MPU-3232

ENTREPRENEURSHIP

Topic 8 : Financial Information and Management

- The financial plan provides the entrepreneur with a complete picture of how much and when funds are coming into the organisation, where funds are going, how much cash is available and the projected financial position of the firm.
- It provides the short-term basis for budgeting control and helps prevent one of the most common problems for new ventures – lack of cash.

- The financial plan must explain to any potential investor how the entrepreneur plans to meet all financial obligations and maintain the venture's liquidity in order to either pay off debt or provide a good return on investment.

Operating and Capital Budgets

A Sample Manufacturing Budget for First Three Months

	Jan.	Feb.	Mar.
Projected sales (units)	5,000	8,000	12,000
Desired ending inventory	100	200	300
Available for sale	5,100	8,200	12,300
Less: beginning inventory	0	100	200
Total production required	5,100	8,100	12,100

Table 10.2 - A Sample Operating Budget for First Three Months ($000s)

Expense	January	February	March
Salaries	$23.2	$23.2	$26.2
Rent	2	2	2
Utilities	0.9	0.9	0.9
Advertising	13.5	13.5	17
Selling expenses	1	1	1
Insurance	2	2	2
Payroll taxes	2.1	2.1	2.5
Depreciation	1.2	1.2	1.2
Office expenses	1.5	1.5	1.5
Total expenses	$47.4	$47.4	$53.9

Pro Forma Income Statements

- Pro forma income is the projection net profit calculated from projected revenue minus projected costs and expenses.
- Pro forma income statement for the first year will be tabulated as monthly basis and the subsequent years can be shown yearly.
- Generally, investors prefer to see three years of income projections.

Pro Forma Cash Flow

- Cash flow is not same as profit.
- Profit is the result of subtracting expenses from sales whereas cash flow results from the difference between actual cash receipts and cash payments.

Pro Forma Balance Sheet

- Pro forma balance sheet summarises the projected assets, liabilities and new worth of the new venture.
- Assets refer to the items that are owned or available to be used in the venture operations.
- Liabilities refer to the money that is owed to creditors.
- Owner equity is the amount owners have invested and/or retained from the venture operations.

Break Even Analysis

- Break even is the volume sales where the venture neither makes a profit nor incurs a loss.

Financing the New Venture

Debt versus equity

- Debt finance is money borrowed from an outside party
- Debt does not provide a residual ownership interest in the business
- Debt must be reimburse on a fixed date
- Debt also requires the payment of interest at a fixed and predetermined rate

Financing the New Venture

Debt versus equity

- Equity finance is money provided by the owner(s) of a business venture.
- Equity provides a residual ownership interest in the business
- Equity is not reimbursed unless the business goes into liquidation
- Equity providers receive a variable remuneration in the form of a dividend

Financing the New Venture

Short-term versus long term finance

- Short-term finance is the debts that must be reimbursed within 12 months
- It usually takes form of a bank overdraft, trade credit, credit card purchase or cash advance.
- Long-term finance encompasses all forms of finance where the term extends beyond 12 months
- It usually takes from of long-term loan or a mortgage.

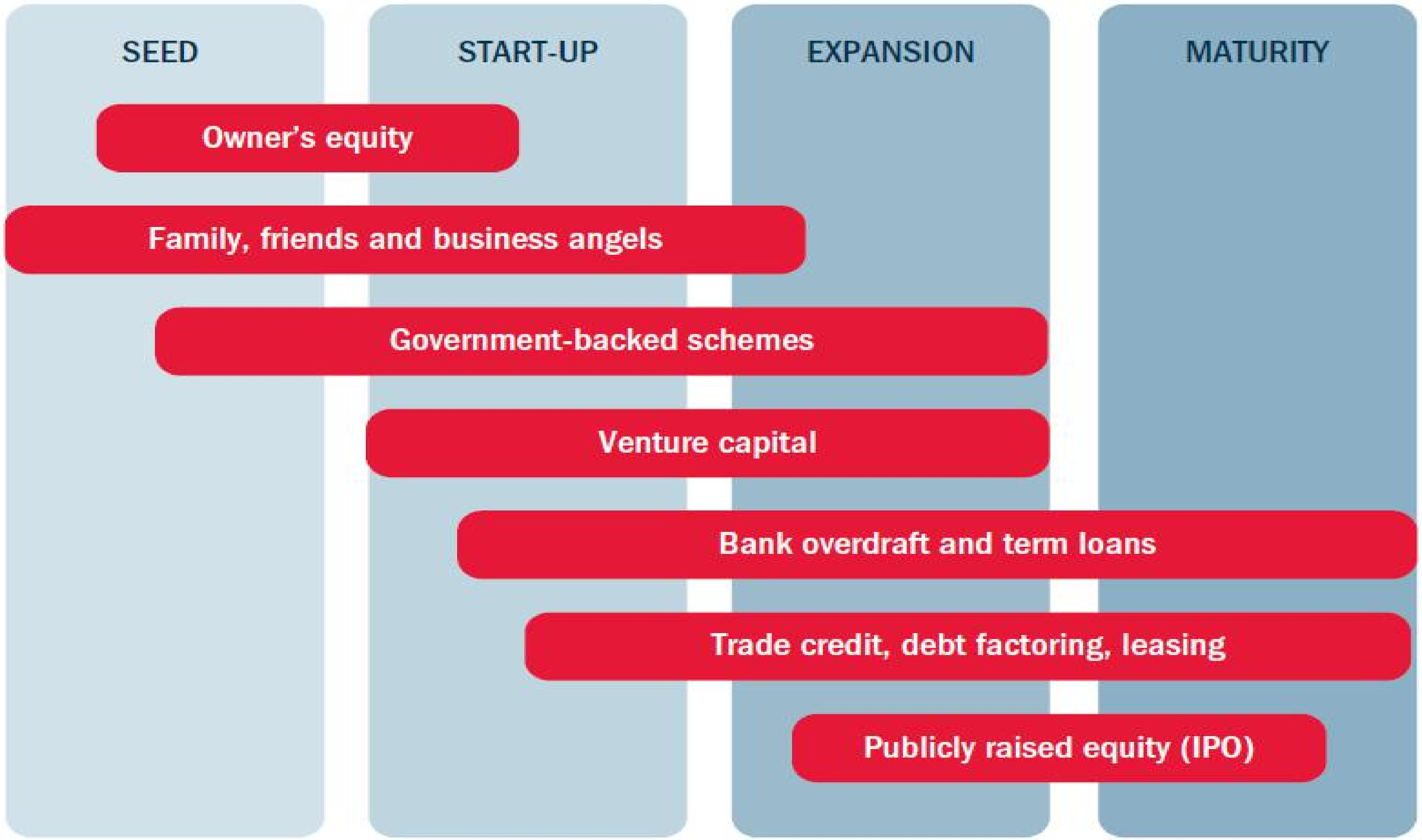
Financing the New Venture

Short-term versus long term finance

- Debt lenders (creditors) make loans to businesses that show strong management ability and steady growth potential.
- A business plan including a cash flow projection demonstrating the business's ability to repay the loan principal and interest over the term of the repayment schedule is required.
- The lender will expect the entrepreneur to have appropriate insurance to protect the assets.

Financing the New Venture

Early-stage versus expansion finance



Equity Finance

Owner's equity

- This type of equity is usually acquired from the owner's savings or the sale of their personal assets
- Funds can be used with maximum flexibility, and invested for the long term

Equity Finance (cont.)

Family and friends

- Family members, friends and friends-of-friends are the best place to start the search for capital
- Entrepreneurs should be cautious with this type of financing: many cherished friendships and family relationships have been destroyed through inadequate protection and provision for the business failure

Equity Finance (cont.)

Business angels

- Angel investors are wealthy individuals who invest in entrepreneurial firms and also contribute their business skills
- Some business angels are members of angel groups — business introduction services — allowing them to increase their access to investment opportunities and giving them the possibility of investing jointly with other angels

Equity Finance (cont.)

Venture capital

- Venture capitalists (VCs) are independently managed, dedicated pools of capital that focus on equity investments in high-growth companies

The Purpose of Financial Information

- Objectivity – indicator of the business performance
- Financiers' expectations – how the money will be used and to convince the lender that the business can repay its debts as they fall due
- Statutory requirements – governments require businesses to keep accurate financial records, both for the purposes of collecting statistical information and more importantly for taxation compliance.

The Purpose of Financial Information (cont.)

- Viability – to assure the investors and the entrepreneur that the idea is in fact financially viable
- Profitability – one of the main goals of being in business is to generate profit
- Goal setting – these include satisfactory return on investment, a comfortable level of owner's drawing or the development of a strong asset base

The Purpose of Financial Information (cont.)

- Purchase or sale of a business – it is easier to sell or purchase a business if all the necessary financial information is available
- Performance appraisal – it can be use to compare with industry benchmarks to determine the firm's performance relative to its competitors.

Analyzing Financial Data

Profitability ratios

- Purpose: to calculate the amount of profit that a business makes for each dollar of goods or services that it sells.
- Gross profit margin % = Gross profit / Sales turnover
- Net profit margin % = Net profit before tax / Sales turnover

Analyzing Financial Data (cont.)

Profitability ratios

- Purpose: to estimate the return on investment that has been made by the owner of the business to establish and fund the venture
- Return on equity = Net profit before tax / Owner's equity

Analyzing Financial Data (cont.)

Profitability ratios

- Purpose: to determine how well is the firm using its assets (not just the owner's contribution) under its control
- Return on assets = Net profit before tax / Total assets

Analyzing Financial Data (cont.)

Liquidity ratios

- Purpose: to indicates the firm's ability to repay its short-term debts.
- Current ratio = Current assets / Current liabilities

Analyzing Financial Data (cont.)

Liquidity ratios

- Purpose: to determine how quickly a firm could meet its short-term debts if payment was required in a short period of time
- Liquid (quick) ratio = Quick assets / Current liabilities

Analyzing Financial Data (cont.)

Efficiency ratios

- Purpose: to indicate the business's assets base is being well used in order to maximize sales revenue.
- Asset turnover = Sales / Total assets

Analyzing Financial Data (cont.)

Efficiency ratios

- Purpose: to measure the proportion of the business owned by the owner-manager
- Ownership = Owner's equity / Total assets

Analyzing Financial Data (cont.)

Efficiency ratios

- Purpose: to measure the extent of a firm's debt burden
- Debt-to-equity ratio = External debts / Owner's equity

Analyzing Financial Data (cont.)

Efficiency ratios

- Purpose: to evaluate how many times a year the business sells or turn over its trading stock
- Stock turnover = Annual cost of goods / Average stock on hand
- Average stock on hand = (Beginning inventory + Ending inventory) / 2

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