Fitness Pedalers

The Price of Startup: Costs and Cash Needs

Based on their assumptions and projections, Mike and Mary were relieved to see that they really could make some money with this opportunity they had been researching. However, they found themselves worrying, at this point, about how much money they would need to start this business. They had managed to save $10,000 but that was surely only a drop in the bucket.

Going back to his entrepreneurship notes, Mike remembered that the costs involved in starting up a business fell naturally into categories:

- Opening inventory
- Hard costs
  - Property, plant and equipment
    - including improvements required for rented space
  - Deposits and prepaid expenses
  - Capitalized costs (legal fees for incorporation, logo design, etc.)
- Working capital
- Contingencies.

He found a useful format for a Schedule of Start-up costs, and decided to use it as a pattern for his work.

Recalling that he had estimated their first three months’ cost of goods sold at just under $50,000, Mike realized that his opening inventory should be $50,000.

Having done some shopping for equipment, Mike estimated that they would need about $20,000 to equip the shop properly and furnish the selling floor with a counter and cash register.

Looking over the rental space they had identified, Mike and Mary realized that they needed to set up some partitions, install some lights, and do some painting. They would try to save all they could by doing some of this work themselves, but Mike’s estimate for this work was $3,000.

The landlord informed Mike that he would require one month’s rent as a deposit and, since Mike and Mary had not established a credit rating, the landlord also required the first month’s rent in advance. One month’s rent is $4,500.

The only capitalized costs Mike anticipated would be $1,500 in attorney’s fees to incorporate the business and advise Mike and Mary on their obligations as officers of a corporation, plus $500 to a friend of Mary’s who was a skilled cartoonist who was developing a comical logo involving a peddler on a bicycle.

Recalling what Uncle Joe had said about the problems that arise from the time lag that always occurs between paying for inventory and labor and collecting revenue from customers, Mike knew that they would need some working capital and that he would need to do a cash budget to determine what that number would be. But for now, he decided to use $10,000 as his working capital for his first efforts at a Statement of Startup Costs. As he typed in the number he smiled because he knew how easy it would be to revise the number and have Excel recalculate the totals.
The text book suggested adding in a contingency amount. The book said the rule of thumb was 10 to 15 percent of the hard costs. Mike decided on 10% of the forecasted “Hard Costs”. With these figures in mind, he generated a Schedule of Startup Costs. He reviewed the numbers and felt good about the assumptions he had made.

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Mike then turned his attention to the cash budget. He knew the cash budget was also a critical statement the banker would want to see. He remembered something one of his professors had said: “Businesses don’t fail because they are not making a profit. They fail because they can’t pay their bills. Cash flow is more critical than profit.” Recognizing the truth of this statement, Mike started on cash requirements. He knew they would need funds in excess of the $10,000 they had saved just to meet their start-up costs. How much more than this they would need to avoid running out of cash was the question he had to address now.

After dinner that night, Mike and Mary broke down their pro forma income statement into quarterly statements to use as the foundation for their cash budget. Recognizing that they would not sell at any even rate during the year, they decided to plan on the basis of $80,000 in the first quarter, $180,000 in the second, $260,000 in the third, and $130,000 in the fourth.

They used the proforma statement that they had generated as a basis for understanding their cash needs and the timing of those needs. Some items could be about the same each quarter, others would only impact cash in particular quarters, like attending the Interbike trade show in September (third quarter). For planning purposes, they decided to pay all of the operating expenses in the month in which they were incurred.

Since this was a budget, Mike decided to simplify forecasting the cash needs for inventory purposes. He knew he had specified $50,000 in opening inventory in this startup costs. For his cash budget, he decided that he would assume that during the quarter he would replenish everything that he sold in that quarter. He also decided to assume that he would be paying for it during that same quarter. To do his calculations, he used a Cost of Goods Sold percent based on his proforma projections. He knew this wasn’t exactly how cash would really flow in and out but for forecasting purposes, he was sure it would work.

Because of their tight cash situation, they decided not to offer any in-store credit to their customers. They would require complete payment (cash, debit card, credit card) at the time of sale. Their research discovered that they would be charged a 2% fee (2% of the purchase price) for every transaction that used a debit card or credit card. They thought that most of their sales would be debit card or credit card sales so decided to assume that all of them would be. Mike updated their pro forma income statement to reflect the credit card fee.

With all of this in mind, Mike began to prepare the Cash Budget. He anticipated that he would see negative cash available, because his first pass at a Cash Budget would not reflect cash from a bank loan. In this first pass, he also decided to ignore their own savings so he could get a direct measurement of their total cash needs. These negative numbers would help him consider his options and estimate the amount of a loan they would need.

They got nervous when they saw red numbers appearing for the first quarter. They checked their assumptions and checked their formulas. These numbers were right, based on their assumptions. They should expect to have losses in the first quarter. It was simply the effect of low sales volume in the earlier months.
Mike and Mary had a preliminary talk with the banker that was recommended to them by someone Mary worked with. After he looked at their start-up costs and cash budget, he indicated that he might be willing to finance their inventory purchases after their business was both profitable and cash flow positive. Besides this, they each had a credit card with a $25,000 balance available. The banker was not happy about them using this kind of financing, but he was willing to consider their loan after they had done a little more research into inventory levels and payroll costs.

Mike and Mary arrived home a bit disappointed. They really thought this was a great opportunity and they didn’t want to pass it up. They listened to their phone messages. Uncle Joe had called to see how they were doing and asked that they call him back.

Mike filled in Uncle Joe on all the leg work they had been doing since they had visited him. When he got to the part about the banker being unhappy, Uncle Joe said, “I have an idea”

“What if I loan you $60,000? You could pay me just interest for the first two years and then interest and balloon payments the next eight years. The guy I bought the business from believed in me and was my “bank” so let me be yours.”

Mike controlled the excitement in his voice as he said “Uncle Joe that would be so generous of you. Let me talk it over with Mary and we’ll get back to you.”

Assignment:
Use the supplied Excel workbook as your starting point for this assignment:

In the tab named “Inc Stmt” add in the new expense (the 2% fee) to their Pro Forma Income Statement. Use this Income Statement when creating your Cash Budget.

In the tab named “Startup” generate a Schedule of Startup Costs for Fitness Pedalers as an Excel spreadsheet using the format in the reading.

In the tab named “Cash Budget” generate a Cash Budget for Fitness Pedalers (by quarters) as an Excel spreadsheet. Don’t take Uncle Joe’s offer into account at this time.

Your faculty will indicate how they wish to have this assignment submitted.