principles of

Entrepreneurship

>>>> 13. The Entrepreneur's Need for Capital

New businesses rarely show a profit in the early months of operation. Generating sales takes time, and receipts are not usually sufficient to offset start-up costs and monthly expenses. Therefore, entrepreneurs need to estimate how much money they need and then raise that amount to transform their dream into a reality.

It doesn't necessarily take a lot of cash to create a successful business. In the mid-1970s, Steve Jobs and Steve Wozniak started Apple Computer by selling a Volkswagen microbus and a Hewlett-Packard scientific calculator to raise $1,300 — enough for a makeshift production line. In 1997, Bill Martin and Greg Wright used the free Internet connections in their college dorm rooms and $175: $75 for a New Jersey partnership fee, $70 to register their Web domain name, and $30 for a month's hosting fee — to start www.ragingbull.com, which is now a successful financial Web site.

Many entrepreneurs start businesses with $5,000 or less, just enough to establish the business, invest in some inventory, and create some advertising materials. There are many ways to reduce expenses: for instance, by initially working out of one's home rather than leasing an office or leasing office equipment rather than buying it.

However, all entrepreneurs need to estimate how much cash they need to cover expenses until the business begins to make a profit. For this task, the best financial tools are the income statement and cash flow statement. Cash flow refers to the amount of money actually available to make purchases and pay current bills and obligations. It is the difference between cash receipts (money taken in) and cash disbursements (money spent) over a specific time period.

It is important to attach notes to these forecasts to explain any unusual expenses or assumptions used in the calculations.

- An income statement sets out all of the entrepreneur's projected revenues and expenses (including depreciation and mortgages) to determine a venture's profits per month and year. Depreciation is a method to account for assets whose value is considered to decrease over time.
- A cash flow statement estimates anticipated cash sales as well as anticipated cash payments of bills. This estimate can be done on a weekly, monthly, or quarterly basis, but experts recommend that it be done at least once every month for the first year or two of a new business. This forecast is used to project the money required to finance the operation annually. By calculating this forecast on a cumulative basis, the entrepreneur can forecast his company's overall capital needs at start up.

The monthly net cash flow shows how much an entrepreneur's cash receipts exceed or fall short of monthly cash expenditures. For most of the first year, the monthly expenditures are likely to exceed the receipts. In many cases, goods are shipped out before payment is received. Meanwhile, the entrepreneur still has to pay his bills. Therefore, the cumulative cash flow, which adds each month's total to that of previous months, will result in a growing negative amount.

A critical point for a new business occurs when monthly sales receipts are enough to cover monthly expenses. At this point, the negative cumulative cash flow will begin to decrease and move toward a positive one. The cumulative cash flow amount reached just before it reverses direction indicates approximately how much capital the new business will need.

Financial projections are inevitably somewhat inaccurate simply because every contingency cannot be predicted. For this reason, experts recommend that entrepreneurs add at least 20 percent to the financial needs calculated in the cash flow statement to create a safety net for unforeseen events.

With these estimates, the entrepreneur can seek funding and concentrate more clearly on launching the new business.