CHAPTER 16
THE FINANCIAL PLAN

Author’s Note

For many students, putting together pro forma financial statements for a new venture is a daunting task. The reason for their timidity about this task is the difficulty in gathering financial information at start-up. It’s perplexing to attempt to project accurate numbers when the business has no track record on which to base those projections. Sales are a particularly troublesome area. Unfortunately, there are no hard and fast rules for finding the right numbers.

This chapter encourages students to come at numbers from several different directions in a process known as *triangulation.* By considering their own knowledge, that of others in the industry, and that of the customers, students should be able to zero in on a range for any number they’re attempting to estimate.

Learning Objectives

This chapter will give students an understanding of:

- How to estimate sales and capital expenditures
- How to prepare a pro forma income statement
- How to prepare a pro forma cash flow statement
- How to prepare a pro forma balance sheet
- How to use ratios to describe the business

Supplementary Lecture Material

Getting a Handle on Earnings

The U.S. accounting system has always been “the envy of the world” for its transparency, uniformity, and credibility. But all that has been sorely tested in the wake of recent corporate earnings scandals with companies like Enron and Tyco that found creative ways to manage their pro forma corporate earnings.

Because of this, Standard & Poor’s has proposed a tough new measure of corporate earnings that it hopes will improve financial reporting. The proposal will eliminate three financial strategies that have been the mainstay of companies to push their numbers higher when needed. Under the proposal, stock options will be expensed as regular compensation; pension gains will be excluded from earnings; restructuring charges from operations will be included, but gains and losses from asset sales will not.

To illustrate the impact of this proposal: Because of having to expense option grants, Cisco Systems Inc. would report a loss of 35 cents a share in fiscal 2001 instead of the 14 cents-a-share loss it reported under the old system.

Another reason for S&P’s proposal is that it has become difficult, if not impossible, to compare companies’ and industry performance due to the variety of earnings measures. It believes that taking away “fake earnings flows” would enhance the quality of earnings numbers and perhaps actually result in a higher multiple and therefore higher company valuation. Without the ability to smooth out earnings using “fake earnings flows,” stock numbers will be more volatile but more honest. It will be interesting to see if the proposal sticks.

Source: Editorials, “A Good Idea about Earnings,” Business Week Online, May 27, 2002.

Films to Rent

Finance and Accounting for the Non-Financial Manager

Wharton faculty presents the fundamentals of finance and accounting, and shows how they apply to both large and small companies.

www.films.com
Item: **BVL10806**
Format: **VHS**
List Price: **$149.95**
Rental Price: **$75.00**

Introduction to Financial Management

This film introduces financial statements and their analysis and financial management.

www.films.com
Item: **BVL5844**
Format: **VHS**
List Price: **$149.95**
Rental Price: **$75.00**

The Story of Inventory

This film untangles the often messy process of keeping track of inventory. It explores how to manage inventory with a focus on the bottom line.

www.films.com
Item: **BVL29654**
Format: **VHS**
List Price: **$89.95**

Cases Relevant to This Chapter

Beanos Ice Cream Shoppe

Alcoholes de Centroamerica, S.A. de C.V.

Answers to Issues to Consider

1. *Why is the cash flow statement the most important statement for the entrepreneur?*

   The cash flow statement is the most important because cash pays the bills and allows the company to grow. You cannot pay bills with profit, which is an accounting measure.

2. *Define an effective strategy for gathering the information required to complete the financial statements.*

   You must collect information on sales demand, capital expenditures, operating expenses, and taxes. One way to begin to identify those numbers is to do an imaginary tour of the business as described in Chapter 13. Then look at your business goals and prepare a timeline for when specific events, like hiring an additional person, will occur.

3. *Why would you want to consider a variety of economic scenarios when developing your financial statements?*

   Pro forma financial projections are more art than science. You need to do a sensitivity analysis that looks at the impact of a change in economic condition. For example, what would happen to your projections and expected profitability if sales only reached 80 percent of your targeted number? How could you deal with that situation? What if demand exceeded your expectations? How would that affect your financial assumptions?

4. *What is the role of ratio analysis in considering the financial condition of the business?*

   Ratios make comparisons of items in the financial statements and put them in relative terms so they can be compared to ratios in other periods. This facilitates looking for important changes in the company's position.

Suggestions for Experiencing Entrepreneurship

1. *Interview an accountant familiar with the type of business you're interested in to learn some of the particular issues you need to consider when doing your financial statements.*

   It might be helpful for the student to go to the accountant with a basic plan for his or her financial statements; then ask how they should be altered to meet the needs of the business.

2. *Interview a banker about your business to learn the key financial ratios the bank looks for when it analyzes your business.*

   Again, with a specific business in mind and some key financial numbers, the student will be in a better position to learn which ratios are the best indicators of his or her business's financial health.