and any interpretation you applied. These increase your confidence in your numbers and signal to investors that you have reasonably thought through this exercise.

Building Your Financial Statements

Typically, entrepreneurs provide five years of financial projections for all three statements, and then a monthly breakdown for the first two years with the income statement and cash flow statement. The reasons for this monthly breakdown are straightforward. For the income statement, monthly detail shows your ramp-up and seasonality. Monthly detail on cash flows shows when you'll have a cash deficit, and when you'll need funding and how much.

For the first two years, you may find it useful first to create annual income statements and cash flow statements for the full five years and take a high-level approach to what this looks like. Then, you could divide the first two years into monthly detail, considering both the initial ramp-up period and any seasonality. But, particularly when applying the bottom-up method described in this note, you may find it useful to estimate what sales look like on a daily and weekly basis, and build this out to monthly and annual numbers as you progress through the initial year or two.



The Income Statement

Revenue Projections

Let's first take a look at three ways you can estimate revenues: top-down, bottom-up, or comparables.

Top Down

With this method, you identify the total size of the market segment you could serve and estimate your share of the market. Of all customers who are reachable with your concept, you can estimate what proportion is likely to buy. You may be able to find market data expressed in total dollar amounts, which includes both numbers of people and the amount they purchase per year. You could calculate market share and revenue data from this.

Another way is to calculate numbers of customers and then apply pricing and purchase frequency. First, consider the proportion of your market that can reasonably become aware of, and access, your product. It is often said, for example, that people will drive no more than 15 minutes to a health club. Given the demographics of the market for a health club, one could identify the number of people in the target market area and adjust for demographic and behavioral characteristics.

Building on this example, say you want to open a fitness business in Welltown, Massachusetts. Your market research and business model indicate a target market segment of older males and females, 45-65 years of age, who exercise regularly.

- a. Population statistics reveal that there are 30,000 people living in Welltown and 30% are between the ages of 45 and 65 years old. This gives you 9,000 people.
- b. A magazine published a survey showing that 50% of people in the region around Welltown engage in regular exercise. Applying this information reveals a market size of 4,500 people.
- c. There is one health club in Welltown, a national franchise, which a source says has 1,800 members. Industry statistics reveal that about half of health club members in the United States are over the age of 44, so you estimate that they have 900 members over 44 or 20% market share in the segment you are targeting. There are also four niche fitness businesses (cycling studio, pilates, personal training, and a weight gym) that have smaller market shares. Your concept is a multi-offering facility targeting the older population, so you project you can achieve 10% market share, or 450 members, after an initial ramp-up period, eventually increasing to 30% by the end of five years. You then apply your pricing information to generate revenue projections.

Bottom Up

You can also count the number of customers you expect to serve, along with how much they will buy. You may be able to get data on customer behavior from various sources. You can talk to reliable informants, such as store owners, sales reps, suppliers, or other industry experts. Or you can physically observe this—counting people entering and exiting a store, tabulating how many buy, and if possible, what and how much. Think reasonably about how many people would buy



A Guide to Creating Financial Statements for Entrepreneurs

BAB466- November 2018

your product or use your service. Given the hours the business is open, what might a typical day be like, including peak or slow hours? How much does a typical customer spend? From this approach, you can build out to weekly, and then monthly and annual sales projections.

Comparables

A third approach is to obtain revenue numbers from comparable businesses, drawing on a company (or companies) selling a similar offering, and adjusting for differences in elements such as stage of business and your source of differentiation. You may not have concrete numbers for your closest competitors, especially if they are private, but you can obtain data on industry averages and public firms.

Particularly for large companies with multiple product offerings, revenues are often aggregated, and you will again have to make assumptions. For example, if you are opening a retail store and you have located a comparable company that reveals the number of stores it has, you can divide total sales by the number of stores to determine average revenue per store.

As another example, say you know a company's total sales for the year. You may be able to locate information showing what proportion of these sales contains the product category that matches your offering. You can draw on published sources such as press releases, journal articles, or the Management Discussion and Analysis (MDA) section and footnotes in annual reports, even expert opinion. With the information available, consider how you can make informed estimates.

In projecting revenues, your price and sales volume should reflect your strategy. If you have a premium product or service, pricing should be relatively higher. Comparisons to the alternatives presented in your competitive analysis are helpful here, so collect good data on pricing for competing products or services. Summarize the logic behind your pricing in your assumptions.

Expenses

Like revenues, expenses may also be approximated in multiple ways. You can obtain data on actual rent costs where you plan to locate, for example, or on average salaries for the types of employees you would need to hire. In addition, you can draw on industry averages or actual expenditures of similar businesses to estimate certain expense categories.

To estimate cost of goods sold, you may be able to determine what it would cost to purchase or produce your product or service.⁶ You can get quotes from suppliers, or ask those purchasing similar products what they pay. You can also look at gross margins for similar alternatives. Industry averages or comparisons may also be helpful. Again, try several different methods and arrive at a reasonable figure, making adjustments for your particular concept. Document your reasoning in your assumptions.

⁶For entrepreneurs, the lower risks and capital requirements of buying a product from a supplier or outsourcing production to a contract manufacturer generally outweigh the advantages of in-house production. Depending on your business, you may be able to start with small-batch production in-house. But when ramping up your operations, consider the implications of doing it yourself: investments you would need to make in equipment and facilities, and the capital requirements, as well as other considerations such as human resources and compliance issues. Having control, and the ability to leverage fixed costs and increase margins, can be attractive, but you also want some flexibility as you establish your product and test the market.



For SG&A costs, you can use comparables or consult experts. Be careful not to underestimate how much it will cost to attract and convince customers, even beyond ramp-up. You are just starting out, and people may not be aware of, or think they need, your concept. They may be happy with competing alternatives, and there may be costs associated with switching to your solution, such as a learning curve, complementary products, or network effects.

Triangulate, Triangulate, Triangulate

In building your income statement, it is useful to try multiple ways to estimate both revenues and expenses and see how they compare. You may find that the various methods reveal different results. In this case, revisit your assumptions and seek additional evidence to revise your numbers. You can make adjustments to your results until the methods triangulate. When they do, you have stronger support for your projections.

You can take into consideration whether one method might be more accurate for your purposes than others, depending on the nature of your business and the availability of relevant information. At the same time, you may find it helpful to combine the most useful aspects of different approaches. Remember, there is a high level of uncertainty associated with estimating revenues and expenses at this point. While acknowledging this, you want nonetheless to project confidence that you have thought about what drives your numbers and that you have evidence to support your assumptions.

Additionally, beware the tendency to overestimate revenues and/or underestimate expenses. Entrepreneurs are inherently optimistic — some would say naïve — when it comes to estimating sales, the speed at which sales ramp up, and the level of expenses required to generate projected sales. Investors and other sophisticated stakeholders will see right through this. Make informed assumptions and back these up with sound evidence.

Startup Costs

The startup phase includes three additional considerations relative to the financial picture. First, what startup costs will you incur, and how many months will you be spending money before generating sales? Second, what would the sales ramp-up time look like? Third, how long will it take for the business to break even, when sales cover your expenses?

The income statement should start with the first expense incurred, even if you have not yet made a sale. Realistically, you will need to spend money to get operations up and running before you generate revenues. Detail the amount it will take to get started. This affects the amount of financing needed to launch the business. In fact, it clarifies for your investors where the money will go. Here, you can think resourcefully (but also realistically) about what you will need at the time of launch. For example, this can include: investments in fixed assets, a budget for your market launch, website development, upfront legal expenses, R&D/design/engineering, and consulting.

Adjusting for the Startup Context

Remember that for both revenues and expenses, it is vitally important to take into account your particular context. This includes the fact that you are a startup, and the extent to which you have a particular source of differentiation, both of which will affect the rate of market acceptance.



Revenues should reflect a reasonable ramp-up period. You do not have the same track record as established competitors, and this will impact your initial sales. It may take several months or longer for your concept to take hold, depending on industry conditions and other external factors. In addition, the greater your uniqueness, the longer it might take customers to become aware of your solution and understand its value. You might be serving a small niche market of likely users in the beginning, before expanding more broadly.

Ramp-up time may also be influenced by choices made around aspects such as sales efforts, marketing expenditures, or location. For example, if your concept will rely heavily on marketing, your sales level may be higher (along with operating costs). Also remember to build in any seasonality that may characterize your business.

Keep it Simple

Keep it simple is the theme of the day. If you are selling a product for which you contract out production, or which you buy from a supplier, the price you pay to the producer or supplier goes into COGS. However, if you are producing a product in-house, it may be relatively easy to track costs for materials, components, ingredients, and so forth. However, attempting to allocate labor and overhead can be complex. For now, put your material costs into COGS, and labor and items that might be considered overhead into SG&A — you could even call the category SG&A and Operations.

The same goes for a service business. Cost of services, like labor for a product company, can be hard to track in a service business, unless you use contract laborers to provide services and pay according to services provided. Unless this situation exists in your service company, try starting with revenues and put all your costs in SG&A and Operations. You can refine this later, but the simpler the better for now.

Breakeven Point

Another key aspect to highlight is the breakeven point. When do you project revenues will cover expenses, and what sales level does this represent? Given that you have a reasonable set of monthly projections for the first two years, you can calculate the breakeven sales level. This is important because it shows what you will need to sell in a month to cover your costs. You can then weigh whether this is feasible: for instance, can you attain the market share required to break even? You may consider changes to your approach, such as taking on more or fewer value chain activities.

To calculate breakeven sales requires an estimate of total fixed costs and variable costs. Fixed costs are those that do not change with short-term variations in sales. For example, rent will be the same whether you sell one more or one fewer unit. Of course, if sales increase to a level for which a larger space is needed, fixed costs will need to be adjusted. The main point, however, is that short-term variations in sales do not affect the level of these costs.

Often people think that fixed costs are all the operating costs, but this is not true. If you pay sales commissions, for example, these are variable. So go through your expenses and determine which are likely to stay the same over moderate variations in sales, and which are expected to change with different sales levels.



Breakeven sales can be calculated as follows.

1. Take your average per unit selling price and subtract your per unit variable cost. This is your per unit contribution (toward fixed costs).
2. Express this as a percentage of sales by dividing it by the unit selling price. This is your contribution margin ratio.⁷
3. Take your monthly fixed costs and divide that by your contribution margin ratio.

$$\text{Breakeven Sales} = \text{Fixed Costs} / \text{Contribution Margin Ratio}$$

The contribution margin ratio represents the percentage of sales remaining after variable costs are covered, and which contributes to covering fixed costs. For example, for every dog bed that Orthopawdic sells for \$125, \$75 is left over after covering the \$50 cost of the bed (contribution margin ratio of 60%). If Orthopawdic had monthly fixed costs of \$7,500, 100 dog beds would need to be sold to cover this amount, i.e., to break even. Above this point, every unit Orthopawdic sells “contributes” to bottom-line profit.

Depreciation

Before we construct cash flow statements and balance sheets, let’s review how depreciation is handled. For items that will be used within a year, or assets of relatively small value (like \$2,000 for a laptop), just expense these. If you are purchasing assets such as furniture, equipment, vehicles, leasehold improvements, or other large ticket items that will be used over a longer period, these will be depreciated on your income statement. In this manner, they are expensed gradually over the length of time that your business benefits from them.

You can easily look up estimates of the useful life of certain categories of fixed assets. Use the straight-line method, where you expense the cost over the number of years of useful life. For example, if you buy a set of weight machines for your health club for \$50,000 and this category has a useful life of 10 years, you could expense it at a rate of \$5,000 per year. Yes, there is such a thing as salvage value, but you can keep it simple for now and depreciate down to zero.

Here is how a fixed asset purchase and depreciation figure in your statements:

- Income statement: you expense a portion of the asset as depreciation expense each period.
- Balance sheet: record the full cost of the asset under fixed assets, and deduct accumulated depreciation from this amount to find the net value. Note that accumulated depreciation is additive—you add the amount of depreciation expense to the prior year’s accumulated depreciation.
- Cash flow statement: recall that depreciation is not a cash flow; when you paid for the asset, you should have recorded the cash outflow under *cash flows from investing activities*. Under *cash flows from operating activities* in your cash flow statement, you need to remember to add back depreciation expense to net income, since it is a non-cash item.

⁷ Alternatively, you can take total sales revenue and subtract your total variable costs, and then divide by total sales revenue.



A Guide to Creating Financial Statements for Entrepreneurs

BAB466- November 2018

- Drawing on the previous example, the \$50,000 you paid for the line of weight machines will be recorded as a cash outflow in *cash flows from investing activities* when you paid for it. The \$5,000 in depreciation expense from your annual income statement will be added back to net income in *cash flows from operating activities*.

As a side note, consider the tradeoffs associated with leasing versus buying fixed assets. Leasing may seem expensive, but it can reduce your need for large amounts of financing early on, as well as provide flexibility.

The Balance Sheet

Let's start with a very basic balance sheet. You do not need all the items you see in balance sheets of publicly traded companies. Keep it simple on this first pass.

Here are the typical categories you place on the asset (left) side:

1. Cash: you can keep this blank and fill in when you complete the cash flow statement.
2. Current Assets
 - a. Accounts Receivable: this assumes your customers will not always pay in cash. If payment terms are 30 days, you could take the last month sales revenue number and place it here (for example, you assume December sales will be paid in January). If your customers pay with credit cards, it may take a few days to receive the cash from the credit card company, but for the sake of simplicity, you can treat this the same as a cash sale.
 - b. Inventory: if you are holding inventory, you can determine how much you need to have on hand. You want to balance tying up cash with avoiding stockouts. Industry practices, agreements with suppliers (small-batch or on-demand production), and products that are perishable or prone to obsolescence, are among factors that can influence this. You might, for example, maintain inventory equal to the next month's COGS, assuming you want to keep 30 days of inventory on hand.
3. Fixed Assets: here is where you put the cost of your large depreciable assets, then subtract accumulated depreciation to get a net value.

On the liabilities and equity side (right side), you have the claims against your assets.

1. Current liabilities: if you have inventory, you could assume you will pay cash on delivery (suppliers often require this for new businesses). In this case, you do not need to include current liabilities on your balance sheet. Obviously, this is also the case if you have a business that does not carry inventory. However, if you have inventory, and if you project something like 30-day terms, you may assume inventory purchases in the current period will be paid in the following period. This amount could thus go into accounts payable.
2. Debt: if you think you will use debt financing, leave this blank until you complete the cash flow statement and calculate the amount needed.
3. Equity has two basic components:
 - a. Equity financing: again, if you think you will raise equity funds, leave this blank until you calculate financing needs in the cash flow statement.
 - b. Accumulated earnings (losses): add the current net income (loss) from the income statement to what has accumulated from prior years.



Cash Flow Statement

Let's assume you use the indirect method to create the cash flow statement, which is the method that starts with results from the income statement. Although this is not always intuitive, it can be easier to reconcile with the other two statements, and this method is used more commonly. Whether you use the indirect or direct method (tracking actual cash flows for operating activities), the only difference between these methods is in the first category, Cash Flows from Operating Activities.

Here is how you set this up:

1. Cash Flows from Operations
 - a. First, take net income and add back depreciation expense. Remember, depreciation is not a cash flow; the cash flow occurs when you made payment on the fixed asset, which goes under investing activities below.
 - b. Look at the difference in your current assets and current liabilities from the last period.
 - i. If you increase current assets (accounts receivable, inventory), you are tying up cash, so subtract that. Decreases are added to cash flows.
 - ii. If you increase current liabilities (accounts payable), you are delaying a cash outlay, so add this. Decreases are subtracted.
2. Cash Flows from Investing: here is where you put the cash outlay for fixed assets, investments in suppliers, or purchases of stock of other companies.
3. Cash Flows from Financing: leave this blank for now until you identify how much cash you will need to cover shortfalls.
4. Add the above three together to get your net change in cash.
5. Input the cash balance from the end of the last period.
6. Add #4 and #5 above to get your ending cash balance.

Given that you have created a monthly cash flow breakdown for the first two years, look at where you find big cash deficits. You will likely need money even before you make a sale, depending on big-ticket purchases and the amount of pre-revenue costs you incur. You also want a cushion so you do not run out of cash if things do not go as you expect. You can determine a minimum level of cash to maintain as a reserve, an amount below which you will not go. This may include several months of expenses, so you can pay employees and bills even if you do not have revenues.

You want to strike a balance between securing too much money too early, which is generally more expensive, and risking cash outages. You can examine the amount needed, and whether you have access to some quick or temporary sources of financing. Just remember that it often takes time to raise money, sometimes several months.

Once you fill in the financing amount on your cash flow statement, this can go into the debt or equity section of the balance sheet. With your financing in place, you now have your ending cash balance and can put this on the asset side of the balance sheet. The asset side of the balance sheet, and the liabilities and equity side of the balance sheet, should display the same bottom line.



Presenting the Financials in Your Business Plan

Your financial statements should go into an appendix in your business plan. You can include additional spreadsheets that break down some key components, but do not overload the appendix with a lot of subsidiary ledgers. Rather than show every last detail, just describe how you calculated certain numbers. A list of assumptions should accompany your financial statements. Provide as much evidence as you can to support your numbers; cite published or primary sources where possible.

In the main text of your business plan, highlight key results and insights derived from your financials. Discuss your financial model; put into words what you see in the spreadsheets. For example, identify the length of the pre-revenue period and list major upfront expenditures. Describe the ramp-up period, any seasonality, and how your source of differentiation is reflected in the financials. Identify when you will break even.

A final reminder: once you complete reasonable financial projections, you may recognize that the route you have chosen is not viable or attractive. You may need to cycle back and rethink the product or market. Use the numbers to inform, not just impress.