

**SMALL BUSINESS BRIEF**

**FALLACIES VERSUS REALITIES IN FINANCIAL PLANNING AND  
MANAGEMENT AMONG ENTREPRENEURS:  
LESSONS FROM THE TRENCHES**

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**ABSTRACT**

*This paper summarizes fallacious thinking about financial planning and management among entrepreneurs and small business owners. This thinking often continues from start-up through initial liquidity and beyond and creates problems for the venture. These problems can usually be avoided with an understanding of the realities associated with fallacious thinking and following some fairly simple "rules" enunciated by the authors.*

**INTRODUCTION**

Entrepreneurs often make mistakes in financial planning as they start and manage new ventures that result in cash flow problems ranging from minor to fatal. These mistakes often occur because of the fallacious thinking that entrepreneurs use in the startup, early growth, and the early excess liquidity time frames of new ventures. Problems arise from a failure to be specific and deliberate in planning and managing finances. For example, pre-start up expenses are ignored or underestimated, startup costs are underestimated and/or improperly financed, sales are overestimated and expenses are underestimated, cash flow is poorly estimated, business growth is assumed to be strong and self-financing, and early liquidity is often mismanaged. Unfortunately, most entrepreneurs and many advisors, formal and well-meaning friends, have not had the benefit of formal education in business or finance (Adelman & Marks, 2000).

This article distills 40 years of experience counseling thousands of entrepreneurs and small business owners in financial planning and management from pre-business planning through initial prosperity. Entrepreneurs, counselors, students and teachers may benefit from understanding common financial planning and management fallacies in entrepreneurial thinking and the realities learned in the trenches.

## FALLACIES AND REALITIES OF FINANCIAL PLANNING AND MANAGEMENT

***Fallacy 1: "I don't need a business plan! I have a good location that needs some fixing up and a little money!"***

In their haste to get started entrepreneurs often do not do any formal business or financial planning. There is a tendency for entrepreneurs to ignore or underestimate pre-business expenses. Pre-business expenses include market and marketing research, business planning assistance, licenses, permits, repair and renovation of facilities, utility deposits, grand opening, and other expenses associated with expenditures incurred in preparation to start a businesses. In their haste to open, limited attention is given to these, often substantial, expenses. Failure to prepare for such expenditures can create cash flow problems from the very beginning of business operations. Proper planning requires that these expenses be thoroughly considered and anticipated (Adelman & Marks, 2000).

***Reality from 1: Haste leads to a lack of or inadequate business plan. A good business plan lays a proper foundation for a successful business. Pre-business expenses must be part of that plan.***

***Fallacy 2: "I have a great idea and need to get started! All I need is \$50,000 to \$100,000 for the building and a few pieces of equipment"***

Startup costs, basic fixed asset financing, present a challenge for entrepreneurs. The most common error in financing fixed assets is the tendency to do rough estimates of a few "important" assets. In determining startup costs, entrepreneurs need to determine all the assets that will be needed to run the business and how those assets will be financed.

If a building and land are required, realtors and contractors can provide estimates. Purchasing buildings and land involve very long-term commitments and can result in problems whether or not the business succeeds. In startup situations, it is usually better to rent or lease than buy. It will be easier and more graceful to get out of a lease than a mortgage if the business fails to develop as expected. Of course, if the needed facilities are not available, purchasing may be necessary.

Equipment, furniture, and fixtures required to operate the business can be determined by talking to vendors. However, many entrepreneurs do only rough estimates of these costs instead of doing the necessary research. Failure to determine actual costs of fixed assets often leads to financing gaps that create critical cash flow shortages that may threaten the viability of the firm. Many protest that they will determine these costs later. They have to be reminded that if they are going into business, "later" is now.

Financing fixed assets is usually equated with long-term sources of funds, long-term debt or equity. The source of funds matches the useful life of the asset. This equation is reasonable and most entrepreneurs get it right. It is unreasonable to expect that new ventures will generate sufficient cash flow to pay for these assets in a short period of time. For example, financing a building using a 180-day note (not for interim financing) presents a real problem for the few who make the mistake. Similarly, financing equipment, furniture, and fixtures is usually done using long-term sources of funds. Most entrepreneurs properly associate fixed assets with long-term sources of funds. A few, however, do not (Lewellen, Halloran, & Lanser, 2000; Keown, Martin, Petty, & Scott, 2002; Brigham & Houston, 1999; Kuratko & Hodgetts, 1995).

***Reality from 2: A complete list of all fixed assets needed must be determined and financed with long-term sources of funds.***

***Fallacy 3: I have enough money and savings to get started and buy the equipment so I can own my assets. I need to borrow a little, but not for too long! I want new equipment for my business.***

One of the biggest problems the authors encounter with entrepreneurs in fixed asset financing is the use personal funds to finance them. Entrepreneurs seem to have a desire to own fixed assets. This desire often leads them to use their own, usually limited, funds to buy fixed assets. Entrepreneurs need to understand that they do not need to own assets, just control them. Leasing or renting is often a better option. Leasing and renting involves shorter time commitments than buying and, if the business is not successful, it is usually easier to terminate contractual arrangements.

Personal resources used to purchase fixed assets may be better used for working capital and for survival cash. Liquidity is important to entrepreneurs. A good financial plan involves finding the costs of fixed assets and financing them appropriately. Lenders are much more inclined to loan money for fixed assets than for working capital and to cover expenses before the firm reaches break even. Another common error is to buy fixed assets from vendors on terms. This approach also creates problems for lenders since the vendor will have the first lien on these assets.

It is usually better for entrepreneurs to use savings accounts and other time deposits as collateral for loans rather than cashing them in to use in the business. Borrowing against those personal resources will increase liquidity. The logic is that borrowing against such savings imposes "fiscal discipline" on the entrepreneur. Entrepreneurs will use borrowed funds more judiciously and typically repay such loans. Cashing and using savings accounts and other securities often result in spending and not resaving. The cash from savings often leads to another common error made in acquiring fixed assets, the purchase of new "first class" equipment, fixtures, and furniture rather than good used items. Suppliers of these assets typically sell and/or lease good, refurbished assets that will do the job. In addition, new equipment, furniture, and fixtures depreciate in the broader market place much faster than good used ones. Early liquidation may lead to higher losses if it is necessary to get out.

***Reality from 3: It is not necessary to own fixed assets, just control them. Conserve personal resources for working capital and survival needs. Savings and other time deposits are good collateral; avoid using these to buy fixed assets. Good used equipment will often do the job. Avoid trying to go first class.***

***Fallacy 4: "Suppliers will provide me with inventory. Why do I need to finance accounts receivables? If I run short of money, I can go back to my banker for more."***

Financing current assets is an often-misunderstood proposition. Many entrepreneurs and some small business advisors relate current assets to short-term sources of funds. Because of this association of current assets (uses of funds side of the balance sheet) and short-term sources of funds (sources of funds side of the balance sheet) many entrepreneurs assume that current assets can be financed using short-term sources of funds. It is important to distinguish between "permanent" current assets (such as accounts receivables and inventory) that will be

on the balance sheet as long as the business exists, and "variable" current assets (such as receivables and inventory needed to cover seasonal and/or cyclical changes) that vary over time.

The use of short-term sources of funds--trade credit or short-term loans for inventory, for example--to finance permanent current assets during startup usually results in an almost immediate cash flow problem. While inventory turnover converts inventory to accounts receivables and back to cash, initial sales may be slow to develop and inventory that is sold is quickly replaced and the cash inflow generated may be needed to meet operating expenses. Additionally, terms of purchase for startup companies are typically cash-on-delivery or very short term. Some entrepreneurs underestimate permanent inventory requirements based on the inventory-turnover idea.

If the new venture extends credit to its customers, the problem is compounded by the length of time it takes to collect receivables. Generally, entrepreneurs should not extend credit in their own name. It is better to arrange to accept credit cards from customers and avoid having to manage a credit business on the side. The fees charged by credit card companies are small compared to maintaining a credit department. If it is necessary to extend credit--and it sometimes is--entrepreneurs must get adequate funds to support such credit. It is not uncommon for business customers to expect or take 30-90 day terms for their credit. Extending credit can create a cash flow problem for entrepreneurs who have not arranged for the resources to support those accounts receivables.

"Permanent" current assets should be financed using equity or longer-term debt (ranging from 180 days up to three to five years). "Longer" is used to convey the notion that time must be allowed for the entrepreneur to convert debt to equity through cash flow<sup>1</sup> in an orderly way. The reason for the use of longer is that many lenders do not want to lend long-term to finance current assets. Lenders will often consider longer term, however, when the need for such terms is properly documented and explained. Vendors, for example, have been known to finance basic inventory for up to three years in new ventures about which they felt confident.

Short-term sources can be used to finance "variable" current assets, but proper attention to length is also important. Using too short-term sources to finance these "variable" current assets can still result in cash flow difficulties. For example, a small manufacturer of hunting equipment must remember that financing seasonal inventory and receivables may involve the period from one season to the next, perhaps nine months to a year, not just one or two months (Lewellen et al., 2000; Keown et al., 2002; Brigham & Houston, 1999; Emery, 1998; Kuratko & Hodgetts, 1995).

Some entrepreneurs think that if they run short of funds, they can go back "back to the well" for more. Lenders usually find it very difficult to provide more funds to entrepreneurs who, by requesting additional funds shortly after the initial loan, indicate that they failed to plan and/or manage well in the first instance.

***Reality from 4: Finance "permanent" current assets with longer-term equity or debt. "Variable" current assets can be financed with short-term sources of funds.***

***Fallacy 5: "If push comes to shove, I can use credit cards for emergencies."***

Entrepreneurs sometimes attempt to finance business startups, survival, or growth with credit cards. The authors have had clients with as much as \$170,000 in credit card debt (often off

the balance sheet) incurred to finance startup, survival, or growth in their business. Needless to say, this approach leads to cash flow problems. Credit card interest rates are extremely high and terms are short, both of which are undesirable. Even though the debt is off balance sheet, it will be shown on the credit report and impact the personal cash flow of the entrepreneur. Of course, using credit cards to purchase efficiently if the debt can be paid off monthly is appropriate.

***Reality from 5: Credit cards should be used only for efficient purchasing and paid monthly.***

***Fallacy 6: "My friends tell me they would buy my product. Everybody needs this product. My inventory will turn, and I can replace it as I sell it!"***

Cash flow problems result when new venture entrepreneurs underestimate the time it takes for sales and cash flow to develop. High estimates of quick profits and cash flows that do not materialize within the time frame estimated lead to cash deficits that may last for some time. Survival cash, enough to cover operating expenses through cash flow breakeven is reached, must be determined.

Marketing takes time! Sales grow over time from building a customer base. Sales, profits, and cash flow, therefore, do not usually come in the amounts expected or as fast as many entrepreneurs expect. The result can be cash flow problems from mild to severe. Cutting price to increase sales, which cuts per unit gross margin, and/or increasing promotion expenditures to increase sales do not necessarily improve sales, profit, and cash flow.

Realistic forecasting should consider that potential customers do not even know the firm exists initially. Initial sales are typically low and grow slowly for several months or a year or more for many businesses. While new ventures in smaller markets often develop fairly quickly, if they are going to develop, those in larger markets usually take longer. In smaller markets, potential customers are likely to become aware of the business quicker. Operating expenses can consume a good gross margin until sufficient sales and cash flow develop. While it is more difficult to forecast sales than expenses, a good sales forecast should anticipate the time needed to develop the required customer base and allow for the estimation of survival cash needs.

Negotiating survival cash when financing startup is important since the lender will be aware of this future potential need for funds and may well finance such needs with a line of credit. Most loan officers view the anticipation of survival cash needs as good planning. If the loan officer changes, the line of credit will still exist.

***Reality from 6: Survival cash needs must be determined and arranged for when planning and financing startup.***

***Fallacy 7: "Sales are going to be really good and pick up fast. My rent is fairly low and my other expenses are not going to be that much!"***

Entrepreneurs tend to overestimate sales and underestimate, or miss, some operating expenses for new ventures. Most operating expenses can be determined by asking someone in a similar business or by asking suppliers. Many entrepreneurs do rough estimates that are often too low. In addition, they do not think of or know how to estimate all expenses they will incur. Depreciation, with its cash flow and tax implications, is a mystery to most entrepreneurs, and

interest expense is not always easy to determine. If the total funds needed are underestimated, interest expense and note payments also will be underestimated. Overly optimistic estimates of sales and the time required to achieve them, combined with low or overlooked estimates of expenses results in the overestimation of profits and cash flow. This situation quickly leads many entrepreneurs "down the primrose path toward disaster."

Breakeven analysis, on both income statements and cash flow, often overlooked and relatively easy to do, can help entrepreneurs understand that it is important to keep fixed expenses down and can be used to help determine how much and how long money will be needed to cover operating expenses before breakeven. The question becomes: "How much do I have to sell? Not "How much can I sell?"

***Reality from 7: Sales and expense estimates must be realistic with respect to amount and timing. Breakeven analysis, income statement and cash flow, is a very useful tool for entrepreneurs.***

***Fallacy 8: "I will make 50 cents on every dollar sold. Cash flow will not be a problem!"***

Converting overestimated sales and underestimated operating expenses into cash flow estimates will hide potential problems. Losses on the income statement are one thing, cash flow deficits are quite another. Underestimating the length of time it takes to reach cash flow breakeven can result in problems ranging from sweaty palms to failure. Most entrepreneurs get just enough cash to open their business, but not enough to allow them to reach cash flow breakeven in an orderly way. Good cash flow estimates require a realistic monthly cash flow projection, including the lag in collecting receivables, prepaid expenses, and other temporal issues associated with cash flow, to determine how much cash is needed for how long. Estimates should be made for 15-36 months particularly if the business is subject to substantial seasonality. Such estimates will show when cash flow deficits are likely to occur and how large they are likely to be. Once the deficits have been estimated, the entrepreneur can see how much additional cash is needed to reach cash flow breakeven.

Ideally, the entrepreneur should have adequate equity to cover these deficits. That is a major reason the authors earlier suggested conserving personal resources. If debt is to be used to cover cash deficits, there should be a written commitment when startup funds are negotiated. It is very difficult to go back to the lender to ask for more money to cover cash flow deficits since they are typically needed to cover working capital or operating expenses that do not represent good collateral. Equity, lines-of-credit or appropriate-length term loans can be used to finance survival cash. Terms on these sources should be long enough to allow the entrepreneur to convert any debt to equity in an orderly fashion (Lewellen et al., 2000; Brigham & Houston, 1999; Emery, 1998).

***Reality from 8: The amount and timing of cash receipts and cash disbursements must be realistically estimated to avoid cash flow problems.***

***Fallacy 9: "My family likes the idea of me being my own boss—I can make money for myself instead of for someone else."***

Particular problems arise when entrepreneurs expect to be paid as much from their new venture as they were in their previous employment. Entrepreneurs are the last persons paid from profits and cash flow. In startup ventures, owner's compensation may often be low or nonexistent for a substantial time period. This may make it necessary for the entrepreneur to

start the new venture on a part-time basis while retaining a full-time job or letting their spouse work until the venture can provide an adequate profit and cash flow to provide a family income.

Many entrepreneurs, in their haste to get started, fail to determine their personal and family survival cash needs as they plan their venture. Determining personal needs is a fundamental issue that must be considered in business planning.

***Reality from 9: Personal and family needs must be included in financial planning for new ventures. "Don't quit your day job."***

***Fallacy 10: "I expect my sales and profits to double the first year! We're on our way!"***

Many entrepreneurs think that sales growth is good and will lead to increased profits and cash flow. If a new venture grows in a deliberate, orderly way, increased sales, profits and cash flow can be expected and it may be possible to finance growth from internally generated funds. If the business grows at a faster rate than can be supported by internally generated funds, it will be necessary to manage growth carefully. Rapid growth in sales will mean more cash flowing into fixed assets, "permanent" current assets (inventory, receivables), and perhaps operating expenses.

Such uncontrolled growth often creates cash flow problems for entrepreneurs. If internal funds can be generated or if borrowed funds can be acquired at affordable rates, these may be used. Such funds should be obtained for an appropriate length of time. Additional funds required for fixed and "permanent" current assets should be financed from long or longer-term sources of funds, such as internally generated funds, additional equity injections, or long-term debt (Lewellen, et al., 2000; Keown et al., 2002; Brigham & Houston, 1999).

If additional funds are not available from equity or debt, the entrepreneur can use price strategy to control growth. Many entrepreneurs recoil at the suggestion that they raise prices because "customers will stop buying." That is actually the goal of controlling growth. While some customers will stop buying, all will not and raising prices will generate additional profit and cash flow from each unit sold. Of course, price increases should be judicious and incremental. Raising price is a quick way to control growth.

***Reality from 10: Finance fixed and "permanent" current assets for growth with long-term sources of funds. Price can be used to control growth.***

***Fallacy 11: "Honey, the business is doing great, this house is too small for people like us. I can buy that new equipment too!"***

The entrepreneur, their spouse, children, and others will have sacrificed, sometimes substantially, to get the new venture going. After entrepreneurs have gotten through startup, survival, and growth successfully, one additional area requires attention. When the business is up-to-speed and cash flow exceeds normal business requirements including an income for the entrepreneur, there is a strong temptation to use any excess liquidity for business or personal "life style" changes.

Business "life style" changes typically show up as the purchase of newer, fancier buildings and other better (first-class) fixed assets, changes in wages and benefits to employees, and various business perks. Personal life style changes show up as new cars, a family boat,

extraordinary vacations, or a new, larger home in a better section of town. Such business and personal uses of initial extra liquidity neglect the changes that inevitably occur in the economy. If the extra liquidity is used for life style changes, particularly permanent changes that require long-term commitments, a downturn in the economy or other set back requiring resources to keep the business going can result in cash flow problems for the entrepreneur.

Before any permanent business or personal lifestyle changes are made, future business conditions and plans should be considered. Some initial liquidity should be used to purchase marketable securities. These securities are a buffer against changes in the economy and/or additional growth that may occur (Lewellen et al., 2000; Keown et al., 2002; Emery, 1998). Once the entrepreneur has created this buffer, business and personal life style changes may be possible.

***Reality from 11: Conserve initial liquidity, in marketable securities, to insure long-term survival.***

### **The Reality of Financial Planning and Management for New Ventures**

Many entrepreneurs are in a hurry and often engage in fallacious thinking. This fallacious thinking can, and often does, result in poor financial planning and management with the related cash flow problems ranging from mild to severe. Entrepreneurs and their advisors should avoid fallacious thinking and consider the reality of financial planning and management of new, growing enterprises outlined by this article. Several "rules" flow from the reality of the situations posed by the fallacies discussed in this article. These "rules" are summarized in Table I.

Proper financial planning requires entrepreneurs and those who advise them to understand and plan and manage new venture startup, survival, growth, initial liquidity, and changes that will occur. Proper attention to the issues presented here should result in fewer financial problems and more success for new ventures.

*(Continued on next page)*

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**Table I**  
**Realities of Financial Planning and Management for Entrepreneurs**

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***Reality from Fallacy 1:***

- Haste leads to poor business planning.
- A good business plan lays a proper foundation for a successful business.
- Pre-business expenses must be part of that plan.

***Reality from Fallacy 2:***

- A complete list of all fixed assets needed must be determined and financed with long-term sources of funds.

***Reality from Fallacy 3:***

- It is not necessary to own fixed assets, just control them.
- Conserve personal resources for working capital and survival needs.
- Savings and other time deposits are good collateral; avoid using these to buy fixed assets.
- Good used equipment will often do the job. Avoid trying to go first class.

***Reality from Fallacy 4:***

- Finance "permanent" current assets with longer-term equity or debt.
- "Variable" current assets can be financed with short-term sources of funds.

***Reality from Fallacy 5:***

- Credit cards should be used only for efficient purchasing and paid monthly.

***Reality from Fallacy 6:***

- Survival cash needs must be determined and arranged for when financing startup.

***Reality from Fallacy 7:***

- Sales and expense estimates must be realistic in amount and timing.
- Breakeven analysis (income and cash flow) is a very useful tool for entrepreneurs.

***Reality from Fallacy 8:***

- Cash receipts and cash disbursements must be realistically estimated in amount and timing to avoid cash flow problems.

***Reality from Fallacy 9:***

- Personal and family needs must be included in financial planning new ventures.
- "Don't quit your day job."

***Reality from Fallacy 10:***

- Finance fixed and "permanent" current assets for growth with long-term sources of funds.
- Price can be used to control growth.

***Reality from Fallacy 11:***

- Conserve initial liquidity in marketable securities to insure long-term survival.
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