

# BE AN Entrepreneur

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# Chapter <sup>^</sup>

## THE FINANCIAL PLAN



# THE FINANCIAL PLAN

Cash Inflows

Financing Section



Cash Budgets

Cash Outflows

Measuring Risks



# Chapter 8 overview



In chapter 8, we take a close look at financial risks, how to measure them, and express them.

We relate risk to the rewards of a business.

We find ways to evaluate if the business is “worth the risk” or “worth the trouble.”

# Coverage of the Chapter



Cash Budgets



Cash Inflows



Cash Outflows



Financing Section



Measuring Risks



# Learning Objectives



**Define**

Define a financial plan and discuss its importance to an investor



**State**

State the goals of a financial plan



**Discuss**

Discuss ways to set up the time frame for a cash budget



**Explain**

Explain how a cash budget helps determine the funding need



**Discuss**

Discuss measures of return of an investment

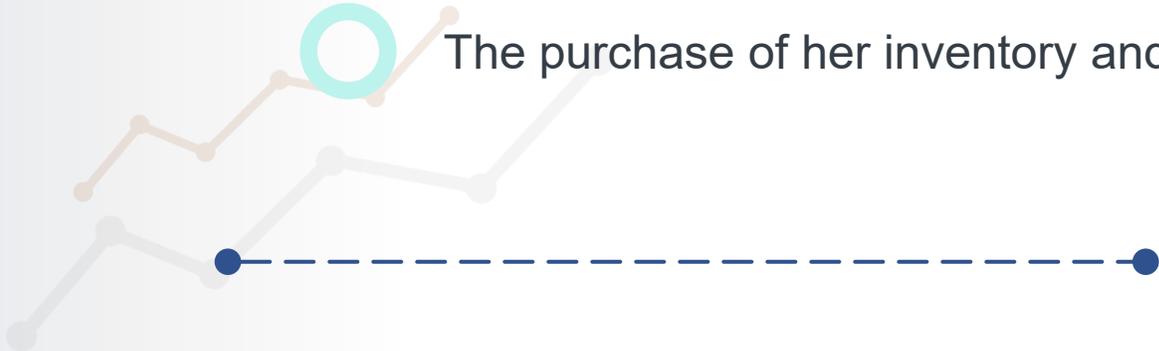


**Discuss**

Discuss the required rate of return, break-even analysis, and sensitivities as measures of risk.

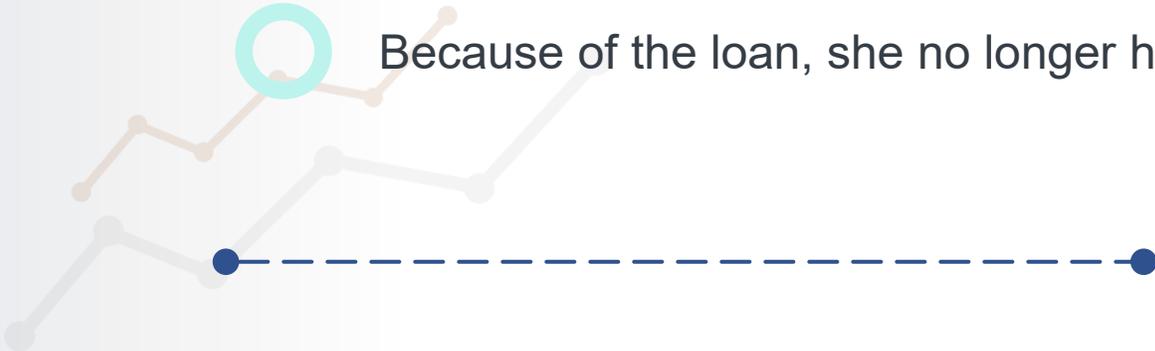
# Story from Real Life

- Ms. Yong Suk Daley, a Korean-American, opened a clothing-alteration shop in Springboro, Ohio, in 2000 and operated it successfully.
- Business slowed down in 2005.
- She renovated her business in 2006 and called it, “Young’s Special Occasion Apparel.”
- She refocused on altering and fixing clothes for special occasions like weddings, where the consumer budgets are bigger.
- The purchase of her inventory and display was financed with her personal credit cards.



# Story from Real Life

- In August 2006, Ms. Yong finally got a business coach who helped her develop a proper business plan.
- She prepared a cash budget as part of an application for a loan, to supplant the credit card debt.
- She strengthened recordkeeping and financial management. She improved the marketing plan.
- A loan was finally granted to her in October 2006.
- Because of the loan, she no longer had to use her credit card to finance inventory.



# THE FINANCIAL PLAN

1

The business plan expressed in numbers of money terms.

2

It includes the cash budgets, the amount of external financing required and an assessment of the risks and rewards of the business.

3

The financial plan is a convenient summary of all the components of your business plan. It expresses how high the start-up costs will be, how much the new factory will cost, and what sort of working capital will be required.

4

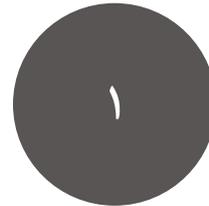
The financial plan quantifies all of your plans into measurable units of money. It explains the total investment required this year, how much will be in fixed assets, how much in working capital, and how big are salary expenses versus raw material costs.



# THE FINANCIAL PLAN



The financial plan shows the rewards. It shows how much the investor's money can grow.



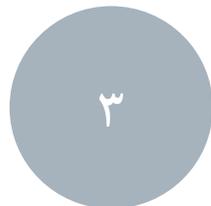
To demonstrate the need for funds.



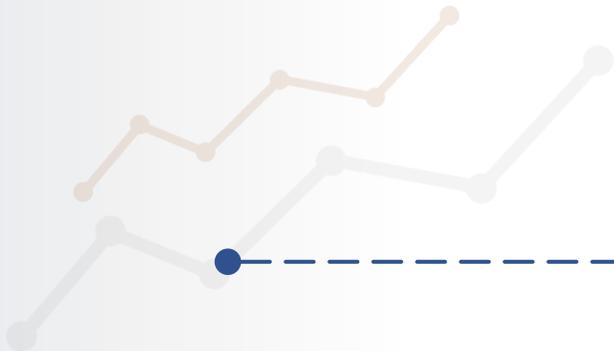
Your financial plan has three goals:



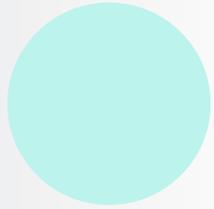
To demonstrate the reward or return of a business.



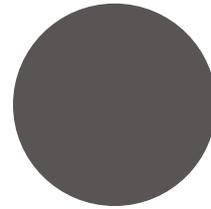
To demonstrate the reward or return of a business.



# THE FINANCIAL PLAN



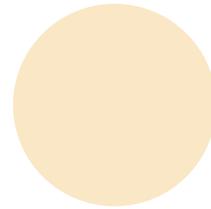
To address these goals, your financial plan will have three components:



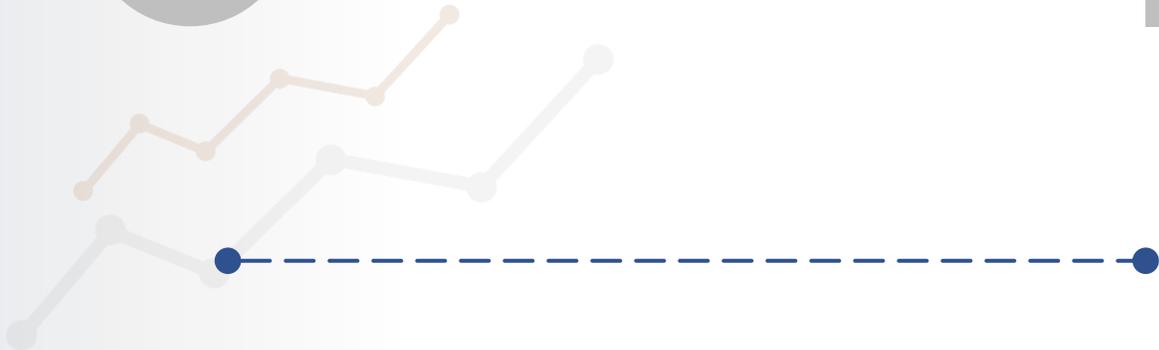
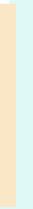
the conclusions reached from the cash budgets



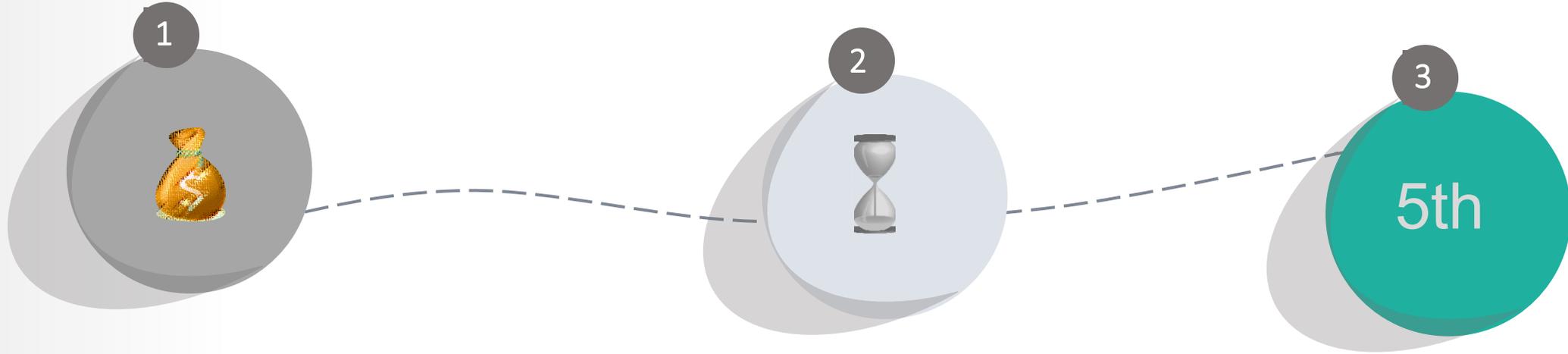
the cash budgets



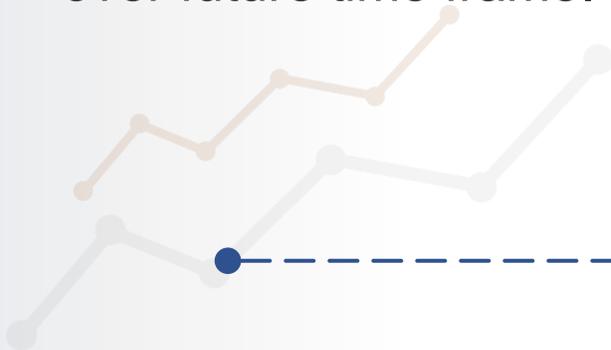
ways to measure risk.



# Cash Budget



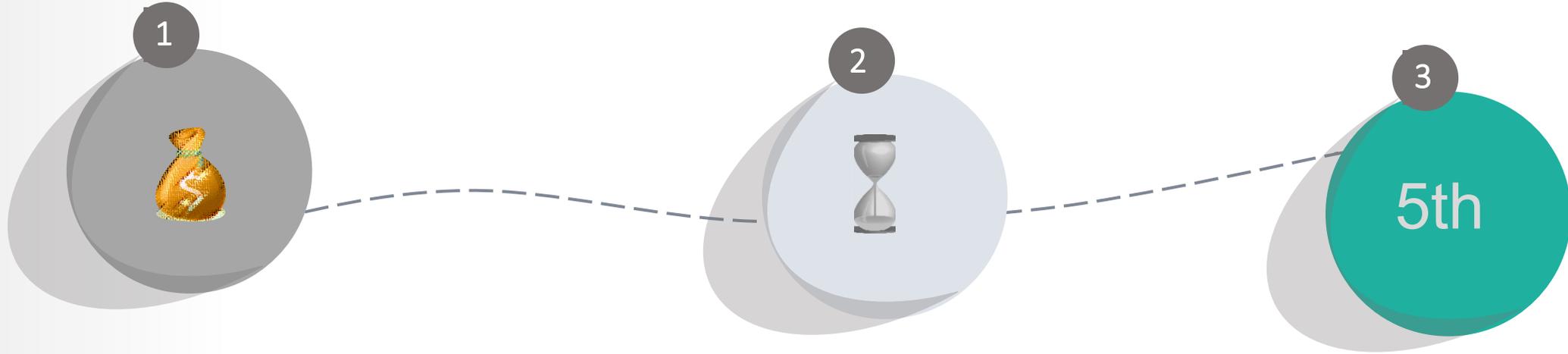
Cash budget: A budget that tracks expected cash flows over future time frame.



The time frame or period of a cash budget will usually cover several years.

If you estimate that it will take five years to build up the business, and that the business will be stable by the fifth year, it would mean that your cash budget should be enough to cover five years.

# Cash Budget



Another way to determine the time frame is to take the point of view of the investor (the provider of funds).

The time frame of the cash budget has to be equivalent to the time frame of the investor.

Five years would be a reasonable time frame, for most investors.



# Cash Inflows

## 1 Cash from customers



Over the specified period, where will cash come from?

When will the cash inflow happen? The main, regular, and obvious source of cash is the cash generated as your business sells products and services to customers. Your marketing plan will provide the sales information that you will then convert into cash inflows.

(Sales value = units sold x unit price.)

# Cash Inflows

## 2 Cash from investors



It is the cash comes from other people who invest in your business. It is so essential to do the calculations for the cash budget to determine the amount the business needs from internal and external sources. Besides, you write this amount at the very start of the cash budget to represent the initial investment that is required.



# Cash Inflows

## 3 Cash from hypothetical sale of the business



At the end of the period there should be a terminal value, which would represent a big inflow of cash. There are several ways to calculate a terminal value. You can:

- ▶ Assume that everything that the business owns is sold.
- ▶ Obtain a single value to represent all future earnings beyond some future time.
- ▶ Obtain a comparable amount.

# Cash outflows

## 1

### Variable costs



Cash outflows or costs may be sorted into variable and fixed costs. Variable costs change or vary with the number of units sold. The more you sell, the higher your variable costs will be.

Raw materials and labor used in production are examples of variable costs. Because of their relation to sales, variable costs are usually expressed as a percent of sales.

# Cash outflows

## 2

### Fixed costs



By contrast, fixed costs do not change with the number of units sold. The amount remains constant for a wide range of sales volumes, or constant over a time period.



# Cash outflows

## 3 Recurring costs



Some fixed costs recur. They happen every subperiod and are therefore budgeted in every subperiod.

Examples are of lease space rental, the salaries of managers, advertising, and insurance.



# Cash outflows

## 4 One-time costs



Other fixed costs are one-time lump sums. Building a factory and buying delivery trucks are examples of such fixed costs. Your plans for paying for these items determine the timing of these fixed costs



# Cash outflows

## Working capital

One important variable cost that is often missed is working capital, the amount needed to support day-to-day operations.

Common sense will tell you that as your business grows, cash will be tied up in the form of goods for sale and credit extended to customers. (This means that the goods were sold today, but the cash payment may reach you one month from now, or perhaps over three months in equal installments.) Your cash will take a long time to come back. Meanwhile, you still need cash for day to day operations. So you need additional working capital.

# Cash Budget

For most new businesses, the first years are years of investment and hard work. We see this in the cash budget as negative net cash flows in the first years.



# Cash Budget



- ▶ If the beginning cash balance is small, a negative net cash flow will lead to a smaller, even negative, ending cash balance.
- ▶ External funds will then be required to bring the amount back to minimum operating cash level, in the sub-period.
- ▶ That is how, you find out, how much external funding is required.

# Measuring risks

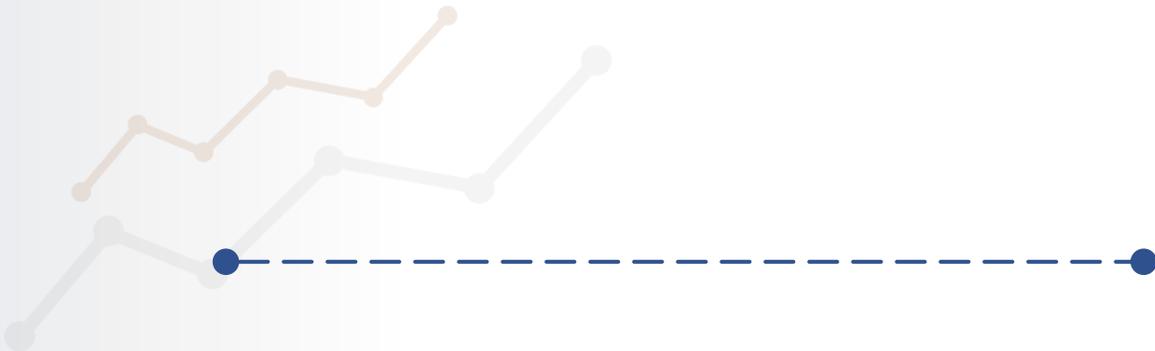
NET PRESENT VALUE



REQUIRED RATE OF RETURN

Net present value is today's value of all future cash flows minus the initial investment.

You need to input a required rate of return in the calculation, to see if the business gets to earn sufficient money each year, to pass the test of the investor, and to see if it still produces a net positive amount, by the end of the project.



# Measuring risks

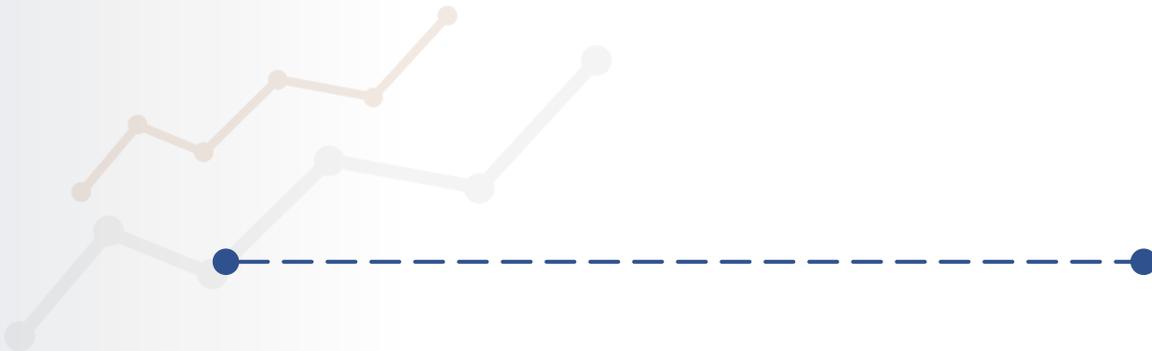
NPV



REQUIRED RATE OF RETURN

A business with positive NPV is attractive.

Required rate of return: the minimum reward a business must provide for an investor to invest in it. It is expressed as a percentage.



# Measuring risks

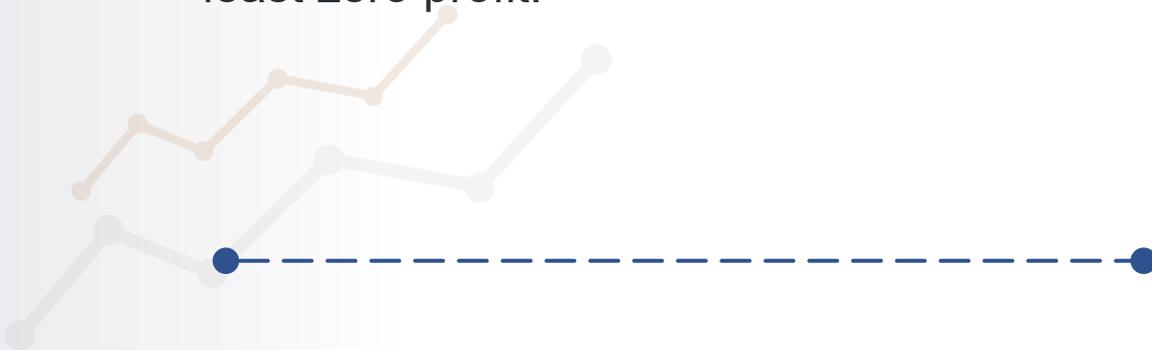
BREAKEVEN POINT



BELOW BREAK-EVEN

The breakeven point is the number of units your business must sell to just cover all its costs or “break even” or to achieve at least zero profit.

Below break-even, your business is not profitable.



# Measuring risks

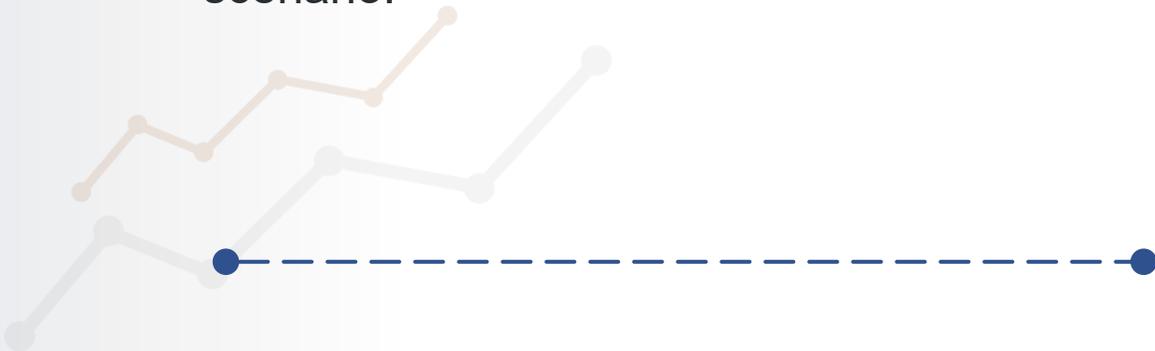
SENSITIVITIES



SCENARIOS

If you present alternative cash budgets, you would be giving sensitivities. You can present an optimistic and a pessimistic scenario.

You can present a best-case and a worst-case scenario. This is how you know what would happen if: (a) sales is higher than expected or (b) lower than expected.



# Glossary

Cash Budget:

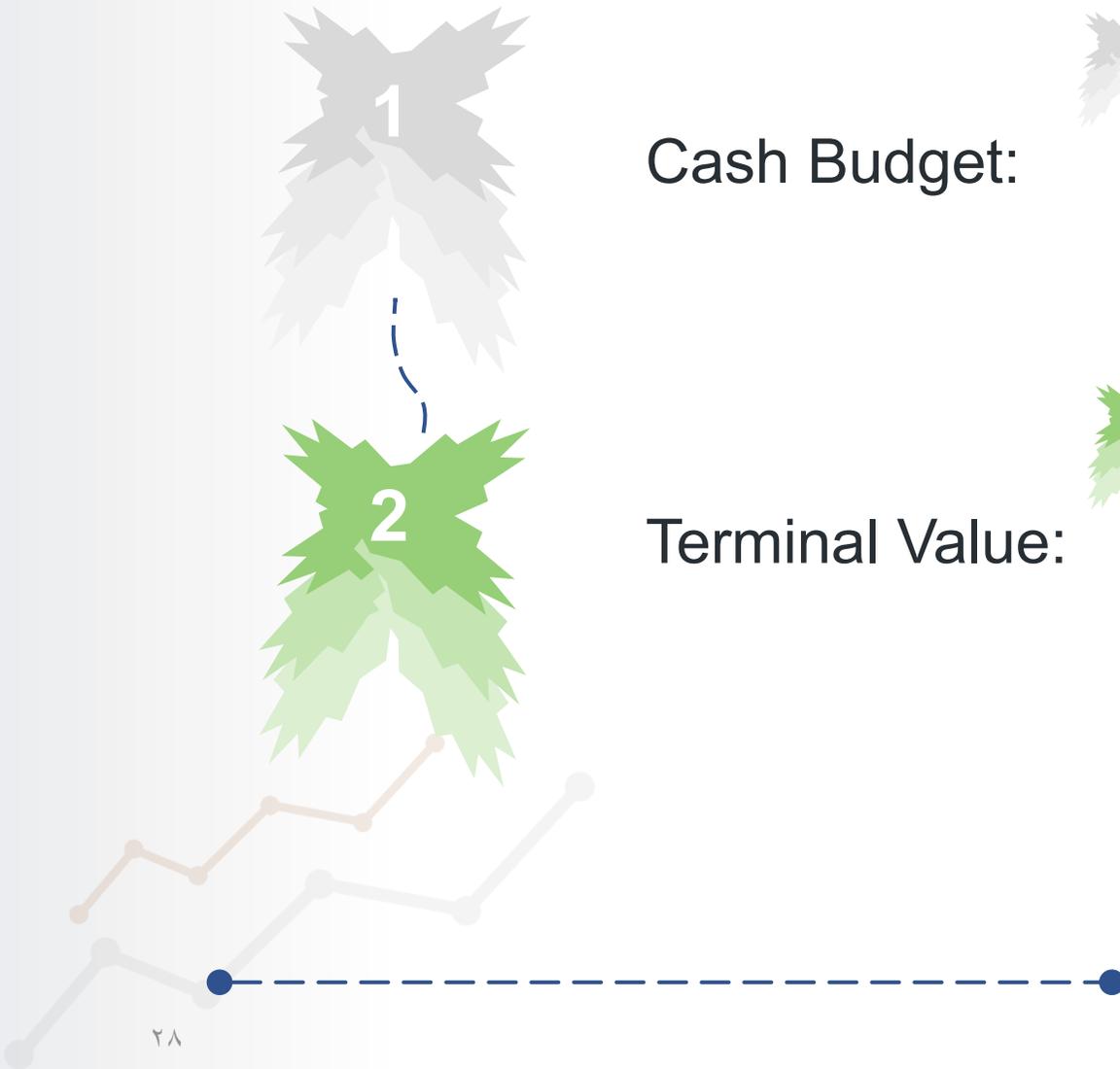


A cash budget tracks the expected flow of cash as it comes into and goes out of a business over a future time frame.

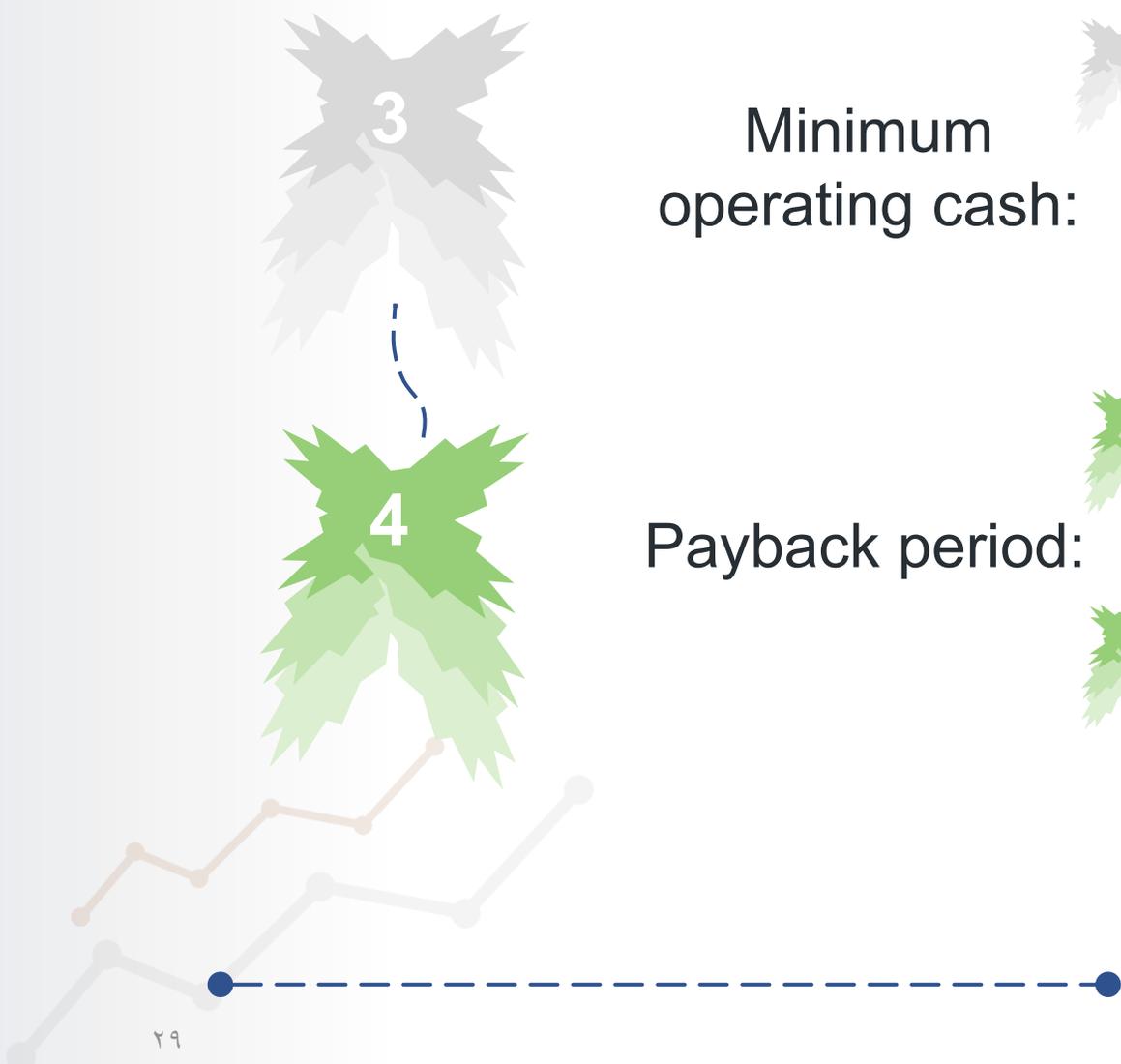
Terminal Value:



The forecast value of your business at the end of a specified period. It is used to limit the time frame in a cash budget



# Glossary



Minimum operating cash:



The least amount of cash a business needs for day-to-day operations.

Payback period:



The time it takes for a business to fully recover or pay back the initial investment.



Shorter payback periods represent more attractive businesses.

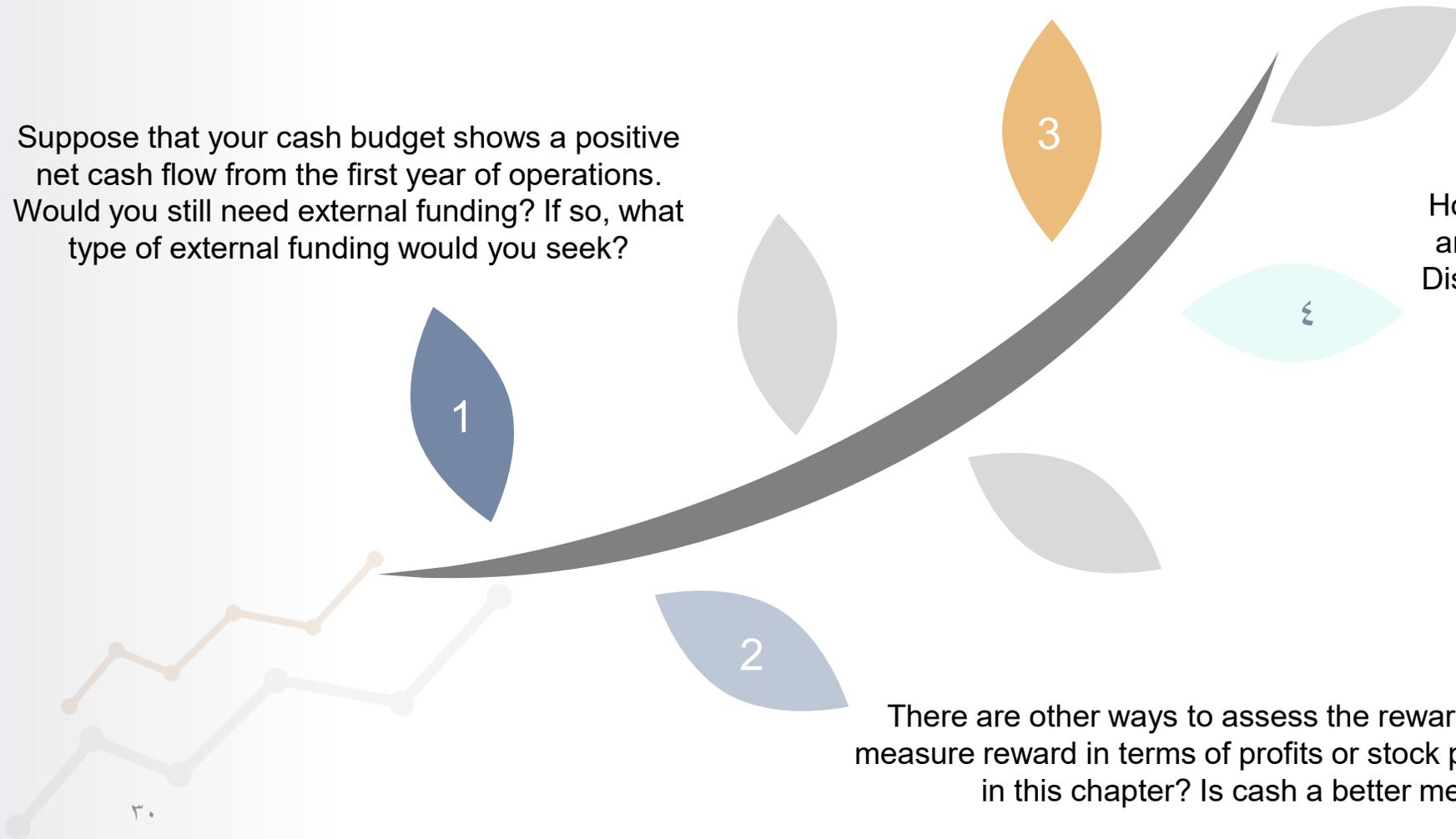
# Questions for Discussion

Where there is little or no inflation, money today is not very much different from money tomorrow. In such cases, wouldn't the quicker, simpler payback period be a better way to assess the attractiveness of a business?

Suppose that your cash budget shows a positive net cash flow from the first year of operations. Would you still need external funding? If so, what type of external funding would you seek?

How many sensitivities should you make and what changes should we consider? Discuss this question with your peers and come up with a general answer

There are other ways to assess the rewards of a business. One can measure reward in terms of profits or stock price. Why the focus on cash in this chapter? Is cash a better measure than profits?



# Case Study questions



Do you think a cash budget would help Abdulilah even though his business is already running? Why or why not?



Do you agree to start business with your mother's money?

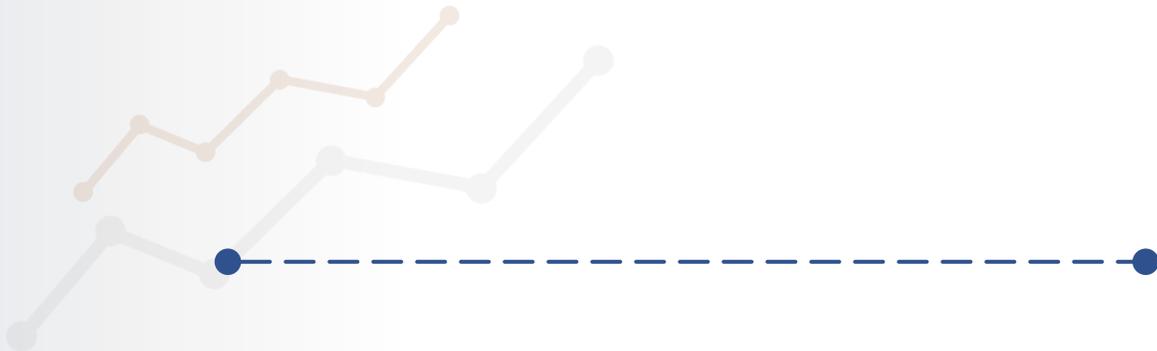
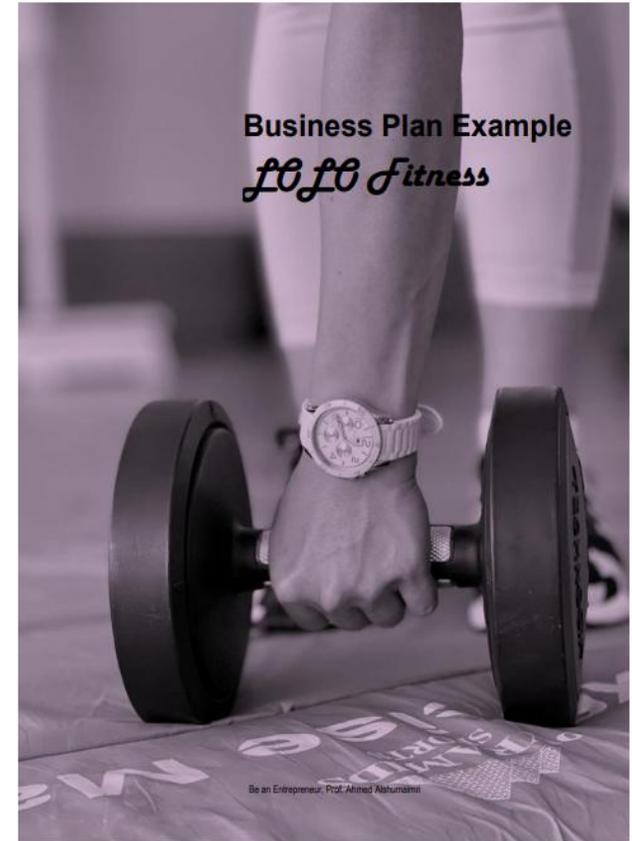


What would you suggest to Abdulilah to improve his business?



# Financial Plan Example

See financial section in LOLO Fitness  
Page 148



# Do your Financial plan

<https://knowhow.ncvo.org.uk/tools-resources/business-plan-template/writing-your-business-plan/11-cost-and-income-structure>

