Supplement A: Financial Statements and Projections for Startups

Financial Projections for Startups
(1 of 2)

- Entrepreneurs need to look at the financial fit of their startup.
- Develop assumptions, and a market perspective based on data analysis.
- Primary data enables entrepreneurs to make a convincing case for financial projections.

Financial Projections for Startups
(2 of 2)

- Potential investors don’t invest: Financial projections are often built on untested assumptions.
- Presenting carefully thought-out financial projections to investors lowers risk.
- Understand resources required and how to allocate them in a fluctuating market.

Three Essential Financial Statements (1 of 9)

- Financial statements: Window into financial health and performance.
  - The income statement measures the financial performance of your business.
  - The balance sheet shows what the company owes and owns.
  - The cash flow statement details the inflows and outflows of cash.

Three Essential Financial Statements

(2 of 9)

The Income Statement

- Subtracts the COGS and expenses from the total revenue.
- Operating expenses: Company spends to generate income.
  - It reflects depreciation and amortization.

Three Essential Financial Statements (3 of 9)

The Income Statement

- Depreciation is referred to as a “noncash” expense.
  - Replacement is needed in the long term.
- Operating profit: Amount left over from revenue once all costs and expenses are subtracted.

Three Essential Financial Statements
(4 of 9)

The Income Statement

- Interest expense: Extent of the company's debt burden.
- Net income: Income left after all costs, expenses, and taxes have been paid.
  - The balance sheet and cash flow statements need to be analyzed for an accurate picture.

Three Essential Financial Statements
(5 of 9)

The Balance Sheet

- Shows assets, liabilities, and shareholder equity.
- Current assets: Cash and other assets.
- Accounts receivable: Money owed to the company.
- Prepaid expenses: Payments the company has already made.

Three Essential Financial Statements
(6 of 9)

The Balance Sheet

- Fixed assets: Property, plant, and equipment
- Other Types of Assets:
  - Goodwill (price paid for an asset).
  - Intangible assets (value of patents, etc.).
  - Long-term investments (more than a year old).

Three Essential Financial Statements
(7 of 9)

The Balance Sheet

- Liabilities and Shareholder Equity:
  - Liabilities (economic obligations of the company).
  - Current liabilities (bills that must be paid).
  - Accounts payable (money owed to suppliers).
  - Accrued expenses (wages and taxes).
  - Short-term debt (bank loans).

Three Essential Financial Statements
(8 of 9)

The Cash Flow Statement

- Tracks the movement of cash into and out of the company.
  - Include loans, sales, interest and shares.
  - Only cash transactions affect cash flow.
- Cash flow statements: Cash generated from operations.

Three Essential Financial Statements (9 of 9)

The Cash Flow Statement

- Net income versus cash flow
- Net income: Determined by accounting principles
- Cash flow: Deals only with actual cash transactions.

Linkages Between the Three Financial Statements

The Cash Flow Statement

- Pricing and credit policies have a direct impact on revenue.
  - Each statement is related to the other.
- Revenue increases, when a sale is made.
- Payment becomes cash inflow.
- Sales go from inventory to COGs.

The Journey of Cash: The Cash Conversion Cycle (1 of 3)

- Used to buy materials then made into products.
- Products in inventory are sold.
- The company collects cash for the selling price, hopefully at a profit.
- The CCC is the number of days cash is tied up in production and sales.

The Journey of Cash: The Cash Conversion Cycle (2 of 3)

- The journey: Leaving the company to the point of return.
  - DSO (number of days that it takes to collect on accounts receivable).
  - DOI (average number of days it takes to sell the entire inventory of a company).
  - DPO (number of days it takes you to pay your bills).

The Journey of Cash: The Cash Conversion Cycle (3 of 3)

- To calculate CCC, include:
  - Income statement (beginning and ending inventory).
  - Revenue and COGS (beginning and ending accounts receivable).
  - Balance sheet (beginning and ending accounts payable).
- Working capital must support company growth.

Building Pro Forma Financial Statements

(1 of 6)

- Make projections and build pro forma statements.
  - They give an idea of the actual statement.
  - Should contain three scenarios of financial forecast: Manipulate revenue and cost drivers.
  - Strategically compelling and operationally achievable.

Building Pro Forma Financial Statements

The Mechanics and Research

- Entrepreneurs often begin with an existing model and then try and tweak it.
- Research various elements that drive revenue and costs.

Building Pro Forma Financial Statements (3 of 6)

Research

- Focus on customer, market size, etc.
- Segment your market to understand subgroupings and buying habits.
- Primary research: Data gathered through focus groups, interviews, and surveys.
- Secondary research: Data gathered from external sources.

Building Pro Forma Financial Statements
(4 of 6)

Building Assumptions: Forecasting Sales

- The Bottoms Up or Build Up Method
  - Estimate revenue and build.
- Data and formulating assumptions help in understanding the levers.

Building Pro Forma Financial Statements

Building Assumptions: Cost of Goods and Operating Expenses

- The first cost item is the COGS.
- Businesses incur operating expenses.
- The buildup method: Rounds the costs.
- Operating profit is not net profit.

Building Pro Forma Financial Statements (6 of 6)

Labor Estimates

- Complex businesses need a detailed approach to structuring new hires.
- Match to product development and sales requirements.
- Plan to be constructed.
- Capital expenses are not line items.
- Show depreciation on income statement.

Building Assumptions: Operating Policies and Other Key Assumptions (1 of 5)

- Operating policies affect the speed of cash flow back into the company.
- Critical policies include:
  - Purchasing Policy.
  - Pricing Policy.
  - Compensation Policy.

Building Assumptions: Operating Policies and Other Key Assumptions (2 of 5)

- Critical policies include (Contd.):
  - Credit Policy.
  - Payables Policy.
  - Inventory Policy.
- Other assumptions and cash flow timing.
- Training time for new hires.
- Consider assumptions for inflation and taxes.

Building Assumptions: Operating Policies and Other Key Assumptions (3 of 5)

Building Integrated Pro Forma Statements

- Build these for a minimum of 2 years.
- Understand changes and their affect.
- Understand linkages: Difference between success and failure.
- Amount of funding required.

Building Assumptions: Operating Policies and Other Key Assumptions (4 of 5)

Sensitivity Analysis

- Address critical assumptions: Revenue and cost drivers.
- Three scenarios analysis recommended.
- Mitigate any controllable circumstances: Understand right or wrong.

Building Assumptions: Operating Policies and Other Key Assumptions
(5 of 5)

Reasonableness Test

- Compare statements: Numbers should not be too different.
- Account for seasonal changes in demand.
- Answer questions of potential investors.