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How to Prepare Your Business Plan

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Preface

This publication was prepared in the framework of a technical assistance project aimed at strengthening the capacity of least developed countries to mobilize resources through venture capital funds. It is intended for use in the training of senior and middle management in business planning and as a reference manual for individual enterprises to prepare their business plans, for submission to investors for funding, including venture capital funds. The manual is applicable to many types of businesses, including start-ups; on going or expanding businesses; production or service firms in any sector; small, medium or large corporations; sole proprietorships; partnerships; joint-stock companies; and locally, nationally or internationally active companies. It is thus unavoidable that the manual gives almost a “maximum list” of items for inclusion in a business plan. Companies can pick and choose among the items discussed, according to their specific situations and needs.

Under the overall direction of Karl P. Sauvant and Anh-Nga Tran-Nguyen, this manual was prepared by George Malcotsis, in collaboration with Reinhard Behrens, Rene Gerber, Janos Fazekas, Dietmar Kuck, Andreas Ragaz and Lukas Schärer. It has benefited from comments by Petri Koivula as well as by participants by in several training workshops to discuss business plans, organized in Ukraine in 2001.

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Geneva, January 2002

Rubens Ricupero
Secretary-General of UNCTAD

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THE ABCs OF A BUSINESS PLAN

A. What is a business plan?

A business plan is a comprehensive, written description of the business of an enterprise. It is a detailed report on a company's products or services, production techniques, markets and clients, marketing strategy, human resources, organization, requirements in respect of infrastructure and supplies, financing requirements, and sources and uses of funds.

The business plan describes the past and present status of a business, but its main purpose is to present the future of an enterprise. It is normally updated annually and looks ahead for a period of usually three to five years, depending on the type of business and the kind of entity.

It is a crucial element in any application for funding, whether to a venture capital organization or any other investment or lending source. Therefore, it should be complete, sincere, factual, well structured and reader-friendly.

B.Why a business plan?

There are many important reasons for drawing up a business plan. Some of the most significant are the following:

- *Getting an integrated view of your business*. By preparing your business plan, you get an integrated view of all issues regarding your business. For example, it helps you to identify better your target clients, outline your market segment, shape your pricing strategy and define the competitive conditions under which you must operate in order to succeed. Business planning ensures that all these considerations are consistent and properly harmonized. Also, the business plan process often leads to the discovery of a competitive advantage or new opportunities as well as deficiencies in the plan. Committing your plans to paper, ensures that your overall ability to manage the business will improve. You will be able to concentrate your efforts on any deviations from the plan before conditions become critical. You will also have time to look ahead and avoid problems before they arise.

- *Mutual understanding within the management team*. Reaching mutual understanding among the members of the management of the firm is particularly important in cases in which the recommended policy of engaging as many managers as practically possible is applied in the preparation of the business plan.

- *Determining financial needs and applying for funds*. Determining the amount, type and sources of financing and when it is required. Using the business plan in the process of application for funds.

- *Approval from board of directors/shareholders*. Using it as a basis for getting approvals from the company board and shareholders.

- *Recruiting.* Using it in recruiting and introducing new members of the management and staff.

- *Deriving objectives for employees*. Deriving from the business plan measures and objectives for units and individuals in the organization (management by objective).

- *Informing employees.* Using it as a means of informing/motivating employees about the objectives of the company.

- *Informing lenders*. Giving it to banks/investment funds that have financed your business in the past and require periodical information for monitoring purposes.

- *Informing partners*. Using the business plan in informing business partners and other relevant organizations.

In preparing this manual, it has been assumed that the primary objective of preparing a business plan is to determine the financing requirements of your business and to apply for external funding.

C. Who reads the business plan?

Among the readers of your business plan will most probably be key employees, the board of directors and shareholders, selected business partners, and current or prospective lenders and investors. Which parts of your business plan should be distributed to which persons depends on its confidentiality and on the particular responsibility of the persons concerned. If you include in your business plan confidential strategic decisions or secrets, you should be restrictive in distributing copies of it. Give it only to persons who you are confident will not pass on information without your consent. In some cases, you may request the recipient to sign a confidentiality declaration.

Some of the most important target readers may well be potential lenders or investors. If you are looking for outside financing to develop your business, there are many possible sources you can approach with your business plan. The most important of these are the following:

- *Commercial banks.* Commercial banks provide loans to viable businesses on standard market terms and conditions. They are normally very risk-conscious and require adequate coverage by means of collateral. This may consist of, in the order of preference of the banks, cash accounts, precious metals, tradable securities, infrastructure (land, buildings, machinery), accounts receivable and inventory. If some of these assets are accepted as collateral, the bank may require the loan to be covered with 200 per cent or more of their value. The interest rate depends on the prevailing macroeconomic conditions in a country, but also on the risk the bank attributes to a project. Experience has shown that interest rates demanded by commercial banks in some countries can often be too high to be really supportive of the development of a business.

- *Private investment funds.* Recent years have seen a rapid increase in the number of private venture capital funds that operate on a commercial basis. The objective of these funds is to make a profit, and they will scrutinize your business until they are convinced that they can get substantial return on their equity at a calculable risk. A particular advantage of such funds, as compared with bank loans, is that they can finance your business by placing equity without requiring collateral. On the other hand, they will expect a good share of the profit and will demand a control function in your business, for example through appointing one of their staff members to the board of directors of your company.

- *Development funds*. Such venture capital funds are established and supported primarily by Governments or governmental institutions and have a social and macroeconomic development objective. Particular characteristics of these funds are:

- They are willing to take more risks than commercial/private venture capital funds.

- They participate in the business only for a limited period of time. They exit when the business is financially self-sufficient.

- They particularly favour businesses with special social and environmental benefits (creating many jobs, including a strong value-added component, transferring a substantial amount of know-how, being friendly to the environment, etc.). Therefore, if you address yourself to such a fund you have to cover these issues well in your business plan.

Nevertheless, most development funds, like all other funding institutions, are only ready to finance a project if the business plan shows the viability and profitability of the business.

- *Multilateral development institutions.* Among the most prominent multilateral development institutions are:

- The International Finance Corporation (IFC), which is part of the World Bank Group located in Washington, DC, United States;

- The European Bank for Reconstruction and Development (EBRD), located in London, United Kingdom;

- The Asian Development Bank (ADB), located in Manila, Philippines;

- The African Development Bank (ADB), located in Abidjan, Côte d´Ivoire;

- The Inter-American Investment Corporation/Inter-American Development Bank, located in Washington DC, United States.

The share capital of these institutions is held by many Governments. Their common goal is to assist the social and economic development of the regions they cover. Their philosophy and their objective are similar to those of the development funds mentioned above. They tend to finance directly large projects (with equity and/or loans) costing $5-10 million or more. They also cover smaller investment projects through intermediaries such as local commercial banks and leasing companies.

- *<u>Private investors.</u>* Private investors are usually independent and wealthy individuals who are seeking opportunities to put money in promising businesses. Their incentive is to get a higher return on investment than on marketable securities or investing in a fund. Quite often they allocate a percentage of their fortunes for start-up or expansion projects. Placing money in diverse businesses reduces the overall risk in their investment portfolio.

- *<u>Technical assistance credits/grants.</u>* Depending upon the type and location of your business, there may be some possibilities to access government funds that provide soft loans or grants. Typical examples of applications for such soft loans or grants are for training your personnel, preparing a feasibility study, implementing a pilot project prior to an investment, and making environmental-protection-related improvements.

Nevertheless, even for a grant, the donor will most probably assess your business plan before taking a decision. Donors wish their grants to be given only to well-planned and viable ventures. They rightly believe that these are the ones that can have a substantial social, microeconomic and macroeconomic impact.

D. How to prepare a business plan?

1. Who prepares a business plan?

The answer to the question about who contributes to the preparation of a business plan depends very much on the type of business and the structure and size of the entity. In a very small company, the planning work and the drafting of the document have to be done by the managers and owners themselves. In larger organizations, contributions have to come from different people.

The larger the number of management and staff members involved in the preparation of a business plan, the less the chance that non-viable solutions will be arrived at. Ultimately, those employed by the business will assume some of the responsibility in implementing the plan. Therefore, it makes sense from a technical, psychological and team-building point of view to involve them at an early stage of the process. Firstly, employees have the best knowledge of the different aspects of the company's operations, and secondly no plan will be implemented successfully unless key employees identify themselves with the targets set and the means committed. Company employees contributing to the preparation of a business plan are typically:

- The **Chief Executive Officer** (CEO), who should have the main responsibility for supervising the business planning process;

- The **marketing and sales manager,** who understands best the demand of the market, its growth potential, the specific requirements of clients, the prices that they are ready to pay, the moves of competitors, etc.

- The **development and production managers,** who provide input of central importance for the business plan, such as lead times for developing new products, requirements for new production machinery and equipment, personnel needs and raw material requirements.

- The **financial manager,** who usually puts the financial data of the business plan together, works out the financing requirements of the firm, and is one of the key figures in talking to investors and lending institutions.

In some ventures, these persons inform their personnel about the business planning process and ask them to assist by contributing data, information, opinions and ideas. This system approach of mobilizing a large part of the organization has the great advantage of stimulating the awareness and motivation of the firm as a whole.

The best skills available within the company should then be used for synthesizing and harmonizing the input provided by the above team members and for producing the actual report. This work should not be allocated simply to the least useful member of staff who happens to have time available. Many large entities have highly competent business development managers whose main tasks are to coordinate the business planning process and edit the relevant documents. Other enterprises do not have adequate internal resources and hire external consultants to guide and facilitate the business planning process.

2. What are the steps in the planning process?

A business plan should not be something you prepare once, then put on a shelf and forget. Dynamic planning should be an integral part of managing your business. Most successful ventures prepare a three-to-five year business plan every year. This involves updating last year's business plan by comparing the planned figures and goals with results achieved and taking into account changes, new information, experiences and new ideas. The steps involved in the business planning process are the following:

1. Assessing the situation

2. Developing a mission

3. Getting ready

4. Setting goals

5. Working out the business plan

6. Setting employee objectives

7. Monitoring the process

a. Assessing the situation

This should be an assessment of how your customers, partners, competitors and suppliers view your business. It should answer the question "where are we now?" It should also be a honest and self-critical exercise trying to answer the important questions any businesspersons should be asking themselves regularly: "What are our important strengths and main weaknesses?" "What can we do well and what should we not be doing at all?" "What are the major mistakes we have made in the past and what can we learn from them?" "Do we make a reasonable number of mistakes?"

b. Developing a mission

Before proceeding further you should formulate a clear mission statement for your enterprise. Developing your mission is often the most valuable part of the dynamic planning process since it can change or reconfirm the direction of your business. Missions are intended to provide a sense of purpose and act as a tool for communicating where the business is heading. Shareholders, employees and business partners can be better motivated and support the mission if they know what it is.

- Your **vision** says how you see yourself in the far future. It expresses what you want your company to become. A vision shared by all the people concerned with the business is an important factor for its successful development.

- Your **mission** defines what you want to achieve. It states the benefits your business will bring to clients, employees, shareholders and the community as a whole.

- Your **philosophy** expresses the values and beliefs of your organization's culture.

- Your **strategy** indicates how to get there.

A business is often founded on the vision of an individual. As the entity grows, the organization may lose its original *raison d'être* and its mission may change. The mission should be reviewed regularly and if necessary adapted. This should be providing an updated picture of what you are trying to achieve and answering questions such as:

- What business are you in?
- What do you do best?
- Whose needs do you meet?
- What needs do you meet?
- What benefits do you generate?

Philosophies or values should be included in the written business plan. They are an important foundation that should be communicated to all levels within your organization and to your outside business partners. A consistent corporate culture and a good understanding of the entity's direction and values can improve decision-making and staff productivity. Staff may feel better about what they do. People are motivated by more than just getting a salary.

The vision, mission, philosophy and strategy of a firm are usually developed by the top management, sometimes at an off-site location has many benefits (getting away from the day-to-day distractions for the purpose of this process).

c. Getting ready

After the mission and the philosophical basis have been defined, you need to start the actual work of preparing the business plan. Some important matters you need to address when getting ready are:

- *Appointing a coordinator*. Appoint the staff member who will be responsible for coordinating the business planning process and for delivering the final document (business planning project manager) in time.

- *Hiring a facilitator*. Consider the value of an experienced facilitator. Hire one if you do not have a staff member who is available and has the relevant experience and talent in guiding complex business planning processes. Very often an external person - neutral and independent - can be of value in moderating complex consensus-seeking sessions. This person should be knowledgeable about the requirements of the readers of the business plan.

- *Defining tasks.* Define the different tasks and steps involved in the process, the timing of these and the overall schedule for the work.

- *Identifying team members.* Identify the people who will be involved in the process and define their roles, competencies, responsibilities and expected contributions/deliverables.

- *Gathering information.* Gather and organize all the basic information that will be required from internal and external sources (market surveys, reports on competition, new technological developments, etc.). In addition to information available in-house, there are valuable sources and tools such as industry associations, databases and specialized consultants to be considered.

d. Setting goals.

Setting goals for the future development of the business is a prerequisite for the preparation of the business plan. Although these goals will have to be adjusted in the iterative planning process, they can still be of great value in setting the "tune" and "spirit" for further work. The goals should be time-bound, realistic and measurable. Examples of such goals can be:

- Over the next three years increase sales volume by an average of 20 per cent per year by intensifying marketing and sales effort in the neighbouring countries (export);

- In the coming year reduce production costs by 10 per cent through greater automation of production lines;

- By the end of the second planning year launch three new products on the local market.

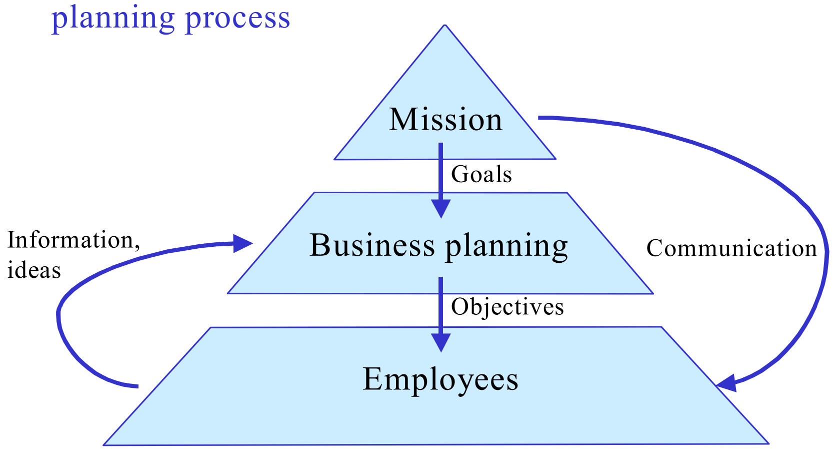
e. Working out the business plan

Working out the business plan basically involves synthesizing and harmonizing your marketing, sales, development, manufacturing, operations and financing targets in such a way as to enable the enterprise to meet its overall objectives. This "matching work" is usually conducted in an iterative process until full consistency of all elements of the business is achieved.

f. Setting employee objectives.

One of the most important actions after your business plan has been completed is to use it as a basis for setting the objectives of units and individuals in your firm. The objective of your sales manager is to achieve the sales volumes set in the plan. The production manager has to meet the quality standards and production rates anticipated. The development staff have, among other things, to meet the schedules planned for bringing into production the new product. These individual objectives should be fixed in writing and the results of the work should be monitored and assessed periodically. These should form the basis for the financial compensation of the employee.

Figure I.1. Role of the employees in the business planning process



Source: UNCTAD.

g. Monitoring the process.

Systematic monitoring of the implementation of your plan is a very important factor for the success of your business. Action plans, monitoring systems and constant feedback should be integrated to ensure successful implementation of the plan and achievement of its objectives. Participation in this process can have a profound effect on the way your team members view their role in the enterprise, and can have an immediate impact on their performance. If the business plan is completed and then locked up in a cupboard and forgotten for a year, your employees will never take business planning seriously again.

If key assumptions change, the plan must be adjusted. Accordingly, mid-term corrections are recommended. The key to maximizing the benefits of dynamic planning lies in implementation, action and keeping the plan up to date.

E. What is expected from the investor/lender?

In addition to contributing funds required to run and further develop the business as envisaged in the business plan, investors and bankers can provide support such as that described below.

- An experienced person from the investor organization should be assigned to the supervisory board of your entity. He/she could bring to the business new contacts with the market, new ideas and useful advice.

- If the investor is an operating company in a related business sector, there could be good potential for synergies and partner cooperation in one or more of the following fields:

    - Entering new markets through the network of the partner;
    - Adding the products of the partner to your list to enlarge your assortment;
    - Joint development and production efforts to take advantage of economy of scale effects;
    - Transfer of technical and management know-how, etc.

- If the investor is a government-sponsored fund with development aims, your company may get additional political and lobbying support.

F. Different types of business plans

The structure, content and depth of a business plans depends on many factors, such as:

- The main objective of the business plan;

- The stage of the business (start-up or existing company or spin-off);
- Type of business/industry;
- Financing situation;
- Size of the company, etc.

The brief discussion below gives some examples of relevant factors.

- *Type of business/industry.* If you are in trade, your business plan will not be dealing with issues such as manufacturing process or investments in machinery. You will put more emphasis on obtaining funds to finance the building up of your procurement and sales network and pre-financing the goods you will be trading with. The mix of products and services to be offered can also affect the content of a plan. Issues relating to inventory, storage and so forth become less significant as the product/service mix moves towards a pure service business. In any case, your business plan should cover standard issues such as development of human resources and marketing.

- *Sole ownership.* If you are a sole proprietor of a small business, perhaps you will be drafting the entire business plan yourself. For a small business, the size, complexity and effort spent in producing the business plan have to be kept within limits. In such a case the business plan has to put emphasis on your own person. Personal financial information may be required in order to support your statement that you will be allocating a certain part of your own funds as an investment in the business. You should also provide specific details regarding any personal non-financial assets that you plan to use in your business.

- *Transnational corporation.* The corporate business plan of a transnational corporation with an annual sales volume of several billion dollars does not put emphasis on the same issues as an average medium-size company with an annual turnover of a few million dollars. Issues covered in the business plans of transnational corporations are:

➢ Global image promotion strategies;

➢ Expansion through acquisition of other companies/mergers, etc.;

- Analysis of global macroeconomic developments and international politics that are likely to influence the business;

- Prediction of long-term trends and developments in demographic, social and consumer behaviour;

- Long-term product development (5 to10 years or beyond);

- Government relations and lobbying policies.

Issues of less significance for corporate business plans are perhaps the following:

- Production techniques (such corporations have many different types of products);

- Sales tactics (these could vary in different continents/countries);

- Staff policy (with perhaps the exception of top management in the different countries, etc.).

- *Divisional business plan*. The plan of a business division (unit) of a large corporation does not differ much from the business plan of an independent company. However, in addition to the standard issues covered in the business plan (production, sales, resources, etc.), it has to cover all issues of interfaces and synergies with the other units of the corporation.

- *Start-up business.* If you are just starting, you face a special challenge because you do not have an established track record. Instead, you must concentrate heavily on your ability to sell yourself and the partners that you may have as potentially successful businesspersons. It does not matter whether you are using your business plan in an effort to obtain financing or to convince prospective employees to come to work for you. You need to convince whoever reads your plan that your business idea is going to be a success. In essence, your ability to sell yourself is a substitute for the historical information that does not exist. Therefore, your plan should include personal information about all persons involved in the start-up venture (previous occupation, experience, business achievements, etc.), instead of the historical information that an ongoing business would be able to provide.

As is the case of an established business, you also need to provide projected profit and loss statements and a cash flow plan. These documents quantify the results you expect to achieve through your operations. Be sure to include any start-up costs that will be incurred prior to the opening of your business. While your business will probably involve certain expenses that are unique to your industry, do not forget some of the more common start-up expenses such as:

- Professional fees (legal or accounting);
- Regulatory charges (licensing, company registration costs, etc.);
- Deposits for rented space;
- Market study.

- *Major expansion of existing business.* If your business plan is produced with the main aim of raising finance to expand your business, the two following issues have to be properly covered:

  - That the market of the business sector you are targeting has potential for further growth; and
  - That your entity, on the basis of its history and competitive strengths, is well positioned to win a substantial share of this market.

- *Regularly continuing business.* There are also business plans that do not anticipate significant growth or major investments and therefore are not concerned with the issue of raising additional funds. In such cases, business plans are produced to inform or get approval from the decision-making bodies and existing investors and/or the team of managers write themselves in order to reach a common understanding of their goals and to determine their future priorities and activities. Obviously, in such business plans, less emphasis is put on justifying the market potential to accommodate growth. Many firms produce such business plans every year.

- *Financing stage.* As has often been mentioned, one of the primary purposes of producing a business plan is to inform your lenders and investors. If you are not seeking new money but only intend to keep your present financiers informed, you need to put less emphasis on the background of the business (which is already known), but to emphasize more new developments in the business. However, if you are approaching new lenders/investors (so-called second and third round and/or the stock market), your plan has to contain a more detailed description of the background of your business (including markets and products).

- *Specific project.* Perhaps you are drawing up a business plan not for the entire business of your entity, but only for an isolated one-time investment project such as:

  - Opening a subsidiary/profit centre in a specific country abroad;
  - Starting a new business unit for a set of new products or services.

For such business plans you need only to provide general information about the entire group. Your business plan should be concentrating on the new specific business you are planning. However, lenders or investors will be interested in having a wider picture of your company's finances in order to assess the overall financial risks. If your company has financial difficulties, obviously this will reflect on the project as well.

G. Format and organization of a business plan

Before discussing the content (substance) of a business plan, it is important to consider some basic issues regarding its format and presentation. If the plan has to look professional and to be a useful tool, then there are a number of points that require special attention, as discussed below.

- *The cover.* The purpose of a cover page is to tell readers what they are about to read and how to reach the author. The cover of the document is often the first impression of a business that any interested parties or investors get. Your cover page is also a way to make your business plan noticed. Financiers receive numerous business plans every week, but something as simple as a cover page on good-quality paper may attract their attention (and thus ensure that they give higher priority to the business plan). Your cover should bear the words "Business Plan" and should include:

  - The legal name of the business;

- The entity's logo. (If you have spent time and effort on a company logo, slogan or other identifying graphic or text, the cover page is the place to put it. If you have not considered these basic marketing tools, you are advised to do so. Building an identity is vital if you want people to recognize and remember your business.);
- The date of preparation or modification of the document, and the period it covers.
- The address;
- The telephone number;
- The fax number;
- The e-mail address and website (Internet address) if applicable;
- Other contact information, if any.
- Optional: a notice advising the reader that the plan is confidential. If you have prepared multiple copies of your business plan, you might also put a copy number on the cover page to ensure control of distribution.

The cover should be attractive and look professional. The fonts used should be easily readable, and colour contrasts should be pleasant to the eye. Any nice graphic or photograph could make it look even more appealing.

- *Table of contents*. Your table of contents provides readers with a quick and easy way to find individual sections in the plan. Be sure to list headings for major sections as well as for important subsections. If your table of contents is more than one page long, reconsider the length of the entries, the length of your plan and the number of documents you have attached.

- *Paper.* Print the plan on good-quality paper. Print on one side of the paper only.

- *Contact person.* Be sure to include identifying information for the business and to name the person who should be contacted regarding the plan.

- *Fonts.* Use a typeface that is easy to read and a font size that is large enough to prevent eye strain. This may require tables with financial projections to be spread over several pages in order to maintain legibility.

- *Margins.* Maintain reasonably wide margins. These are useful to readers for noting their questions and comments.

- *Terms and acronyms.* If your business uses specialized terminology or acronyms, use them sparingly and be sure that you define any terms that someone outside your area of expertise would not know.

- *Page numbers.* Number the pages, and be sure that these numbers are correct in the table of contents.

- *Size of document.* Keep the plan short and concise. Limit the inclusion of extraneous material. You can always provide additional detail in an appendix, if required.

- *Samples.* Include in the appendix samples of advertisements, marketing material and any other information that aids the presentation of your plan.

- *Editing.* Be certain to edit the document carefully. Spelling mistakes and grammatical errors do not make a good impression. Modern word-processing software provides effective spelling and grammar checking tools - use them. It is worth while having one or two persons to read and check the text and figures again.

- *Binding.* Bind the document so that it lies flat when opened.

- *Overall quality of presentation.* Do not go overboard on expensive binders, binding, embossing etc. According the form of the plan more importance than its substance can raise doubts among those reading it. But not let it look cheap or sloppy.

H. Planning period

One of your first questions would probably be when starting the planning work: “For what period of time should the business plan be prepared?” There is no straight answer to this question. There are entities planning for only one year, but there are also entities planning for 10 years or more. However, statistics show that most entities tend to produce business plans projecting from three to five years. The optimum planning period depends on the type of business and kind of company. Some important criteria and considerations in deciding about the time-span to be planned for are set out below.

- *Break-even point.* If you are starting a new business or planning a major expansion of your existing business, you expect probably to have a net loss for the first one or two years. In such a case, your business plan should go beyond the break-even point and also cover at least two profit-making years. This means that your business plan should cover a total of four years. It is psychologically important that your lender or investor sees at least two consecutive years of profit at the end of which dividends can possibly be paid.

- *Management fluctuation.* Management fluctuation in an average company varies between 10 and 15 per cent per year. If in your company the turnover is about that rate, it means that, within four years, more than half of the managers will have changed. In such a case it does not make sense to plan for any period beyond that. It is important that future managers contribute with their own ideas to the planning of the business for their period of time. On the other hand, if you are in a family business or if the management is a small team of partners committed to the firm, you may be able to plan for a longer period of time.

- *Infrastructure development (project) period.* The appropriate business plan period would also depend on the time scale required in order to develop the infrastructure needed for the business.

If the business you are planning is the acquisition of land, planting of rubber trees and production of latex, you should be thinking of a time frame of at least 10 to 15 years. Rubber trees are usually ready for latex production when they are about six or seven years old. Maximum output is reached when they are about 10 years old. On the other hand, if you are planning to lease a farm and equipment to grow tomatoes, you are in business earlier. A few months after you have leased the farm and planted the tomatoes, you can bring the produce to the market and generate cash. Therefore, in this case a planning period of between one and three years may be sufficient.

Projects with typically long planning periods are infrastructure projects. Power stations, motorways and the like take a long time to construct and require substantial investment, and the depreciation of capital expenditure must be spread over a long period. Therefore, planning periods of 20 to 30 years are often necessary for such businesses.

At the other extreme are businesses that are quickly set in motion and do not require major investments in infrastructure. A typical example is the trade business. If you are an intermediate in exporting textile garments, your only infrastructure may be a small office. You can engage a transportation company to deliver the products directly from your supplier to your buyer and thus you do not even need storage space. In such a case, you do not necessarily need a business plan for more than a couple of years.

Box I.1. Where did the habit of five-year planning originate?

The former Soviet Union offers an interesting example of how planning periods are determined by the time scale required to complete infrastructure projects. The entire economic development programme of that country was based on consecutive and centrally planned five-year cycles. These came to be known as "five-year plans". This five-year rhythm was adopted later by other socialist Governments. Furthermore, many Western enterprises adopted the habit of planning their businesses on a five-year basis.

Why did the Soviet leadership choose a five-year cycle? The explanation goes back to the first five-year plan for the years 1928-1932. At the end of the revolution, the industrial capacity of the country was in a dire state and far behind that of Western Europe and the United States. It was during the mid-1920s that the Soviet leaders drafted an ambitious industrialization plan at the core of which was steel, energy and heavy machinery production. The "flag ship" of industrialization was the colossal Magnitogorsk iron and steel plant, which was to deliver the much-needed raw material. Other elements of the plan were the huge Tchelyabinsk agricultural machinery plant and the Dnepropetrovsk hydropower station, which was one of the largest in the world at the time. This national industrialization programme formed the central part of the overall economic plan.

The completion period for Magnitogorsk and all peripheral and associated industries was forecast to be about five years. The time frame of the first plan (1928-1932) was chosen so as to include start-up, output and other industrial achievements at the end of the planning period. In this period, a total of 64.9 billion roubles was invested in the economy, 23.3 billion of which was allocated to heavy industry. As a consequence, it became customary to plan the development of the Soviet economy on the basis of five-year plans.
Source: UNCTAD.

- <u>*Market/client development period.*</u> Most business plans show growth of the business over time. An important assumption is that the number of buyers will be increasing as the firm becomes better known in the market. Thus, the rate of growth of a company depends on the time factor required for making itself or its products known. If you plan an art gallery for selling paintings and sculptures, you may find that it would take five to eight years for you to acquire a reputation and for the sales curve to begin to flatten. But, if you establish a fast food shop in the main passage of the central train station, you may find that you achieve the maximum amount of sales within a few months. In the first case, it takes a great deal of time for art lovers from the region to discover your gallery, familiarize themselves with the art you are selling and decide to buy. Here, word of mouth plays an important role. In the second case, people passing in front of your shop (most of them while commuting every day) will very soon discover the appetizing sandwiches in the window. Therefore, in the case of the gallery, you may need to plan the business for a longer period of time than in the case of the fast food shop.

- <u>*Macroeconomic stability.*</u> If you are operating in an environment of stable and easily predictable macroeconomic conditions, you can afford to make financial projections for a longer period of time. If, for example, inflation and interest rates over the past five years have been stable (varying only within a band of a “few” per cent), you can reasonably plan for a period of another five years. If, on the other hand, these parameters vary significantly and there is no reason to believe that a more stable and predictable situation can be reached, there is no sense in making financial projections over a period longer than two to three years.

- <u>*Product technology.*</u> Technologies have life cycles. The business plan period would also depend upon the type of product, its technology and the technology used in producing it. If you consider setting up a facility for producing cotton T-shirts or blue jeans, you can be almost sure that for many years there will be no radical change in the product or the way it is produced. There can be a danger of more competitors coming into the market but no threat of product substitution. Consequently, from the product and technology point of view, you can reasonably plan the business for five years or more.

But if you are setting up a small firm to provide services in relation to Internet access, you cannot be sure how your business will look after two or three years. Not only is this market completely open for any competitor to enter without a major investment, but also technological developments occur so rapidly that projections beyond two to three years would not be sensible.

Average period

As a general practice, for an "average" business a four-year plan is reasonable. This does not mean that somebody has to plan in detail month by month, or week by week, what is going to happen over the next 48 months. The level of detail will decrease as your plan extends further into the future. The cash flow that is tracked monthly during the first year of operation may be projected by quarter in the second year, and annually in the third and fourth years. For the first year you may have to plan (budget) on the basis of actual costs (actual salaries, rent, etc.) and most probable sales (confirmed orders, identified opportunities, etc.). For subsequent years, you have to make some assumptions about how sales and costs are expected to develop. The most usual practice is to update the business plan on a yearly basis.

I. Content and structure of a business plan

After you have considered the purpose of your business plan and have done the necessary background preparation, it is time to consider the actual elements that you will include in the written document. This should contain five types of information as follows:

- The mission of your business and the objectives you want to achieve;
- Your targeted markets and clients, the products and/or services you will provide and the position of your competitors;
- The qualitative and quantitative results you expect to achieve;
- The human resources, infrastructure, equipment, raw material and financial resources you need in order achieve your goal in business;
- The technical, organizational and administrative processes you will apply.

The above information can be conveniently structured in your business plan in to eight chapters, as follows:

1. Executive summary
This is arguably the most important single part of your document. It provides a high-level overview of the purpose of the business plan, the main highlights and the financial resources required.

2. Background

This is the section that provides summarized entity-specific information, describing the business organization, location and premises, principal products and customers, key data, constitution/ownership and management, history, and business strategy and vision. It gives the reader an initial overview of the business before specific details are provided later on.

3. Products and services

Product description and history, product attributes, research and development, costing and pricing, production process, quality assurance and control, sourcing and intellectual property.

4. Markets and clients

Market characteristics, clients, competition, positioning, marketing strategy and projected sales.

5. Business operations and organization

Location and premises, marketing and selling methodology, manufacturing, distribution, order processing/inventory control, company structure/organization, project management and management information systems/reporting.

6. Human resources

Management (shareholders, board of directors, executive/operations management, middle management, external support services) and personnel.

7. Legal framework, and environmental and social factors

Approvals and licensing requirements, environmental risks, social compliance, development and social benefits.

8. Financial planning

Financial history (financial statements), projected income statements, cash flow, balance sheet and important ratios, funding requirements and other supporting information.

Appendices

- Product literature;
- Asset valuations;
- Historical financial statements and auditor’s reports;
- Legal documents (for example, company registration);
- Curriculum vitae of key management persons;
- Market research;
- Other relevant and important information.

The above chapters are presented in the order in which they usually appear in a typical business plan. But do not feel constrained to follow this format exactly if another way makes more sense because of the specifics of your business.

The following chapters in this manual discuss criteria and considerations that may be of use to you when preparing the above-mentioned chapters of your business plan.

PART TWO
BASIC ELEMENTS OF A BUSINESS PLAN

CHAPTER II

EXECUTIVE SUMMARY

The executive summary is probably the most significant part of the entire business plan. It is what most readers will read first. Lenders or investors in particular read executive summaries before looking at the rest of a plan in order to determine whether they are interested in this business and want to learn more about it. Numerous business plans are submitted to lenders every week. Not all of these plans are reviewed in depth. In fact, only a small fraction of them are read beyond the executive summary.

Therefore, even though your whole business is well described later on, a short summary highlighting the key points of your business plan helps to persuade the reader to study the complete document, thus greatly enhancing the chances of obtaining the financing you are looking for.

Important points regarding your executive summary are as follows:

- It should be between one and three pages long, and should take only a few minutes to read.

- Even though your executive summary is the first part of your plan, write it last.

- In drafting your executive summary, you may include a few sentences from other important sections. The statements in the summary should be consistent with the information and wording in other parts of the business plan.

- The words should be chosen carefully and should be crisp, comprehensive and interesting to read.

- Polish your executive summary. Have several people read it - both those who know your business and those who do not. Ask for their opinion and suggestions.

The contents of the executive summary can be divided into three parts as described below:

1. Purpose of the business plan

↓

2. Highlights

↓

3. Financial requirements

A. Purpose of the business plan

This is a short section stating the main purpose for developing and presenting your business plan.

When writing your business plan you may have various objectives in mind. The readers you are targeting could also be interested in different aspects. However, the basic objectives of your business plan that you probably need to mention are threefold:

- To ensure for yourself the viability of the business you are planning to start (or expand or simply continue the same way);

- To raise new capital from outside investors or lenders (or to inform and assure present investors or lenders about the progress of the business they have financed);

- To establish the basis for developing a detailed plan of activities.

B. Main highlights

The main questions to be discussed briefly in the executive summary in order to give the reader a quick overview (of about a half to one page) of your business are the following:

- *Type of business*

- What is your company's type of business? (Production? Services? Trade? What sector?)
- What are its product lines and services? What are they used for?
- Where is it located?
- What are the main facilities? (Production factory? Storage facilities? Transportation fleet? Just offices?)
- How many employees does it have?
- What is its mission and what are the overall business objectives? (A short mission statement can be appropriate here.)

- *Corporate structure*

- Is it a business start-up or expansion?
- When was it formed?
- Who established it and how?
- What is the legal form of the company? (Sole proprietorship? Partnership? Corporation?)
- Who are the key persons in the business today?
- What is the share distribution? (Mention the principal shareholders.)

- *Markets and clients*

- What is your primary market? (Local? Regional? Export?)
- What is the size of the market and its growth potential?
- What is your market share? How will it develop?
- Who are your most important clients?
- Who are your main competitors?

- *Financial features*

This paragraph should include historical and projected key financial data such as revenues, net profit, total assets and equity. It should also include the main assumptions used in forecasting.

- *Major action plans*

In this paragraph you should briefly summarize any major action plans you have for the future. Particularly important are those plans which will absorb considerable financial resources (Expanding into a new market? Developing/introducing new products? Building new facilities? Modernizing existing production lines? Restructuring the business?)

C. Financial requirements

If one of the main objectives of your business plan is to mobilize additional funds, this section of the executive summary has to include the following:

- What is the total amount of funds you require?

- In which currencies? (Local? Foreign? Both?)

- For which purpose? (Working capital? Purchase of new machinery? Development of new products? Refurbishment of plant and equipment?)

- When do you need the funds? (The first part, the second part, etc.?)

- Are you seeking shareholders' funds? Loans? Or a combination of both?

- Are your forecasts based on optimistic, realistic or pessimistic assumptions?

- Borrowing. What type of borrowing do you require? (Overdraft? Term loan?) How and when do you plan to repay the money? What guarantees or collateral are you able to provide?

- Equity. What kind of capital stock is offered to investors? (Preference shares? Common shares? Convertible loans? Other?) What is the anticipated return on investment? When may investors expect it? What are the exit terms for the investors?

D. Example of an executive summary

Executive summary of NileJam in Egypt

The present business plan is established with a view a to a major expansion anticipated by NileJam. Its objective is twofold: to be used as a basis for developing cooperation with a new business partner in Europe and to seek bank loans to finance investments planned within the foreseeable future. This summary highlights the key points of the business plan.

NileJam specializes in the production and marketing of jams and marmalades. The main products are 250 gram glass jars containing processed fruit of the region (oranges, strawberries, figs, mangoes, apricots etc.).

The company is located in a small town called El Amriya. This town is situated on the western edge of the Nile Delta and about 30 kilometres south of Alexandria along the desert road to Cairo. The infrastructure consists of four connected buildings constructed on a piece of land of two hectares owned by the company. These house the following facilities:

- A cool storage unit of 4,000 cubic metres capacity;
- Fruit processing lines (sorting, peeling, washing, crushing, evaporators, sterilizers, filling machines, etc.);
- The main storage building for keeping the empty jars, sugar and the final product.
- Offices and canteen.

The company employs 220 full-time and 180 part-time (seasonal) staff. Its mission is to add value to fruits of the region by producing superior-quality jams and marmalades and sell these to national and international markets at competitive prices.

Hassan Machfus established NileJam in 1974. Together with his wife and three relatives he started producing orange jam. The fruit was bought from neighbouring farms. He delivered the product in 5 or 10 kilogram plastic containers to pastry shops and hotels in Alexandria. After his retirement in 1999, his daughter Fatima Machfus and his son Ahmed Machfus took over the business. Today, NileJam is a joint-stock company with a share capital of 5 million Egyptian pounds. Fatima and Ahmed each hold 50 per cent of the shares. They are jointly responsible for the executive management of the firm. Fatima supervises the finance, administration and sales/marketing functions, while Ahmed is in charge of product development and production.

About two thirds of the total production is supplied to the Egyptian market and distributed through five chains of food supermarkets. The other one third is exported to surrounding Arab countries, particularly Saudi Arabia, Kuwait and Libyan Arab Jamahioiya. For each of these countries, NileJam has an exclusive agreement with a single distributor.

Last year's total sales were 18 million Egyptian pounds. Revenues over the past three years have grown steadily at about 25 per cent per year, mainly as a result of the company's gaining market share from competitors thanks to faster delivery service and better quality. The corresponding net profit margin was 9.0, 10.0 and 10.5 per cent respectively. The company now has about 10 per cent of the Egyptian market, which is estimated to be worth about 120 million Egyptian pounds. The total market for exports in the above-mentioned countries is roughly 90 million Egyptian pounds and the share of NileJam is on average about 6 to 7 per cent.

A recent major success of the company is its agreement with Delicia Foods Inc. of Denmark, which specializes in the supply of food products to hotels and restaurants in the European Union. Under the agreement NileJam is to produce, under the brand name and, according to the recipe of Delicia, individual portions of jam (30 gram containers). Also, Delicia was given the option of a 20 per cent participation in the equity of NileJam. A decision on this option will be made within two years.

This new cooperation is expected to contribute substantially to the growth of revenues and profitability. Financial projections are showing Nilejam´s a sustainable growth of 30 per cent over the next three years. Net profits are expected to increase gradually to 15 per cent by the end of the third year. However, the new cooperation requires the following investments:

- Construction of two new production lines according to the quality standards and specifications of Delicia (mainly evaporators/concentrators and filling/packaging equipment);

- Expansion of the existing cool storage capacity by another 2,000 cubic metres.

The total investment to be made in the first quarter of next year is estimated to be 2 million euro plus 5 million Egyptian pounds. Delicia has agreed to provide a loan of 0.5 million euro. The owners of NileJam are prepared to contribute with a shareholders' loan of 2 million Egyptian pounds. Therefore, the external financing required is 1.5 million euro and 3 million Egyptian pounds. These funds are to be available on 1 January of the coming year. The repayment of the loan to the external lender can be made in two instalments: the first half to be paid one year after and the rest two years after the loan disbursement. The interest rate assumed in the financial projections is 8 per cent for the euro and 12 per cent for the Egyptian pound loan. The assets of NileJam are unencumbered and the company has no debts at the present time. The fixed assets of NileJam, with an estimated value of 9 million Egyptian pounds (including land, buildings and equipment), are offered as collateral for the loan.

CHAPTER III
BACKGROUND

This section of your business plan may consist of a few pages of background information that is specific to your particular business. The reader should be given a rapid overview of what your business is, how it started, how it developed over the years and where it is heading. This will be a useful preparation before the details are set out later. You should also briefly describe how the business is organized and the resources and infrastructure required for running it. The business background section generally covers the topics discussed below.

A. Main products, markets and clients

Without going into much detail, this section should briefly describe:

- Your most important products or services;
- What they look like and how are they used;
- Their distinguishing features or innovative characteristics;
- The existing and targeted markets (local, regional, national, international/export);
- The size of the target markets and their growth potential;
- Your present and future market share;
- Your customers. (Consumers? Which demographic category? Businesses? What type of businesses?);
- The main strengths and weaknesses of your products and services compared with those of your competitors.

B. Location and premises

Later, a special section will describe in detail the location and premises of your business. In the present section, you should give a short summary only. Typical examples of descriptions of a manufacturing entity and of a service provider are given below.

➢ Production of mango concentrate

The main assets of the business are a mango tree plantation and a factory for processing the fruit in Burkina Faso. The plantation covers of 80 hectares, 75 per cent of which are planted with fruit-bearing trees. It is located 30 kilometres south of Ouagadougou on the road leading to the border with Ghana.

The factory is situated at the south-eastern corner of the plantation along the north-south road. The plant consists of four buildings:

- A building covering an area of 900 square metres for storing equipment and fruit before processing;
- A factory housing two fruit-processing lines;
- A refrigeration building with a total capacity of 300 cubic metres.
- An office and a canteen with a total area of 400 square metres.

➢ Software development

The offices of the company are located in a new three-storey building four kilometres away from the centre of Chennai on the road to the international airport. The company occupies the entire building of 1,600 square metres. The open plan offices on the first and second floors accommodate 80 software developers and information technology consultants. The third floor is split up in to individual offices for the administrative personnel, management and meeting rooms. The underground floor contains the air-conditioned computer server rooms, archives, material storage rooms and a canteen.

C. Key data (personnel, total production, revenues)

Key data are useful for quickly grasping the size of the business. Typical data are:

- Number of personnel;
- Total production (in numbers of products, tons etc.);
- Annual revenues and profits;
- Number of clients (per category);
- Number of affiliates (domestic, foreign);
- Number of countries to which you are exporting.

D. Legal form, ownership and management

The human resources section of your business plan should include detailed information about the owners, the board of directors and the management. You should provide a brief introduction to the structure of the entity and the reasons for the choice. Specific questions that the lender or investor would like to have answered early on in the document are:

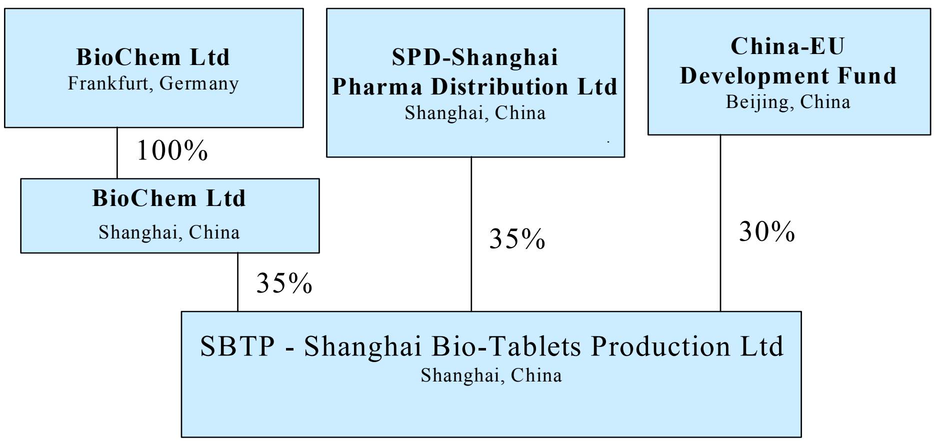
- Is the business a partnership or a limited company? What are the reasons for the form of constitution?
- Are shares traded on the stock exchange? If yes, where?
- Who are the shareholders and who holds the majority/control of the company?
- Who are the key managers? What is their background and what strengths do they bring to the business (experience, expertise, special abilities, etc.)?

- Do the management and other employees hold shares? If so, what is their participation?

This short section should give potential lenders or investors enough information to understand which forces drive the business and who the decision makers are.

An organization chart showing the legal and shareholding structure of the business, as shown in figure III.1, is an attractive feature.

Figure III.1. Example: Legal shareholding structure of SBTP Ltd



Source: UNCTAD.

E. Historical development and track record of the business

If your company has a long history and a successful track record, it is easier to convince the reader that there are good chances of success in the future. If not, you have to have strong arguments to prove the viability of your business. If your company has done well until now, it has a reasonably good basis for being successful in the future, unless there have been very unfavourable developments. Particular questions of interest are:

- Who started the business and when?
- How did the business idea start?
- Where was the first domicile, and where were subsequent ones?

- What were the original products? How did these develop into the products of today?
- What was the growth rate in the light of key data (number of personnel, production capacities, sales/revenues, total assets, equity, number of clients, subsidiaries etc.)?
- Are there any particular achievements?

F. Business strategy and mission

In this section you should summarize your business strategy and mission. Here is a typical example:

Production of dry mango chips

A company has been producing and exporting mango fruits to Europe for many years. The margins have been declining owing to increasing competition, rising transportation costs and greater losses caused by mangoes rotting while waiting to be sold/transported.

"The new <u>strategy</u> is to build on the plantation site a plant for processing mangoes and producing dried chips. The objective is to add value to the product locally and to reduce transportation costs and losses."

"The <u>vision</u> is to become the largest supplier of high-quality dry mango chips to the European markets."

"The <u>mission</u> is that consumers benefit from buying an extraordinarily tasty and healthy product at a reasonable price."

G. General organization/operating units

In this section you should elaborate on the main operating units (production unit, development unit, marketing and sales, etc.) and the relationship and interactions between each of them.

A diagram shoving the main elements and units of your business, such as the one below, will be useful for the reader of the business plan.

CHAPTER IV
PRODUCTS AND SERVICES

In this section of your business plan, describe your products or services, emphasizing any distinguishing features that may give you a competitive advantage. Discuss what market demand your products or services will meet, and outline the plans for future development. The following specific information should be included.

A. Product description and history

Provide a description of your product in detail, but in terms understandable to persons who are not experts in the field. Explain how it looks, what it does, how it works, how long it lasts, what variations and options are available, etc. There should be a particular focus on how the product or service will be used. Where appropriate, include photographs, diagrams, sketches, general product specifications, engineering studies and sales brochures, if any (as annexes to the business plan). Go into as much detail as necessary for the reader to have a clear understanding of what you are selling.

Another issue to discuss is whether you expect to sell items on a one-time or infrequent basis, or whether repeat sales or after-sales services are an important part of your business. For example, if you are opening a food supermarket you are going to count on the same customers returning on a regular basis. If you are selling cars you expect that repairs and routine maintenance will make a considerable contribution to your business. But if you are a civil contractor specializing in the installation of roof insulation, you are probably not going to provide the same service to the same client within a short period of time. A similar issue to discuss is how long the product or service will last and whether you intend to upgrade or replace the product or service at some point in the future. Some business are interested in product updates or after-sales service almost as much as in selling the initial product or even more (software providers, elevator suppliers, etc.).

If relevant to your business, a short history of the product should be included for the reader to understand the evolution of your business. Important questions to deal with are: When did the first products in the series enter the market? What were the initial difficulties encountered with the product? What are the features of the new product compared with old designs?

B. Product attributes

In this section you should concentrate on the features that make your product or service unique and preferable for customers.

An effective way to present a particular product or service is to show a features/benefits analysis. A feature is a specific product attribute or characteristic. A benefit is the advantage a customer or user will derive from the product or service. Consider the following two boxes, which illustrate this type of analysis through practical examples.

Example 1: Tourist tour through Ukraine on a boat

Take as an example a travel office that offers package tours to foreign tourists interested in spending a holiday in Ukraine. The tourists wish to see as much as possible of this country within the time and budget available to them. The package offered is a two-week boat cruise along the river Dnieper. It includes:

- Air travel from abroad to Kiev;
- Two weeks accommodation on the boat;
- Two days sightseeing in Kiev;
- Travel along the river from Kiev to the Black Sea and then back to Kiev;
- Daily excursions to the countryside, including visiting cities along the way such as, Zaporozhye, Dnepropetrovsk, Odessa and Sevastopol and Yalta in the Crimea;
- Air travel from Kiev back to the home country.

The table below sets out the features/benefits of the programme (for example, compared with renting a car and making the tour individually).

Features	Benefits
➢ Boat travels along a low-traffic-density river in an idyllic and serene part of the country.	➢ Relaxation.
➢ Tourists will always sleep in the same rooms (cabins) throughout their vacation.	➢ No inconvenience and waste of time through often packing and unpacking personal belongings.
➢ Boat will be moving mostly during the night and will be anchored during the day when people go on excursions.	➢ Optimal use of time for seeing as much as possible of the country.
➢ Excursions are guided by knowledgeable staff who are accommodated on the boat and do this work regularly.	➢ Learning about the country's history, cultural heritage and folklore.
➢ The package deal includes everything for a lump sum price: air travel, cabin and meals, entertainment on board, excursions, service, etc.	➢ Cost (and price) effective means of touring. Tourist can plan his/her budget with precision.

Example 2: Recordable compact disc for music

Take as another example the vinyl compact discs (CDs) for recording music or data. The table below gives a features/benefits analysis of such products.

Features	Benefits
➢ Digital recording and replaying by using a laser beam technology.	➢ Music can be copied and reproduced with practically no losses. Clear and clean sound with no effects of electrostatic, dust, scratches, etc.
➢ Large amount of data can be compactly stored within a small and light piece of vinyl material.	➢ CDs do not take much space to store and are convenient to carry around.
➢ Globally standardized product.	➢ Flexible and universal in use. Can be used in the home stereo system, in the car disc player and in the portable player. Can be given as a present to a friend, who most probably also has a compatible player.

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C. Research and development

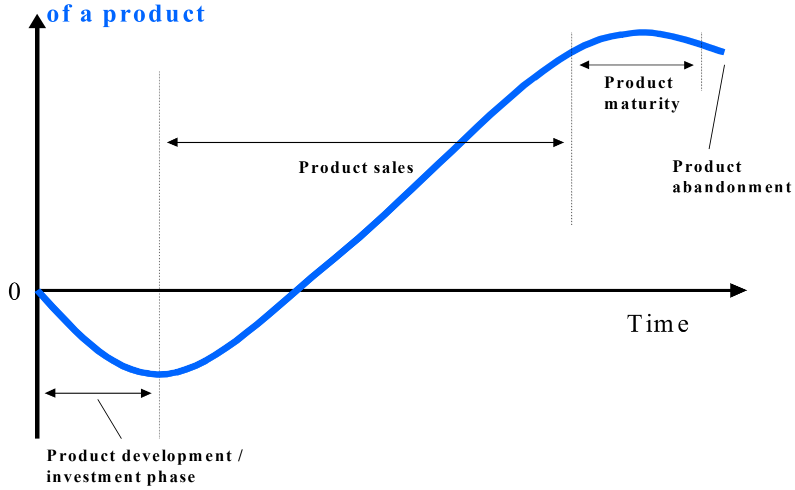
In this section you should describe any research and development activities that are required before you launch your product. Describe the current stage of your product or service development and give a clear indication of the effort/cost involved and the time required for completion. Be realistic about the effort and the time it will take to develop it. These points are often underestimated, and this leads to serious financial difficulties before the product is ready to be sold and bring in cash. Therefore, readers of your plan, especially potential investors, will scrutinize your development plan to determine whether you have taken into consideration all issues that could lead to delays or cost overruns.

Describe the plans for future development of the product, as well as any plans for development of new or related products in the light of changing market needs.

D. Product life cycle

Each product has a life cycle. The first phase of the cycle is development. During this phase the firm has to invest to develop a concept, design the product and the process for producing it, build and test the prototype, set up the manufacturing line, etc. Then comes the phase of selling the product. Sooner or later the product will reach maturity, it will become obsolete and will have to be abandoned. The income in such a cycle is shown graphically in figure IV.1.

Figure IV.1. Accumulated income during the life cycle of a product



Source: UNCTAD.

Typical examples of products with limited life cycles are cars, personal computers and fashion articles. Almost every year suppliers put new models of such products on the market. Many companies start working on the development of a new product as soon as the previous product enters in the market, or even before. A typical chain of product cycles is shown in figure IV.2. In this example, the income from the sales of existing products is partly used to finance the development of new products.

Optimum timing of different product cycles is very important for the overall success of a company. Being too quick or too slow in starting the development of a new product, or in introducing it into the market, may result in a serious gap in cash flow or/and affect the overall profitability of a business. Therefore, it is important that your business plan deals with the timing of the cycles of the future generations of products. Your financial projections will then show how this timing affects the overall cash flow and profitability of your business.

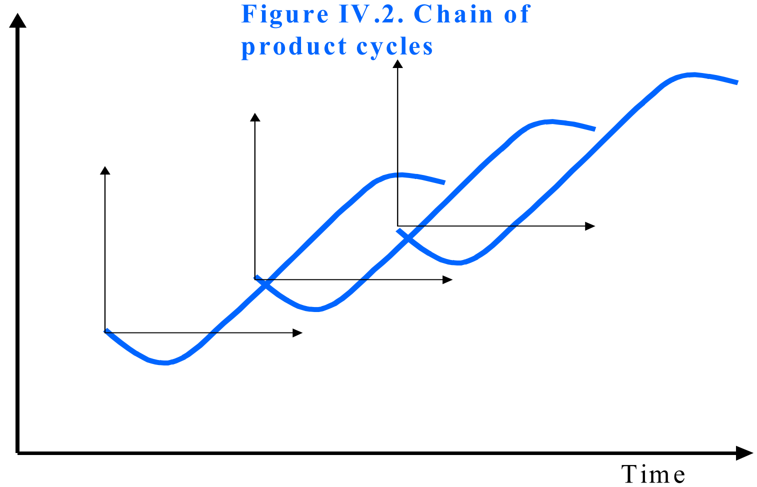


Figure IV.2. Chain of product cycles

Source: UNCTAD.

E. Costing and pricing

1. Costing

By estimating the cost of production and the directly connected overheads you set up the basis for developing your pricing policy and for preparing the financial plan of your business.

The cost of your business is composed of four basic components that need to be briefly discussed in your business plan. These are explained below.

- *Cost of product development.* This budget may include the costs of any fundamental research, product development and design work as well as the costs of producing and testing a prototype. Be sure to include labour, materials, consulting fees, certification costs and the costs of professionals such as attorneys. Development costs are relevant not only for companies making products. Service businesses also incur costs in developing their services. Consulting companies, for example, incur costs in developing methodologies and tools, training their staff and preparing documentation.

Design and development costs expected in the future are often underestimated. Also, the real costs of past development work are often neglected and not fully included in the price of a product. When planning costs, also provide a contingency plan for what will happen to costs if problems such as delays, a failure to meet industry standards and mistakes occur. Such problems are common.

In many cases regulations allow for the costs of developing a product or a service to be entered on the asset side of the balance sheet. In such a case those costs can be treated as any other investment of the company (for example, the purchase of machinery and equipment) and thus be depreciated over a period of time. The depreciation period is dependent on the life cycle of the product developed as well as on the tax regulations.

- *Cost of goods.* For a manufacturing company, the cost of goods is the cost incurred in the production of the products. In such a case, the costs included are those for materials, labour and overheads related specifically to product manufacturing. You can work out the average "cost of goods" for each product by adding all related costs mentioned above and dividing by the number of products produced. This unit cost will be a useful indicator in developing your pricing policy and assessing your competitiveness.

For a retail or wholesale business, the cost of goods includes the purchase of inventory and associated costs such as transportation and insurance.

When working out the costs of your goods, be alert in identifying any measure that can lower your costs.

- *Operating expenses*. To establish the total of your operating expenses, you add up all the expenses incurred in running your business. Expense categories include marketing, sales and overheads. Overheads include fixed administrative expenses such as management and secretariat, which remain constant regardless of how much business your company does. Overheads also include variable expenses, such as travel expenses, equipment leases, supply of electricity and office material supplies.

- *Depreciation and interest on capital.* This includes the depreciation of the equipment and infrastructure that are required in order to operate your business. As mentioned earlier, part or the whole of the development costs (depending on the stance of the tax authorities) can be entered on the asset side of the balance sheet and then depreciated over a period of time.

The interest expense for any loans needed to finance equipment or working capital is also included in this category.

2. Pricing

When establishing your price policy, you should examine two principal sets of questions:

- How sensitive are your target clients to price? How does the price variation influence their buying behaviour? Which spread of price levels is acceptable to them? How would they react to lower prices of comparable products from your competitors (buyer's standpoint)?

- Which price covers your costs and leaves you a satisfactory profit (seller's point of view)?

When setting the price of your products or services, a good balance of these two considerations has to be found.

a. Buyer's standpoint

The buyer's price acceptance will depend upon three main factors:

- Value. The value that your product brings to your clients is the primary factor determining the price they are ready to pay. The examples below illustrate some types of product values.

Suppose you are selling a specific electronic component to a supplier of complete systems. This component part would be of great value to your client if it forms a crucial part for the operation of the entire system and if his/her business is a profitable one.

The value of a consumer product can often be measured by how much it contributes to cover basic or important needs of daily life. For example, an ordinary pharmaceutical product (such as an aspirin) or a basic food product (say a loaf of bread) can often be of immense value to people when they need it.

Some products can also be of great value to clients even if they do not meet a primary or practical need in their daily life. Aesthetic and psychological factors can also play an important role. For example, some people are prepared to pay huge sums of money for a piece of art (say a painting) for only one simple reason: they just like it very much. Obviously, this piece of art is of great value to them.

- *Affordability.* Other important issues to examine when fixing your prices are the following: Can your target clients afford the price you offer? Is it within their budget? Is the level of income of the consumer group you are targeting high enough to enable them to buy your product? If your clients are businesses, can they include the price of your product or service in the overall price they are charging their clients without being too expensive themselves?

The above consideration is also important in differentiating between need and demand in the market. Your target clients are those who will ask for your products, i.e. those who need them but can also pay for them.

- *Competitive choices in the market place.* Although your product may be good value, and although your clients can afford to pay the price, you can be sure that they will buy it from elsewhere if it is cheaper there. The competitive choice in the market place is an important mechanism that keeps prices under control. Consequently, before fixing your own prices you have to examine the products and prices of your competitors.

Your pricing policy should consider all three criteria discussed above if you are to be successful in selling your product. People will buy it if it is of value to them, if they can afford it and if the price is competitive. If your product fails to satisfy one of these three conditions you will probably not sell it.

b. Seller's point of view

From the seller's point of view, there could be various policy options in setting the price. Important options are maximizing total profit, maximizing the volume of sales or maximizing the margin per unit sold.

The above options can be demonstrated by a simple example:

- Assume that you are planning to set up a small business assembling mountain bikes. You will be selling them directly to the end users from the shop of your small factory. Your market is your home town with a population of 25,000 inhabitants. You will be the only supplier in town. Until now, people in town were buying their bikes in the nearest, larger city.

- Together with a marketing consultant, a friend of yours, you have surveyed the characteristics of your target market and analysed the buying behaviour of your potential clients. You came to the conclusion that the number of bikes you may expect to sell will depend upon the price you fix for each bike. Your forecast is as follows:

➢ If you set the price of a bike at $310, you could expect to sell 260 bikes per year.
➢ For $350 you could sell 210 per year.
➢ For $400 you could sell 160 per year. Faced with the higher price, some people may not buy a bike at all; or they may make the extra effort and go to buy it cheaper in the neighbouring city.

- Then you estimate the costs of production for the different options. The cost per unit will be decreasing with increasing production because for bigger orders you will be getting better prices from your suppliers for components such as frames, wheels and brakes, and also because of economies of scale in your overhead expenses.

Then, you make your overall calculation as shown in table IV.1 and you discover the following:

With price option 1, you can maximize the overall sales volume. With option 2, you can maximize profit, and with option 3, you can maximize the margin for each bike you sell. Now, you have to make a strategic decision and set a price that serves your plans better:

- If you wish to gain more clients, become known quicker in the market and expand the business by introducing more products later on, option 1 is perhaps the most appropriate. In this way you are also establishing a reputation as a supplier with reasonable prices.

- If you choose option 2, your decision is also justifiable. It is the preferable option if you are looking to maximize net profits in the foreseeable future, but not necessarily to expand the business.

- With option 3, neither sales nor profit are maximized, but you get the best margin for each bike sold. There are not many advantages with this option, except that you have less work to do in managing the business and can still make a reasonable profit.

Table IV.1. Comparison of different pricing options

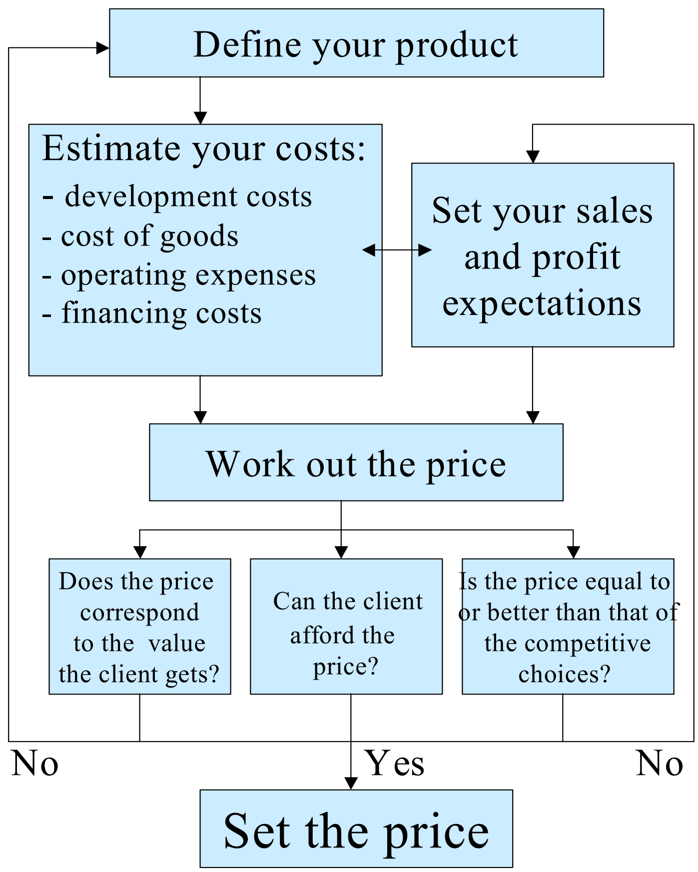
Dollar

Option	Price per unit	Expected Sales (No. units)	Total sales	Cost per unit	Margin per unit	Total cost	Profit
1	310	260	80 600	240	70	62 400	18 200
2	350	210	73 500	250	100	52 500	21 000
3	400	160	64 000	290	110	46 400	17 600

Source: UNCTAD.

Figure IV.3 gives an overview of all considerations discussed above in fixing the price of your product or service.

Figure IV.3. The method for setting the price of your product



Source: UNCTAD.

The above considerations may be of use in establishing your expected costs and developing your pricing policy. In the written business plan you only need to state the costs and prices of your products, giving a breakdown of the main elements and summarizing the key assumptions and methods you have applied.

F. Production process

Most investors will provide money only for a business that they understand. Therefore, explain to the reader the different stages of the production of your product, starting with the preparation of the raw materials and finishing with the last stage of making your product ready to be sold. With a service company, describe the process of delivering the service. Boxes IV.1 and IV.2 contain examples.

Box IV.1. Example: fish processing

As an example, assume a business of catching, processing and selling frozen fish to supermarket chains abroad. The description of the process could be as follows:

- Catching the fish with a fleet of four fishing boats (200 tons each) by trawling nets through the 400 kilometres long lake.

- Transporting the fish from the harbour to the near by factory in three refrigerated trucks (eight tons each).

- The fish is manually washed, filleted and vacuum-packed in plastic bags. Each bag contains one kilogram of fish fillet. This work is done by 40 people working along both sides of a 25 metres long process line.

- At the end of the process line, the fish packs are quality controlled and a label including the price is attached to them.

- The packs are frozen by passing them for 10 minutes through a shock-freezing machine of the “Antarctic” type (maximum capacity 1.8 tons per hour).

- The frozen products are placed manually in cardboard boxes with a capacity of 12 kilograms each. Then they are placed in the main deep freezer of the factory until delivery. The boxes are maintained at a constant temperature of minus 18 degrees Celsius.

Source: UNCTAD.

Box IV.2. Example: executive search

As a service example take the search for and selection of executive personnel. This process would most probably involve the following:

- Establishing the job profile together with the client;
- Design of the campaign;
- Search via a confidential network and/or the media;
- Pre-selecting candidates on the basis of their credentials;
- Further shortlisting through interviews;
- Presenting two to three candidates to the client and providing advice in the final selection.

Source: UNCTAD.

Part of your production process discussion should give a justification of the make-or-buy strategy for the different elements of your product. A make-or-buy strategy deals with the issue of whether you will manufacture all components of your product in-house, or buy some specific components from outside and integrate them into the final product. This should also apply if you are in a service business. If you are starting a business developing and selling software, you might decide to engage an administration service firm to do your invoicing, accounting and other logistic tasks (buy). This may increase profits by enabling you and your partners to spend more time on money-generating activities.

A firm producing telephone sets finds it advantageous to concentrate on the development of new designs and on the production of the basic electronic equipment (make). Production of the plastic casing is a different type of business and is left to outside suppliers (buy).

The consideration here is to maximize efficiency and cost-effectiveness by focusing effort and attention on the core part of the business and to leave peripheral components to others who can probably produce them better and cheaper.

G. Quality assurance and control

Many businesses go bankrupt every day because they are not able to deliver the quality of products or service expected by their clients. Bankers and investors are aware of this and like to see which measures you will be taking to ensure quality. Depending on your type of business, quality can be ensured by one or more of the following features:

- Use of high-quality raw materials and components;
- State-of-the-art design;
- Appropriate manufacturing process using a suitable process and equipment;
- Smooth finishing;
- Thorough inspection and testing of the final product;
- Appropriate packaging;

Very important for ensuring high-quality products and services is your policy with regard to selecting, training and motivating your staff. This policy should be covered partly in this section and partly in the human resources section.

If your products or services, production process or firm as a whole are certified or highly rated by any independent organization, this should be mentioned in your business plan. Customers will trust your capability to deliver quality.

H. Sourcing

In the sourcing section, the reader wants confirmation that the supply of the material and utilities required for production is ensured. Investors and bankers are aware that interruption in the supply of any essential material, spare parts or equipment could have a serious impact on the overall profitability and even viability of the business. Such supplies may include:

- Raw materials for the products;
- Outsourced components of the products;
- Spare parts for machinery and equipment;
- Energy (oil, gas, electricity, etc.);
- Consumable chemicals, lubricants, colours, etc.;
- Packaging material;
- Water, etc.

Depending on the location of your production facility, supply problems may arise because of import restrictions or custom delays, transport difficulties, unreliable logistics, etc. In this section of the business plan you have to convince the reader that you understand the critical issues involved and that you have contingency plans to deal with problems if they arise.

I. Intellectual property

Describe the patents and copyrights that your company owns and explain how these may give you a competitive advantage or a superior position in the industry.

If your business depends on important licences granted by others, give a short description of these licences and indicate who provides them. Explain how crucial they are for your production and how you have secured their use on acceptable terms in the future.

It is also important to assess and comment on the financial and technical strength of any licensor you may have. Investors or lenders may be interested to know what would happen to your business if your licensor went bankrupt.

CHAPTER V
MARKETS, CLIENTS AND COMPETITORS

A. Introductory remarks

The aim of this section is to convince investors and lenders that:

- You have a thorough understanding of the market.
- There is a demand for your product or service.
- Your company is sufficiently competitive to get a good share of this market.

Much of the planning work presented in the sections that follow (production plan, financial planning, etc.) will be based on the forecast of sales that you will make here.

The main issues that you need to cover in this section of your business plan are:

- Market characteristics;
- Clients;
- Competition;
- Positioning;
- Market strategy;
- Projected sales.

B. Market characteristics

In this section you should cover two main aspects:

- *Market characteristics.* This should be a description of your target market, using lifestyle, sex, age, occupation, geography, company size, business organization and other characteristics to describe the consumers or company clients likely to buy your product or service. You should also include comments about any special features of your target market, such as industry profitability, innovation potential of the industry, susceptibility to recession, substitution danger and client loyalty.

- *Market size.* Here you should summarize particulars regarding the current size of your target market and its growth potential in the short, medium and long term. Support any growth estimates with factors such as industry trends, new technological developments, socio-economic trends, government policy, population shifts and changing customer needs. Clearly state the sources and assumptions used and try to be realistic in the estimates. Do not overstate either the size of the market or the potential share you expect to get, otherwise the credibility of the entire business plan will be in question.

There are many sources of information to tap in creating a complete picture of your market. In addition to information you yourself have gathered over time, possible sources are:

- Government statistics bureaux;
- Specialized market survey consultants;
- Friendly competitors;
- Chambers of commerce and industry associations;
- Data bases accessible through the Internet;
- Commercial banks (these can sometimes be very knowledgeable and frank about the market in their region).

Remember to cite all sources for your data. This will confirm that you have done your work carefully and will assure the reader that your information comes from reliable sources.

C. Clients

In this section outline the existing and identified target client groups or major single clients (key accounts). Particular issues to be covered are:

- Who they are?
- Where are they located?
- Why do they buy?
- When and under what circumstances do they buy? What types of concerns do they have?
- What are their expectations concerning price, quality and service (are they primarily cost- or quality-sensitive)?

You may narrow down the range of your target clients by briefly describing customers you do not want to reach. For example, if you are in the business of delivering office materials to companies, you may not want to target service companies with fewer than 20 employees or manufacturing companies with fewer than 100 employees.

D. Competition

This section indicates where your products or services fit in the competitive environment of the market. Presenting your business in the landscape of its competitors shows that you understand your industry and are prepared to cope with some of the challenges to your company's success. In this section, you should provide the following:

- *Description of competitors.* A description of the main competitors, naming the companies and their trade marks, their size and locations, their annual sales and their market share, and how their products/services compare with yours in price, quality and other respects.

- *Relative strengths and weaknesses.* Where possible, assess the strengths and weaknesses of the competition in areas such as management, image, marketing, distribution networks, technology, production capability, financial resources and cost/price advantages. If you think that there are competitors a share of whose business you can capture, explain why you can do it better and how you will do it. Describe also how your competitors could possibly react to your strategy.

- *Those whom you do not consider to be competitors.* It may also be useful to describe briefly which companies in your sector or associated fields you do not consider to be competitors. The reader of your business plan may misunderstand who your competitors are. If this is the case, you will have to dispel that misunderstanding by explaining why these businesses are not in competition with you.

E. Positioning

How do you want to position yourself in the market? What do you want your identity to be? How do you want your clients, your business partners and your competitors to perceive your product or service?

- Do you want to be seen as a: Supplier of highest-quality products?

- Provider of excellent service to clients buying your products?

- Discount supplier of (low-cost) mass products and/or services?

- Quick and flexible provider of services?

- Trustworthy provider of consistently reliable services?

If you position yourself carefully, you will successfully differentiate yourself from most of the competition. However, take care in combining the above features. You can say that you are providing products of very good quality at reasonable prices. But do not make the mistake of saying that you can provide best-quality products at the lowest price and that you are also able to provide the best service in the market. Not many people will believe that.

The position you choose will form the basic element of your image promotion, advertising and overall marketing campaign.

Many companies have attempted to include in their portfolio products of different qualities (price levels) and thus target different segments of the market. Some have been very successful, but some have failed. The following are typical examples:

- *Japanese car manufacturer.* Toyota was known for many years as a supplier of simple, low-price and reliable cars. With these features it penetrated the world markets and became one of the largest mass-production suppliers. At a later stage, it started also producing models to cover the luxury/high-price segment. This has been done successfully.

- *European pen manufacturer.* Caran d'Ache was for many decades a supplier of expensive gold-plated pens. In an effort to diversify and expand its business, it started more recently also to produce low-price plastic pens. This was done successfully. The good brand name of the luxury product helped in penetrating the market for the cheaper product. Furthermore, the introduction of the latter did not damage the image of the firm as a supplier of luxury pens.

- *European shoe manufacturer.* A shoe manufacturer of traditionally high-quality/high-price (niche market shoes) attempted to expand the business by starting production also of medium-quality/medium-price shoes under the same brand. In trying to use the excellent brand name to penetrate the mass-product segment it confused the market. The lower quality of the cheaper products damaged its image as a supplier of exclusive shoes. The image it acquired in the end was summed up in the words: "Still expensive but not necessary of best quality".

If you are planning to expand your business by introducing new products of a different quality/price level, important questions to be examined are:

- What are the chances of the market accepting your new product?

- What is the potential for damaging the image of existing products?

- What are pros and cons of introducing the new product under a new brand name?

F. Market strategy

After you have examined the attractiveness of your market and you have examined your competition, it is perhaps useful to rate your business through a simple *portfolio analysis*. This could give you interesting hints for developing your business strategy and positioning yourself in the market. The analysis can be done in four steps as follows:

Step 1:
Rate your business by using the criteria listed in table V.1. The average at the bottom of the table gives an overall rating of the competitive advantage of your firm.

Step 2:
Rate the features of your target market by using the criteria listed in table V.2. The average at the bottom of the table gives an overall rating of the attractiveness of your market.

Step 3:
Mark in table V.3 the position of your firm in the market (by using as co-ordinates the results from step 1 and step 2). This exercise can be repeated for different business segments or products of your firm. You can also try to indicate the position of some of your competitors in this diagram.

Step 4:
Table V.4 may give you some indications and suggestions about possible measures you might choose to undertake.

Although not every business plan includes a portfolio analysis, the exercise of conducting it is certainly of value for directing your thoughts and ensuring that you cover all the important issues when assessing the attractiveness of your market and evaluating your competitiveness.

Table V.1. Analysis of competitive advantages

Competitive advantages/ success criteria	*<< Competition is stronger we are stronger >>*								
1. Market share									
2. Cost structure/cost advantages									
3. Product/service quality									
4. Technological know-how									
5. Marketing know-how									
6. Management									
7. Location/distribution advantages									
8. Financial resources									
9. Own brands, patents, etc.									
10. Spare capacity									
	1	2	3	4	5	6	7	8	9
Overall evaluation/summary									

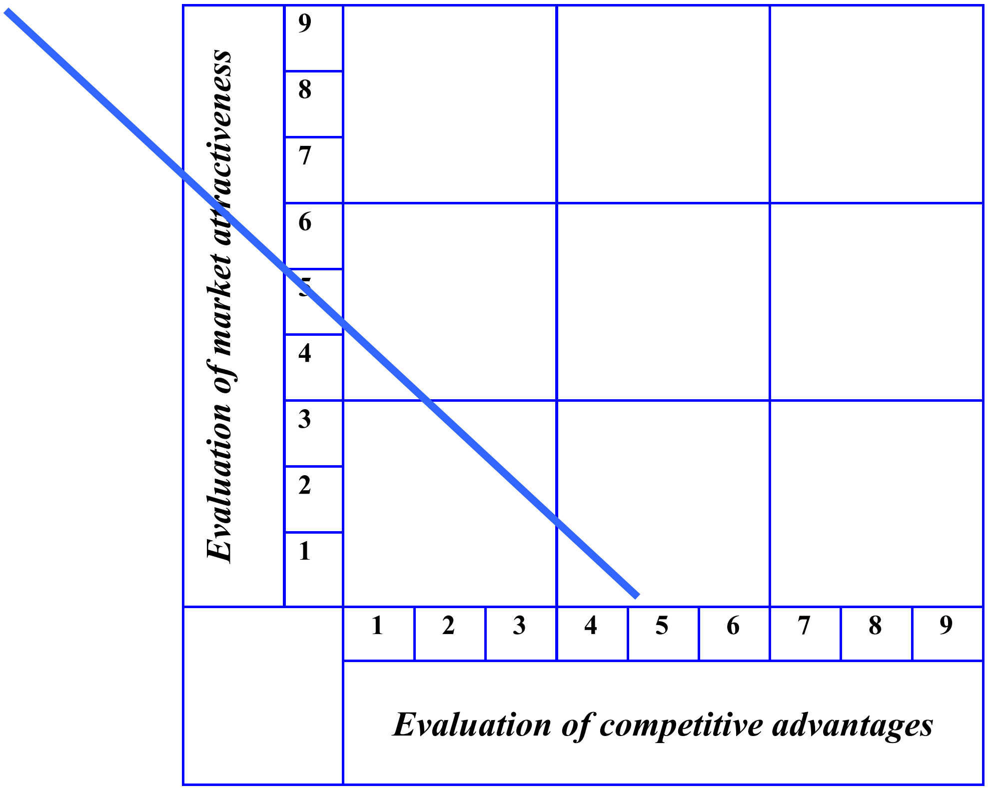
Source: UNCTAD.

Table V.2. Analysis of market attractiveness

Market evaluation criteria	*<< Very negative very positive >>*								
1. Market size									
2. Market growth									
3. Branch profitability									
4. Innovation potential of the industry									
5. Competition intensity									
6. Recession susceptibility									
7. Substitution danger									
8. Client loyalty									
9. Security of supply (materials/spare parts)									
10. Regulatory/public opinion risks									
	1	2	3	4	5	6	7	8	9
Overall evaluation/summary									

Source: UNCTAD.

Table V.3. Position in the market



Source: UNCTAD.

Table V.4. Matrix of strategies

Market attractiveness				
	High	**Concentrate** Concentrate your activities on niches. Specialize in the few products/services that you can do best.	**Selective investment and growth** Consider in particular building up strengths (management improvements, cost reduction, quality upgrading, new technologies, etc.).	**Maximize investment and grow**
	Medium	**Partnership** Consider joining forces with a partner, perhaps with a strong company interested in entering your type of business/market or you type of clients.	**Gradual development** Strengthen your competitiveness through incremental improvements (as you earn) and shift emphasis to the most attractive market segments of the business.	**Selective investment and growth** Identify the most attractive growth segments of your market and invest in them (intensify marketing / promotion, expand geographically etc.).
	Low	**Divest**	**Partnership** Consider joining forces with a partner, perhaps with a company interested in some of the strong features of your company (infrastructure, networks, location, human resources, etc.).	**Harvest/diversify** Maintain your position and get as much as you can from the market. Consider diversifying and entering new markets, possibly through the development of new products.
		Low	***Medium***	***High***
		Relative competitive advantages		

Source: UNCTAD.

G. Projected sales

The estimated sales of your business should be based on your assessment of the advantages of your product or service, the size of your market and the share you expect to get. For existing businesses, the current client base and client gains anticipated in the foreseeable future form a sound basis for the sales forecast. This should include sales in units and cash for the planning period of your business. The first year should be broken down by month or by quarter, whatever is appropriate for your industry, taking into consideration seasonal effects and variations. Your projections derived from this section will be an important input to the financial planning section of your business plan (projected income and cash flow statements).

Justify your sales projections by explaining the underlying assumptions made. Lenders or investors look critically at forecasts of sales since they form the main basis of your income and thus your ability to service your debts and pay dividends.

Be realistic about your projections in order to maintain your credibility as a serious, sincere and pragmatic businessperson. Experienced lenders/investors know that new businesses very seldom experience a sales boom right from the first or second year of operation. On the other hand, being too conservative about the growth of sales will not encourage people to put money in your business. It is therefore recommended that you use "best case", "worst case" and "likely" scenarios to create a spread of sales projections.

CHAPTER VI
BUSINESS OPERATIONS AND ORGANIZATION

In the previous sections you may have convinced the reader that you have a superior product and that there are sufficient clients that would be willing to buy it at a fair price. However, most lenders are aware that it needs much more than that to run a profitable business. If you do not have a well-functioning infrastructure in a suitable location and if you do not have an efficient manufacturing and distribution system, it is unlikely that your business will remain profitable for long, despite the superiority of your product and interest in buying it. The same applies if you do not have an appropriate management information system or if the duties and responsibilities of the personnel in your organization are not well defined. The way you organize and operate your business is an important factor for your success.

The types of operational and organizational issues you will be facing depend on the type of business you will be operating. For example, a building contractor has to be very well organized in all matters of project planning and control. A trader in tropical fruits has to plan carefully storage, transport and distribution.

The sections below discuss some of the most important operational and organizational issues that need to be covered in a business plan.

A. Location and premises

1. Location

In this part of the business plan, you should explain the considerations that made you select the present location of your business. Specific questions to be answered are:

- *Local market.* Is there a market for your products or services in the region? Or have you chosen your location because it is just a suitable place in which to produce?

- *Availability of workers.* Can you find in the vicinity skilled managers, specialists or workers whom you need to operate the business? Are there any plans for major industrial development programmes that are likely to strongly compete with your business for human resources? Do you see any critical limitations in this respect? (In one case, the owner of a metal processing shop that produced components for foreign toolmakers decided to completely relocate his business. The main reason was that a foreign car manufacturer that had recently moved into the area had caused a dramatic rise in salaries. The shop was not able to operate profitably any more in this place.)

- *Living conditions.* Are suitable infrastructure and appropriate services available to employees, visitors and their families for living and working in the region? (Housing, shopping facilities, restaurants, hotels, schools, hospitals, religious centres, cultural and recreational centres, etc.)

- *Supporting services.* Are there the necessary services to support your operations in the region? (Law and accounting offices, repair and maintenance workshops, suppliers of consumables, etc.)

- *Material supply.* Are raw materials, components, spare parts and other supplies readily available in the region?

- *Utilities.* Are the necessary utilities to accommodate the present and future expansion needs of your business available at your location? (Electricity supply, gas supply, water for industrial use and cooling, adequate telephone lines, sink for discharges of effluents, waste depositories, etc.)

- *Cost of premises.* How do the cost of premises and utility rates compare with those in other areas? Can you get a similar site on more advantageous terms in another area?

- *Transportation.* How easily can your location be reached? What means of transportation are available? (Road, rail, ship, aeroplane, etc.) Is the cost in transportation of raw material and finished products reasonable? Is there any risk that an increase in transportation costs could harm the competitiveness of your business? (In the former Soviet Union one practice was to construct very large factories (central production) and locate them thousands of kilometres away from sources of raw materials and also very far from most of the end users of the products. Transportation costs were not an important consideration at that time. After the transition to a market economy, transportation and associated energy expenses started to be an important issue when planning product costs. The result was that some of these businesses with production facilities in remote areas were not commercially viable any more.)

- *<u>Future development</u>*. Are there any plans for changes or projects in the region that may affect your business? (New housing complexes, new motorways, expansion of industry, etc.) Will these changes have beneficial or detrimental effects?

- *<u>Competition</u>*. Are there any present or foreseeable competing businesses in the immediate neighbourhood? What could be the impact of their presence?

- *<u>Image.</u>* Is your location compatible with the image of your business? Do clients visit your premises? (For example, if you have a boutique for high-quality and expensive jewellery, perhaps you should ideally be located in an exclusive street in the centre of the town. But if you operate a discount (low-budget) shop for electrical home appliances, you would rather be located in a back street. Not because you will pay less rent; but because you will provide your clients with the image of a real discount shop.)

- *<u>Economic growth.</u>* Is the area showing high economic growth? (Most entrepreneurs wish to see high economic growth in their region. This is particularly true for those who have their clients in the region where their company is located. The stimulation of the economy will eventually enhance the buying power of their clients. However, rapid economic growth in the region often has disadvantages for some businesses. Negatively affected are those that produce for markets in other regions. They will not profit from the enhancement of the local buying power. They will perhaps see only an increase in their production costs, which is a phenomenon accompanying economic growth.)

- *<u>Local authorities</u>*. Do the local authorities support the development of business in the area? Do they provide any special incentives such as local tax reductions, training schemes for employees and attractive conditions for leasing land and buildings? Are the local regulations reasonably flexible? Are procedures for obtaining permits and licences efficient enough?

- *Site accessibility.* Can the site be accessed easily by employees and clients? Is the transport of materials and goods practical?

2. Premises

Your business operations can be performed in an efficient and effective way only if you have the appropriate production facilities, storage space and office infrastructure. As your lender or investor is certainly aware of this requirement, you are advised to briefly describe in your business plan your premises and their suitability for your business. Particular issues to be addressed are set out below.

- *Licences.* Can the premises be utilized for the planned business? Is any application to the local authorities necessary in order to change the use for which the premises were previously licensed? Will you make any structural alterations? If so, a permit may be required. Did you apply for it? Have you received it? (Never underestimate the time required to obtain a permit. The lender or investor will carefully check any permit required. They may be aware of cases in which - with or without a good reason - the procedure for obtaining permits have been very slow. In some cases permits were in the end not granted at all. Particularly critical are greenfield construction projects.)

- *Layout.* Are the layout and the architectural design appropriate to performing the daily operations in an efficient way? (Optimum flow of personnel and materials, short transport distances, adequate storage capacity, appropriate working environment, etc.)

- *Representation.* Does the appearance of the premises match the type of your business and the image you like to give to it? (For example, if you are running a specialized law practice and you are planning to charge your clients the upper-level rates of the market, you may need to have representative offices in the centre of the city. In such a case, getting elegant furniture, acquiring paintings and sculptures, setting up spacious and representative reception and meeting rooms, etc. will be an advantage to the development of your business. But if you are in the software development business and your clients do not visit you regularly in your offices, simpler facilities on the outskirts of the city would be adequate.)

- *Expandability.* Are the premises of appropriate size? Can you expand if necessary? (For example, by having the option of renting nearby some more space later on.) Or do you have already have to bear the extra costs of renting more space that you may need in the future?

- *Safety regulations.* Will the premises comply with fire, health and safety regulations?

- *Environmental issues.* Do you have proof that the site you are going to buy or lease is environmentally sound and that there is no existing contamination and liabilities from the past? If you are not sure, an environmental survey has to be carried out. Lenders are very sensitive on this matter.

- *Buy or rent.* Are you planning to buy or to rent the premises? What are the considerations for this decision? (For example, you may be faced with the choice of renting property or buying it now. The trends of the local real estate market could have a major impact on your decision. If real estate prices are rising quickly, buying may provide some protection against the risk of escalating rental expenditure. On the other hand, if you are starting a new business you may not want to invest immediately in real estate, in view of other financing priorities. You might also want to see first how your business develops before you enter into more substantial financial commitments.)

B. Marketing

1. General remarks

For many companies, highly effective marketing is the key to success. It is therefore usual that the work of developing the marketing concept and supervising its implementation is placed under the direct responsibility of top management.

Marketing consists of the following four major elements:

1. Market study

Study the market environment and future trends to understand the demand for products or services in your field. Identify the geographical markets and types of clients to be targeted.

2. Product development

Develop the products demanded by the market. Important features that your marketing efforts have to define are - apart from the technical specifications of the product - finishing, presentation/packaging, price, etc.

3. Selling and distribution concept

Select channels for selling and distributing your products or services in the market.

4. Product promotion

Develop and execute a promotion, advertising and Public Relations campaign to inform the target clients about your products or services and the benefits they can derive from them.

An important characteristic of marketing is that elements of it form an integral part in most of your business activities. When developing your products, when communicating with your clients and when fixing your prices, you have to keep in mind your marketing concept. It is therefore obvious that marketing elements are to be found in most sections of your business plan. The present section concentrates on describing how you plan to promote and advertise your products.

2. Promotion and advertising

The purpose of your promotion and advertising campaign is to communicate information about your product or service to the market. Specific objectives are:

- Make your product or service known.
- Build up its image.

- Show benefits to users.

This section should include a description of all media that you plan to use for advertising (Internet, billboards, newspapers, magazines, direct mailings, radio and TV, etc.). It should also describe your public relations programme, sales/promotional materials (such as brochures and product sheets), package design, exhibitions, trade fairs, etc. Through such information you will show to the reader that thought has been given to this issue and that the appropriate channels have been chosen for attracting clients to buy the products.

If you are employing agencies or outside specialists to assist you in the advertising and Public Relations work, include information about the efforts, competence and benefits they will provide to the promotion work.

If you have copies of advertisements, brochures, product sheets etc. it would be an advantage to include some of these as an attachment to your business plan or at least have them available to show when meeting your lender or investor.

C. Selling methodology

In <u>marketing</u> you are concerned with:

- Assessing the demand for your product;
- Establishing ways of communicating its attractiveness to your clients.

<u>Selling</u> is the process for:

- Finally convincing your clients to buy it.

The selling section of your business plan has to demonstrate that you are well organized with regard to managing the selling process. Specific questions to be discussed are the following:

- *<u>Selling responsibility.</u>* Who will sell your products, and have they been professionally trained to sell? Who will define, coordinate, monitor and control the overall sales effort? Who will bear the overall responsibility for the sales?

- *Selling channels.* Will you be selling directly to your clients? Will you be using sales representatives, distributors or agents? If you will be using third parties for selling, describe the benefits of using them. What special advantages do they bring to the business? (Lobbying connections, established sales and distribution networks access to valuable clients, market knowledge, etc.)

- *Selling methods.* What selling methods will you apply? For example, telephone selling, cold calling/direct client visits, mailings, shops, advertisements and mail ordering, participation in fairs/exhibitions.

- *Targets.* What sales volume and activity targets, such as visits per day, have you set for each salesperson or selling method?

- *Selling aids.* What selling aids, such as leaflets, brochures, videos, CDs and technical back-up material, will you provide to the sellers? Include also details of in-house sales support such as technical service.

- *Training.* How do you plan to train the salespersons? How do you plan to transfer the necessary knowledge of the product to them and enhance their selling skills? (Internal or external training, types of courses, duration, on-the-job training programmes, etc.)

- *Arguments.* What hesitation and resistance do you expect from possible clients? How do you consider encountering them? What arguments would defend your position? What are the unique selling points your salespeople have to emphasize?

- *Client decisions.* Who exactly makes the buying decision, and what other people can influence that decision? How can you approach them? (If you sell office material to companies, you know that the procurement officer is the right person to approach. But if you are an auditor and you want to acquire the financial audit, the Chief Financial Officer is your contact person. If you want to sell PC hardware and software, you cannot by pass the Chief Information Officer.)

- *Selling process time.* How much time elapses between your clients becoming aware of your product or service and their decision to buy it, and finally pay for it? (The answer to this question is an important factor for your cash flow projections and for determining the financing requirements of your company.)

- *Payment terms.* What payment terms and conditions are you proposing to your clients? This issue is of the utmost importance for your cash flow development. On the one hand, for the purpose of improving your cash flow you would like your clients to pay you as soon as possible. On the other hand, you would like to offer to your clients convenient payment terms so that they can continue buying from you. Describe how you balance these considerations.

- *Incentives.* What incentives do you have in place for motivating salespeople to meet their targets? How does their compensation depend on the amount they sell? How can you motivate your salespeople to cross-sell, i.e. to initiate the process of selling another product of your company for which they are not directly responsible? (For example, by being alert and informing their colleagues if they see an opportunity.)

- *Order processing.* How are the orders transferred from the salespeople to the order processing people? Is this transfer smooth, with a clear division of responsibilities? Do you have the common problem of production personnel complaining that delivery schedules agreed with the client are too short or the prices too low? If so, how do you intend to deal with such problems?

- *Orders on hand.* Which orders are currently on hand (value, etc.) or are expected in the immediate future, and from whom? Are there any documents that can prove that there is a pipeline of committed orders? If so, it would be convincing to show these to the lenders or investors concerned. Are there any concrete proposals with a reasonable chance of being accepted by the clients? Vague letters of intent from prospective clients are usually not sufficient to convince investors or lenders about the future viability of the business.

- *Handling complaints.* What procedures do you envisage for handling customer complaints? (If you take quick action to satisfy a complaining client, the odds are that he will stay with you. If you do not do anything, you will probably lose him and you may also lose other clients to whom he is talking.)

D. Manufacturing

If you are in the business of manufacturing products, your business plan should include a section on the manufacturing process. Important issues to be covered are:

- *Make or buy.* Which parts of the product do you make yourself and which parts do you purchase? Do you make the final assembly of the product yourself or do you contract it out?

- ***Manufacturing process.*** Briefly describe the different stages of the manufacturing process and the flow of materials and goods. Begin with the preparation of raw materials and continue to finishing and packaging the end product.

- *Major equipment.* What plant and major equipment will you need and what are the main specifications? (Rated capacity, spare capacity, sizes, power consumption, etc.)

- *Layout.* Provide a rough layout sketch of your manufacturing unit, showing the ground plan and main dimensions of the facility and the arrangement of the main equipment.

- ***Resources and services.*** Which resources and services are required in order to keep the manufacturing line running (energy and cooling media, maintenance service, engineering support, spare parts, etc.)

- ***Quality factors.*** What are the critical factors in achieving the required quality of the end product? (Type of production machinery used, adjustments and manual control of the production line, testing/inspection of the final product, etc.) What measures are you envisaging to ensure the quality of the final product?

- ***Interruption risks.*** What are the probable incidents (machinery breakdown, etc.) that could lead to interruption of production? How long could interruptions last? What are the necessary measures for resuming production? (One common problem leading to a long interruption of production is the unavailability of appropriate spare parts on site or difficulties in procuring them from abroad. Briefly discuss the worst and the most probable scenarios of production interruption in your factory.)

E. Distribution

This section should describe the channels and mechanisms by which your product or service will be reaching the end user. You should demonstrate that you have established appropriate logistics for ensuring that your product will reach the clients in time, in perfect condition and in a cost-effective way. Particular questions that will probably be of interest to the lender or investor are the following:

- *Distribution channels.* What are your primary distribution channels? (Retail stores, wholesalers, mail order, door-to-door selling, electronic commerce/Internet etc.)

- *Intermediaries.* Is the entire distribution chain under your control or are you using intermediaries such as supermarkets and distribution agents? If the latter is the case, what type of agreements do you have with them? (Division of responsibilities, sharing scheme for income, price margins by shops, etc.)

- *Impact on quality.* Is the quality of the products adequate when they reach the final consumer? For example, if you distribute perishable goods such as flowers, tropical fruits or fresh fish, will these be fresh enough when they reach the consumer? Will they also have adequate remaining shelf life? Are your products stored and transported at an appropriate temperature and humidity? Does the delivery time meet the requirements of the product? Can the products survive delays caused by transportation or customs irregularities? If so, for how long?

- *Compatibility.* Are the distribution channels chosen compatible with your capacity and the structure of production and delivery? Here is an example of a company in the food business. It has been using chains of supermarkets to sell its products for many decades. Then it decided to start selling through electronic commerce (home delivery for orders received via the Internet). The demand increased so fast that it could not manage the home delivery logistics properly. On the other hand, the demand in the supermarkets dropped considerably, which resulted in an ineffective way of utilizing the infrastructure and equipment invested in over many years. Hence, the company had to stop advertising the e-commerce service for some time until it switched its logistics and restructured its assets (sold supermarket space).

- *Image compatibility.* Are the distribution channels compatible with the image of your product? (For example, you can sell a new type of floor cleaning chemical through door-to-door selling. However, this kind of distribution is not recommendable for high-quality cosmetics. Or you can sell machine-made woollen carpets through a supermarket store; but for fine handmade silk carpets you would want to sell through special galleries/boutiques.)

- *Costs.* Is the chosen distribution channel cost-effective for the type of products, quantities and markets that you are targeting? (Suppose that you operate a pizza home delivery business and you produce all the pizzas in one central facility. A basic question that you would be asking yourself is how far you can deliver the pizzas economically. A one-kilometre distance is certainly no problem and five kilometres may also be no problem; but if you start delivering to clients in another town 50 kilometres away, you are probably not competitive. Either you establish a second production unit in this town or you leave the business to somebody else there.)

- *Mark-up.* Can your product bear the mark-up required by the distributors? If you are distributing your products through shops in foreign countries you have to assume that the shops will add a mark-up of say 100 per cent. The importer may require another 20-30 per cent. On top of this, transportation costs, import duties and so forth have to be added. Can your products be sold at a price that includes such mark-ups?

- *Packaging.* Is the packaging of your product suitable for the distribution and transportation channels that you have chosen? Can you be sure that the product reaches the client in a perfect condition? The more stages in the distribution channel and the more loading/unloading, the more robust your packaging has to be.

F. Order processing and inventory control

In other sections of your business plan, you have described your capability in manufacturing your products and your competence in selling them to the market. An important link between manufacturing and selling is the internal work of your firm in processing the client orders and controlling the inventory of finished products. This part of the chain is critical to the successful development of the business. If the work is done efficiently it ensures the satisfaction of your clients and reduces the costs of your company. Your lenders or investors will most probably be interested to know more about it. Particular questions of interest are:

- *Registering orders.* How is a new client order entered into the company system by the sales department? Who takes on the responsibility for delivery in accordance with to the terms and conditions agreed with the client? What are the interfaces and how are the responsibilities split between the salespeople and the people producing the product and delivering it to the client?

- *Client satisfaction.* What procedures do you apply to monitor whether the client is satisfied with the product or service?

- *Inventory control.* What mechanisms and schemes do you apply to control the inventory of your products? How do you optimize the inventory to ensure that it is not too much (binding cash and occupying a lot of storage space) or too little (reducing flexibility to supply clients fast enough).

G. Company structure

In planning your business you have most probably thought about how you would like to structure the company, i.e. divide it in distinct functional units. You probably have also identified the head of each of these units. If this work has been done, you should compile an organizational chart and include it in your business plan.

Organizational charts are very useful pieces of information. They enable the reader to quickly grasp the way you plan to structure your business. They define responsibilities and lines of reporting of middle and higher management.

An organizational chart is particularly useful in:

- Providing evidence to the lender or investor that you have seriously considered the future of your business;

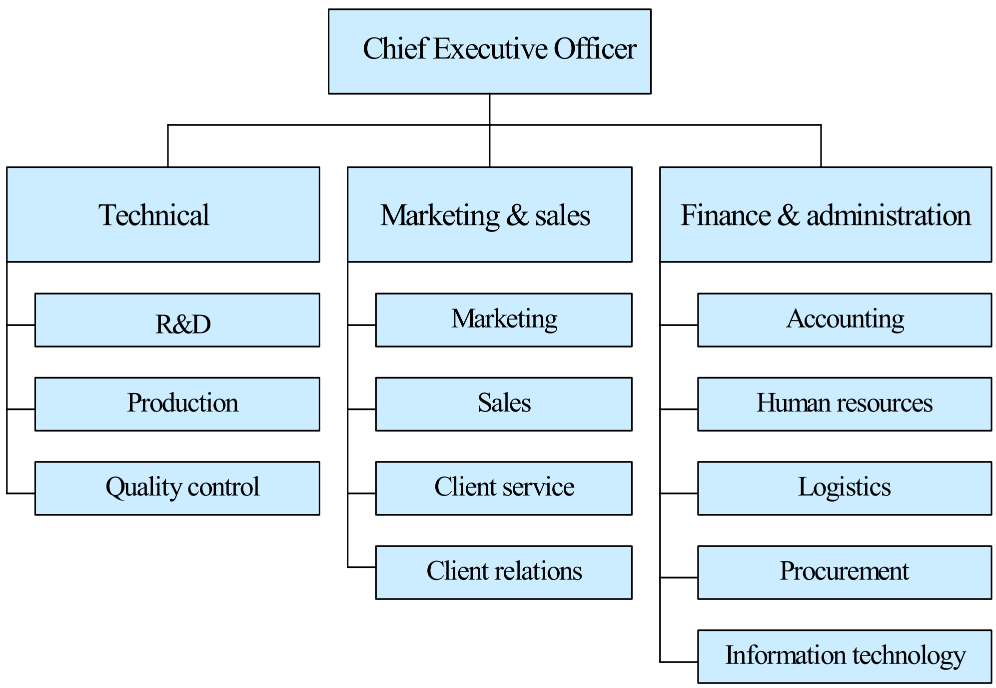
- Confirming that you have identified the people required for operating the business. Naming persons in the chart helps to give a sense of reality to your business plan;

- Making clear to everybody in or outside the company who is responsible for what.

There are many different ways to structure a company. Factors that play an important role are the type of business, the industry, the size of the company, the ownership situation (partner organization, family business etc.), the profiles and competences of managers available, and the style of management.

Figure VI.1 is a typical example of an organization that is often seen in production companies. It consists of three major divisions. Each division consists of a number of departments. In such an organization, the three division managers and the Chief Executive Officer (CEO) form the higher executive management of the company. This team should meet regularly to discuss and decide on important company issues. The department managers (middle management) of a division and the responsible division manager form the management of a division. These should also meet regularly to discuss and decide about division matters. The division manager is the link between middle and higher management. He or she plays an important role in the transfer of information, opinions, suggestions and instructions between the two management levels.

Figure VI.1. Typical organization chart of a production company



Source: UNCTAD.

Note: Each box should include the name of the responsible manager and his or her deputy.

H. Project management

In your business plan you may anticipate the implementation of one or more projects. A project can be anything, such as developing a new product, constructing a new building or plant, establishing a new affiliate abroad or refurbishing your production machinery. The success of your business will depend upon your ability to complete these projects successfully within the budget and according to schedule. Therefore, you may have to demonstrate to your banker or investor that your projects have been thoroughly planned and that you have established schemes for monitoring their progress. Below are some important steps and methods for presenting a plan for such projects.

- Break the project into small tasks (modules) or clearly defined activities as in figure VI.2, which shows activities related to the construction of a plant for producing mango concentrate. For each activity, set measurable targets and milestones.

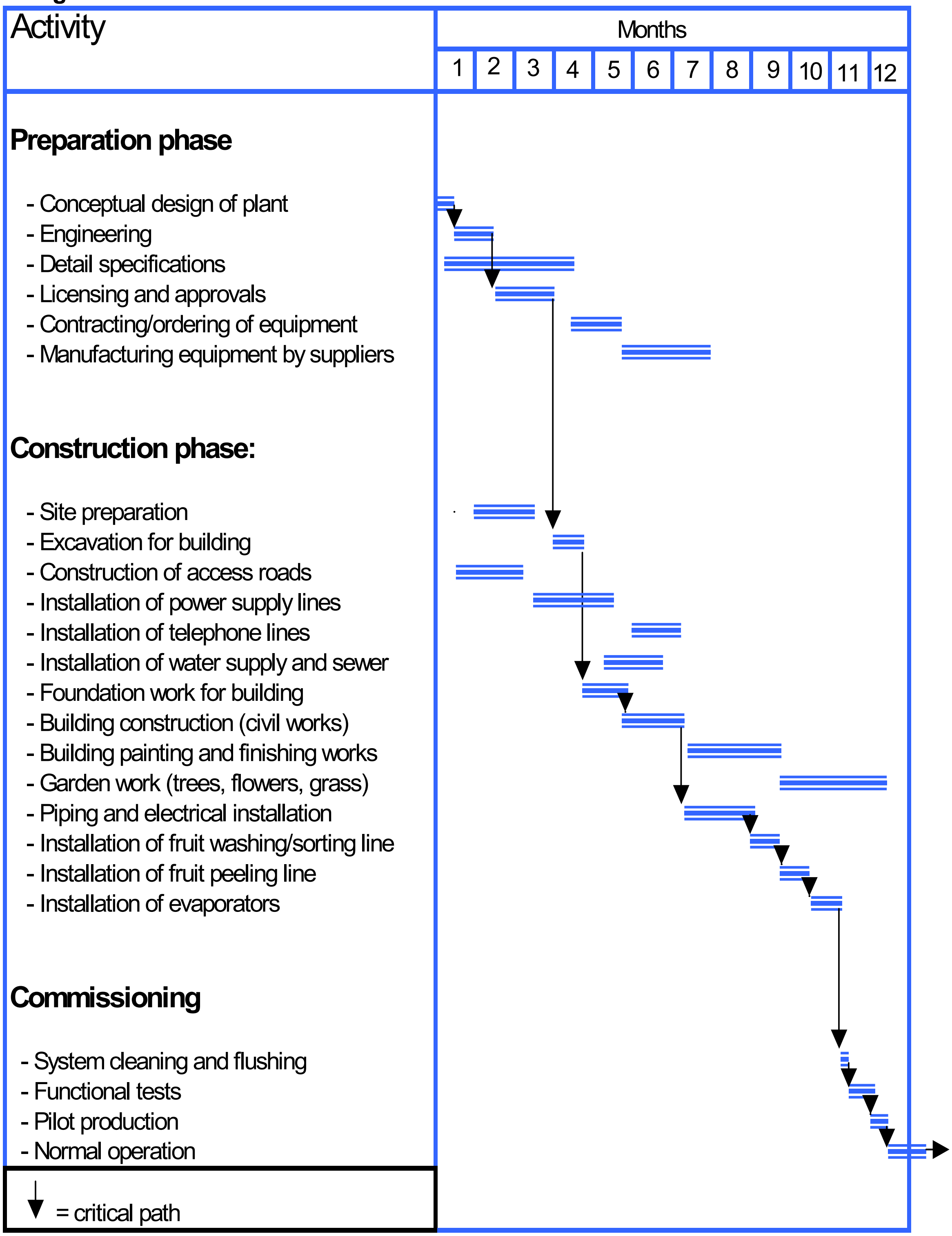
- Identify the critical path. Each activity on the critical path has to be completed before the next one can begin. This path is the longest path through the diagram and indicates the shortest possible period of time for completion of the project. This means that unless the time taken for the different activities can be shortened, the project cannot happen any faster than this.

- Assign responsibilities for each activity and for the overall coordination of the project.

- Set up a mechanism for monitoring whether the targets have been met, and if so, how. Act immediately if a target is missed or a problem appears.

There are various cost-effective computer software packages available for drawing up and monitoring project plans. These allow you to record information about the project, make changes with relative ease and view project information in various ways.

Figure VI.2. Example of a project plan: construction of a plant for production of mango concentrate



Source: UNCTAD.

I. Management information systems/reporting

The readers of your business plan are most probably aware that the use of an effective management information system (MIS) is an important requisite for conducting your business successfully. Your MIS should assist you in monitoring whether your business is developing as anticipated in your business plan. It serves as an early warning system. It helps you understand of the dynamics of the business and puts you in a good position to guide it in the right direction. It can therefore be expected that lenders or investors may want to see an outline of your MIS. Important questions that need to be briefly answered in this section of your business plan are:

- *Periodicity.* How often will you receive and use the reports produced by your MIS? (Monthly, quarterly, annually, on-line, etc.)

- *Content.* What is the content (output) of the MIS reports? Typical reports of special interest to you, depending on the type of business, could be those on the following:

- Liquidity status, with projections over the coming months (these are important in confirming that you have sufficient cash to operate the business);
- Income statement (with breakdown of the revenue and expense sides) and balance sheet (with breakdown of the assets and liabilities);
- Financial ratios;
- Sales (business opportunities identified, proposals made, proposals pending, proposals rejected, new orders, etc.);
- Production output (number and type of products produced, or number and type of clients serviced, etc.), and production capacity utilized;
- Status of projects in implementation (in particular, information relevant to cost and schedule control);
- Special/unexpected developments/events;
- Other information (personnel fluctuation, market indicators, etc.).

- *Information recipients* Who receives reports via the MIS or who has access to them? What kind of information/reports are foreseen for different functions and persons?

- *Processes/actions.* What processes are used in discussing results and taking actions? (Periodic meetings of the general management, group discussions, bilateral discussions, etc.)

- *MIS input/responsibilities.* Who is providing and feeding the input data (raw information) into the management information system? What procedures are in place to ensure that data are regularly fed into the system and that the quality of the input data is satisfactory? Who is responsible for ensuring that the process operates well and that the input and output are of the necessary quality? (Make sure, for example, that data are fed into the system in a timely fashion, information provided is complete and meaningful, etc.)

Experience shows that enforcing the procedures for collecting and feeding the appropriate data into the MIS of a company is one of the most challenging tasks of management. This is particularly true where the data have to be collected throughout the organization. The general tendency is that people who are responsible for providing the information do not give high priority to this task. Possible improvement measures that often help are:

- Reducing the amount of data and information collected to what is really necessary. If too much data are required and if their purpose and usefulness are not obvious, people will lose their motivation to provide the data;

- Persisting in communicating to people the significance of the MIS system;

- Disseminating MIS output to the people in your organization to whom this information may be useful.

- *Information technology systems.* What kinds of software and hardware are used to process the data and to generate reports?

CHAPTER VII
HUMAN RESOURCES

A. Management

Most lenders and venture capitalists base their investment decisions mainly on the strength of the company's management. In general, there is a common belief that the qualifications of the management are one of the most important criteria for a lender or investor in deciding to invest in a venture. It often happens that despite a well-presented business plan, an investor does not have the technical knowledge necessary for judging with confidence the viability of a specific business. Issues such as projections of future market potential, product competitiveness or technological trends can often be very difficult for persons not directly involved in the business. However, if they believe that the management has the necessary experience, track record, competence and reputation, they will be more inclined to finance the business.

On the other hand, no serious lender or investor will ever finance a business before the management has been properly examined, regardless of how great the business opportunity appears to be. The same will apply if the management presented does not appear to have the required experience, competence and ethics.

For the above reasons, the management section of your business plan should:

- Show that the key members of the management team have been identified, are available and keen to join the team;

- Demonstrate that they have the required talents, skills and experience to achieve the objectives and goals.

It is also important that the individual skills of the members of your team complement each other and that they can cover jointly all the functions and disciplines necessary for running the business.

Depending on the structure and type of business, management functions and input/support to management are provided by the following groups:

- Shareholders;
- Board of directors;
- Executive management;
- Middle management;
- External support services.

Therefore, the management section of your business plan should present the key persons of these groups as discussed below.

1. Shareholders

In this section you should briefly describe the individuals who own and control your entity (their name, activity/occupation and equity participation) and their involvement in strategic or operational decision-making processes. Depending upon the structure of a company and the role of its shareholders in the business, lenders or investors may require more detailed information about their background. Suppose, for example, that you are starting a new entity as a sole owner or together with a few partners and that all of you will be active in the business. In this case, the lender will be keen to have more information about your and your partner's background, paying particular attention to the private financial situation. In addition to standard information on personal assets and liabilities, some lenders or investors may go so far as to require copies of tax declarations, records of unpaid debts, court cases, etc.

2. Board of directors

The shareholders of the company appoint the board of directors. Its role and responsibilities are, among others, to:

- Take overall responsibility for the company on behalf of the shareholders;
- Develop a company strategy;

- Ensure the establishment of an appropriate organization;
- Ensure the implementation of an appropriate accounting, financial control and financial planning system;
- Nominate and dismiss the executive management of the entity;
- Supervise the management to ensure that it complies with the laws and regulations, statutes of the company and specific objectives;
- Report to the shareholders in required format and at the required intervals.

In this section you should outline who are the members of your board, listing their names, business activity, education and expertise, and any special tasks they may have. If the board members have special industry connections, good reputation or special knowledge relevant to your business, it is worth briefly mentioning these facts in your business plan. It adds credibility to your business since a strong board of directors is always considered to be a valuable asset to a company. In any case, considering that the board exercises all strategically important functions listed above and bears the ultimate responsibility for the company, lenders and investors will ask who its members are.

The general practice in many countries is that members of the board are not employed by the entity and are not engaged in the daily business operations. However, the managers of many small and medium-size businesses use the skills of board members to receive expertise and support which they cannot afford to hire. If you can choose or suggest such members yourself, select those who complement existing management. If, for example, you operate a small engineering company and you do not have any experience in finance, search for board members who can provide this know-how. Do not forget that the individual members of the board can help enhance the standing of your business if they enjoy high esteem in the business community and/or work for reputable organizations.

3. Executive management

In this section you should describe the structure of executive management, including the expertise, responsibilities and competencies of each individual. Demonstrating that your executive management team possesses complementary skills will help to convince investors that your business has a promising future.

Readers will be particularly interested to know who will be managing the following important functions:

- General management (Chief Executive Officer-CEO);
- Financial management (Chief Financial Officer-CFO) and administration;
- Marketing and sales management;
- Production management.

Depending on the type of business, other functions that may need to be represented in executive management are technology management, information technology management, research and development management, quality management, etc. For example, if you are in the electronic commerce business, your IT manager will be a central figure in the management of the company. If your firm is in biotechnology and develops new medical products, your chief research and development officer is a key person in the organization. In such cases, you should also describe the skills of these individuals.

Specific information to be given for each of the above managers, in concise sentences, should relate to the following:

- Present employment and function;
- Education;
- Professional history (which company, what type of business, how many years, which functions);
- Special experience, talents and areas of high competence (examples: has excellent understanding of the Russian market and has many contacts in the Russian Federation; is highly specialized in the production of concentrates from tropical fruits; has long experience in general management of companies with over 100 employees, etc.);
- Any special achievements (examples: as a sales manager of company X doubled the sales volume within three years; registered four patents in the food processing sector; developed and implemented a programme which

resulted in reducing the costs of production by 20 per cent within one year, etc.).

It could be advantageous to include complete résumés of the key persons as an attachment to the business plan.

The management section should also include a short description of the company's policies for enhancing the performance of its managers and for ensuring their strong commitment to the business. Particular issues to be mentioned are:

- The main criteria and the process for selecting managers;

- Policies for remunerating managers (proportion of fixed to variable salary, success-based bonus schemes, stocks and stock options as an incentive, fringe benefits, etc.);

- Training schemes;

- Cultural elements promoted by top management (regular and efficient communication, open information policy, team-based decision-making processes, respect for individuals, fairness in personnel assessment, etc.);

- Specific measures to retain key experts.

If you have a small business and you work on your own or with only few other persons, many of the functions mentioned above have to be combined and performed by yourself or only partially shared with the others. You may have to assume responsibility yourself for production, sales and even managing the finances of your business. In such a case, you should explain what amount of time you expect to allocate to each type of activity and what the priorities are. You should also mention what you are planning to do when the business has grown so much that you are not able to deal alone with all these functions any more. Since one-person business will be hard to sell to the lenders or investors, try to dispel fears by appointing a well-regarded supervisory body and experienced partners/employees.

4. Middle management

If your company will be growing from a small to a medium-size enterprise, you are probably thinking seriously about developing middle management capacity.

In such a case, your considerations and the measures you plan to implement should be adequately discussed in your business plan.

Experienced lenders and investors have often seen the difficulties some companies fall when the number of their employees increases from 30-40 to 70-80. In a company with 35 employees, a team of 3-5 division managers may be able to operate the business without needing to have a middle level of managers. But if the business grows to, say, 75 employees, this team may have some difficulties in managing the business successfully. The rule of thumb says that one manager cannot effectively supervise the work of more than 7-10 subordinates fulfilling different functions. Therefore, the obvious thing for a growing company to do is to introduce a second (middle) level of management. - for example, to divide a division of 12-15 persons into three departments of 4-5 persons each. In such a case instead of 15 persons reporting to the division manager, there would be only three department (middle) managers reporting to him or her and the rest of the employees in the division would be reporting to the department managers.

Difficulties often arise in growing companies that do not implement measures to develop sufficient capacity of middle management early enough. In such cases the executive managers keep assuming more responsibilities and overload as the business grows. They end up managing directly more people than they really can. The result is that no proper supervision is provided, the quality of the work deteriorates, the motivation of the employees diminishes and the managers get burned out too quickly, with repercussions on the working climate, efficiency and finally profitability.

It is therefore likely that the lenders or investors will be looking to find answers to the following questions in your business plan:

- Do you employ during the period of growth people with talents and potential to be developed into middle-level managers? Who are they? What are your plans to develop their management skills and prepare them for taking jobs with increased responsibilities?

- If you do not have the necessary resources in the company, what are your plans to recruit suitable middle-level managers from outside?

- Introducing another level of management is a major step with important repercussions on the structure and culture of your firm. The sensitive process of change should be accompanied by a well-conceived information and consultation scheme with employees throughout the organization. Have you developed such a scheme?

Developing competent middle managers is also significant for the longevity of your business. They will form the pool of talents from which your business can draw the executive managers of the future.

5. External support services

If you are using or plan to use external support such as specialized industry consultants, lawyers, accountants or public relations/marketing agencies, name these and mention what type of service you will be getting from them. In your description of each support service, mention which strengths the firm or individual possesses, as well as what experience and/or contacts they provide to your business.

By properly selecting and effectively using external support services you demonstrate to the reader that:

- You have acquired and are utilizing all the knowledge and resources necessary for running the business.

- You are a manager who is capable of integrating and building up the indispensable networks.

B. Labour

This section of the business plan provides details of the workforce you need in order to run your business. Whether you are going to start a new business or intend to expand an existing one, you need to indicate the number of people required and what skills they need to possess. Other important questions that have to be answered are:

- Are there sufficient local workers available? If not, from where and how will you recruit them?

- Are the workers trained? If not, how will you train them?

- What are your plans for ongoing training?

- What are the labour costs, current and prospective?

- Which benefits, incentive plans and other schemes do you envisage for motivating people to work for you? In other words, what is particularly attractive in working for your business? (Good opportunities to learn? Location? Pleasant working environment? Flexible working hours? Interesting and challenging work? Encouragement to take initiative? Culture of mutual respect? Job security? Employees' information and participation system? Good wages and fringe benefits? Other?)

If you are continuing an existing business without any anticipated changes in staffing (for example, no expected growth, no restructuring etc.), you still need to answer some of the above questions in your business plan. Investors would be interested to know whether your existing employees and present staff policies are adequate to ensure successful continuation of your operations.

C. Practical issues venture capitalists will check

The final decision of a venture capital fund to invest in your business will not be based on your business plan alone. In the negotiation process and during the due diligence stage the investor will be examining in detail the success and failure factors of your business. In particular, they will be critically observing your management team in order to evaluate its strengths and weaknesses and to assess the values, norms and overall culture of the firm. And they will probably have plenty of time and many opportunities to do this as the negotiation and due diligence processes are often long and intense. They involve many functions and disciplines. Therefore, many of the senior managers of the company have to become involved in them and thus exposed to the investor. An investor may even particularly ask to meet all key people before a final decision is made. The general impression from the people in your business will certainly influence the final decision to invest or not.

As a prominent venture capitalist once said:

I invest in people, not in ideas

Particular features on which an investor will be placing emphasis are:

- Technical skills and competences of managers;
- Attitudes and human characteristics of managers;
- Team spirit;
- Values and norms of the firm;
- Compatibility of business type and people's culture.

Detailed criteria and considerations that investors will apply in assessing the above features are summarized below. You should be aware of these while planning your business or when interfacing with venture capitalists later on.

1. Technical skills and competencies of managers

Table VII.1 summarises the basic characteristics managers should have in order to be of value to their firms. It is therefore very probable that the prospective investor will be looking at these characteristics.

Table VII.1 The basic characteristics of managers

Position	***Responsibilities***	***Necessary abilities***
General management	**Communicating**	The ability to communicate clearly and effectively in written and oral form. The ability to explain ideas and put forward arguments.
	Making decisions	The ability to listen, receive input from others, consider all relevant factors and make decisions quickly. Ensure that major decisions are taken in agreement with the other members of the management. Follow up to ensure that these decisions are implemented.

	Overview	Good overview of most of the key disciplines and functions involved in the business. Although they are not directly responsible, it is necessary to have substantial knowledge of product development, human resources, finance, marketing, production, etc.
	Negotiating	The ability to solicit different points of view from all sides, balance opinions, moderate and arbitrate fairly for mutual benefit (everybody should feel satisfied with the result).
	Planning	The ability to develop and implement action plans, identify obstacles, establish attainable goals, define tasks and assign them to the management team.
	Problem solving	The ability to gather and analyse facts, anticipate problems and know how to avoid them, implement solutions effectively, and follow up thoroughly.
	Objective setting	The ability to properly define and set objectives with management (derived from the overall business objectives of the firm) and to monitor and assess their completion.
	Team selection	The ability to understand the strengths and weaknesses of people, select, hirer and appoint or promote the right managers to the appropriate positions.
	Leadership	The ability to develop a vision, define a business mission and inspire and motivate others to pursue it.
Operations	**Inventory and quality control**	The ability to establish suitable inspection standards and quality control procedures, and set up effective systems for managing the inventory of raw material, finished goods or goods in process.

	Manufacturing	Experience of the manufacturing process, openness to continuing improvements, understanding of time, cost and quality needs of the client, and ability to use machinery, material and people's skills in an effective way.
	Purchasing	The ability to identify the most appropriate sources and suppliers (considering cost, delivery time and quality) in order to effectively negotiate contracts and to optimally manage the schedule of buying products and services.
Financial management	**Statements and ratios**	The ability to produce detailed up-to-date and projected income and cash flow statements and balance sheets as well as to analyse and monitor the overall performance of the business by using financial ratios.
	Control of funds and cash	The ability to design and implement overall and individual systems for effectively executing and monitoring all money operations and particularly spending of the firm. Make sure that costs remain within budget and cash flow is under control.
	Fund planning and raising	The ability to forecast financing needs and structure debt/equity, short- versus long-term loans, etc. Familiarity with sources of funds and procedures for obtaining them.
Marketing/ sales management	**Evaluation and research**	The ability to conduct thorough market studies by using the best available information, to properly interpret and analyse the results, and to derive clear and correct conclusions.
	Client orientation	The ability to be client- and service-oriented. Have an understanding of the needs of the clients and make an effort to satisfy them. Maintain close contacts with the clients and be quick and flexible in responding to their requirements.
	Planning	The ability to develop effective promotion, advertising and sales programmes with sales representatives and distributors.

	Product continuation	The ability to determine service and spare parts requirements, track customer complaints, and supervise the establishment and management of the service organization.
	Product distribution	The ability to manage and supervise product flow from manufacturing through the channels of distribution to the end user, with attention to costs, scheduling and planning techniques.
	Support	The ability to obtain market share by organizing, supervising and, most important, motivating the sales force.
Engineering and R&D management	**Development**	The ability to guide product development so that a product is introduced on time and within budget, and meets the customers' needs.
	Engineering	The ability to supervise the final design through engineering, testing and manufacturing.
	Research	The ability to distinguish between basic and applied research, keeping a bottom-line balance.
Human resources management	**Technical skills**	In-depth knowledge of recruiting strategies, people and performance assessment schemes, training procedures, human resource development concepts, modern compensation and incentive schemes, outplacement, etc.
	Culture	The ability to create an atmosphere and attitude conducive to high performance and rewarding good work verbally and monetarily.
	Conflict	Ability to deal with differences openly and resolve them through teamwork.
	Help	The ability to listen to and understand human problems and needs, to assess situations in which help is needed and to initiate actions and follow them up.

Legal management	**Contracts**	Experienced in structuring clear and complete agreements, in identifying all possible pit falls, liabilities and points of potential conflict and in developing measures for protection against these. Knowledgeable about regulations and procedures of commercial law, warranties, default, incentives, etc.
	Intellectual property rights	Experienced in and knowledgeable about the intricacies of incorporation, patents, licences, copyrights, etc.
	Compliance	Experience in compliance with local, State, federal and, if necessary, international regulations concerning all aspects of employment and business operations.

Source: UNCTAD.

2. Attitudes and human characteristics of managers

In addition to technical and administrative skills and entrepreneurial competencies, potential investors will be assessing the attitudes and human characteristics of the managers in your firm. Some investors place even greater emphasis on such characteristics.

Box VII.1. Making a good impression

An investor from New Jersey, United States, was negotiating to invest $13.5 million in a firm in Baden, Switzerland, specializing in computer software and services for processing inter-bank payments and security transactions. The investor United States investor was planning to use the Swiss firm as a basis for entering into the rapidly growing electronic banking business in Europe. After two weeks of intense and complex negotiations involving six to seven persons from each side (accountants, marketing and sales managers, technical specialists, general managers and lawyers), a deal was made and an agreement was signed. While saying good bye at Zurich airport, the moderator of the negotiations asked the investors: “What was the main reason that made you finally decide to invest in this firm?” The answer of the head of their delegation was short but meaningful: “These guys make an honest impression”.
Source: G. Malcotsis.

On the other hand, many cases are known in which investors walked out of negotiations and no deals were concluded despite the high potential of the businesses and the experience of the management. Wrong attitudes and character deficiencies of management are good reasons for investors not to invest in a business. Table VII.2 lists some typical characteristics of managers that play an important role.

Table VII.2. Characteristics for success

Characteristics	***Distinctive success traits***
Orientation	Do not lose orientation, motivation or the momentum of work if things for the future are suddenly not very clear or if a situation involving paradoxes and discrepancies arises. Can quickly adapt to changing situations and implement changes. Maintain optimism and positive attitudes for the future even in adversity.
Collective spirit	Integrate in to the company and the management team and feel part of it. Try to make individual objectives compatible with the overall objectives of the business. They do not isolate themselves, and follow their own way and interests.
Balanced life	They are committed to their work, they work hard but they also know how to keep a good balance and do not neglect family life, social responsibilities, personal hobbies and interests, and health.
Problem solving	They will always look at options to solve problems that stand in their way and they take the initiative in implementing solutions. They know how to solve problems quickly, effectively and with confidence. If necessary, they ask for advice from others but do not overwhelm them with their problems. Once a CEO placed a banner with the following slogan in her office: “If you do not have a solution for your problem, then you are also part of the problem”.
Objective thinking	Not afraid to admit they are wrong or have made a mistake. Can take advice from others. Try to understand themselves and assess their performance on a continuous basis and learn from their successes, mistakes and failures.
Cultural sensitivity	Respect and are sensitive to other cultures and are able to operate across cultural barriers. Have no prejudice against people of other cultures, religions or ethnic groups or nationalities.

Fairness and openness	Honest and fair attitudes and conduct towards everybody: own firm, clients, suppliers, employees, shareholders, authorities, others and even competitors. Direct in criticism and substantiate this with concrete facts and reasoning. Criticism is accompanied with suggestions for improvement. Avoid rumours and gossip.
Social responsibility and environmental consciousness	Conscious in complying with social standards and in making a contribution that benefits people, society as a whole and the environment.
Trusting others	Appreciation of strengths of others, belief in their potential for improvement, optimism regarding what people can accomplish. Willingness to assist others in self-improvement. Ability to trust and inspire people. Ability to delegate responsibility and not keep everything under direct control.
No power need	No great need for power, status, prestige, influence and control. Tendency to guide the actions of others rather than dictate. No aggressive attitude or narrow, rigid thinking. No tendency to feel threatened by perceived attempts to undermine authority.
Realism	Pragmatic and down-to-earth forecasting on targets and achievements that can be reached. No false optimism. Ability to distinguish between important and less important, highest priority and less urgent.
Coping with overload and stress	Have the stability to withstand stress and strain. Ability to cope with changes, high demands, obstacles and work overload. Good health and physical stamina to work long hours. Ability to occasionally distance oneself from the business, to relax and recover.
Responsibility	Strong tendency to take responsibility, face problems directly and promptly, not feeling guilty about real or imaginary mistakes, no fear of failure and no preoccupation with own concerns.
Independence	Take initiative and charge of a given situation. Pro active and not just following. Not easily influenced and not any difficulties in taking decisions.
Achievement orientation	Focus on achieving a standard of excellence, commitment to making things better, inspire others by being an example, knowledge of the individual effort it takes to achieve something, setting realistic attainable goals, asking for honest feedback and use this for further improvements.

Self-actuation	Self-directed individuals with strong self-discipline. Strong intuition, freedom from feelings of guilt and worry, energetic approach to life, strong desire to know about things and to experience things directly, openness to new experience, positive about the future and ability to enjoy things.
Competitiveness	Maintain competitive spirit and happiness in winning but do not develop “winning obsessions” and aggressiveness, fixed ideas and a “win-loose” orientation that distorts perspective and goals. No need to win at all costs, do not always have to be right and to be the best. Fair, take losing in good part and try to learn from experience.
Perfectionism	Do things well but are not perfectionists. No tendency to place excessive demands on self and others. No preoccupation with detail that distorts perspective and judgement. No excessive concern to avoid mistakes. They are diligent in planning activities properly, but on the other hand they do not slow processes and make them extra costly by over-planning. Leave space for improvisation. Do things as well as necessary but not as well as possible.
Originality	No preference for staying unseen and unnoticed, no tendency to cover mistakes, no tendency to view rules as a source of comfort and security, not seeking the feelings of security within a bureaucracy. Develop ideas and initiatives of their own.
Not oppositional	Not scrutinizing everything, not systematically asking tough questions, no need to look for flaws and criticizing everything, do not tend to make others feel uncomfortable, no negative cynical attitude or sarcastic sense of humour.
Relationships	Form healthy, positive interpersonal relationships that are meaningful and reciprocal. Give and derive satisfaction from interactions with others.
Enthusiasm	Become fascinated and enthusiastic about things and are able to spread positive attitudes and enthusiasm to others.
Self-approval and motivation	No excessive need to be liked or approved by others. No preoccupation with the opinions of others and no tendency to say and do only what others think and expect. Able to be self-motivated without the need for compliments or influence of other people.

Source: UNCTAD.

3. Team spirit

In addition to assessing characteristics of individual managers, prospective investors may be interested to see how the management team works as a whole.

Characteristics of a successful management team are:

- Strengths and weaknesses of team members complement each other.
- The team covers all core disciplines and functions of the business.
- Most team members have been working together for a long time.
- All team members share the same vision: success!
- The team has a consensus about the mission, objectives and strategy.
- All are clear about their role and the division of responsibilities.
- Core team includes at least three members, very seldom more than six.
- They work in a spirit of mutual respect and friendliness and support each other.
- They bonded together, including in difficult times.
- Core members know their weaknesses and are ready to fill the gaps;
- The ownership structure is clarified between team members (shareholders).

4. Values and norms of the firm

Successful companies have specific values and norms by which all employees live and which the top management cultivates. Examples are:

- We strive to do the best for the benefit of our clients.
- We are always available to our clients.

- Our knowledge and work should benefit our community and society as a whole.
- Our integrity is uppermost, even if we lose money.
- Team results are uppermost, not individual goals.
- We strive to be market leader in volume/in quality.
- Our employees are our most valuable assets.
- Bringing value to our shareholders is a major objective.

Investors will most probably seek to ascertain whether the firm has made a commitment to endorse any such values and norms, and if so, whether these are indeed applied in practice.

CHAPTER VIII
LEGAL FRAMEWORK, AND ENVIRONMENTAL AND SOCIAL FACTORS

In this section you should demonstrate, whenever applicable, that:

- You know which approvals and licences are required, and that these can be obtained without any major difficulties. That you have taken appropriate action to obtain them, or that you have already obtained some or all of them.

- Your business will respect important issues of social compliance that are related to the safety and well-being of your employees and the community as a whole.

- Your company provides development and social benefits to the local community.

- The risks of image and financial damage to your company from any possible environmental problems are well understood, and that you will comply with laws applicable to safety and the environment. You should show further, if and where applicable, that your business contributes substantially to the protection of the environment.

A. Approvals and licensing requirements

In this section you should describe the regulatory and licensing requirements and/or the approvals that are necessary to operating your business. You will certainly need these if you are starting a new business. A typical checklist of items needing approvals and licences is as follows:

- Establishment of the company (name, logo, registration);

- Construction permits;
- Environment-related permits;
- Health- and sanitary-related approvals;
- Work permits for foreign employees;
- Foreign currency exchange and international procurement permissions;
- Import of machinery and equipment;
- Import of raw materials and components;
- Land and water use rights.

The above list can be much longer, depending on the local regulations, the planned business activity and the nature of your operations.

State in your business plan the efforts already undertaken to obtain approvals, their present status and the time frame estimated for accomplishing the task. Your lender or investor is aware that failure or major delay in obtaining important approvals can have a severe impact on the financial situation of your business. Be cautious when estimating the time required. Experience has shown that the time required to obtain a licence is often underestimated by entrepreneurs.

B. Social compliance issues

Governments and multilateral development institutions have developed and are enforcing standards for ensuring the safety and well-being of employees at work. Many progressive enterprises apply their own practices, going even further to ensure the well-being of their employees and the population in their community. Such practices go beyond physical well-being. They often cover moral and ethical matters. For example, many global enterprises will not invest in a local company - or not even outsource to it - unless it is confirmed that it does not discriminate between the sexes, that no children are employed, and that the company provides a healthy working environment for its employees.

In your business plan you do not need to provide an extensive description of how you comply with all issues listed below; nevertheless, you need to touch on the most important issues related to your business and be ready to answer questions from lenders or investors. Typical issues of concern are:

- *Age requirement.*

No employees are to be younger than the minimum age specified by the local authorities and international conventions.

- *Involuntary labour.*

Employees have to be working of their own there is to be volition, they are to be free to leave when the shift ends, they are to be free to move and there is to be no physical or mental abuse of any kind.

- *Working hours.*

The weekly employee working hours and the maximum hours of overtime allowed have to be within the limits of the local laws and regulations. Employees have to be given sufficient breaks each day to rest, lunch, have drinks, pray, etc.

- *Compensation.*

The wage rate paid to each employee cannot be less than the minimum wage specified by law. Wages are to be paid regularly and payments have to be well documented. Deductions from wages have to be fair and justifiable and overtime wages have to be properly calculated and paid. Employees are entitled to paid days off as per local customs or regulations.

- *Insurance and pension.*

Workers are to be properly insured against accidents. Pension schemes have to be established and managed as per local customs and regulations.

- *Discrimination.*

No discrimination on the basis of gender, ethnic group, religion etc. is allowed. Equal opportunities are to be provided to all.

- *Health and safety.*

- ➢ There should be adequate availability of fire extinguishers and emergency exits available.
- ➢ Workers should be properly protected against accidents/injuries with (goggles, ear plugs, helmets, boots, uniforms, etc.).
- ➢ Temperature and humidity should be appropriate and ventilation and lighting should be adequate.
- ➢ Facilities and site should be clean and hygienic.
- ➢ Workers should be properly protected from hazardous leakage, accidental spills, exposed electrical wiring, moving parts, flying objects, etc.
- ➢ Employees should have reasonable access to drinking water.

C. Development and social benefits

Governmental and multilateral development organizations like to see that the businesses they are financing are not only complying with regulations but are also bringing social and economic benefits to the community. Therefore, if your project contributes to the development of the region, it is certainly an advantage to mention this in your business plan.

Typical examples of impact worth mentioning, if applicable, are:

- Creation of new jobs in the region;
- Transfer of technical and management know-how; training and skill development of locals;
- Value added to local natural resources and products;
- Local procurement and subcontracting that contribute to the stimulation of the economy in the region;

- Infrastructure/services established by your firm which can be shared by the community (new access roads, new water supply lines, water purification plant, new electric/telephone lines, medical service, school/kindergarten, etc.);

- Development of products or processes that have a positive impact on the environment (i.e. products and processes that use less energy, fewer material resources, encourage more recycling, etc.).

D. Environmental risks

Loans to entities plagued by environmental problems have become a major concern for lenders and investors in recent years. In a number of cases when investors had to pay enormous amounts of money to resolve problems they did not anticipate when investing in the business. Typical examples of such situations are: cleaning up contaminated soil on factory sites, upgrading production systems releasing hazardous wastes exceeding given limits and modifying environmentally unacceptable products. In some cases, the financial consequences have been so serious that investors have lost their investment, or lenders never got back their loans. Experienced lenders and investors are aware of these risks and therefore wish to know:

- Whether there is an audited environmental report available;

- What the environmental risks of your business are;

- Whether the management of your entity is aware of them;

- How your business could be affected and what would be the consequences for the lenders or investors;

- Which measures are planned to prevent or mitigate damage.

Your business plan needs to contain answers to the above questions. The lenders or investors will probably come back and ask for more details. You should be prepared to provide them.
The sections below briefly describe the concerns of lenders and investors and give a list of typical questions asked by them before they decide to finance a project.

1. The concerns of lenders

The environmental risk involved for the lender is mainly related to the:

- Risk of the customer's potentially reduced solvency;
- Risk of the potentially reduced value of collateral.

Non-compliance with environmental standards may cause serious economic damage through withdrawal of permits, loss of market share, compensation payments, fines etc., impairing the creditworthiness and solvency of the business of the borrower.

The risk of reduced value of collateral becomes easily apparent in cases of real estate, when potentially contaminated sites are involved. As long as the lender does not take possession of the real estate the maximum potential loss of the lender is limited to the principal and accrued interest of the loan.

In the case of equipment being used as collateral, the environmental risk is related to the loss of its value if the product or the process involved is environmentally problematic (e.g. product or production equipment not in compliance with present or future environmental standards or market expectations). The lender's maximum potential loss in this case is also limited to the principal and accrued interest of the loan.

2. The concerns of investors

The risk involved in equity participation is mainly related to the:

- Risk of the company's reduced earning power;
- Risk of degradation of the company's assets;
- Risk of high compensation payments and even bankruptcy;
- Risk of losing reputation.

The potential losses of investors are limited to the amount paid for their investment, including income lost since payment. In addition, a potential image loss could be associated with the case. If investors control the business, their liability might even go further.

If the investor is actively participating in the management of the company, the personal liability of the responsible management members may arise, depending on the applicable laws.

3. Examples of questions lenders and investors may ask

- *General information*

What are the main environmental issues that your business faces from the points of view of legislation, and pressure from suppliers, customers, the general public and other pressure groups?

- *Legislative information*

Which of the following environmental laws and regulations in your opinion apply to your business? How are you going to comply with them?

- General protection of the environment;
- Air pollution control;
- Waste water discharge;
- Handling and storing of hazardous materials;
- Treatment of waste;
- Noise abatement;
- Disaster prevention (factories and plants are a potential risk to the environment because of possible operational accidents);
- Other.

Are you aware of any impending changes to the laws and regulations that will affect your operations? If so, give details. Has the business ever been prosecuted for failure to comply with environmental legislation? If so, give details.

- *Site details*
  - ➢ What was the site used for prior to the company's current occupation?

  - ➢ Has a survey for potential contamination/groundwater monitoring been carried out? If so, what are the results?

- *Operations with environmental relevance*
  - ➢ Include information with regard to generation, treatment and disposal of waste, effluents and emissions, and storage areas for hazardous materials.

  - ➢ Are there any power generation, waste incineration or waste treatment activities on site? If so, comment on how they conform to laws and regulations related to the protection of the environment.

  - ➢ Are any significant environmentally related changes planned in the entity's operations or regarding materials used, produced and/or stored?

  - ➢ What precautionary measures have been taken in case of plant failure with potential environmental consequences? Is there a written accident prevention plan? Is there any emergency response plan?

- *Air emissions*
  - ➢ Are any of the air emissions subject to regulation? If so, are they within the limits? Has the company ever violated the regulations?

  - ➢ Are any gases, odours or smoke generated or contained in the workplace area and/or discharged in the atmosphere?

  - ➢ What procedures are in place to control emissions in air?

  - ➢ Are any changes planned in the control or monitoring procedures? Will they require any improvement to meet any new air pollution regulations? If so, provide details with particular emphasis on the costs to be incurred for the implementation of the necessary changes.

  - ➢ Has the company ever been subject to any legal action in connection with air pollution (including nuisance complaints)?

- *Liquid effluents*
  - ➢ Are there any liquid effluents that are produced by the entity? If so, where are they discharged to?

- Are discharges subject to licensing and regulation? If not, has confirmation of this been obtained from the regulators? If so, are the discharges within the limits? Has the company ever violated the regulations?

- What procedures are in place to control liquid effluents?

- Are any of the effluents treated on the premises? If so, provide details.

- Are effluents stored on the site prior to disposal? If so, provide details of any containment measures, procedures to prevent and monitor leakage / spills, and period of storage.

- What kind of system for monitoring effluents is installed and how frequently does it operate?

- Have the regulators visited the site? If so, were they satisfied with the monitoring and control procedures in place?

- Are changes in the control and monitoring procedures planned? If so, how will they affect the plant? What are the installation and operating costs?

- Has any action ever been taken against the company with respect to effluent discharges?

- *Waste*
- Is any waste disposed of on site (or has this been done in the past)?

- Is any waste ever known to have caused contamination on site?

- Have inspectors visited the site with regard to disposal of waste on site? If so, have they been satisfied with the procedures in place? Has the company ever been prosecuted for offences related to waste?

- Where and how are wastes stored on site prior to removal? Is this adequate? Are they adequately labelled and containerized?

- What procedures are in place to ensure adequate separation of wastes?

- Are any changes in disposal procedures planned? If so, how will they affect the plant? What will the costs be?

- Are there any above- or underground storage tanks on site?
- Is the entity aware of any leaks or spills, giving rise to contamination of the site? Are records maintained of such incidents?
- Has any integrity/pressure testing of underground and aboveground tanks been carried out? If so, when, and what was the result?
- Do the tanks have alarms/level indicators/cut-off devices?
- How often are tanks emptied?
- Is there a spill prevention plan? Is such a plan required by the regulators? If so, are they satisfied with the current procedures?

• *Hazardous substances*

- Ascertain the location of areas of bulk storage of hazardous materials.
- Are the containers protected from accidental damage and corrosion?
- Are the measures to contain accidental spills/releases adequate?
- Are drums adequately labelled?
- Is there evidence of previous spills/releases?
- Are inflammable substances located in a contained store?
- Are fire precautions adequate to control fire risks, taking into consideration the quantities stored?
- Is the store licensed? If so, was the fire officer satisfied with the precautions taken?
- Is the store adequately ventilated?
- Are there any hazardous wastes generated which require a disposal licence? If so, has this licence been obtained?
- Have the terms of the licence ever been broken?

- *Sources of nuisance*
  - Does the company engage in any operations that could result in nuisance complaints, e.g. noise, dust, smell, fumes, heavy traffic?
  - Have any nuisance complaints been lodged against the company?
  - What controls/monitoring procedures are in place to prevent nuisance complaints?
  - Are records of any noise monitoring kept?
- *Building issues*
  - Was any sort of asbestos used by the contractors in any part of the building? If so, where is it and in what condition is it?
  - Do any of the batteries, transformers or other electrical installations on the site contain PCBs?

CHAPTER IX
FINANCIAL PLANNING

A. Introductory remarks

Financial planning is a key element of your business plan. It is as important for you as it is for your lender or investor.

For you
Financial planning is an integral part of your overall business management concept. All decisions and assumptions you make will be reflected in the financial projections which are to be included in your business plan. If you introduce new products, change the focus to new markets, refurbish your machinery, change your human resource policies, change the advertisement mix, etc., each one of these actions will eventually have an impact on your financial statements.

The two most important features of your financial planning are:

- An indication of how profitable your business is expected to be in the future, and possible financial risks involved;

- A definition of additional funds required for developing your business, i.e. how much money you need, when you will need it and when you will pay it back.

For your lender or investor
The financial statements presented in your business plan (historical and projected) are the principal tools that will be used to analyse the performance of your business. Your lender or investor will particularly want to know what you will be doing with the money you get and how you plan to generate the necessary cash flow to pay it back. A decision on whether your business will be funded or not, and if so on what terms and conditions, will depend on how attractive and convincing the projected financial results of your business are.

While developing your financial plan, you must keep in mind a number of critical considerations, as follows:

- *Adequate back-up reserves*. Whether you are starting a new business or whether you are taking a large step in expanding your existing business, you are probably going to experience a period during which cash outflow exceeds cash inflow. Without adequate cash reserves, borrowing capacity or other means of meeting expenses, a cash shortage can cause the early termination of your business. Regardless of how good the idea of the business is, without adequate capital it will probably fail.

- *Timing of cash movements*. The timing of revenues and expenses is critical to all businesses, whether new or established. Even if revenues from sales are higher than expenses, the actual receipt of cash has to occur in time to meet expenses when they are due. Inability to pay in due time may damage your reputation and trustworthiness with employees, suppliers, banks etc. Assessing your expenses, both recurring (e.g. rents, wages, payments to suppliers) and non-recurring (e.g. unexpected repairs), is vital. Statistics on the reasons for business failures (bankruptcies) show that the single most common cause is shortage of cash. The inability to service liabilities causes companies to fail. This issue will be discussed extensively in the cash flow section.

- *Contingency plan for unexpected costs*. Let us say that you plan to start a business for growing pineapples. You used your financial statement projections to study the impact of changes in the cost of fertilizers, herbicides, pesticides and insecticides. Your projections warn that if these costs rise by more than 25 per cent, your monthly revenues might not be sufficient to pay your suppliers and employees if you cannot increase the price of your pineapples in due time. You must have a contingency plan. This might include securing credit from a bank until the costs decrease again or until the market price of pineapples possibly increases.

- *Basis for start-up businesses*. The type of financial information that you will need for preparing your financial plan depends on whether your business is an established enterprise or is just starting. If you are writing a plan for a new business, you need to assess your assets and borrowing capacity. However, since your business has probably only a few assets and no financial history, your lender or investor is going to have to rely almost entirely on financial projections. Start-up businesses, or business expansions, frequently involve start-up costs that are not applicable to on going businesses. These start-up costs should be included in your projected financial statements.

- *Standardization and regulation of financial statements*. It is a great advantage that financial statements are standardized and regulated documents.

"Standardized" means that there are no surprises or inventive and difficult computations involved in their preparation. They include standard terms that only have to be worked out mathematically for each specific business. "Regulated" means that the format of your financial documents will be dictated in large part by accounting conventions in your country and the specific requirements of your auditors. It is also fortunate that the use of the International Accounting Standards (IAS) is becoming increasingly common practice in most countries around the world.

Following is a list of major elements to be included in the financial part of your business plan:

- Financial history/or start-up information;
- Income statement projections/budget;
- Balance sheet projections;
- Cash flow projections;
- Important financial ratios;
- Request of funds and other supporting information.

The following sections provide guidance for preparing these elements.

B. Financial history

Results of past and ongoing operations will support the credibility of your business plan. A proven track record is persuasive evidence of your chances of continuing success. Most probably, you have been creating and maintaining financial records since the inception of your business. If so, most of your work is already done.

If you are preparing a business plan for an existing business, you should include the following financial information for the last two to three years (or from the inception of the business if it is less than three years old):

- An ***income statement***, which lists the sales revenues, expenses and net profit of your business;

- A ***balance sheet***, which lists the type and book value of your business's assets, liabilities and shareholders' interest;

- A ***cash flow statement***, which lists the cash you generated, the cash you spent, and the cash balance at the end of the period (per month or quarter for the last year, and per year for the years before);

- The ***financial ratios*** derived from your income statement and balance sheet.

For existing businesses, these financial statements are the most objective pieces of evidence that most lending institutions and venture capitalists will look at in order to support or to contradict your forecasts for future performance. With this in mind, you are going to make sure that you present them in a format that is accurate, concise and easy to follow. If you have scattered the data in such a way that they have to search everywhere and piece together information that was supposed to be in one place, they will not look favourably upon the rest of your plan.

It is an advantage if the format and type of information included in the financial history section are similar to those of the financial projections (discussed below). This will enable the reader and yourself to get a better overview and quicker understanding of the development of your business.

C. Income statement projections

The income statement is also called the profit and loss statement. It shows your revenues from sales, expenses and net profit (or loss). The net profit (or loss) is equal to revenues minus expenses.

An income statement for a business plan should be broken down by month or by quarter for the first year. This projection (which is basically your budget) should include seasonal effects (for example, if you are in the pharmaceutical business you may have higher sales in the cold months of the year owing to the higher consumption of medications and vitamins). The second year can be broken down quarterly. For the third and following years estimates can be presented on an annual basis. Analyse the results of the income statement briefly and include this analysis in your business plan. If your business already exists, include income statements for previous years (financial history section).

Many business plans tend to show rapid annual growth projections of 30, 40, 50 per cent or more. If this is also the case with your plan, provide the basis for your assumptions. In other words, if you say you expect your firm to grow by 30 per cent in the first year and by 40 per cent in the second, you need to document why such growth can be attained. It can be because similar companies have had this growth path; because the industry is growing at this rate (indicate the source for these data); or because of projections from a specific market researcher, industry association or other sources.

Avoid large sales or expense categories that are lumped together without back-up information about the components.

Table IX.1 contains an example of the major items included in an income statement.

Table IX.1. Income statement

(Dollars)

Item *Planning years- new company*	Xxx1	xxx2	Xxx3	xxx4
Total net sales	.....	.....	.....	.....
+ Other operating revenues	.....	.....	.....	.....
= Total revenues	.....	.....	.....	.....
- Cost of goods sold	.....	.....	.....	.....
= **Gross profit**	**.....**	**.....**	**.....**	**.....**
- Selling, general and administrative expenses	.....	.....	.....	.....
= **Operating profit (EBITDA)***	**.....**	**.....**	**.....**	**.....**
- Depreciation	.....	.....	.....	.....
- Interest expenses / + income	.....	.....	.....	.....
- Extraordinary charges / + credits	.....	.....	.....	.....
- Corporate tax	.....	.....	.....	.....
= **Net profit (loss)**	**.....**	**.....**	**.....**	**.....**

Source: UNCTAD.

*EBITDA: earnings before interest, tax, depreciation and amortization.

D. Cash flow projections

1. What is cash flow?

An income statement shows the profit (or loss) made during an accounting period. It contains non-cash items such as accruals, income not yet received in cash, etc. A cash flow statement shows a company’s in-and-out flow of cash and how cash is generated to cover outgoing payments.

The two basic elements of your business's cash flow are the cash inflows and cash outflows.

Cash inflows are the movement of money into your business. Inflows are from the sale of your goods or services to your customers. If you grant payment terms to your customers, an inflow occurs only when you collect money from the customers. The funds received from a bank loan are also cash inflow.

Examples of typical sources of cash revenues are:

- Cash from direct sales (sales against cash) of products and services;
- Collection from accounts receivable;
- Other cash revenues from business operations;
- Proceeds from sale of real estate or equipment;
- Interest earned from bank deposits;
- Proceeds from new loans;
- Capital increases in cash (new money put into the business by shareholders);
- Dividends received from financial investments of the business itself.

Cash outflows are the movement of money out of your business. Outflows are generally the result of paying expenses or investing, for example purchasing equipment. If your business involves reselling goods, your largest outflow is most likely to be for the purchase of retail inventory. A manufacturing business's largest outflows will most likely be for the purchase of raw material and other components needed for the manufacturing of the final product. Purchasing fixed assets, paying back loans and settling accounts payable are also cash outflows.

Examples of typical cash disbursements are:

- Payments for raw material procurement;
- Payments for procurement of finished/semi-finished products;
- Payments for buying machinery and equipment;
- Personnel salaries;
- Management bonus;
- Commissions and/or royalties to agents;
- Cash dividends to shareholders in the business;
- Advertising and promotion expenses;
- Professional fees (legal, audit, training and consulting);
- Licences, registrations and permits;
- Patents, trade marks and distribution agreement fees;
- Rental payment for premises;
- Rental (or lease) payments for equipment and furnishing;

- Other rental payments (including vehicles);
- Motor vehicle expenses;
- Insurance premiums (for premises, equipment, vehicles);
- Repair and maintenance expenses paid (for premises, equipment, vehicles);
- Utilities (electric, gas and water);
- Communications (telephone, fax, Internet provider);
- Postal expenses (mail, courier, telegrams, etc.);
- Cash payments for office supplies;
- Other business expenses (not elsewhere listed);
- Interest (and principal) payments to the bank for mortgages;
- Interest payments to the bank for working capital credits;
- Tax payments (duties, tariffs, on income, etc.).

Some of the most important elements that need special attention when you are preparing your cash flow projections and in managing your cash flow are:

- *Credit terms and policy.* *Credit terms* are the time limits you set for your customers' promise to pay for the merchandise or services purchased from your business. Credit terms affect the schedule of your cash inflows. Offering discounts for immediate or fast payments might be one way of improving your cash flow. A *credit policy* is the blueprint you use when deciding to extend credit to a customer. An appropriate credit policy is necessary in order to ensure that your cash flow does not become the victim of a credit policy that is too strict or one that is too lenient.

- *Accounts receivable.* Accounts receivable represent sales that have not yet been collected in the form of cash. An account receivable is created when you sell something to a customer in return for a promise to pay at a later date. To manage your cash flow properly, you must know the time it takes your customers to pay. Although your credit terms and policy may say that clients have to pay within 30 days of receiving the product, you may find that some of them take 60 or 90 days or more.

- *Inventory.* Inventory describes the extra merchandise or supplies that your business keeps in stock for meeting demands of customers. An excessive amount of inventory hurts your cash flow by binding funds that could be used for other purposes. The “just-in-time” concept introduced by many companies in recent times has as a main objective to minimize the amount of inventory (stock of products). This is done through well-timed and highly coordinated production and distribution processes involving all major suppliers of raw materials and clients in the planning and execution work. This reduces the costs of storage space but also improves cash flow.

- *Accounts payable*. Accounts payable are amounts that you owe to your suppliers and are usually payable in the near future, "near" meaning 30 to 90 days. Without trade credits you would have to pay for all goods and services at the time you purchase them. For the best cash management, you need to examine regularly your schedule of payables and have tight control of them. Arranging for favourable (longer-term) credit terms and paying on time (and not earlier) improve the cash situation of your company.

The above-mentioned sources and uses of cash can be conveniently divided into three categories as indicated in table IX.2.

Table IX.2. Sources and uses of cash flows

Cash inflows from:	Activity	Cash outflows from:
♦ Sales of products/ services ♦ Decreased accounts receivable ♦ Decreased inventory ♦ Increased accounts payable	**Operating activities**	♦ Expenses ♦ Increased accounts receivable ♦ Increased inventory ♦ Decreased accounts payable
Sale of: ♦ Fixed assets (property, plant and equipment) ♦ Long-term financial investments (shares, others) ♦ Patents, trademarks and licences	**Investing activities**	Purchase of: ♦ Fixed assets (property, plant and equipment) ♦ Long-term financial investments (shares, others) ♦ Patents, trademarks and licences
♦ Increased borrowing (loan) ♦ Sale of marketable securities ♦ Increased equity (contribution of new capital)	**Financing activities**	♦ Debt repayment ♦ Acquisition of marketable securities ♦ Dividend payments ♦ Decreased equity (capital withdrawal)

Source: UNCTAD.

Your profit is not the same as your cash flow. It is possible to show a good profit at the end of the year, and yet face a significant money squeeze at various points during the year.

2. Why do you need cash flow planning?

A cash flow projection shows sources and uses of cash for the period under consideration. It shows which amounts of cash are expected to come in and go out, and when. It also shows the net cash amount available at any time. A cash flow projection is an important instrument for you as well as for your lender.

<u>For you</u>
Used properly, a cash flow projection will provide you with the tool to keep your business decision-making on track and your inventory purchasing under control. It will also serve as an early warning indicator when your expenditures are out of line or your sales targets are not met. If your cash flow estimates show that you will occasionally not have enough money to pay your bills, you can arrange in advance for other sources of funds to get you through temporary cash shortages. A proper cash flow forecast will give enough time to devise remedies. It will specifically tell you how much money is needed when it is needed, and where it will come from.

Analysing your cash flow will also help you to spot any problem areas in your business. As in any good analysis, you need to look at each of the important components that make up the cash flow cycle in order to determine whether it is a problem area.

Improving your cash flow will make your business more successful. Accelerating your cash inflows and delaying your cash outflows (but still paying within the time frame agreed with your creditors) are necessary measures for improving and managing your business. Handling any cash surplus is just as important as the management of money into and out of your cash flow cycle. Through proper cash management you may find that you have some spare cash, on which you could earn some interest if you place it in a bank deposit account.

<u>For your lender</u>
Your projected cash flow is very important to most lenders because it provides an indication of whether you will have enough cash to pay your suppliers and other creditors on time, including the lender himself. Furthermore, the completed cash flow forecast will clearly show your lender what additional

working capital, if any, the business may need. If the performance projections are realistic, they will also provide support for the feasibility of a term loan for purchasing equipment or for building up a distribution network.

When making your cash flow projections you may have to distinguish between three different time frames as follows:

<u>Short-term</u> cash flow accounting. This predicts the anticipated cash revenues and disbursements of your business on a week-to-week or even a day-to-day basis. This is to ensure that your bank account is optimally managed and has sufficient cash to cover payment transactions over the coming weeks. Your business plan will probably not be concerned with such short-term operational control.

<u>Medium term</u> cash flow projections. These are typically made for the first year of your business plan (or your budget for the coming year). They are made on a month-to-month basis and will help you to predict the amount of any short-term loans required for covering, for example, seasonal liquidity shortages. If, on the other hand, such projections show a substantial liquidity surplus over several months, you have to discuss with your banker the best way to invest some of this money (for example, putting it in a deposit account which gives you higher interest than your settlement account). Proper treasury management is important for enhancing the profitability of your business.

<u>Long term</u> cash flow projections. These cover the entire period of your business plan (3-5 years) and are of use in establishing requirements for long-term bank loans or equity. This is typically the case when planning long-term product development, expansion in infrastructure, buying of new machinery, etc. A very important purpose of long term cash flow planning is to predict your business's ability to take in more cash than it pays out. This will give you some indication of your business's capacity to generate the resources necessary for expansion.

A sound cash flow is essential for any successful business. Some business people claim that appropriate cash flow management is even more important than the ability of the business to deliver goods or services. If you fail to satisfy a customer and lose that customer's business, you can always work harder to please the next customer or regain the disappointed one. But if you fail to pay your suppliers or your employees, you may soon be out of business. It is obvious that management of cash flow is a very important element in making your business successful.

3. How to prepare a cash flow projection

a. Steps in preparing your cash flow projections

Preparing a cash flow projection involves three steps as follows:

Step1. Forecasting cash revenues

▼

Step 2. Projecting cash disbursements

▼

Step 3. Reconciliation of cash revenues and cash disbursements

Step one: Forecasting cash revenues

Find a realistic basis for estimating your sales each month. For new operations, the forecast sales to identified client groups should be the foundation for your projected revenues and should be based on existing sales of competitors of similar size. It is also recommended that you make adjustments for this year's predicted trend in the industry if any such information is available and you can get it. Furthermore, be sure to reduce your figures by about 40-60 per cent a month for the start-up months in the first year.

For existing operations, sales revenues from the same month in the previous year provide a good basis for forecasting sales for that month of the following year. For example, if analysts of the economy and the industry predict a general growth of 5 per cent for the next year, it will be entirely acceptable to show each month's projected sales at least 5 per cent higher than your sales of the previous year. Include notes to the cash flow to explain any unusual variations from the numbers of the previous year.

If you sell products on credit terms or with instalment payments, you must be careful to enter only the part of each sale that is to be collected in cash in the specific month you are considering (realized accounts receivable). Any amount to be collected after 30 days will be termed as “collections on accounts receivable” and will be shown in the cash flow projection in the month in which it will be collected. It is important that sales be considered only at the moment when cash is received. This is an important principle of the cash flow projection and should be applied whenever you are in doubt about the amount to enter and when to book it.

Step two: Projecting cash disbursements

Project each of the various expense categories, beginning with a summary for each month of the cash payments to your suppliers (accounts payable). Again, follow the principle of not averaging purchases.

Each month must show only the cash that you expect to pay in this particular month to your suppliers. For example, if you plan to pay your supplier invoices in 30 days, the cash payments for January's purchases will be shown in February. If you can obtain trade credit for longer terms, cash outlays will appear two or even three months after the goods purchased have been received and invoiced.

Your insurance expenditure is an example of a different type of expense. Your commercial insurance premium may be $2,400 annually. Normally, this would be treated as a $200 monthly expense. But the cash flow will not see it this way. The cash flow wants to know exactly when it will be paid. If it is to be paid in two instalments $1,200 in January and $1,200 in July that is how it must be shown on the cash flow spreadsheet. Exactly the same principle applies to all other cash expenses.

Once total collection of cash, total cash payments for goods purchased and any other expected expenses have been estimated for each month of operation, it is necessary to reconcile the cash flow. This involves linking the cash flow status of each month to the cash flow status and respective activity of the preceding and succeeding months.

Step three: Reconciliation of cash revenues and cash disbursements

The reconciliation section of the cash flow worksheet begins with the balance carried forward from the previous month's operations. Then add the total of the current month's revenues and subtract the total of the current month's expenditures. This adjusted balance will be carried forward to the first line of the reconciliation part of the next month to become the base to which the next month's cash flow sources and/or uses will be added and/or subtracted. The reconciliation example given in table IX.3 indicates that there is a need to borrow funds in order to cover the cash shortage in June.

Table IX.3. Example: reconciling cash revenues and disbursements
(Dollars)

Item	Planned April	Actual April	Planned May	Actual May	Planned June	Actual June
Opening cash balance	12 000	12 000	7 000		3 000	
Total cash revenues	10 000	10 100	8 000		6 000	
Total cash disbursements	15 000	15 100	12 000		12 000	
Closing cash balance (carry forward to next month)	7 000	7 000	3 000		(3 000)	

Source: UNCTAD.

It is necessary that you complete the projected income statements and projected balance sheets before preparing the cash flow projection worksheet, as the latter will be based on data and assumptions made in the other two financial statements. Remember that the income statement, balance sheet and cash flow worksheet have to be consistent.

b. Designing a cash flow worksheet

There are various ways of structuring a cash flow worksheet. To derive the optimum benefit, it is recommended that it be structured to show separately the inflows/outflows from (a) operating (b) investing and (c) financing activities. An appropriate format is given in table IX.4. The cash flow statement shows the main headings (aggregate amounts) that are appropriate to be included in a business plan. In another part of your worksheet there will be all the details of cash inflow and cash outflow for your own purposes.

c. Tools for cash flow projections

Computer spreadsheet programs such as Microsoft Excel, Lotus 123 or any other standard business software can be very useful for creating cash flow worksheets. One of the great advantages of these spreadsheets is that they allow you to change input parameters easily and to see immediately how your business and the cash requirements respond to different assumptions about the course of the business.

4. Some more hints for preparing/improving your cash flow

When developing cash flow projections, the following important considerations are to be kept:

- *Avoid an unrealistically rapid increase in sales* that generate cash. Most companies experience a gradual increase in sales. A sudden unexplained spike will stand out and will not look like a credible appraisal of your business.

- *Include effects of seasonal variations* and business cycles in all cash flow projections. For example, if you are in the accounting business, your cash flow will show peaking values in spring when you charge your clients for preparing their annual reports and assisting with their tax declarations. On the other hand, if you are in the business of selling winter sports articles, spring and summer months are those with the least flow of cash in your business. Seasonal variations are particularly noticeable in the agricultural business, in which farmers harvest, sell and earn revenues only once or twice a year.

- *Do not underestimate cash flow needs*. This can lead to under funding, which means that your funds will prove inadequate for meeting your obligations.

- *Avoid large cash flow categories* that are lumped together without back-up information about the components.

- *Compare planned and real figures*. Cash flow plans are living tools and must be constantly modified as you learn new things about your business and your customers. Since you will use the cash flow forecast to compare regularly each month's projected figures with each month's actual figures, it will be useful to have a second column for the actual figures alongside each column of the planned figures. As the true strengths and weaknesses of your business unfold before your eyes, patterns of cash movement emerge. Look for significant discrepancies between “planned” and real figures. For example, if the figures of the business fail to meet your cash revenue projections for three consequent months, this is an unmistakable signal that it is time to revise the year's projections. It may be necessary to delay stock replenishment, or apply to the bank for an increase in the limit of your credit line. Approaching the bank should be done well in advance of the day on which the additional funds are required. Never leave cash inflow to chance.

- *Using cash surplus*. A cash surplus is a situation when the cash coming into the business exceeds the cash required for covering the expenses of your day-to-day operations. How you handle your cash surplus is just as important as the management of money going in and out of your cash flow cycle. Two of the most common uses of extra cash are paying of your debt and investing the cash surplus. Deciding how to use your cash surplus requires some planning and is also part of the business planning process.

- *Improving your cash flow*. Cash outflows and inflows rarely occur at the same time. More often than not, cash inflows lag behind your cash outflows, leaving your business occasionally short of cash. Think of this money shortage as your *cash flow gap*. The cash flow gap represents an excessive outflow of cash that might not be covered by a cash inflow for some time. Although business, large or small, may experience a cash flow gap from time to time, it does not necessarily mean that the business is in financial trouble. Preparing a cash flow budget is the best way to eliminate the cash flow gaps in your business. Improving your cash flow means increasing or accelerating your cash inflows or decreasing or delaying your cash outflows. The most obvious measure is to minimize expenses, i.e. the amount of operating expenses. Other important steps are:

    - Decreasing inventory;
    - Decreasing accounts receivable (through faster invoicing, offering a discount for quicker payments, etc.);
    - Negotiating longer terms for payables to your suppliers, etc.;
    - Negotiating deferment of larger payments in the event of a cash flow emergency;
    - Trying to borrow from the bank the necessary additional funds (however, you will have to show your lender when and how you will be able to repay the loan).

Table IX.4 contains an example of the major items included in a cash flow statement.

Table IX.4. Cash flow statement

(Dollars)

Item *Planning years- new company*	xxx1	Xxx2	Xxx3	Xxx4
Cash flow from operating activities:				
Operating profit (EBITDA)*	…..	…..	…..	…..
- Interest expenses / + income	…..	…..	…..	…..
- Extraordinary charges / + credits	…..	…..	…..	…..
- Corporate tax	…..	…..	…..	…..
Changes in working capital:				
+ Decrease (increase) in accounts receivable	…..	…..	…..	…..
+ Decrease (increase) in inventories	…..	…..	…..	…..
+ Increase (decrease) in accounts payable	…..	…..	…..	…..
= **Total cash flow from operating activities**	**…..**	**…..**	**…..**	**…..**
Cash flow from investing activities:				
Sale (purchase) of property, plant and equipment	…..	…..	…..	…..
+ Sale (purchase) of long-term financial investments	…..	…..	…..	…..
+ Sale (purchase) of patents, trademarks and licences	…..	…..	…..	…..
= **Total cash flow from investing activities:**	**…..**	**…..**	**…..**	**…..**
Cash flow from financing activities:				
Proceeds from new loans	…..	…..	…..	…..
- Repayment of funds borrowed	…..	…..	…..	…..
+ Sale (purchase) of marketable securities	…..	…..	…..	…..
+ Increase (decrease) in share capital	…..	…..	…..	…..
- Dividends paid out	…..	…..	…..	…..
= **Total cash flow from financing activities**	**…..**	**…..**	**…..**	**…..**
Total net increase (decrease) in cash	**…..**	**…..**	**…..**	**…..**
Cash balance (beginning of the year)	**…..**	**…..**	**…..**	**…..**
Cash balance (end of the year)	**…..**	**…..**	**…..**	**…..**

Source: UNCTAD.

*EBITDA: earnings before interest, tax, depreciation and amortization.

E. Balance sheet projections

The balance sheet is a statement of your company's relative wealth or financial position at a given date (say 31 December of each year). It is often referred to as a "snapshot" because it gives you the picture of the business at a specific moment, but does not in itself reveal how the business got there or where it is going next. That is one reason why the balance sheet is not the whole story. You must also look at the information in each of the other financial statements (including historical information) in order to get an overall picture of the financial situation of the business.

If your business plan is for a start-up business, you will need to include an "opening" balance sheet. If your business already exists, include the balance sheets of the last two to three years. Analyse the balance sheet briefly and include this analysis in your business plan.

As in the case of the other financial statements, avoid large asset or liability categories that are lumped up without detailed information.

The balance sheet of a company limited by share capital consists of the following categories of items:

Assets

- Long-term assets (called also fixed assets);
- Current assets.

Liabilities

- Long-term liabilities;
- Current liabilities.

Shareholders' equity

- Share capital;
- Reserves;
- Retained earnings.

- *Assets*. Assets are those things owned by your business that carry a certain value. They include all the physical and monetary items that are necessary for operating your business. Assets must be valued in money terms and they must be valued at their original cost. Over time the value decreases by the accumulated depreciation. Assets are generally divided into two groups, long-term assets and current assets (short-term).

Long-term assets
Long-term assets (fixed assets) such as plant and equipment are being "consumed" by the business over a number of years. The process by which they are "consumed" in the financial statements and therefore disappear from the balance sheet is termed "depreciation of fixed assets".

Current assets
Current assets are entered in the balance sheet in the order of their liquidity. Since cash is the most liquid of all assets, it is entered the first, followed by marketable securities, accounts receivable, inventory, etc.

- *Liabilities.* Liabilities are obligations/debts of your company to third parties. They are claims that creditors have on your business. Liabilities come from two sources. They can be placed in the business through a borrowing process, or they can be unpaid expenses incurred during business operations. Liabilities are generally divided into two groups, long-term liabilities and current liabilities (short-term).

Long-term liabilities
Long-term liabilities are those that must be paid during periods longer than one year.

Current liabilities
Current liabilities are those that must be paid within one year from the statement date.

- *Shareholders' equity***.** Shareholders' equity (or net worth) represents those assets that were placed at the disposal of the business by the owners of the company. It enters a business in one of two ways: through investments by the owners (shareholders) or through profits retained in the business. Accordingly, it leaves a business in one of two ways: the owners can withdraw assets from the business, or they can sustain losses from the business operations. The three important positions in the balance sheet are:

➢ *Share capital*
  Paid in by the shareholders/owners.

- *Reserves*

  The position in the balance sheet to which part of the profit is allocated as a reserve (the minimum percentage amount allocated to cater for risk inherent in the business is regulated by law).

- *Retained earnings*

  Profits (or losses) accumulated over different accounting periods after dividends and allocation to the reserves have been deducted. The retained earnings remain as wealth to the company.

For any business and at any point in time the assets of the company should be balanced with the liabilities plus the shareholders'/owners' equity (that is the reason for the name "balance sheet").

Assets = liabilities + shareholders' equity

Table IX.5 shows the major items included in a balance sheet.

Table IX.5. Balance sheet

(Dollars)

Item *Planning years-new company*	Xxx1	Xxx2	xxx3	xxx4
Long-term assets:				
Land, plant and equipment	…..	…..	…..	…..
+ Long-term financial investments (stocks, bonds)	…..	…..	…..	…..
+ Goodwill (patents, trademarks and licences)	…..	…..	…..	…..
= **Total long-term assets**	**…..**	**…..**	**…..**	**…..**
Current assets:				
Cash and cash equivalents	…..	…..	…..	…..
+ Marketable securities	…..	…..	…..	…..
+ Accounts receivable	…..	…..	…..	…..
+ Inventories (goods and materials)	…..	…..	…..	…..
= **Total current assets**	**…..**	**…..**	**…..**	**…..**
Total assets	**…..**	**…..**	**…..**	**…..**
Long-term liabilities:				
Total long-term loans	…..	…..	…..	…..
= **Total long-term liabilities**	**…..**	**…..**	**…..**	**…..**
Current liabilities:				
Bank loans (overdrafts)	…..	…..	…..	…..
+ Accounts payable	…..	…..	…..	…..
+ Corporate tax payable/other provisions	…..	…..	…..	…..
= **Total current liabilities**	**…..**	**…..**	**…..**	**…..**
Shareholders’ equity:				
Share capital	…..	…..	…..	…..
+ Reserves	…..	…..	…..	…..
+ Retained earnings (-accumulated losses)	…..	…..	…..	…..
= **Total shareholders’ equity**	**…..**	**…..**	**…..**	**…..**
Total liabilities and equity	**…..**	**…..**	**…..**	**…..**

Source: UNCTAD.

F. Important financial ratios

Financial ratios are derived from information included in the income statements and balance sheets of your business plan. These are used as indicators for:

- Providing a picture of the financial health of your business through evaluating its ability to generate profit, pay its bills on time and utilize its assets efficiently;

- Comparing the performance of your business with other businesses in the industry;

- Monitoring the changes in the performance of your business over a certain period of time;

- Assessing whether certain operations of your business need fine-tuning.

In order to assess how your business is doing, you will need to examine some of the figures in the financial statements not only in absolute terms but also in relation to other parameters of the business. For example, your income statement may show a net profit of $50,000. How good is that? If this profit is earned on sales of $250,000, it may be very good (20 per cent); but if sales of $1,000,000 are required to yield a net profit of $50,000, it does not seem too good (5 per cent). A $3,000,000 sales figure may seem impressive, but not if it takes $3,000,000 of assets to generate those sales. Such comparisons are the reason why financial ratios have been developed.

By routine calculation and recording specific ratios at the end of every accounting period chosen you may see possibilities for improvement in key areas. Lenders use financial ratios to assess a business that is applying for a loan, and some suppliers use them to determine whether to extend credit to you.

When developing your business plan you will be looking at ratios derived from both historical financial statements and financial projections. In many cases, ratios are computed for a number of years (past and future projections), so that you compare and spot important trends.

There are several dozens standard ratios that can be worked out. However, there are only 15-20 ratios that are regularly used in business planning. These can be grouped in to four different types as follows:

1. Liquidity ratios

2. Efficiency ratios

3. Profitability ratios

4. Solvency ratios

These ratios are explained in the following sections.

1. Liquidity ratios

Liquidity ratios are probably the most commonly used of all financial ratios. Your creditors may often be particularly interested in them because they indicate the ability of your business to generate the cash needed to pay your bills. This information should also be highly interesting for you, since inability to meet your short-term debts is a problem that deserves your immediate attention. Liquidity ratios are sometimes called working capital ratios. The liquidity ratios are:

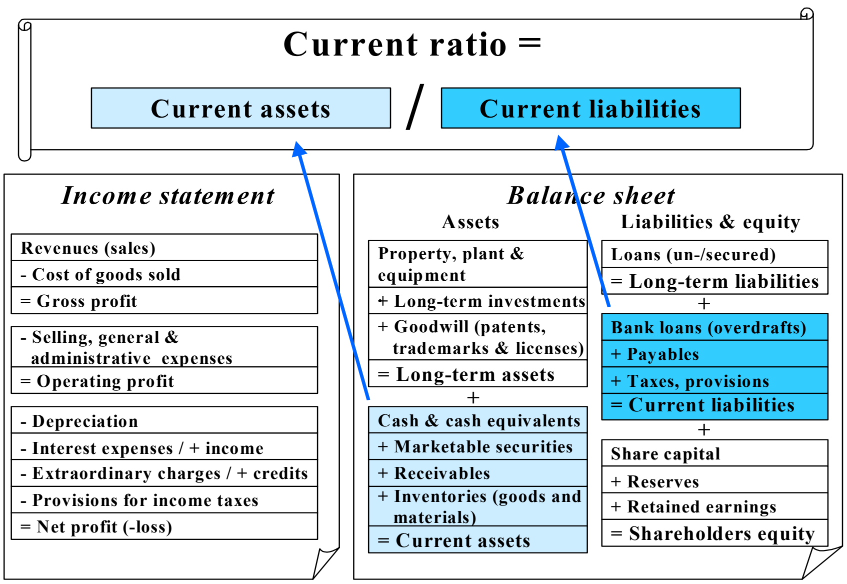
- Current ratio;
- Quick test ratio.

Lenders commonly examine liquidity ratios when they are assessing loan/credit line applications. Once a loan/credit line is allocated to you, your lender may request that you continue to maintain a certain minimum ratio as part of the credit arrangements. Hence, steps to improve your liquidity ratios are sometimes necessary.

a. Current ratio

Table IX.6 exemplifies the current ratio.

Table IX.6. Current ratio



Source: UNCTAD.

This ratio indicates the amount of current assets, such as cash, stocks and bonds, accounts receivable and inventory, that can be converted into cash to pay your short-term liabilities. Generally, your current ratio shows the ability of your business to generate cash to meet its short-term obligations, say over the coming one-year period. A decline in this ratio can be attributed to an increase in short-term debt, a decrease in current assets, or a combination of both.

Lenders often require that you have a current ratio of 2:1 or better. This assures them that you will have enough working capital to run your business in the foreseeable future.

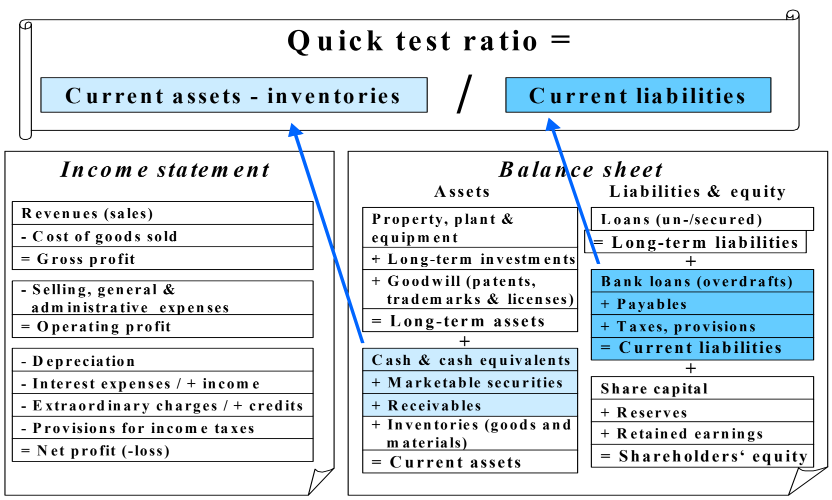
If your business lacks the cash to reduce current debts, long-term borrowing to repay the short-term debt can also improve this ratio. For example, if the total amount of your current assets is $50,000 and your current liabilities are $40,000 the current ratio is equal to 1.25, which is rather low. If you manage to get $15,000 as a long-term loan in order to refinance an equal amount of short-term debt, the ratio will increase to 2.00 (you will have $50,000 in current assets to $25,000 in current liabilities).

Other possibilities may appear if you carefully scrutinize the elements in the current asset and current liability sections of your company's balance sheet. The idea is simply to take steps to increase total current assets and/or decrease total current liabilities as of the balance sheet date. For example, can you increase the value of your year-end inventory? Is it possible to value any work in progress in order to create assets? Can pending orders be invoiced and placed on your books sooner in order to increase your receivables? Can purchases be delayed to reduce accounts payable?

b. Quick test ratio

Table IX.7 exemplifies the quick test ratio.

Table IX.7. Quick test ratio



Source: UNCTAD.

The quick test ratio serves a purpose that is similar to that of the current ratio. The difference between the two is that the quick test ratio subtracts inventory from current assets and compares the resulting figure with current liabilities.

Many lenders are interested in this ratio because it does not take into account inventory, which may not be sold so easily.

Over time, a stable current ratio with a declining quick test ratio may indicate that you are building up too much inventory. The quick test ratio can be improved through many of the same actions that would improve the current ratio. Converting inventory to cash or accounts receivable also improves this ratio. In evaluating the current ratio and the quick test ratio, you should keep in mind that they give only a general picture of your business's ability to meet short-term obligations. They are not an indication of whether each specific obligation can be paid when due. This can be obtained only through a detailed cash flow projection. In general, a quick test ratio of at least 1:1 is satisfactory. This signals that your quick current assets can cover your current liabilities.

2. Efficiency ratios

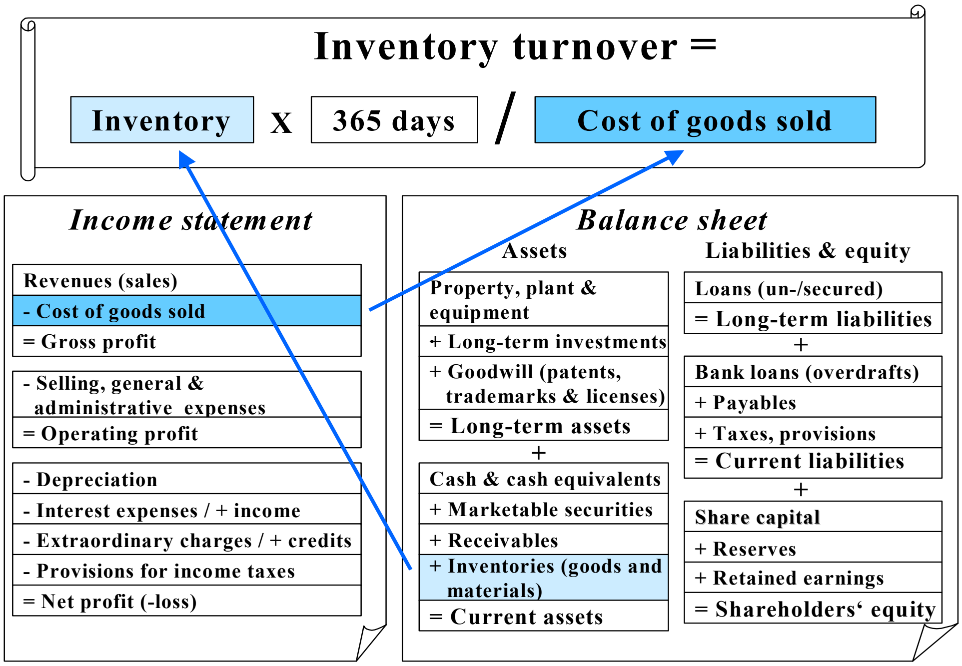
As a business owner/manager, you are concerned with optimizing the use of your assets and being a cost-effective producer. You can determine how efficient your business uses its assets, and where there is room for improvement, by looking at the following ratios:

- Inventory turnover;
- Accounts receivable turnover;
- Accounts payable turnover;
- Fixed assets turnover;
- Total assets turnover.

a. Inventory turnover

Table IX.8 exemplifies the calculation of inventory turnover.

Table IX.8. Inventory turnover



Source: UNCTAD.

Inventory is the amount of merchandise, parts, supplies or other goods your business keeps in stock for meeting the demand of its customers. Depending on the nature of your business (e.g. manufacturing, trading, service), the efficiency of your inventory management may have a significant impact on your cash flow and on the overall performance of your business.

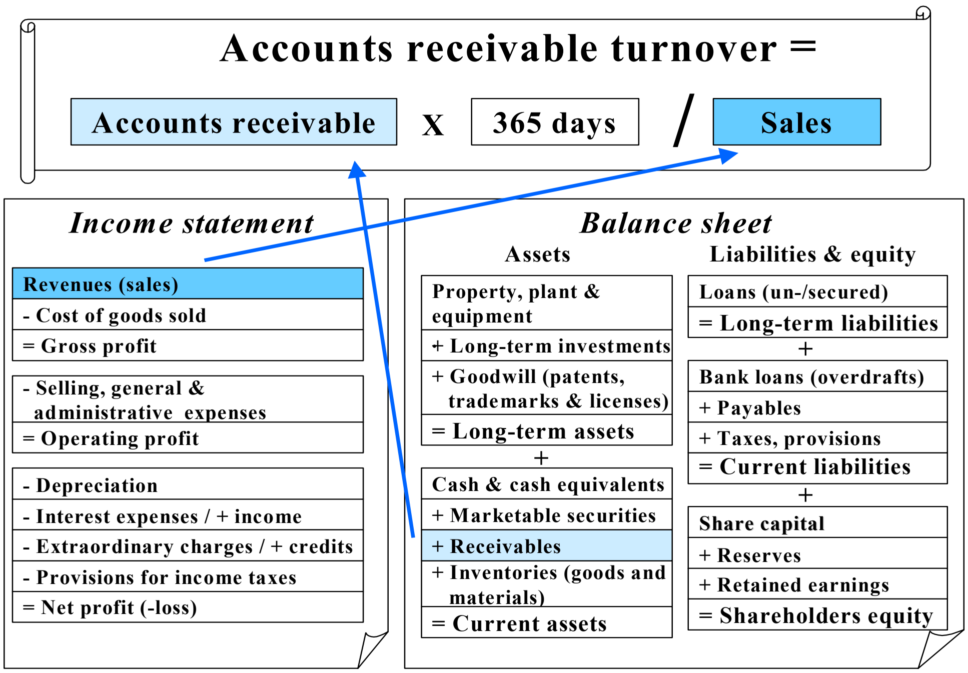
The most significant inventory ratio is the inventory turnover in days. These are the days (on average) before inventory is turned into accounts receivable or cash through sales. To compute this you need to estimate the average inventory over the year, multiply by 365 days and divide by the cost of goods sold. A high inventory turnover is a sign of having slow moving or obsolete items in the inventory. The shorter the period, the more efficient the inventory management of your firm (the more liquid the inventory).

For example, if the total inventory of your computer equipment business is $300,000 on average, and if the cost of goods sold in a year is $500,000, the average inventory turnover is 219 days, which may be quite high for the business you are in.

b. Accounts receivable turnover

Table IX.9 exemplifies calculation of accounts receivable turnover.

Table IX.9. Account receivable turnover



Source: UNCTAD.

Accounts receivable represent sales for which payment has not yet been collected. If your business normally extends credit to its customers, the payment of accounts receivable is likely to be your most important source of cash inflows.

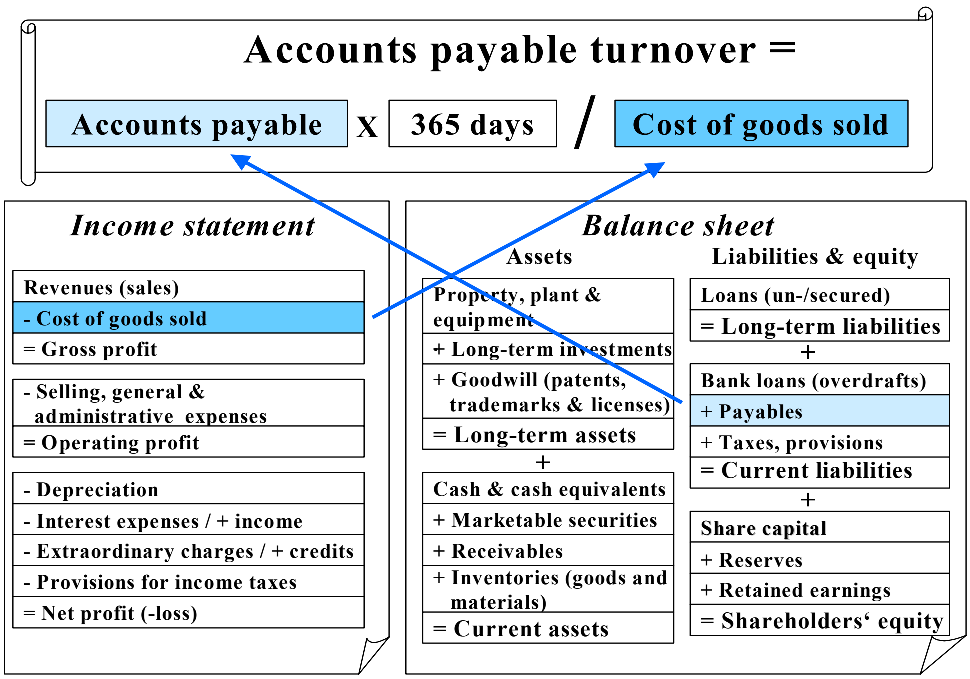
The turnover of receivables in days represents the average period of time it takes your business to convert credit sales into cash. It is calculated by multiplying the average current accounts receivable by the number of days in the year. The result is divided by your annual credit sales. The resulting ratio shows the average number of days it takes to collect your receivables. A ratio that is high by industry standards will generally indicate that your business needs to improve its credit policies and collection procedures.

If your average value of accounts receivable is say $100,000 and your total annual sales is $400,000, the receivables turnover is 90 days. If you are in the construction business this may be acceptable. If you are in the retail business of selling electrical appliances, this may be too high and you may have to take measures to reduce it.

c. Accounts payable turnover

Table IX.10 exemplifies the calculation of accounts payable turnover.

Table IX.10. Accounts payable turnover



Source: UNCTAD.

Accounts payable correspond to materials and goods your company has bought for which no payment has been made yet. If suppliers extend credit to you, accounts payable are likely to be one of the most important items in the current liabilities position of your balance sheet.

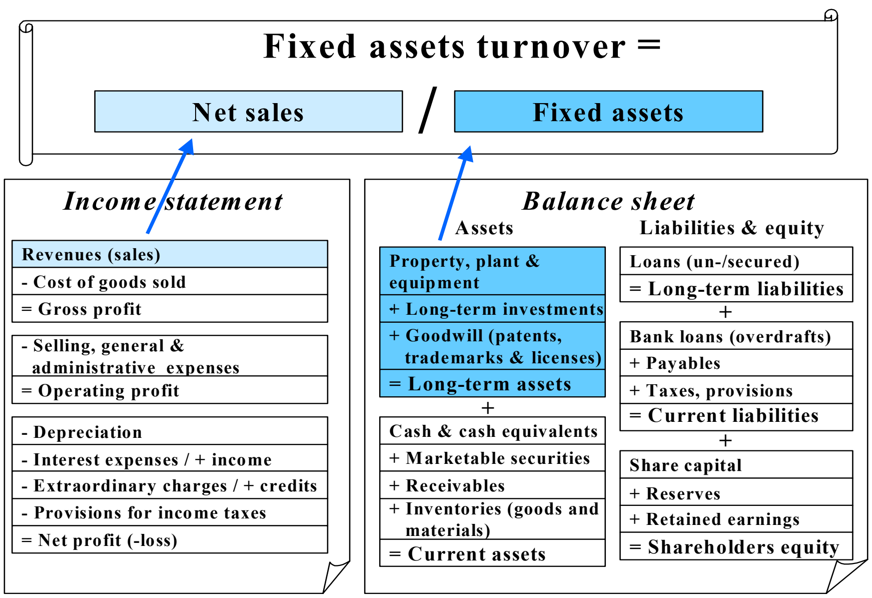
Accounts payable in days represent the average period of time it takes your business to pay its creditors. It is calculated by multiplying your current accounts payable by the number of days in the year. The result is divided by the total cost of goods sold (assuming that most of the accounts payable are related to expense items indicated in the cost of goods sold). The resulting ratio shows the average number of days it takes you to pay your bills. A ratio that is low by industry standards will generally indicate that there is still room to negotiate better terms with your suppliers.

Here again an optimum has to be achieved. Terms with long schedules for payables are good for the cash flow and profitability of your business. On the other hand, trying very hard to get advantageous terms, or delaying payments beyond the agreed dates, can spoil your reputation and make you an unattractive business partner.

d. Fixed assets turnover

Table IX.11 exemplifies the calculation of fixed assets turnover.

Table IX.11. Fixed assets turnover



Source: UNCTAD.

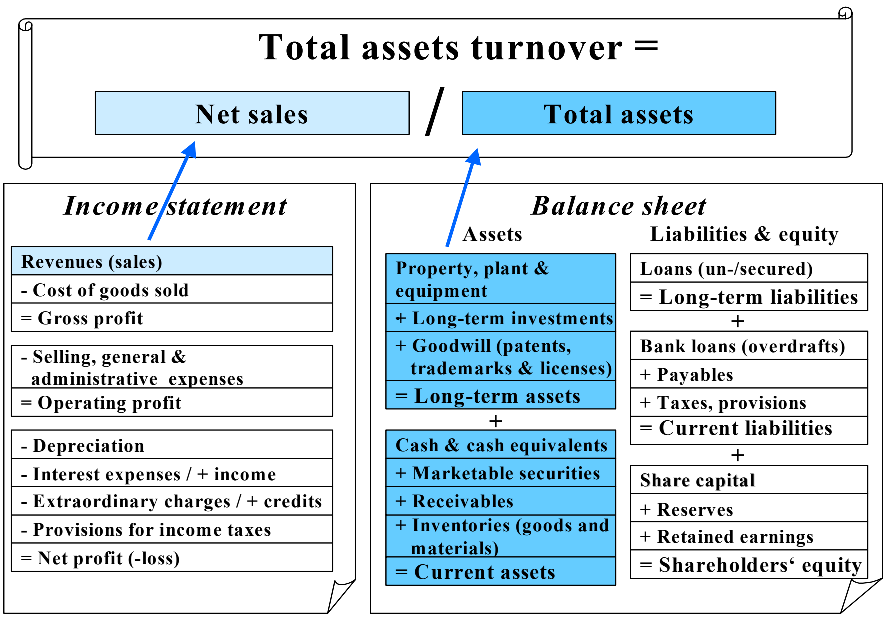
Fixed assets turnover is the ratio of sales shown in your income statement to the fixed assets on your balance sheet (land, buildings, machinery, equipment, patents, trade marks, licences etc., also called long-term assets). It indicates how well your business is using its fixed assets to generate sales. Generally speaking, the higher the ratio the better, because a high ratio indicates that your business has less money tied up in fixed assets for each dollar of sales revenue. A declining ratio may indicate that you have over invested in plant, equipment or other fixed assets.

As in the case of the other ratios, it is always useful to compare the fixed asset turnover of your business with industry standards or that of your competitors if the data can be obtained.

e. Total assets turnover

Table IX.12 exemplifies the calculation of total assets turnover.

Table IX.12. Total assets turnover



Source: UNCTAD.

The ratio of the sales in your income statement to the total assets in your balance sheet indicates how well you are using all your overall business assets to generate revenue (rather than just inventories or fixed assets).

3. Profitability ratios

You can use a set of ratios to assess the profitability of your business. The ratios listed below and explained on the following pages are probably the most important indicators of the financial success of your business. Lenders and investors will be interested in these ratios as they demonstrate the performance and growth potential of the business:

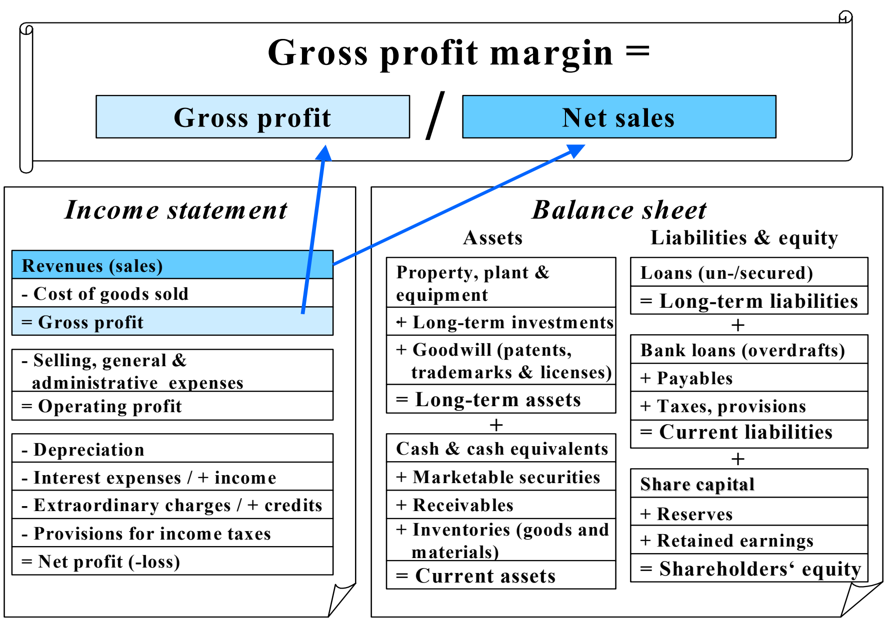
- Gross profit margin;

- Net profit margin;
- Operating profit margin;
- Return on assets;
- Return on equity;
- Dividend pay-out.

a. Gross profit margin

Table IX.13 exemplifies the calculation of the gross profit margin.

Table IX.13. Gross profit margin



Source: UNCTAD.

The gross profit is the amount of money remaining from sales after the cost of goods sold has been deducted.

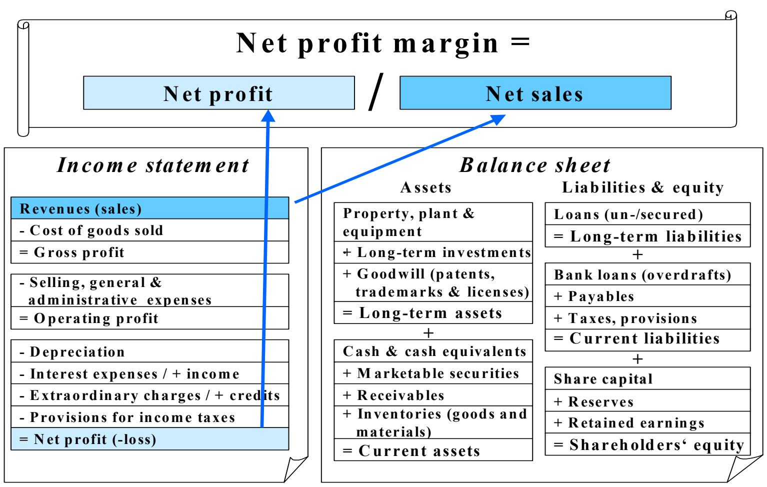
The gross profit margin ratio is an indication of your business's ability to manage the production costs (or cost of goods sold) at a given amount of sales. For example, if your profit margin has been diminishing over consecutive periods and sales have remained the same, you may want to take a close look at your production costs to see if they can be reduced without affecting sales. It may also mean that your selling prices are not rising as fast as the costs of purchasing or manufacturing the goods.

If you are a manufacturer, it means that your costs of production are rising faster than your prices, and adjustments on either side (or both) are necessary. If you are in the trade business and your gross profit margin is diminishing with time, it means that you are buying more expensive or/and you are selling cheaper. In such a case, a comparison with your competitors or with the average ratio in your sector may give you useful hints about your situation.

b. Net profit margin

Table IX.14 exemplifies the calculation of the net profit margin.

Table IX.14. Net profit margin



Source: UNCTAD.

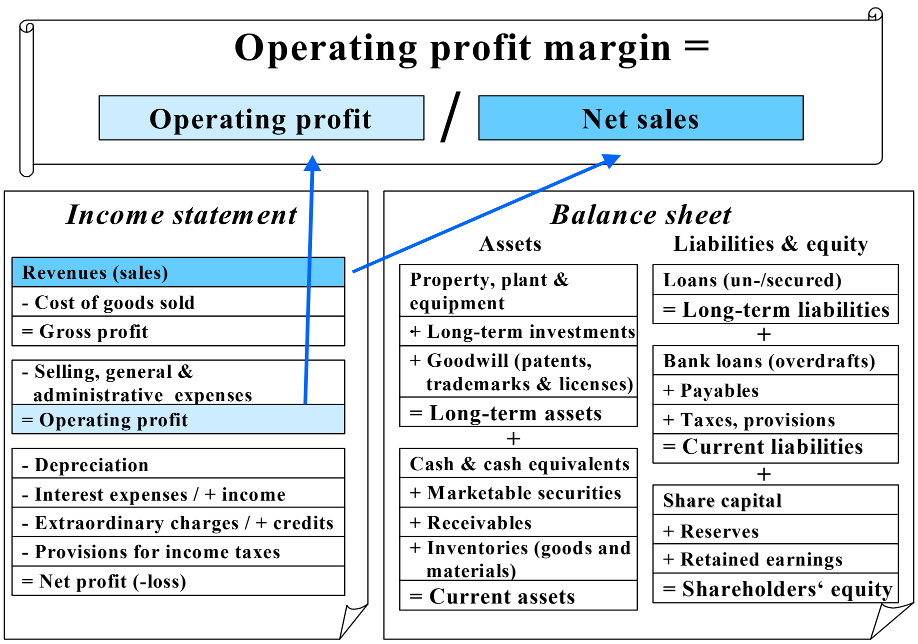
Your net profit margin shows you the bottom line: how much money is ultimately available for you to withdraw from your business. It is probably the figure you are most interested in looking at. The net profit margin ratio takes into account all your costs, including depreciation, interest expenses, extraordinary charges and provisions for income taxes. If your net profit is $500,000 and sales are $2,000,000, your net profit margin ratio is 0.25 (or 25 per cent).

You should have some idea of the range within which you expect your profit margin to be. This should be determined by taking into consideration the industry standards. If you fail to meet your target, it could mean that you have set an unrealistic goal, or it could mean that something is not going too well (excessively high costs of production, high overheads or/and low selling prices).

c. Operating profit margin

Table IX.15 exemplifies the calculation of the operating profit margin.

Table IX.15. Operating profit margin



Source: UNCTAD.

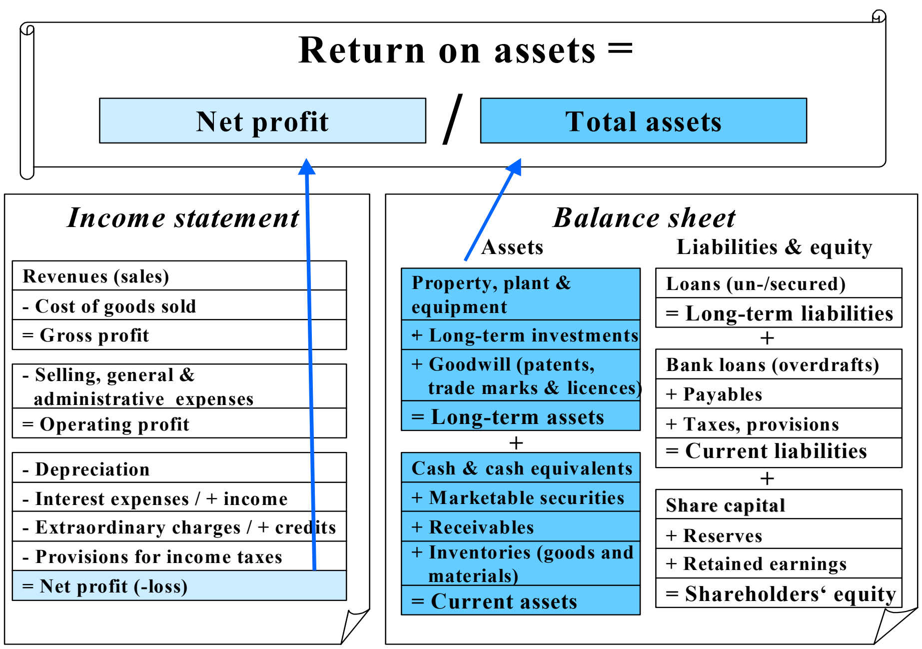
The operating profit is lower than the gross profit but higher than the net profit. It is the profit remaining after deduction of the cost of goods and other operating costs (personnel, overheads, etc.), but before depreciation, interest expenses and taxes.

The operating profit ratio is designed to give you an accurate idea of how much money you are making on your primary business operations. It is an indicator of the profitability of the business itself, independent of investment plans and how the business is financed. It shows the percentage of money remaining in the business after all regular costs of operations have been deducted from the revenues. By looking at the changes in this ratio over time, you can get information on whether your overall costs are trending up or down, and why.

d. Return on assets

Table IX.16 exemplifies the calculation of return on assets.

Table IX.16. Return on assets



Source: UNCTAD.

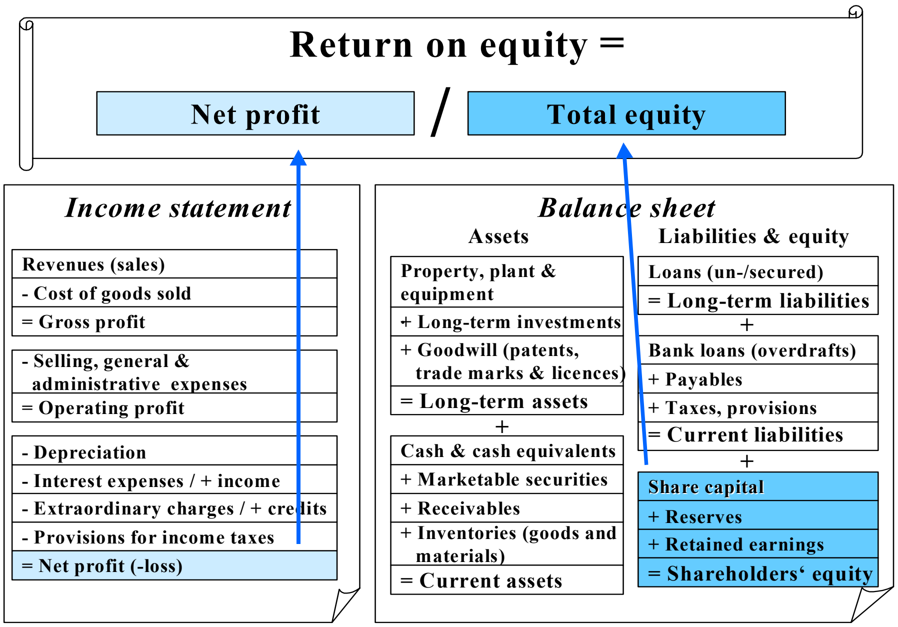
This ratio indicates the rate of return generated by the assets of your business. In some cases, consecutive periods of diminishing ratios may indicate poor utilization of your plant and operating equipment. On the other hand, one or two periods of a lower ratio should not necessarily cause concern. In many cases, businesses gearing up for future growth invest in operating assets that do not immediately generate additional sales and, therefore, will result in a lower return-on-assets ratio.

This ratio can be viewed as a combination of two other ratios net profit margin (ratio of net profit to sales) and asset turnover (ratio of sales on total assets). A high return on assets can be attributed to a high profit margin or a rapid turnover of assets, or a combination of both.

e. Return on equity

Table IX.17 exemplifies the calculation of return on equity.

Table IX.17. Return on equity



Source: UNCTAD.

The ratio of net profit to the shareholders'/owners' equity shows what you have earned on your investment in the business during the accounting period.

You can compare your business's return on equity with what you might have earned on the stock market or on a bank deposit during the same period. Over time, your business should be generating at least the same return as you could earn in more passive investments such as stocks, bonds or a bank deposit account. Otherwise, why should you spend your time, trouble and capital on it? A high return on equity may be a result of a high return on assets extensive use of debt financing, or a combination of the two.

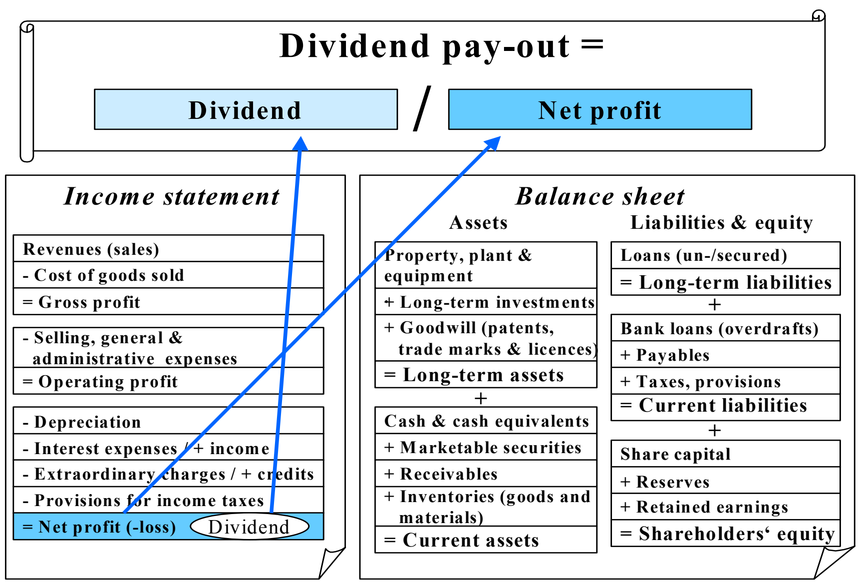
In analysing the return on equity and return on assets, do not forget to consider the impact of inflation on the book value of the assets. While your financial statements show all assets at their book value (i.e. original cost minus depreciation), the replacement cost of many older assets may be substantially higher than their book value. Generally, a business with older assets should show higher return percentages than a business using newer assets.

If you are assessing return on equity for a corporation, keep in mind that the net profit is the amount left after deduction of costs for any salary paid to any shareholder-employees. Since many shareholder-employees of privately owned corporations — for tax purposes — draw the highest salaries possible, return actually may be higher than indicated by this ratio. Or in some cases the return may be lower than indicated if stock-option plans for shareholder-employees are implemented. In such cases the firm maintains salaries at a lower level and instead compensates employees with additional shares in the company.

f. Dividend payout

Table IX.18 exemplifies the calculation of the dividend pay-out.

Table IX.18. Dividend pay-out



Source: UNCTAD.

The dividend pay-out is an indication of the policies applied for allocating the profits of the company. The general trend is that in the build-up phase (start-up), companies pay no or reduced dividends and reinvest most of the profit in order to strengthen the company. In a business that develops well this ratio should begin to gradually increase after the first two to three years of operation and may reach 30-40 per cent of net profit.

4. Solvency ratios

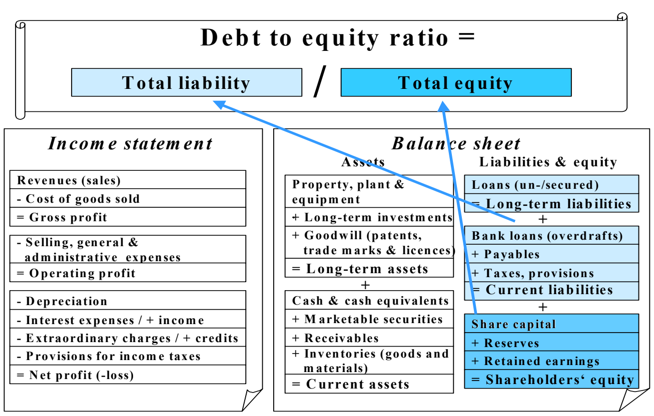
The final group of ratios is designed to measure the degree of financial risk that your business faces. "Financial risk" in this context means the extent to which you have debt obligations that must be met, regardless of your cash flow. By looking at these ratios, you can assess your level of debt and decide whether this level is appropriate for your company. Commonly used solvency ratios are:

- Debt to equity ratio;
- Total assets to equity ratio;
- Total assets to total liabilities ratio;
- Capitalization ratio;
- Interest coverage ratio.

a. Debt to equity ratio

Table IX.19 exemplifies the calculation of the debt to equity ratio.

Table IX.19. Debt to equity ratio



Source: UNCTAD.

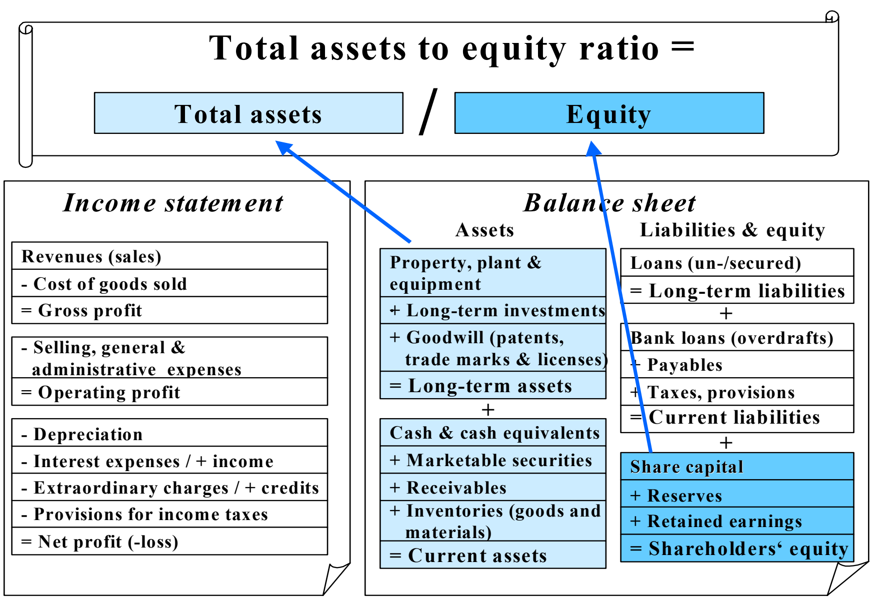
The debt to equity ratio is the ratio of total debt (which is the entire amount of the balance sheet minus the shareholders' equity) to the shareholders' equity or net worth. It is often called leverage ratio.

The ratio of total debt to shareholders' equity shows to what extent your company is financed by debt, or in other words the degree of financial leverage that you are using to enhance your return. Companies usually take debt because it costs less than equity funds. By adding debt to its balance sheet, a company can generally improve its profitability, add to its share price, increase the wealth of its shareholders and develop a greater growth potential. Your lender will probably like to see a lower ratio that gives larger margin of protection in the event of shrinking asset values or losses. Debt in your company increases both profit and risk. It is your job to maintain a proper balance between the two.

b. Total assets to equity ratio

Table IX.20 exemplifies the calculation of the total assets to equity ratio.

Table IX.20. Total assets to equity ratio



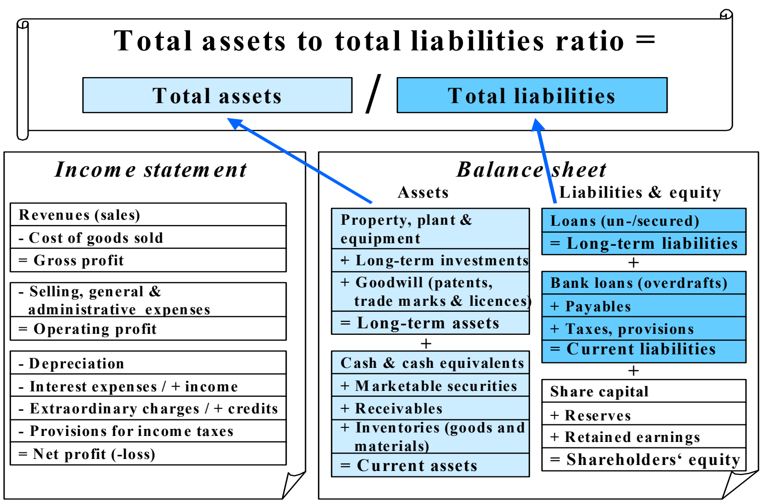
Source: UNCTAD.

The ratio of total assets to equity is for some lenders a more acceptable indicator for examining the leverage effect created by taking debt into the company. The "total assets" is the value of all items the company owns. This ratio shows how many times more the value of these items is as compared with the book value owned by the shareholders. The average ratio in continuing businesses is between 2 and 4. A ratio of 2 means that 50 per cent of the assets are financed by the shareholders themselves and 50 per cent are financed by externally borrowed money. Here again, lenders feel more comfortable with lower ratios, i.e. a higher share of equity. More equity (including reserves and accumulated profit) means higher margins to survive difficult business times in the future. On the other hand, you are perhaps interested in a higher ratio, i.e. in expanding the business (increasing the assets in the balance sheet) but without providing any more funds of your own. Here again, a proper balance has to be found between these conflicting interests.

c. Total assets to total liabilities ratio

Table IX.21 exemplifies the calculation of the total assets to total liabilities ratio

Table IX.21. Total assets to total liabilities ratio



Source: UNCTAD.

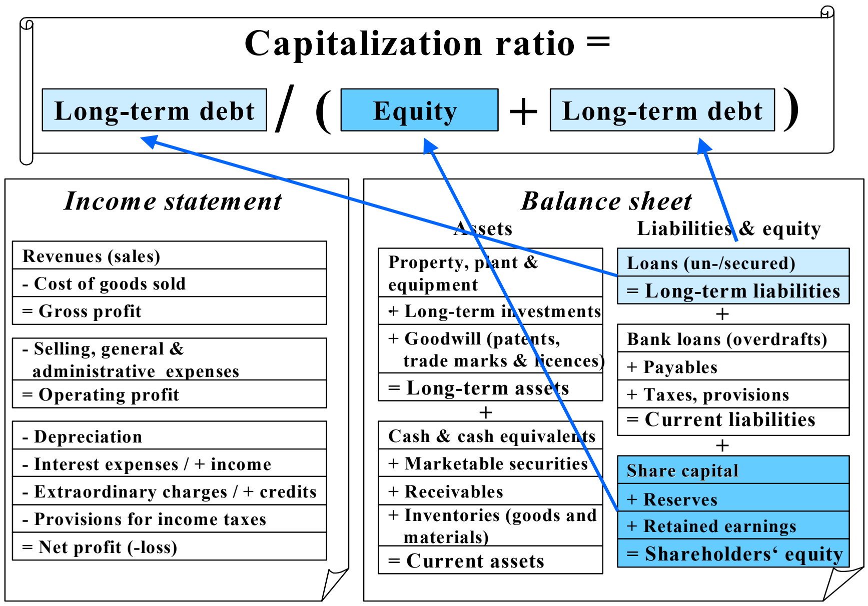
The ratio of total assets to total liabilities is another indicator by means of which some lenders are accustomed to assess the debt-equity relationship. Lenders prefer to see higher such ratios, as this means higher equity (more commitment by the shareholders) and therefore a greater ability to absorb any financial losses.

The above and the other solvency ratios discussed earlier are examined very carefully by lenders also for another reason. If shareholders as part of the operating management are committed to making a substantial equity contribution from their own money, lenders will tend to trust the whole business more.

d. Capitalization ratio

Table IX.22 exemplifies the calculation of the capitalization ratio.

Table IX.22. Capitalization ratio



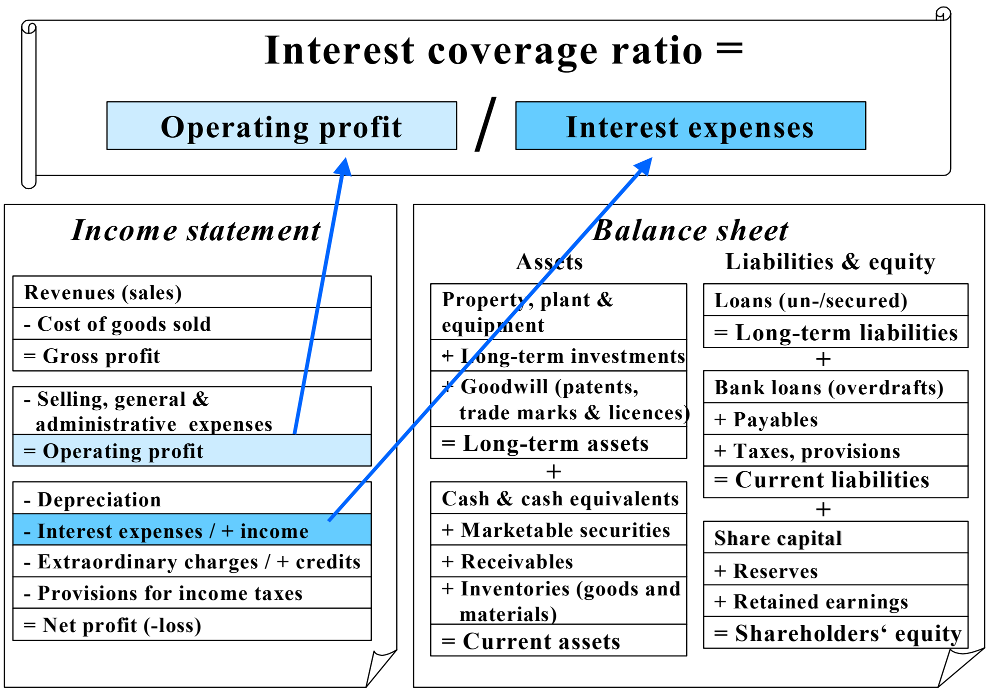
Source: UNCTAD.

This ratio is concerned with the capital structure of the company. It examines, like the other ratios above, the debt-equity relationship. However, it disregards short-term assets and liabilities and looks only at the long-term debts of the company in relation to the long term committed capital equity. Here again, lenders would like to see that this ratio does not exceed certain levels that are standard for well- capitalized companies. Such levels depend upon the type of industry and the kind of company.

e. Interest coverage ratio

Table IX.23 exemplifies the calculation of the interest coverage ratio.

Table IX.23. Interest coverage ratio



Source: UNCTAD.

By comparing the operating profit with the interest expense you measure how many times your interest charges are covered by earnings from your operations. The higher the ratio, the bigger your cushion and the more the business is able to meet interest payments when due. If this ratio is declining over time, it is a clear indication that your financial risk is increasing. This ratio is particularly useful when planning to borrow money for making investments. It shows whether the expected income from your operations is adequate to pay comfortably the interest expenses.

G. Methods for ranking investment projects

Investors use a number of methods to evaluate investment projects, rank them and select the most attractive among them to finance. This section discusses three of the most popular criteria applied:

- Payback period;
- Net present value;
- Internal rate of return.

Depending on the type of investment you are anticipating, it may be advisable to work out these criteria and include them in your business plan.

1. Payback period

The payback period is defined as the number of years it will take to recover the original investment from the future net cash flows. This was the first formal method developed for evaluating capital investment projects. The easiest way to calculate the payback period is to accumulate the project's net cash flows and see when they sum to zero.

Example

Assume that you invest $100,000 in a project. A year later you invest another $50,000. From the second year onwards the net cash you receive is $45,000 per year over a period of five years. The cash flow is as follows:

Year	Net cash flow	Cumulative cash flow
0	- $ 100,000	-$ 100,000
1	- $ 50,000	-$ 150,000
2	+ $ 45,000	-$ 105,000
3	+ $ 45,000	-$ 60,000
4	+ $ 45,000	-$ 15,000
5	+ $ 45,000	+$ 30,000
6	+ $ 45,000	+$ 75,000

The cumulative total becomes positive in year 5, and so the investment is recovered in that year. In general, investment projects with a relatively short payback period are preferable.

One advantage of this method is that it is easy to calculate and apply. Its disadvantage is that it ignores cash flows beyond the payback period (i.e. it is biased against long-term projects) and ignores the time value of money.

2. Net present value

The net present value (NPV) method is a useful method for evaluating investment projects. The NPV is equal to the present value of future net cash flows discounted at the cost of capital, minus the present value of the cost of the investment. The advantage of this method is that it takes into account the time value of money and takes into consideration the potential of the business over the entire planning period of the investment.

The steps for obtaining the NPV are as follows:

1. Find the present value of each net cash flow, including the initial outflow, discounted at an appropriate percentage rate. The discount rate is based on the cost of capital for the project. The latter depends on the level of interest rates in the economy, the riskiness of the project and several other factors.

2. Add up all discounted net cash flows over a defined planning period; their sum is defined as the project's NPV.

3. If the NPV is positive, the project can be normally accepted; if negative, it has to be rejected; and if two projects are mutually exclusive, the one with the higher positive NPV should be chosen.

The NPV can be expressed as follows:

$$NPV = CF_0 /(1+k)^0 + CF_1 /(1+k)^1 + CF_2 /(1+k)^2 + CF_3 /(1+k)^3 \ldots\ldots\ldots F_n /(1+k)^n$$

Where:

- CFt is the expected net cash flow at time t;

- k is the expected discount rate, or the project's cost of capital.

Take again the example discussed above in the payback period section. Assuming the cost of capital to be 9 per cent and a planning period of six years the NPV is calculated to be as follows:

$$
\begin{aligned}
&NPV = \\
&- 100{,}000/1.09^{0} \\
&- \ \ 50{,}000/1.09^{1} \\
&+ \ 45{,}000/1.09^{2} \\
&+ \ 45{,}000/1.09^{3} \\
&+ \ 45{,}000/1.09^{4} \\
&+ \ 45{,}000/1.09^{5} \\
&+ \ 45{,}000/1.09^{6} \\
&= \$\ 14{,}710.37
\end{aligned}
$$

The above calculation can also be expressed in a time line as follows:

Year	0	1	2	3	4	5	6
Cash flow	-$100,000.00	-$50,000.00	$45,000.00	$45,000.00	$45,000.00	$45,000.00	$45,000.00
	-$45,871.56						
	$37,875.60						
	$34,748.26						
	$31,879.13						
	$29,246.91						
	$26,832.03						
NPV =	$14,710.37						

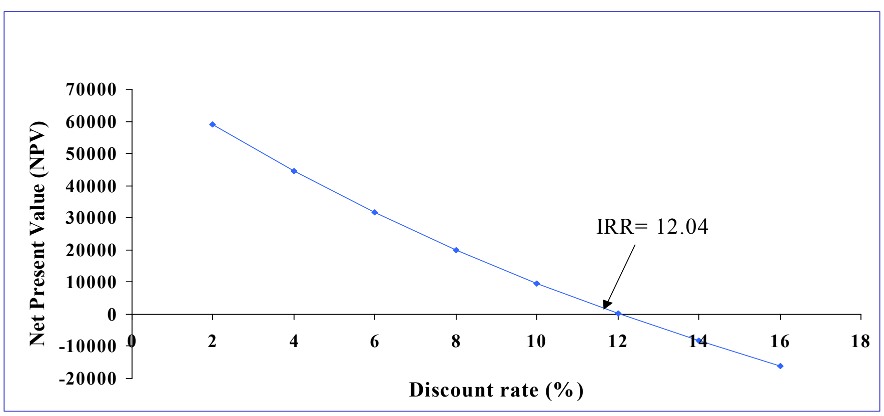
In this example your original wealth as an investor will increase by $14,710.37. Therefore, it is probably a beneficial investment.

3. Internal rate of return

Another method of ranking investment proposals is using the rate of return on an asset investment calculated by finding the discount rate "k" that equates the present value of future cash flows to the investment's cost (or equivalently the discount rate for which the NPV would be equal to zero). This value of discount rate is defined as the internal rate of return (IRR).

A convenient method for finding IRRs involves plotting a curve that shows the relationship between a project's NPV and the discount rate used to calculate the NPV. Such a curve is defined as the project's net present value profile. The IRR is at the point at which NPV equals zero, i.e. the point at which the present value profile crosses the horizontal axis. The present value profile for the example described above is shown in figure IX.1. The IRR value is found to be 12.04 per cent. This is the upper limit of the cost of capital for which the wealth of the investor would increase. Investors obviously expect to see business plans with a cost of capital below the IRR value.

Figure IX.1. Determination of IRR



Source: UNCTAD.

H. Request for funds and other supporting information

1. Request for funds

In this section of the business plan you should clearly define the amount of funding and the type (debt or equity) of investment you seek. It is important to provide a breakdown of how the money will be used. Discuss what effect the capital will have on the potential of the business to grow and to possibly increase profit, when the money is needed, and what investments have already been made in the company. Investors or lenders will also want to know what they will receive in return for their capital. Investors would also like to know who will be making decisions for paying dividends and what criteria will be applied.

A common mistake in some business plans is that no clarity is provided in this section, which turns potential investors away. If the company's founders have invested in the company, include this fact in your plan. Some investors are encouraged if they see that the promoters are risking their own money in the business. Finally, create an exit plan that describes how investors will get their money back. A common worry of investors is that even if a business is profitable, it may be difficult for them to get a price for their shares remunerating them adequately for the risks incurred and the length, of time during which the funds were locked in. A cash-out option in five years' time or so, the assurance that the company will become a strong candidate to be taken over or an initial public offering are what many venture capitalists will insist upon.

In your request include also the following elements as appropriate;

- Minimum or maximum amount of financial participation;
- How new capital and future investors' funds will dilute current and subsequent ownership;
- Payback period and return on investment;
- Arguments to prove the soundness of the investment;
- Collateral being offered if any;
- Information on current investors;
- Access to additional funding sources (for further expansion);
- Tax advantages/benefits for investors;
- Exit plan/strategy.

Include also future financing needs. In other words, do not just look at what you need today, but give an idea of the funds you will require in the future to take your company to the next step to success.

Be sure to document how investors will make money and what return they will get. This cannot be stressed enough. If you are asking for money, you cannot just say something like: "You will make lots of money from this." You need to show how much money they may expect to make on their investment and what the risks involved in this investment are.

Make sure that you do not ask for less money than you think you will need because you think that this will help you to get the money. It is better to ask for more money than having to go back to your lenders and investors and to ask again when you have run out of cash.

2. Risk assessment

No business is without risks. Your ability to identify and discuss them demonstrates your skills as a manager and increases your credibility. You will show that you have taken the initiative to raise these issues and are capable of handling them. The opposite may also be true. Should a potential investor discover any non-mentioned negative factors, it will undermine the credibility of your plan and reduce your chance of raising finance and other support.

The following list of problems is by no means complete, but should give you an idea of some possible risks you run and have to cope with:

- Key employees leave the business.
- Your competitors cut their prices.
- Changes in the rates of exchange affect your exports unfavourably.
- A key customer cancels a major contract.
- New unforeseen regulatory requirements have a negative impact on sales.
- The industry's growth rate drops.
- An economic crisis decreases the purchasing power of your customers.
- Design or manufacturing costs exceed your projections.
- Your sales projections are not achieved.
- An important advertising campaign fails.
- Important subcontractors fail to make deliveries.
- Your competitors introduce a new, better product or service at a lower price.

- Public opinion with regard to your product or service changes to your disadvantage.
- You cannot find skilled labour.

Evaluate your risks honestly. Put yourself in a "what if" situation and then, if possible, develop contingency plans to deal with this situation. If you like, you may incorporate the analysis of risks and contingency measures into the various parts of your business plan. For instance, you could discuss possible long lead times for subcontracted parts in the "manufacturing process" section of the plan, or the impact of a lower than anticipated response rate to a direct mail campaign in the "sales tactics" section. In many industries, small companies innovate and large companies copy and get the benefit. This is always a risk you need to consider. Think of ways you can stay ahead of your competitors and retain your unique selling position.

To generate a complete list of risks, examine all your assumptions about how your business will develop and what the chances and opportunities are. As each coin has two sides, the opposite of many of these chances and opportunities may be risks for you.

Consider some common mistakes as potential risks. Some of the most important ones are:

- Paying employees too much or too little;
- Hiring friends rather than the most qualified candidates;
- Underestimating costs;
- Overestimating the growth of sales;
- Underestimating the length of the sales cycle;
- Underestimating competition;
- Fast growth which cannot be properly dealt with by the organization;
- Trying to do everything for everybody.

It may be wise to produce three different versions of your financial projections, comprising an optimistic, an average and a pessimistic scenario. The pessimistic scenario should take into consideration the most probable risks.

This part of the manual discusses potential risks in more detail. It will assist you in identifying and evaluating the uncertainties and risks of your business and in developing suitable contingency plans.

3. Start-up business financial information

If you are just starting a new business as an individual entrepreneur or together with a few partners, you face a special challenge because you do not have an established track record. There is no history of operations. Instead, you must rely heavily on your ability to sell yourself (and your partners) as a potentially successful business owner. It does not matter whether you are using your business plan to obtain financing or to persuade prospective employees to come to work for you. You need to convince whoever reads your plan that you have a genuine opportunity for success. In large part, your ability to sell yourself is a substitute for the historical information that does not exist.

Therefore, your plan should include personal financial information instead of the historical information that an ongoing business would be able to provide. This personal financial information should identify the amount and source of funding that you have available and are prepared to invest in the business. Nobody will trust your business ideas unless you are prepared to make a considerable contribution and risk your own money.

The plan should provide specific details regarding any personal assets that you intend to use in running your business. Other documents that may be required, particularly if you are trying to obtain outside financing, are your personal income tax returns for the last few years. Be sure to include any start-up costs that will occur prior to opening your business. While your business will probably involve certain expenses that are unique to your industry, do not forget some of these more common start-up expenses:

- Professional fees (legal or accounting);
- Regulatory charges (licensing, cost of incorporation);
- Security deposits for rented space, etc.

I. Numerical example

Below is a numerical example that shows how the income statement (table IX.24), balance sheet (table IX.25) and cash flow projections (table IX.26) are structured and reconciled. This is for a new (start-up) company that is planning the first four years of its operation. The primary objective of the entrepreneur is to estimate how much money has to be borrowed from banks in order to develop the company. The basic assumptions and steps are as follows:

- *Sales (income statement)***.** The sale of products is the only source of revenue. There are no other revenues such as commissions, subletting facilities income from special services. The sales in the first year are estimated to be \$300,000. In the following years, the business is forecast to grow substantially as the new company establishes itself in the market (growth: 2nd year, 70 per cent; 3rd year, 30 per cent; and 4th year, 35 per cent).

- *Cost of goods (income statement)***.** The cost of goods in the first year is estimated to be about 70 per cent of total sales. However, owing to the effects of mass production (increasing volume of production) this percentage is expected to gradually decrease (2nd year, 60 per cent; 3rd year, 50 per cent; and 4th year, also 50 per cent).

- *Selling, general and administrative expenses (income statement)***.** These are expected to be about 30 per cent of sales in the first year. Here again, owing to learning and economy of scale effects this percentage is expected to gradually decrease (2nd year, 25 per cent; 3rd year, 20 per cent; and 4th year, also 20 per cent).

- *Depreciation.* The company is planning to invest in infrastructure, production machinery, cars, furniture and computers. An investment and depreciation plan is drawn up, as shown in table IX.27. This plan provides, as a result, three important parameters:

➢ The total investment per year as input into the cash flow projection;
➢ The depreciation per year being introduced into the income statement;
➢ The "net book asset value" after subtracting the yearly depreciation, which is introduced in to the long-term assets position of the balance sheet.

- *Interest expenses (income statement).* The interest expenses in the income statement are estimated by assuming an interest rate of 10 per cent on the average amount of loans outstanding as per the position "total long-term loans" in the balance sheet.

- *Extraordinary expenses/income (income statement).* These are usually non-recurring expenses/income. In this particular example, the first two years include initial costs such as legal fees for setting up the company and establishing an accounting system.

- *Tax (income statement).* As indicated in the income statement, the company makes losses in the first and second years of its operation. It is therefore assumed that tax will be paid for the first time in the third year. It is also assumed that the authorities accept that the losses of the first two years can be deducted from the profits of the third year. Thus, the taxable income is estimated in a separate table (table IX.28).

- *Accounts receivable (balance sheet)***.** The accounts receivable turnover is taken to be 90 days in the first year, 80 days in the second year, 70 days in the third year and 60 days in the fourth year. This gradual improvement is expected as a result of the "quickening" of the invoicing and collecting processes with time and also as a result of the increase in the proportion of clients that are "good" payers. However, it will be noticed in the cash flow statement that the growth of business (growth of sales and therefore growth of accounts receivable) causes cash to be absorbed.

- *Inventories (balance sheet).* The assumptions with regard to the inventory are similar to those with regard to the "accounts receivable". The inventory turnover is 60 days in the first year, 55 days in the second year, 50 days in the third year and 45 days in the fourth year. It is assumed that the company will be able to operate with reduced stock owing to improvements in logistics and delivery service. Here again the growth of the business (growth of sales, growth of cost of goods and therefore growth of inventory) absorbs cash.

- *Accounts payable (balance sheet).* The accounts payable turnover is assumed to be 75 days throughout the four-year business planning period. Unlike in the case of receivables and inventory, the growth of the business will cause the accounts payable to increase steadily and thus be a source of cash in the cash flow statement.

- *Share capital (balance sheet).* The share capital subscribed and paid in by the shareholders in establishing the company amounts to $100,000. No changes to the share capital are expected over the four-year planning period.

- *Dividends.* Table IX.29 shows the reconciliation of shareholders' equity or the use of profit. During the first three years it is assumed that no dividend will be paid. The first dividend will be paid for the fourth year (to be paid during the fifth year after the annual shareholders meeting has taken place) after two important conditions have been met:

➢ The company has made a net profit.
➢ Reserves and retained earnings were built up in the balance sheet.

The total dividend is assumed to amount to 50 per cent of the net profit.

- *Reserves (balance sheet).* Reserves are added only in the fourth year of operation to the shareholders' equity of the balance sheet, after the net profit has added a substantial amount to the retained earnings. The amount placed in the reserves is fixed at 20 per cent of the net profit (see table IX.29).

- *Loans (cash flow statement)***.** The balance sheet gives the cash available at the end of the year. The primary objective of entrepreneurs is to ensure that they always have sufficient cash (working capital) to operate the business. Thus, the final reconciliation of the financial statements can be made by working out the loans required (table IX.30) (introduced in the position: "proceeds from new loans") to have a "positive cash amount" plus some contingency at the end of each year. In this particular example the needs for additional borrowing are found to be:

➢ First year: $ 350,000
➢ Second year: $ 100,000
➢ Third year: $ 100,000

The first calculation has shown that the cash balance at the end of the fourth year is quite high and more than what is needed in cash to run the company operations. The business planner has therefore assumed that $70,000 (part of the loan) can be applied as the first repayment at the end of the fourth year.

- *Important ratios.* Table IX.31 shows the development of the most important ratios over the four-year period. The efficiency, profitability and solvency ratios show an improving trend as the business grows. The liquidity ratios (current ratio over 3 and quick test ratio over 2) are sufficiently high to ensure that the business will have enough liquid means to cover its running costs.

Table IX.24. Income statement: an example

(Dollars)

Item *Planning years- new company*	xxx1	xxx2	xxx3	xxx4
Total net sales	300 000	510 000	663 000	895 050
+ Other operating revenues	0	0	0	0
= Total revenues	300 000	510 000	663 000	895 050
- Cost of goods sold	210 000	306 000	331 500	447 525
= **Gross profit**	**90 000**	**204 000**	**331 500**	**447 525**
- Selling, general and administrative expenses	90 000	127 500	132 600	179 010
= **Operating profit (EBITDA)***	**0**	**76 500**	**198 900**	**268 515**
- Depreciation	30 000	38 000	48 000	48 000
- Interest expenses / + income	35 000	45 000	55 000	55 000
- Extraordinary charges / + credits	12 000	5 000	0	0
- Corporate tax	0	0	1 480	33 103
= **Net profit (loss)**	**-77 000**	**-11 500**	**94 420**	**132 412**

Source: UNCTAD.

*EBITDA: earnings before interest, tax, depreciation and amortization.

Table IX.25. Balance sheet: an example

(Dollars)

Item *Planning year -new company*	Xxx1	Xxx2	Xxx3	xxx4
Long-term assets:				
Property, plant and equipment	286 000	328 000	480 000	468 000
+ Long-term financial investments (stocks, bonds)	0	0	0	0
+ Goodwill (patents, trade marks & licences)	0	0	0	0
= **Total long-term assets**	**286 000**	**328 000**	**480 000**	**468 000**
Current assets:				
Cash & cash equivalents	21 658	38 486	71 475	73 777
+ Marketable securities	0	0	0	0
+ Accounts receivable	73 973	111 781	127 151	147 132
+ Inventories (goods and materials)	34 521	46 110	45 411	55 174
= **Total current assets**	**130 151**	**196 377**	**244 036**	**276 083**
Total assets	**416 151**	**524 377**	**724 036**	**744 083**
Long-term liabilities:				
Total long-term loans	350 000	450 000	550 000	480 000
= **Total long-term liabilities**	**350 000**	**450 000**	**550 000**	**480 000**
Current liabilities:				
Bank loans (overdrafts)	0	0	0	0
+ Accounts payable	43 151	62 877	68 116	91 957
+ Corporate tax payable/other provisions	0	0	0	0
= **Total current liabilities**	**43 151**	**62 877**	**68 116**	**91 957**
Shareholders' equity:				
Share capital	100 000	100 000	100 000	100 000
+ Reserves	0	0	0	26 482
+ Retained earnings (-accumulated losses)	-77 000	-88 500	5 920	45 644
= **Total shareholders' equity**	**23 000**	**11 500**	**105 920**	**172 126**
Total liabilities & equity	**416 151**	**524 377**	**724 036**	**744 083**

Source: UNCTAD.

Table IX.26. Cash flow statement: an example

(Dollars)

Item *Planning years- new company*	xxx1	Xxx2	xxx3	Xxx4
Cash flow from operating activities:				
Operating profit (EBITDA)*	0	76 500	198 900	268 515
- Interest expenses / + income	-35 000	-45 000	-55 000	-55 000
- Extraordinary charges / + credits	-12 000	-5 000	0	0
- Corporate tax	0	0	-1 480	-33 103
Changes of working capital:				
+ Decrease (increase) in accounts receivable	-73 973	-37 808	-15 370	-19 981
+ Decrease (increase) in inventories	-34 521	-11 589	699	-9 763
+ Increase (decrease) in accounts payable	43 151	19 726	5 240	23 841
= **Total cash flow from operating activities**	**-112 342**	**-3 171**	**132 988**	**174 509**
Cash flow from investing activities:				
Sale (purchase) of property, plant and equipment	-316 000	-80 000	-200 000	-36 000
+ Sale (purchase) of long-term financial investments	0	0	0	0
+ Sale (purchase) of patents, trade marks & licences	0	0	0	0
= **Total cash flow from investing activities:**	**-316 000**	**-80 000**	**-200 000**	**-36 000**
Cash flow from financing activities:				
Proceeds from new loans	350 000	100 000	100 000	0
- Repayment of funds borrowed				-70 000
+ Sale (purchase) of marketable securities	0	0	0	0
+ Increase (decrease) in share capital	100 000	0	0	0
- Dividends paid out	0	0	0	-66 206
= **Total cash flow from financing activities**	**450 000**	**100 000**	**100 000**	**-136 206**
Total net increase (decrease) in cash	**21 658**	**16 829**	**32 988**	**2 303**
Cash balance (beginning of the year)	**0**	**21 658**	**38 486**	**71 475**
Cash balance (end of the year)	**21 658**	**38 486**	**71 475**	**73 777**

Source: UNCTAD.

*EBITDA: earnings before interest, tax, depreciation and amortization.
Note: The dividend from the business of the fourth year is effectively paid during the fifth year of operations, after the shareholders' meeting. This particular example assumes that the dividend is advanced to a separate closed account at the end of the fourth year.

Table IX.27. Investment and depreciation plan: an example

(Dollars)

Item *Planning years- new company*	xxx1	xxx2	xxx3	xxx4
Investment (depreciation period)				
1-Infrastructure/production machinery (20 years)	200 000			
2-Infrastructure/production machinery (20 years)			200 000	
3-Cars and furniture (10 years)	80 000			
4-Cars and furniture (10 years)		80 000		
5-Computers (3 years)	36 000			
6-Computers (3 years)				36 000
Total investment	**316 000**	**80 000**	**200 000**	**36 000**
Depreciation				
1-Depreciation for (1) above	10,000	10 000	10 000	10 000
2-Depreciation for (2) above			10 000	10 000
3-Depreciation for (3) above	8,000	8 000	8 000	8 000
4-Depreciation for (4) above		8 000	8 000	8 000
5-Depreciation for (5) above	12 000	12 000	12 000	
6-Depreciation for (6) above				12 000
Total depreciation	**30 000**	**38 000**	**48 000**	**48 000**
Net asset book value	**286 000**	**328 000**	**480 000**	**468 000**

Source: UNCTAD.

Table IX.28. Reconciliation of shareholders' equity

(Dollars)

Item *Planning years new company*	xxx1	xxx2	xxx3	xxx4
Beginning shareholders equity	0	23 000	11 500	105 920
+ Net profit	-77 000	-11 500	94 420	132 412
+ Additions to capital	100 000	0	0	0
- Dividends/withdrawals	0	0	0	-66 206
Ending shareholders' equity	**23 000**	**11 500**	**105 920**	**172 126**
Reserves (year end)	0	0	0	26 482
Retained earnings	-77 000	-88 500	5 920	45 644

Source: UNCTAD.

Table IX.29. Calculation of provisions for tax: an example

(Dollars)

Item *Planning years- new company*	Xxx1	xxx2	xxx3	xxx4
Net profit after extraordinary items	-77 000	-11 500	95 900	165 515
Corporate tax rate (%)	20	20	20	20
Net loss carried forward	-77 000	-88 500	0	0
Taxable income	0	0	7 400	165 515
Corporate tax	0	0	1 480	33 103

Source: UNCTAD.

Table IX.30. Financing plan: an example

(Dollars)

Item *Planning years- new company*	Xxx1	xxx2	xxx3	xxx4
Loans drawn (beginning of year)	350 000	100 000	100 000	0
Basis for interest calculation	350 000	450 000	550 000	550 000
Interest rate (%)	10	10	10	10
Interest expenses	35 000	45 000	55 000	55 000
Loan repayment (year end)	0	0	0	-70 000
Loan balance (year end)	350 000	450 000	550 000	480 000

Source: UNCTAD.

Table IX.31. Ratio summary sheet

Item	*Planning years- new company*	xxx1	Xxx2	xxx3	xxx4
Liquidity ratios					
Current ratio		3.0	3.1	3.6	3.0
Quick test ratio		2.2	2.4	2.9	2.4
Efficiency ratios					
Inventory turnover – days		60	55	50	45
Accounts receivable turnover – days		90	80	70	60
Accounts payable turnover – days		75	75	75	75
Fixed asset turnover		1.0	1.6	1.4	1.9
Total asset turnover		0.7	1.0	0.9	1.2
Profitability ratios					
Gross profit margin		30%	40%	50%	50%
Net income margin		-26%	-2%	14%	15%
Operating profit margin		0%	15%	30%	30%
Return on assets		-19%	-2%	13%	18%
Return on equity		-335%	-100%	89%	77%
Dividend pay-out		0%	0%	0%	50%
Solvency ratios					
Debt to equity ratio		17.1	44.6	5.8	3.3
Total assets to equity ratio		18.1	45.6	6.8	4.3
Total assets to total liabilities ratio		1.1	1.0	1.2	1.3
Capitalization ratio		0.9	1.0	0.8	0.7
Interest coverage ratio		0.0	1.7	3.6	4.9

Source: UNCTAD.

PART THREE
CONTINGENCY PLANS

CHAPTER X
RISK AND SENSITIVITY ANALYSIS

A. Introductory remarks

Your business plan is based on a number of assumptions. No matter how carefully you have made these assumptions, the probability of everything going exactly according to plan is very small. In your business plan you have made assumptions about future interest rates, exchange rates, tax rates, market growth, your market share, behaviour of competitors, etc. While your assumptions may have been realistically made, you know the actual result will not be precisely what you have predicted. The questions your lender or investor will ask are: "What will happen if one or more of the parameters deviate significantly from your original estimates? How will your financial situation be affected? What is the risk that your cash flow, profitability and balance sheet will deteriorate so much that your whole firm is seriously endangered?"

To be able to answer possible questions you need probably to look at a range of scenarios. For each scenario you take parameters that deviate from your original assumptions and then you check what would be the impact on the financial performance of your business. Making alternative assumptions and planning around them is the best way to deal with possible events that are out of your control. For example, if you have assumed an average interest rate of 10 per cent for your bank loans, see what will happen to your financial statements if the banks increase the interest rate to 15 per cent. If you have assumed an annual growth in sales of 8 per cent, see what would happen to your financials if the increase were only 3 per cent. Then make a third check and see what will happen if both these disadvantageous deviations occur at the same time.

The sections below give some examples of the types of risks usually considered in contingency plans. Some of these may be relevant to your business and some may not. Some can be expressed in quantitative terms and thus can be used to analyse how sensitive the financial statements are to a major deviation. Some are qualitative in nature.

The purpose of sensitivity analysis is to help you to develop a contingency plan that you may or may not include in the business plan. A contingency plan is an effort to avoid having your business disrupted when market or economic conditions change beyond what you are prepared to handle without major adjustments to your operations. If you have a contingency plan, you are ready to act. It is critical that you have identified those areas to which your business is vulnerable. If you have already considered possible responses to changes in the market, you can react more quickly than if you have never even thought of the consequences. Thus, whether things go better or worse than expected, you have already identified the likely causes and impact and considered your responses.

B. Types of risks

1. General economic environment

- *Interest rates***.** How can your business be affected by a substantial increase in the interest rates? Here you need to consider the effect on client demand as well as the necessity to make higher interest payments to your lenders. Assume as an example that you are a building contractor. You have recently invested in new construction machinery (cranes, concrete mixing machines, excavators, etc.). For this investment you have borrowed money from the bank at an interest rate of 8 per cent. However, in your loan agreement the bank reserves the right to increase the interest rate if the market rates increase. The maximum rate has been fixed at 12 per cent. You also know from previous experience that if the market interest rate increases to over 10-12 per cent, the market potential for construction of new houses may drop by about 20 per cent. It is therefore wise to repeat your original financial planning calculation by assuming an interest rate for your loan of 12 per cent (instead of 8 per cent) and a reduction in your original sales volume by 20 per cent. It would be interesting to see what would happen in this case to your overall profitability and if and when there would be any critical shortage of cash in your business.

- *Currency fluctuation***.** How can relative movements of currencies affect your production costs or sales? Assume that you source raw material from the United States and you pay for it in dollars; and you sell your final product to Japan and you receive yen. If the dollar becomes weaker or the yen becomes stronger in relation to your currency, you will profit from the situation. Your cost of production will decrease and margins on sales will increase. But if the opposite happens, you may have difficulties.

- *Recession.* How cyclical is the industry of your business? How does it relate to the general economic cycle? How do you expect the next recession to affect your business? Although not every recession cycle affects the same industries in the same way every time, it is wise to study how the last recession cycles affected your industry. It is probably the best forecast of what will happen next.

- *Inflation.* How is your business affected by inflation? What will happen if there is a rapid increase in inflation?

A convenient procedure for handling inflation in a business plan is to assume different inflation rates for both the product's sale price and each cost item and then to let these rates be reflected in the cash flows (which determine the net cash flow from the investment project in the future). The discounting procedure applied under the net present value method (see financial planning section) is a practical way to assess the impact that inflation may have on your investment.

Some economies are often confronted with hyperinflation. In some cases it is found easier to produce financial projections in dollars or other hard currencies.

- *Raw material prices.* How can major changes in world prices of raw materials affect your business (for example, oil, wheat, sugar, cotton and iron prices)?

2. Political/regulatory

- *Licences and approvals.* Are there any possibilities that the Government will not issue, will withdraw or not renew any licences and approvals or that it will introduce restrictions for entering the market, exporting, importing raw materials and machines, etc? How could this affect your business?

Importing machinery or raw material for production is an issue that requires particular attention in planning a business; otherwise, there may be unpleasant surprises (box X.1).

Box X.1. Regulatory surprises

An entrepreneur set up a factory for producing razor blades. When the factory was about ready to begin operating the management set-out importing the high-quality steel necessary. It was an unpleasant surprise to find that the firm was prohibited from importing steel because national regulations protected local steel suppliers. As the quality of local steel could not meet the specifications for producing high-quality blades, the investor decided to abandon the business at a great financial loss. The mistake was that the issue of steel import was not examined with the authorities in the early planning stages of the project.

A similar problem happened to an entrepreneur who established a business for conducting the invoicing work of foreign telecommunications companies (outsourcing). The service involved the following: receiving from the telephone companies electronic raw data on telephone calls made by their customers; processing of the data by high-capacity computers available in the entrepreneurs' firm; and printing monthly invoices, insert them manually into envelopes and sending them directly to the consumers abroad on behalf of the telecom companies. There was no problem in importing the computer equipment or getting the licence for the international transfer of data. The problem occurred as the company wanted to import the special paper for the printing of the invoices by high-speed printers. The authorities refused to grant an import licence, insisting on the use of locally produced paper. As this was proved not to be suitable, the entrepreneur was contemplating abandoning the business. However the issue was resolved, as the import licence was finally granted, but the long delays inflicted great financial damage on the business. The inability to deliver on time inflicted also considerably damage the image of the firm.

Source: UNCTAD.

- *Tariffs and quotas.* Could the Government impose new import or export quotas, duties/tariffs on your products or equipment?

- *Government grants.* Are there any government grants or subsidies that are supporting your competitors but not you? How critical can this competitive disadvantage be for your business?

- *Increase in taxes.* Is there the possibility of a major increase in the tax on your revenues, net profit, assets, etc.? How would any such increase affect the overall profitability or viability of your business?

- *New regulatory requirements.* Is it possible that new regulatory requirements for example, related to environmental protection, safety, client protection and free competition will affect some of your products? If so, how do you judge their effect on the overall financial situation of your business?

- *Exchange rate controls.* Possibility of the Government's changing policy with respect to exchange rates (as a result of which, for example, foreign currency can be exchanged only at specific banks at an exchange rate fixed by the Central Bank).

3. Changes in public opinion

- *Taste and fashion.* Is your industry stable or is it affected by changes in social taste or fashion?

- *Ethical and "green" issues.* Are there any moral, ethical or "green" issues that can affect your business? For example, the fur coat business has suffered a lot in recent years because large parts of the population in numerous countries became sensitive about killing rare species for clothing and fashion purposes. Could there be any changes in public opinion that may affect the demand for your product?

Below are examples of types of businesses that have been affected in a positive or negative way as a result of changes in public opinion and people’s habits:

- Genetics (new food production technologies triggering new discussions);
- Health (tobacco industry, pills for everything, eating habits);
- Lifestyle (more leisure, more fun, less stress);
- Communication (Internet, mobile telephones);
- Energy (attitudes towards nuclear power generation);
- New economy (new business principles and beliefs).

4. Technological

- *Underlying product technology*. Could the underlying technology of your product become obsolete and be likely to be superseded by better new products? For example, in the 1980s and 1990s we saw a number of companies producing drawing instruments and drawing tables going into bankruptcy. The introduction of computer-aided design has made mechanical drawing instruments obsolete. The companies that failed were not able to diversify fast enough to new technologies and products.

- *Production technology.* Could the process technology which you are using be subject to fundamental change in the years to come? If so, would major investments be needed and could there be a complete change in the cost structure of your product?

5. Law suits

There are many possible reasons why a company may get involved in a lawsuit and as a result may have to pay large sums to third parties. In most cases, this is for covering damage that was caused to entities, individual persons inside or outside the company or the community as a whole. Such damage can be mitigated through insurance. However, in many cases insurance coverage may be limited and companies may still be obliged to cover the rest. Typical examples of damage are listed in table X.1.

Table X.1. Examples of damage

Industry	Damage
Oil/chemical	Pollution caused through spills
Food processing/catering	Food poisoning
Transportation (airlines, trains, buses, etc.)	Injuries or deaths through crashes
Pharmaceutical	Health damage through inappropriate drugs
Tobacco	Cancer effects

Financial audit/consulting	Wrong valuation / failure to identify liability during a due diligence
Machinery	Injury or death of persons due to accident attributed to inappropriate design, inadequate instructions or material failure
Construction	Structural failure of a building, bridge, etc.
General products	Replacement of sold products (or specific part in them) due to faulty design

Source: UNCTAD.

6. Staffing

- *Management.* How would your business be affected if one or more of your key managers (sales manager, production manager, finance manager) decided to leave the company? What would be the impact on the operations of your company? What would be the effect if you could find appropriate managers to expand your business?

- *Workers.* What is the risk that new enterprises in the region will start competing for workers, with the result that salaries increase to much higher levels than you had originally anticipated? Or, if for any other reason you cannot find skilled labour?

- *Financial irregularity.* How do you minimize the possibilities of major financial irregularity (fraud) that can do a major damage to your firm?

7. Client-related

- *Loss of clients.* What is the structure of your anticipated client portfolio? What will happen if one or two key clients cease buying your products or service?

- *Client payments.* What would be the situation of your business if one or few major clients did not pay your invoices for an extended period of time? What would be the impact on your cash flow? What measures would you take in order to get paid?

8. Quality/production problems

- *Loss of information.* Loss of information about the market, clients, products, production processes, etc. due to fire, computer failure, theft, viruses, hackers or any other reason may cause a major crisis for many companies. Is such a loss possible in your entity? What would be the implications? What measures have you envisaged to ensure that there will be no such loss (back-up system etc.)?

- *Production failures.* Can production be interrupted for a longer period of time (1 day, 1 week, 2-3 months, longer)? For example, owing to failure of process machinery, difficulty in obtaining spare parts, non-availability of raw material or non-availability of energy or water supply?

- *Quality problems*. What is the risk of loss of long-term profitable business by not being able to produce the necessary quality to satisfy the clients?

- *Delays/cost overruns in product development*. Developing a new product necessarily involves a number of uncertainties. Devising something "new" involves elements of innovation and creativity and therefore it is not always easy to make accurate predictions about the time and effort that will be required. New products have also got to be tested and certified. If they do not fulfil the necessary requirements, some modifications in the design and construction may have to be made. It is therefore not unusual that the actual time frame for and, cost of, developing new products exceed by far the budgeted amount. This is particularly true for goods such as computer software and pharmaceutical products that require extensive testing and certification.

If you are developing a new product, what is the risk that the effort and time required will exceed your forecast? If this happens, what would be the effect as regards the additional development costs? What would be the financial losses resulting from the delays in not putting the product on the market in time? Would these extra costs/losses endanger the overall viability of your business? What measures can you take if the risks are becoming greater? When is the critical point at which at to stop the project?

- *Other cost overruns.* Cost overruns happen often. There are many reasons for this. Typical examples of situations resulting in cost overruns are the following: the construction of a new annex building takes much more time and effort than projected; the time effort and expense involved in winning an order from a new client are much greater than anticipated; the actual staff effort in implementing a new accounting system turns out to be much greater than budgeted.

9. Subcontracting

Outsourcing part of your products or services is often a cheaper and more effective way of doing business. However, there are always potential risks associated with this approach. A typical question is what you would do if you had a major problem with a subcontractor on whom you are highly dependent. Typical examples of problems with subcontractors are:

- They decide to increase their price substantially, and the new price cannot be included in the overall price of your products without making them too expensive for the market.

- The quality of their product or service is no longer satisfactory.

- They regularly fail to meet the agreed delivery schedules.

- They go out of business and will no longer deliver.

- They start competing against you.

What are your alternatives if one of the above happens? Can you find alternative sources of supply within a reasonable amount of time? Are you maintaining close contacts with a network of diverse suppliers? What is the magnitude of the financial or image damage you will be facing if one of the above events prevents you from fulfilling your obligations towards your own clients? Are your agreements with your subcontractors suitable for minimizing your risks?

10. Market

- *Sales variation.* Major variations from your planned level of sales cannot be excluded. They may occur for many reasons. Such variations can have an important impact on your financial situation whether they are positive or negative. A decrease in sales means difficulties in financing fixed costs such as wages, rent and other overheads. Positive increases (more sales than) would require more working capital for inventory, accounts receivables, etc. What would be the effect of deviating from planned sales in your case? (For example, if the industry's growth rate drops, etc.)

- *Stronger competition*. In your business plan you have made assumptions about the structure of the competitive situation in your market. However, what would be the potential effects of a new unexpected competitor in the market? What would be the problem for your business if your existing competitors managed to cut their prices by 25 per cent? What will happen to the viability of your business if you then decide to reduce your prices by the same percentage? Or how would your business be affected if a competitor releases a new product that is of better quality but not more expensive than yours?

C. Managing opportunities

In your contingency plan you should not only consider possible deviations from your assumptions that would mean extra risks for your business. You should also think about how you would deal with the challenge if the business developed much better than you assumed. Here are some examples:

- *Your sales volume rises much more rapidly than you assumed.* How can you increase your production capacity in the short term? How do you quickly find additional suitable employees? Can you outsource some of the work?

- *Your cash flow increases more than expected.* What do you do with your extra cash? Can you negotiate with your bank and repay your long-term debts earlier? What is the optimum way to invest the money: expand the business of the company, acquire another firm, buy securities, etc.?

- *Your major competitor sells his business.* An important competitor decides to sell his business at a good price, for example because there is no successor to the owner, who is retiring. What would you do? Buy the whole company and integrate it into yours? Buy only the assets? Buy only the clients?

A prominent businessperson once said:

> ***My job gets difficult in two situations:***
> ***when the business goes very badly and***
> ***when the business goes very well.***

D. SWOT analysis

It is recommended that you conduct a SWOT (strengths, weaknesses, opportunities and threats) analysis while you are planning your business. A SWOT analysis will help you in structuring your thoughts, analysing your risks and setting up your strategy. Specifically, a SWOT will be of value in helping you to:

- Build on your **strengths;**
- Your **weaknesses;**
- Exploit **opportunities;**
- Develop strategies to deal with **threats.**

- **Strengths and weaknesses** are internal factors over which you have some influence.
- **Opportunities and threats** are external issues that you cannot control.

Typical examples of strengths, weaknesses, opportunities and threats are given in tables X.2 and X.3.

Table X.2. Strengths and weaknesses

Area	**Strength**	**Weakness**
Production process	Reliable machinery with good availability.	Poor automation and low efficiency.
Management	Creative and good at selling.	Inadequate experience in finance planning.
Marketing	Excellent name in the market.	Poor market research capability.
Intellectual property	Trade secrets.	Expiring patent.
Premises	Low rent and adequate space available for expansion.	Remote location.
Information technology	Modern networks and software/hardware of high capacity.	Poor in-house IT support to users.
Finance	Good cash flow.	Debt burden.

Source: UNCTAD.

Table X.3. Opportunities and threats

Area	Opportunity	Threat
Economic trend	Growth makes it easy to get higher prices.	-
Market	Change of habits in market enhances interest in product.	-
Competition	Competition fragmented. No single strong competitor.	Some small competitors sell at lower prices.
Labour market	Locally available skills.	Disruptive strikes.
Financial markets	-	Increasing interest rates result in an increase of expenses.
Exchange rates	Cheaper imported material.	Prices are not very competitive for some export markets.
Environmental laws	Opportunity to sell environmentally friendly products.	-
Government policies	Reduction of taxes increases profits.	Limitation on imports of some materials prohibits expansion.

Source: UNCTAD.

A SWOT analysis is performed by the management team of the entity, at best in an informal and relaxing environment outside the company and away from the hectic pace of daily operations. The analysis can be particularly effective if people are open, realistic, self-critical and honest to themselves when it comes to identifying and defining their strengths and weaknesses. Experience shows that strategic workshops held at yearly intervals produce extraordinary results.

GLOSSARY

Accounts payable: Money owed by a company to its suppliers for the purchase of goods or services bought on credit.

Accounts receivable: Money owed to a business by its customers. Some businesses that sell consumer products such as furniture or television sets will carry accounts for several months and charge interest. Accounts receivable can also include revolving accounts, such as department store or gasoline credit cards.

Accrual liabilities: Items entered on the "liabilities" side of the balance sheet to account for income already received during the past financial year. However, the costs of the products to be delivered will occur in the new fiscal year. Or for expenses incurred during the past year but not payable until the following year.

Amortization: Gradual reduction of a loan (typically mortgage) through periodic back payments. Companies to write off intangible rights or assets such as goodwill, patents or copyrights also use this accounting procedure.

Appreciation: An increase in an asset's value.

Assets: Accounting term for everything a company owns and which has a monetary value listed in the balance sheet (cash, credit balances, inventory, equipment, real estate, etc.).

Balance sheet: A statement of the assets and liabilities of a business at a given date. The "assets" side of the balance sheet provides information on the employment of funds, whereas the "liabilities" side details the procurement of funds (financing) and the composition of the shareholders' equity.

Balance sheet analysis: Assessment of the figures and ratios in the balance sheet and income statement in order to appraise the standing and creditworthiness of a company or to evaluate the securities it has issued for investment policy reasons.

Bond: Debt instrument denominated in a round amount that pays a set amount of interest on a regular basis. The issuer promises to repay the debt on time and in full. Bonds are bought and sold on the market.

Book value: The value at which assets are carried on the books of account. Generally, fixed assets are shown at cost less normal depreciation while inventories may be made at cost or market, whichever is lower. The book value of a share is the company's net worth (the difference between a company's assets and its liabilities) divided by the number of shares outstanding.

Bottom line: Accounting term for the net profit or loss.

Budget: A plan of future income and expenses during a specified period, such as one year. In an operating budget the planned costs and revenues, expenditures and income are compared. The name is derived from the leather bag, or "bougette", in which the funds to meet expected expenses were originally stored.

Call option: Agreement that gives an investor the right but not the obligation to buy a stock, bond, commodity or other instrument at a specified price within a specific time period.

Capital increase: Increasing the capital stock (share capital) by issuing additional shares or participation certificates against cash in the case of a corporation (joint stock company) or adding to the capital of different types of business structures, including in-kind contributions.

Cash: Money in the company's current accounts in a bank and petty cash available in the office.

Cash flow: The flow of money payments to or from a firm. Expenditures are sometimes referred to as "negative" cash flow.

Collateral: Property that borrowers are obliged to turn over to lenders if they are unable to repay a loan. This can be, for example, buildings, land, machinery, inventory of finished or unfinished goods, securities or accounts receivable.

Cost of goods sold: A company classifies all goods and services acquired for later sale as inventory. When the company sells goods, the amount that was originally paid for the goods is recorded in the income statement's "cost of goods sold" account. At the same time this amount is subtracted from the inventory in the balance sheet.

Depreciation: The decrease in value of an asset through wear and tear or other factors limiting its usefulness. Fixed assets are depreciated in the accounts by regularly reducing their book value in the balance sheet.

Dividend: A portion of a company's income paid to shareholders as a return on their investment. The rate of dividend is determined at the general meeting of the shareholders upon the proposal of the board of directors. Distribution to the owners of participation certificates and dividend-right certificates is also called dividends. Dividends can take the form of cash dividends (payments in cash), stock dividends (allocation of new shares of the company) and dividends in kind (distribution of material things).

Dividend yield: A company's annual dividend expressed as a percentage of its current stock price.

Earnings: Income after a company's taxes and all other expenses have been paid. Also called profit or net income.

Earnings per share: A portion of the company's earnings allocated to each share outstanding. Calculated by dividing the earnings by the number of outstanding shares.

Earnings yield: A company's per-share earnings expressed as a percentage of its stock price. This provides a yardstick for comparing stocks with bonds, as well as with other stocks.

EBIT: Earnings before interest and taxes. The figures are often used gauge the financial performance of companies with high levels of debt and interest expenses.

EBITDA: An acronym used in accounting to denote “earnings before interest, tax, depreciation and amortization”.

Employee stock ownership plan: A programme encouraging employees to buy stock in their company and thereby have a greater stake in its financial performance. Abbreviated as ESOP.

Equity: In property, the difference between the property's current market value and the claims against the property. In a firm the shareholders' equity is the ownership interest in the firm (also call “net worth”: the amount by which assets exceed liabilities).

Fiscal year: The 12-month period that a corporation or Government uses for bookkeeping purposes.

Fixed assets (or long-term assets): Land, buildings, machinery, tools and the equipment used by the company to carry on the business. Typically, anything classified under this heading has a useful life of longer than one year. This account may also be referred to as plant and equipment or buildings, machinery and equipment.

Fund: Any amount of cash, or of assets, quickly convertible into cash and which has been set aside or reserved for a particular purpose, such as the pension fund of a company. It is also an abbreviation for investment fund.

Goodwill: In accounting, goodwill is any advantage (expressed in monetary terms), such as a well-regarded brand name or symbol, patents or licences that enable a business to earn better profits than its competitors.

Gross domestic product: The total value of goods and services produced by a nation. It is a measure of economic output. Abbreviated as GDP.

Gross national product: The value of all goods and services produced in a nation's economy. Unlike gross domestic product, it includes goods and services produced abroad. Abbreviated as GNP.

Hedging: Buying or selling a product or a security (or foreign currency) to offset a possible loss from price changes on a future corresponding purchase or sale. A hedging strategy is often used by companies for reducing the risk from possible changes in foreign currency exchange rates.

Holding company: A company whose principal assets are the securities it owns in companies that actually provide goods or services. A holding company enables one corporation and its directors to control several companies by holding a large stake in the companies.

Income statement (or profit and loss account): A list comparing all income items and all expense items of a business for the past financial year.

Interest: A fee charged by a lending institution (bank) for extending a credit to a business or an individual person. The interest rate is the fee charged per annum.

Inventory: Goods or materials bought by a business to sell or to use in preparing a product or service for sale. Inventory includes all raw materials, work in progress (partially completed items) and finished goods. For example, if you have a small factory and you are producing cotton socks, your inventory includes most probably:

- Raw material: cotton yarn, bleaching and colouring chemicals, etc.;
- Semi-finished goods: socks that are not dyed yet;
- Finished products: cotton socks ready for delivery.

Joint stock company: A group or association of people recognized in law as an individual entity with a fixed capital stock (share capital) divided into parts (shares).

Joint venture: A joint undertaking by a number of persons or companies to achieve a specified entrepreneurial objective, such as the construction of a plant or power station, or the execution of a research study. A joint venture can take the form of a contract or the founding of a jointly owned subsidiary, affiliate or holding company.

Leverage: The use of borrowed assets by a business to enhance the return to the owner's equity. The expectation is that the interest rate charged will be lower than the earnings made on the money.

Liabilities: Amounts owed by a business to other businesses, banks or individuals. They may include accounts payable, wages and salaries, dividends, taxes and obligations such as bonds, debentures and bank loans.

LIBOR: The London Inter-Bank Offered Rate. A floating interest rate that serves as a base for many lending agreements. Businesses usually get loans from commercial banks at LIBOR interest rates plus about 1-3 per cent, depending on the risk of the business.

Liquidation: The process of converting stock or other assets into cash. When a company is liquidated, the cash obtained is first used to pay debts and obligations to holders of bonds and preferred stock. Whatever cash remains is distributed on a per-share basis to the holders of common stock.

Liquidity: The ability of an enterprise to meet its payment obligations on time. In a wider sense it means the availability of cash and cash-like funds within a company, on the money and capital markets and within the national or world economy.

Liquidity statement: Statement showing the relationship between disposable means and easily marketable assets on the one hand and short-term liabilities on the other.

Loan syndication: A process in which banks resell portions of large loans to other banks; or when a number of banks contribute jointly to provide a large loan to a company (in order to share the risk).

Long-term debt: Debt that must be paid in a year or more.

Market capitalization: The total market value of a company or stock. Market capitalization is calculated by multiplying the number of shares by the current market price of the shares.

Net income: The amount left from the revenues after all the company's expenses, including taxes have been paid. Also called net earnings or net profit.

Net worth: The amount by which assets exceed liabilities. It is also called “shareholders' equity”.

Operating expenses: This category includes rent, salaries, telephone bills, advertising, and other expenses not included in inventory.

Operating income: Net income (or profit) excluding income derived from sources other than the company's regular activities and before income deductions such as depreciation and taxes. Also called net operating income or net operating loss.

Options: An agreement allowing an individual or a company to buy or sell something, such as shares of stock, during a specific period for a specific price.

Profit: The income remaining after deduction of all expenses during a specific period. The gross profit is the total revenues minus the cost of goods sold. The operating profit is the gross profit minus general administrative expenses. The net profit is the operating profit minus depreciation, interest, extraordinary charges and corporate tax.

Profit margin: A measure of a company's profitability, efficiency and cost structure that is calculated by dividing profits by sales.

Reserves: Accounting term denoting an amount of money set aside from profits and transferred to a special “reserves” account in the balance sheet. Laws in many countries specify the amount that can be allocated from the profits to the reserves. Reserves fulfil an important safety function as they can be used to cover any future losses of the company and possibly save it from bankruptcy.

<u>Retained earnings</u>: Accounting earnings that are not paid out as dividends, but are retained by the firm for reinvestment in its operations.

<u>Return on equity</u>: An important measure of how much the company earns on the investment of its shareholders. It is calculated by dividing a company's net profit (income) by the total shareholders' equity.

<u>Return on investment</u>: An important measure of how much the company earns on the money the company itself has invested. It is calculated by dividing the company's net profit (income) by its total assets. This measure is also called "return on assets".

<u>Revenue</u>: Money a company takes in, including interest earned and receipts from sales, services provided, rents and royalties.

<u>Revolving credit</u>: A line of credit that may be used repeatedly up to a specified total, with periodic full or partial repayment.

<u>Sales</u>: Money a company receives from the goods and services it has sold. In some cases, the amount includes receipts from rents and royalties. For a business such as a pizza takeaway, "sales" refers to cash received over the counter in exchange for pizzas. For department stores, "sales" includes cash received, charge account purchases and credit card purchases. In this case "sales" does not always equal "cash".

<u>Security</u>: A financial certificate that indicates that the holder owns a share or shares of a company (stock) or has loaned money to a company or government organization (bond).

<u>Share</u>: A form of security representing a portion of the nominal capital of a company entitling the owner to a proportion of distributed profits and of residual value if the company goes into liquidation. Shares further entitle the holder to vote at annual general meetings and elect directors (equity paper).

<u>Shareholders' equity</u>: The cash the shareholders invested in the business to start it, plus any additional contribution they have made to the business since then, plus any retained earnings and reserves.

<u>Short-term bank loan or notes payable</u>: Amounts borrowed from the bank for less than a year, usually 1, 2, 3 or 6 months. This position can include loans that are outstanding and are due for payment within the next 12 months.

Solvency: Ability of a borrower to meet maturing obligations as they become due.

Stock: An investment that represents part ownership of a company. There are two different types of stock: common and preferred. Common stocks provide voting rights but no guarantee of dividend payments. Preferred stocks provide no voting rights but have a set, guaranteed dividend payment. Also called shares.

Stock option: An agreement allowing an investor to buy or sell something, such as shares of stock, within a stipulated time and for a certain price. Also, it is a method of employee compensation that gives workers the right to buy the company's stock during a specified period of time at a stipulated exercise price.

Turnover: In accounting terms, this is the number of times an asset is replaced during a set period. In trading, the volume of shares traded on the exchange on a given day. In employment matters, "turnover" refers to the number of employees replaced during a certain period divided by the total number of employees. In some countries the term refers to a company's annual sales volume.

Venture capital: Financing for new businesses. In return for venture capital, investors may receive a say in the company's management, as well as some combination of profits, preferred shares or royalties.

Write-off: Charging an asset amount to expenses or losses, such as through the use of depreciation and amortization of assets. Also, claims on debtors who have become insolvent are written off.