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This publication is designed to provide accurate and useful information. However, it is written with the understanding that the Insight Center for Community Economic Development is not engaged in rendering legal, accounting, or professional services. If legal or expert assistance is required, the services of a professional should be sought.

About the Manual

Since 1991, the Insight Center for Community Economic Development (Insight Center) has been actively engaged in efforts to improve the financial skills of child care providers in order to facilitate the development of high-quality child care centers. Our research shows that there is a tremendous need in the child care field for information about financial management and the facility development process. To address this need, Insight Center, in collaboration with the Children's Collaborium, has produced two manuals: *Child Care Center Financial Planning and Facilities Development Manual*, and *Family Child Care Financial Planning and Facilities Development Manual*.

If you have questions about either of these manuals, the Insight Center for Community Economic Development can be reached at (510) 251-2600.

The goal of this manual is to help child care providers manage and understand the financial side of their businesses. Beyond the basic importance of using budgets and financial statements to run a business successfully, understanding the financial status of a business is essential to planning and undertaking a facility development project such as building, purchasing, renovating or expanding a child care center.

Because facility development projects are typically quite costly, it is especially important to be able to demonstrate to funders, typically lenders, that the business owner has a clear idea of what size development project is fiscally feasible, and an estimate of how large a loan the business can qualify for.

This Manual is *not* intended as a substitute for professional financial and business planning assistance. It is designed to help child care center owners and directors become more comfortable with the financial side of their businesses. The hope is that with this increased comfort, child care providers will be more prepared to access professional assistance and financial resources to help them succeed in developing their facilities.

This manual consists of four chapters, each of which addresses a key component of financial planning and the facility development process. These materials are directed at the nonprofit sector, but much of the material is applicable to the for-profit sector as well. A summary of each chapter is listed below.

Chapter One: Budgeting and Basic Financial Statements

Planning for a new or renovated child care facility should be based upon a solid understanding of finances. This chapter introduces the concept of budgeting and describes how to create basic, yet important financial statements.

Chapter Two: Developing Pro Formas and Determining Debt Capacity

This chapter provides a basic explanation of *pro forma* financial statements required by most lending institutions, as well as information about the financial criteria used to determine a business' capacity to carry debt. Understanding *pro formas* and debt capacity can help a business plan a project, be a more informed and attractive consumer of financing packages, and assess its ability to take on debt. To read this chapter the reader should be familiar with the topics covered in Chapter One.

Chapter Three: Developing A Child Care Business Plan

A business plan is a concisely written summary of a child care business and/or a proposed development project. Business plans are important for securing financing for a child care facility development project or just making a

current child care business more successful. This chapter provides instructions about how to write a complete business plan. These instructions are especially useful for anyone who plans to apply for financing to start or expand a child care facility.

Chapter Four: The Facilities Development Process

This chapter provides an overview of the process of developing a child care facility project, such as purchasing or building a new facility, or renovating and expanding an existing facility. This chapter includes detailed information about the many different tasks, roles, and responsibilities that must be managed in order to prepare for and execute a facilities development project.

Appendix A: Where to Go for Help

Appendix B: Glossary of Terms

Bibliography

Services Available from The Insight Center for Community Economic Development

The staff at Insight Center for Community Economic Development has over twenty years of experience in the child care field. The Early Care and Education Program of the organization is currently engaged in many activities related to child care financial management and facility development. For example, the Insight Center has expertise conducting Child Care Economic Impact Reports (CCEIR's) that identify the economic benefits that child care services stimulate in various counties and states across the country.

Additionally, using the resources provided in this *Manual*, Insight Center collaborates with the Children's Collabrium to provide trainings to child care providers throughout California titled, *How to Finance Child Care Facility Acquisition, Construction & Renovation*. These workshops are designed to help child care center and family child care business owners in attaining the skills and tools to finance facility construction. For more information about these trainings contact Gary Kinley at the Children's Collabrium or Liz Winograd at the Insight Center.

Also, in 1997 Insight Center, acknowledging that child care is an essential part of any statewide economy, created the Local Investment in Child Care Project (LINCC). LINCC exists to stimulate public and private investment policy to meet the child care needs of all children and families in California. LINCC also enables local advocates and providers to facilitate the development of effective economic development infrastructures that support child care.

The Insight Center also provides assistance to the child care field, as it is the lead organization on the Building Child Care (BCC) Project. BCC is a collaborative project that operates as a clearinghouse of information and services designed to improve child care providers' access to financial resources for facilities development projects in California. The other three collaborative partners on this project are: the California Child Care Resource and Referral Network, the Low Income Investment Fund, and the Children's Collabrium. Through this collaboration, BCC provides technical assistance and information about facilities development and financing strategies to the child care community throughout the state.

To learn more about the resources available through BCC, visit the project web site, www.buildingchildcare.org, which contains information on community resources, publications, and financial resources; or, call the toll-free line, 888-411-3535, to ask questions related to child care facilities development and to learn more about resources available to help with the process of building, renovating, purchasing, and/or expanding child care facilities.

The Early Care and Education Program of the Insight Center for Community Economic Development can be reached at (510) 251-2600, and the organization's website is www.insightcced.org.

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Gary J. Kinley, Ed.D., Children's Collaborium, Liz Winograd and Jen Wohl of the Insight Center for Community Economic Development.

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Additionally, this manual would not be possible without Jan Stokley's pioneering work in the field of child care financing. This manual was largely developed from an earlier, unpublished manual Jan Stokley wrote for the child care field.

We also thank the hundreds of child care professionals throughout California who participated in the workshop, *How to Finance Child Care Facility Acquisition, Construction & Renovation*. The participants generously shared their experiences with financing and business development and offered valuable suggestions for creating relevant, easy-to-understand materials.

Finally, we are grateful to the David and Lucile Packard Foundation and the California Endowment for providing initial funding for the development and publication of this manual.

CHAPTER ONE:
**Budgeting and Basic Financial
Statements**

Chapter One: Budgeting and Basic Financial Statements

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Introduction

Gaining a clear understanding of the financial side of a child care business will strengthen it significantly, and will help to:

- Manage and plan the business better
- Assess the readiness of the business to take on financing of a development project
- Determine what size development project the business can take on
- Communicate with funders
- Satisfy funders' concerns that there is a clear understanding of the business' financial position and that a sound system of financial management is in place

The goal of this chapter is to help readers formulate an accurate picture of the financial side of a child care business. It is not intended as a substitute for professional financial assistance. Instead, it is designed to help child care business owners become more comfortable discussing the financial side of child care services.

This chapter outlines the following four basic financial tools: **budgeting, statement of activities and income, balance sheet, and cash flow statement.**

This publication is written for nonprofit child care centers and requires no prior background in accounting. Although nonprofit organizations have different accounting requirements than for-profit agencies, for-profit centers may also find this publication helpful.

Section One: Accounting Systems

To learn more about the financial side of a business, one of the first things that must be identified is the kind of accounting system already being used. There are three basic types of accounting systems: cash basis, accrual, and modified accrual. These systems differ in the determination of when to record revenues and expenses within financial records.

Cash basis:

In a cash basis system, revenues are recorded when they are actually received and expenses are recorded as they are paid. No attempt is made to record unpaid bills owed by a business or amounts due to a business. For example, if a parent is billed for the month of September, but the business does not receive payment until December, that payment is recorded in December.

Accrual:

An accrual system recognizes revenues when earned rather than received and recognizes expenses when incurred rather than paid. For-profit businesses almost always use an accrual system.

Modified accrual:

In a modified accrual system records are kept on a cash basis. When financial statements are prepared, this system is used to take into account what is owed by, and owed to, the business.

Although a cash basis system is simpler to use, most lenders will expect an accrual system because it more accurately reflects the current financial position of a business.



Section Two: Budgeting

A. What is a budget?

A budget is a child care business' plan of action, expressed in dollars. A budget estimates the expected income and expenses of a child care center for a specified period of time.

For most nonprofit child care businesses, budgets are a formal requirement. Budgeting also offers many benefits to a business:

- It requires a business to plan ahead;
- It promotes a greater awareness of the business' overall operations;
- It creates an early warning system and helps to control expenses, and
- It is a useful guide for decision-making.

B. Types of budgets

There are several different types of budgets that a business may use. These budgets are not mutually exclusive. In fact, both types may need to be used since each is used for a different purpose.

Organization-wide operating budgets:

Organization-wide operating budgets identify all the income and expenses anticipated for the entire organization. Income and expenses for a given period are broken out in a line-by-line format.

The disadvantage of an organization-wide budget is that it does not identify the revenue and expenses of individual programs within a child care business, such as pre-school, infant care, or after-school programs. An organization-wide budget can be misleading if one program within a business has costs that are not well managed. A sample organization-wide budget appears on page 15.

Program budgets:

When there are several different programs in a child care business, such as pre-school, infant care, or after-school programs, a business may develop separate budgets for each program. Line items are still used, but they are first identified by program and then summarized for the business as a whole. General administrative and overhead costs are also listed separately.

Individual program budgets are often required if a business is seeking funding for a particular program. Program budgets are also more useful in tracking costs since each program's costs can be evaluated separately. However, this means that revenue and expenses for each program, not just for the business as a whole, must be tracked. This requires more bookkeeping time. Each business must decide at which point the detail and expense of a program budget outweighs the benefits gained.

C. Developing a budget

Developing a budget requires estimating both the income a business will receive and the expenses it will pay out. This process should be a collaborative effort involving multiple staff members (i.e. financial management staff or bookkeepers, program staff, the board of directors, and the executive director). Both the accounting and program staff will help balance what is best for the children and families in the program, and couple it with the need for sound fiscal management.

Developing a budget requires time and careful planning. Creating a calendar that maps out the process of writing

a budget will help keep track of the timeline and the tasks involved. The following are some of the key activities involved in developing a budget.

Establish the time period the budget will cover.

A budget period can cover any period of time, but most frequently covers one fiscal year.

Estimate how many children will be served.

The number of children a business is able to serve is based on licensed capacity, desired enrollment, staff size, and other requirements.

Estimate anticipated revenue.

Revenue can come from a number of different sources such as parent fees, public subsidies and/or government funding, foundation grants, in-kind contributions, and fundraising. Each source should be listed as a separate line item. Revenue projections are based on assumptions such as vacancy rate, fee schedules, and the number of days the business is open. It is important that these assumptions are clearly stated, conservative, and based upon historical financial statements. For example, even if the expectation is that 100% of the slots will be filled, the budget should reflect a 90% or 95% expected attendance rate.

Estimate expenditures.

The expense portion of a budget should include a complete list of all the expenditures the business expects to incur. It is important not to underestimate expenses. In order to insure that all expenses are accounted for, include these four steps in the calculation.

Step One: Fixed expenses

Estimate all of the fixed costs required to operate the child care business. Examples include rent, mortgage, insurance, utilities, and telephone; all must be paid in order to operate a child care center. These expenses are considered fixed costs because they do not fluctuate, and must be paid regardless of the number of children being served. For example, rent and insurance costs are not likely to change when the number of children served increases.

Step Two: Salary expenditures

The number of people employed as staff at the center will depend on state licensing requirements as well as desired adult to child ratios. Often, staff salaries can take up to 80% of overall expenditures. Be sure to include benefits, vacation, projected salary increases, education stipends, sick leave and the cost of substitutes in salary expenditure calculations. Also, remember to calculate the cost of employer taxes (i.e. FICA, Worker's Comp., and Unemployment Insurance).

Step Three: Program or funder requirements

Identify any requirements specified by a funder. For example, if an audit or monitoring report is required as a contractual obligation, be sure to include this as an expense.

Step Four: Everything else

Calculate all other expenses, such as materials and supplies, equipment, staff development, fundraising, and advertising. If in-kind contributions are listed as income, it is also important to include in-kind contributions as an expense. For example, if a copy shop has donated \$1,000.00 in printing costs, this amount should be listed as income received as well as an expense.

Any assumptions that are made in estimating expenditures should be stated in a footnote. See the vacancy rates example on the sample budget on page 14.

❑ **Evaluate the relationship between expenses and revenues.**

After estimating the initial expenses and revenues, determine whether the budget is balanced. The relationship between revenues and expenses can be determined by the bottom line of the budget called “Excess of Revenue over Expenses.” This is calculated by simply subtracting the total expense line from the total revenue line. If revenues are greater than expenses, there is a **budget surplus**. If, on the other hand, expenses are greater than revenues, there is a **budget deficit**.

Often revenues are overestimated and expenses are underestimated. Thus, many accountants suggest that a business try to budget revenues and expenses reasonable and realistically. This is especially important when opening a new facility, since limited enrollment during the start-up phase may cause an income shortfall. Additionally, this type of estimating will help cover any other unexpected expenses or loss in revenues.

Lending institutions look favorably upon a surplus because it suggests that a business has the ability to cover the debt service (loan payment) if there is an unexpected decline in revenues or an increase in expenses. If projected expenses are greater than revenues, it will be necessary to make adjustments. Successful businesses are careful not to fall into the trap of changing numbers without making any real changes to programs. For example, if cost estimates are decreased, exactly what programmatic changes will occur?

When making adjustments it is helpful to look at how revenues and expenses vary as the number of children served changes. For example, depending upon adult to child ratios, it may be that by enrolling a few more children, costs will increase only slightly but revenues will increase substantially. This concept is called **economies of scale**, where one dollar invested in expenses results in more than one dollar in revenues. Economies of scale work best when the additional expenses of serving more children are small.

The concept of economies of scale is a powerful business idea. However, economies of scale and other tools of financial analysis may not always be an appropriate guide for decision making in a child care business. While it may be profitable to provide care to large numbers of children, it may not result in high-quality care. In fact, a low child to staff ratio is one of the key quality indicators widely agreed upon by the early care and education field as well as knowledgeable funders. This is an important issue for child care businesses, and one that certainly distinguishes child care from most other industries.

❑ **Compare actual expenses to budgeted expenses at least once a quarter.**

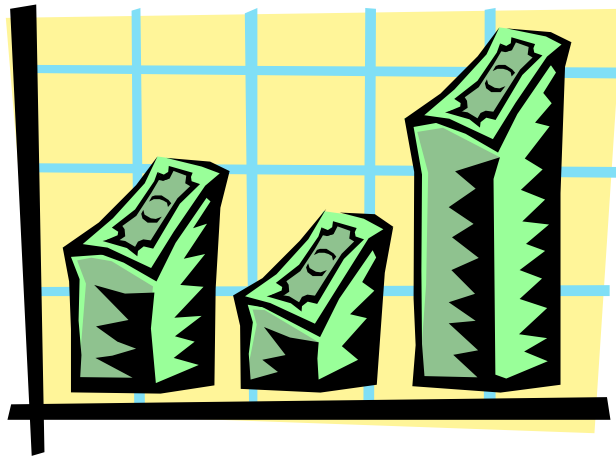
A budget will only be a valuable tool if it is used throughout the year to help manage a business. Many organizations create a budgeted versus actual year-to-date income statement, which allows for the comparison of actual revenues and expenses for the quarter with the budgeted revenues and expenses. After reviewing a budgeted versus actual year-to-date income statement, it may be necessary to revise the budget for the remaining quarters. The budgeted versus actual year-to-date income statement is discussed in more detail beginning on page 16.

D. What to look for when reviewing a budget

- Are the revenue assumptions used to create the budget reasonable and realistic? Can they be supported by past financial statements or extensive market research?
- Are expenses accurately reflected?
- What is the relationship between revenues and expenses?
- How much is the budget surplus or deficit?

- Compare the current budget with last year's budget. Have expenses or income increased or decreased? Why?
- If revenue projections aren't met, how will this be addressed? A funder will be very interested in a business' ability to handle unforeseen fiscal changes.
- Are there particular programs that have a deficit or a surplus? Is one program subsidizing others?

In summary, accounting projections should be used in conjunction with knowledge of what makes a high-quality child care center.



EXAMPLE A: Annual Budget

Happyland Child Care Center Annual Budget for 2002-2003

Revenue:*	
Parent Fees	\$250,000
State Infant-Toddler	
Contract	145,000
Subsidy Programs	175,750
Child Food Program	45,000
Fundraising	21,250
<u>Total Revenue</u>	<u>\$637,000</u>
Expense:	
Payroll	\$345,000
Taxes and Benefits	66,531
Classroom/Office Supplies	33,950
Advertising	2,000
Food	50,400
Travel	800
Facility Repair	1,200
Insurance	15,000
Holiday Party	500
Rent/Lease	100,000
Professional Services	2,000
Utilities	10,000
Phone	2,400
Fundraising	2,000
<u>Total Expense</u>	<u>\$631,781</u>
Excess (or deficit) of	
<u>Revenue over Expenses</u>	<u>+ \$5,219</u>

*Assumptions:
Vacancy rate of 5% included in revenue calculations.

Section Three: Statement of Activities and Income Statement

Section Two laid the groundwork for creating a budget—the financial plan of action for a child care business. This section describes the statement of activities and the income statement as tools to measure how a business actually performs.

A. What is a statement of activities?

The statement of activities identifies the sources and uses of funds for nonprofit organizations. It is very useful because it shows what a business actually earned and what it costs to earn that amount. The statement of activities can be prepared for a twelve-month period as well as at intervals during the year. The statement of activities is very similar to the income statement used by for-profit agencies. All nonprofits are required to prepare a statement of activities, and most financing institutions require a statement of activities as part of a loan application.

B. Components of the statement of activities

1. Revenues and expenditures:

Revenues are always listed on the top half of the statement and expenses on the bottom half. Both revenues and expenditures should be broken down line by line. (A sample statement of activities is provided on page 17).

For those expenses that involve depreciation or an interest payment, only the depreciation or interest portion of the expense is recorded on the statement of activities. For example, for large equipment purchases many businesses choose to depreciate the cost of the equipment over its estimated useful life, instead of listing a one-time expense. This means that if a \$5,000 piece of equipment is purchased and expected to last for five years, there would be a depreciation expense of \$1,000 every year for five years. In that case, the statement of activities would show a \$1,000 depreciation expense, not the \$5,000 equipment expense. The portion of the equipment that does not depreciate (\$4,000) is considered an asset and will be reflected in the balance sheet. The balance sheet is described in greater detail beginning on page 19.

2. Change in net assets:

The change in net assets is calculated by subtracting expenses from revenues. If it is a positive figure, it is also called a profit or net gain. If it is negative, it is a net loss. Lenders want to know that a business has a positive change in net assets.

3. Audited statement of activities:

A statement of activities prepared for internal use may look different from an audited statement of financial activities. Audited statements are required to include a column called “Temporarily Restricted.” Revenues that appear in this column have some type of donor-imposed conditions or restrictions that either expire by passage of time or can be fulfilled and removed by actions of the organization. For the sake of simplicity, we have chosen to omit the “Temporarily Restricted” column on the sample statement on page 17. In addition, audited statements do not provide as many details on specific expenses, but instead group the expenses into categories such as program expense, administration, or fundraising.

C. What is an income statement?

"Income statement" is the term that for profit businesses use instead of "Statement of activities". The income statement identifies the sources and uses of funds for a business. It is very useful because it shows what is actually earned and what it cost to earn that amount. The income statement can be prepared for the year that just ended as well as at intervals during the year. This statement will be required by most lending institutions.

D. Budgeted versus actual year-to-date income statement

Once a statement of activities has been developed, it can be used to compare actual income and expenses to the budgeted figures. See page 18 for an example. It can very useful to do a budgeted versus actual year-to-date income statement at the end of a year, as well as at intervals during the year, in order to monitor the progress of the business.

When listing budgeted and actual figures, budget estimates are listed in the first column and actual revenues and expenses are listed in the second column. Any discrepancies between the budgeted and actual income and expenses can quickly be noted in the third column labeled "Variance." Unfavorable differences are noted using parentheses. The final column shows the percentage a business is over or under budget. However, percentages can be misleading because they do not tell the actual dollar difference. For instance, the example on page 18 shows a 3% difference between the budgeted and actual payroll expenditures. Three percent may not seem like a lot, but in fact it represents a dollar amount of \$10,500.

E. What to look for when reviewing the statement of activities and the budgeted versus actual year-to-date income statement

- Does the business have a net profit?
- Are there any actual line items that differ from budgeted projections?
- How does this difference affect net profits?

EXAMPLE B: Statement of Activities

Happyland Child Care Center
Statement of Activities for Twelve-Month Period Ended June 30, 2003

Revenue:	
Parent Fees	\$240,400
State Infant-Toddler	145,000
Subsidy Programs	175,750
Child Food Program	45,000
Fundraising	15,000
Total Revenue	\$621,150
Expense:	
Payroll	\$334,500
Taxes and Benefits	62,463
Classroom/Office Supplies	32,000
Advertising	2,100
Food	50,000
Travel	776
Facility Repair	1,900
Insurance	15,000
Holiday Party	500
Rent/Lease	100,000
Professional Services	2,000
Utilities	11,325
Phone	2,400
Fundraising	2,000
Total Expenses	\$616,964
Change in Net Assets	\$4,186
Net Assets -Beginning of Year	\$25,502
Net Assets- End of Year	<u>29,688</u>

EXAMPLE C: Budgeted Versus Actual Year-to-Date Income Statement

Happyland Child Care Center
 Budgeted Versus Actual Year-to-Date Income Statement
 for Twelve-Month Period Ending June 30, 2003

	Budget	Actual	Variance (Unfavorable)	Actual as % of Budget
Revenue:				
Parent Fees	\$250,000	\$240,400	\$(9,600)	(4%)
State Infant-Toddler	145,000	145,000	-	0%
Cal Works	175,750	175,750	-	0%
Child Food Program	45,000	45,000	-	0%
Fundraising	21,250	15,000	(6,250)	(29%)
Total Revenue	\$637,000	\$621,150	\$(15,850)	(2%)
Expense:				
Payroll	\$345,000	\$334,500	\$10,500	3%
Taxes and Benefits	66,531	62,463	4,068	6%
Class/Office Supplies	33,950	32,000	1,950	6%
Advertising	2,000	2,100	(100)	(5)%
Food	50,400	50,000	400	1%
Travel	800	776	24	3%
Facility Repair	1,200	1,900	(700)	(58%)
Insurance	15,000	15,000	-	0%
Holiday Party	500	500	-	0%
Rent/Lease	100,000	100,000	-	0%
Professional Services	2,000	2,000	-	0%
Utilities	10,000	11,325	(1,325)	(13%)
Phone	2,400	2,400	-	0%
Fundraising	2,000	2,000	-	0%
Total Expense	\$631,781	\$616,964	\$14,817	2%
Net Gain (Loss), also called "Change in Net Assets"	\$5,219	\$4,186	\$(1,033)	(20%)
Net Assets –				
Beginning of Year	\$25,502	\$25,502		
Net Assets-				
End of Year	\$30,721	\$29,688		

Section Four: Balance Sheet

A. What is a balance sheet?

The balance sheet is typically prepared at the end of an accounting period and shows the financial position of the business as of a fixed date. It is like a snapshot of a child care business at one particular moment in time. The balance sheet often includes a comparison between the current and previous years.

B. Components of a balance sheet

A balance sheet always has three categories: **assets**, **liabilities**, and **net worth**.

Assets:

Assets are listed on the top half of the balance sheet. These include anything a business owns that has monetary value. There are two categories of assets: current and fixed.

Current assets include cash and other assets that can be converted into cash or generally used within a year. They include accounts receivable, or the amount of money owed to a business for services already performed. It is important to closely monitor the amount of money owed to a business. If accounts receivable are increasing, it could be an indication that families are not paying their fees on time or that subsidies are not being reimbursed in a timely manner. A general rule is that accounts receivable should not exceed one month's income. However, this may vary depending upon the billing cycle being used. Current assets also include prepaid expenses - goods, benefits, or services that a business buys or rents in advance, such as office supplies and insurance protection.

Fixed assets include all resources a business owns or acquires for use in operations that are expected to remain in their non-cash form for longer than one year. Fixed assets, except for land, are listed at **cost less depreciation**.

Liabilities:

The second half of the balance sheet should reflect liabilities. These are debts owed by a child care business to any of its creditors. As with current assets, **current liabilities** are those debts that a business expects to pay within one year. The following are all examples of current liabilities:

Accounts payable: Amount owed to suppliers for goods and services purchased in connection with business operations.

Debt payable: The principal balance of outstanding credit and/or debt financing. **Long-term liabilities** are those debts that do not have to be repaid within the upcoming year, such as a long-term loan. Use a brief narrative footnote to describe debt as either short term or long-term.

Interest payable: Any accrued fees due for use of both short and long-term borrowed capital and credit extended to the business.

Taxes payable: Amounts estimated by an accountant to have been incurred during the accounting period. These taxes include both payroll and income taxes.

Payroll accrual: Salaries and wages currently owed.

Deposits: Capital reserves continuously set aside.

Net worth:

Net worth is also referred to as **net assets** or **equity**. A business' net worth is the difference between what a business owns (assets) and what it owes (liabilities). This idea is represented in the equation below.

$$\text{Total Assets} - \text{Total Liabilities} = \text{Net Worth}$$

This means that if a child care business owns more than it owes in liabilities, its net assets will be positive. Conversely, if a child care business owes more money to creditors than it possesses in assets, its net assets will be negative.

According to nonprofit accounting requirements, there are three types of net assets: unrestricted, temporarily restricted, and permanently restricted.

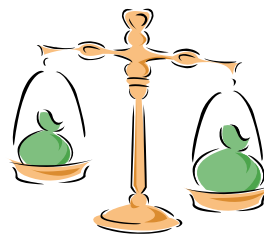
Unrestricted net assets are net assets with no restricted use.

Temporarily restricted assets are net assets that carry donor-imposed conditions or restrictions that either expire by passage of time or can be satisfied by actions of the organization pursuant to certain stipulations.

Permanently restricted assets are net assets that carry donor restrictions that never expire. The most common example of a permanent restriction is an endowment, in which the gift itself may never be spent but the interest earned on the gift may be spent. In such a situation, the principal endowment is permanently restricted; however, the interest may be temporarily restricted or unrestricted.

C. What to look for when reviewing the balance sheet

- Does it balance?
- Are net assets positive or negative?
- Do current assets exceed current liabilities?
- Are accounts receivable "reasonable"?
- How much of the net assets are restricted?
- How does the balance sheet compare to those of previous years?



EXAMPLE D: Balance Sheet

Happyland Child Care Center
Balance Sheet as of June 30, 2002 and June 30, 2003

	at 6/30/03	at 6/30/02
ASSETS		
Current Assets		
Cash, checking	\$6,251.43	\$1,752.00
Cash, savings	2,510.53	1,500.00
Accounts Receivable	10,103.00	17,015.00
Grants Receivable	5,000.00	-
Prepaid Expense	<u>6,221.00</u>	<u>450.00</u>
Total Current Assets	30,085.96	20,717.00
Equipment (fixed assets)	32,750.00	26,015.00
Less Accumulated Depreciation	<u>(3,275.00)</u>	<u>(2,601.50)</u>
TOTAL ASSETS	<u>\$59,560.96</u>	<u>\$43,130.50</u>
LIABILITIES		
Current Liabilities		
Taxes Payable	\$7,295.52	\$6,627.16
Payroll Accrual	9,877.60	8,752.00
Vacation Accrual	237.50	250.00
Accounts Payable	8,962.34	1,110.85
Deposits	<u>1,500.00</u>	<u>1,500.00</u>
Total Current Liabilities	27,872.96	18,240.01
TOTAL LIABILITIES	<u>\$27,872.96</u>	<u>\$18,240.01</u>
NET ASSETS		
Unrestricted Net Assets	\$31,688.00	\$25,890.49
Temporarily Restricted Net Assets	-	-
Permanently Restricted Net Assets	-	-
TOTAL NET ASSETS	<u>31,688.00</u>	<u>25,890.49</u>
TOTAL LIABILITIES AND NET ASSETS	<u>\$59,560.96</u>	<u>\$44,130.50</u>

Section Five: Cash Flow Statement

Cash flow management is the greatest challenge that small businesses face. Cash flow is the difference between (a) the amount of actual cash coming in to a business from support and revenues and (b) the amount of actual cash going out of a business in the form of expenses, such as salaries, rent, office supplies, and other payments. Difficulties in cash flow management often result when income lags behind expenditures.

A. What is a cash flow statement?

A cash flow statement helps to track the cash in and out of a business. In a cash flow statement, the focus is on the timing of receipt and disbursement of cash, regardless of when the income was earned or the expense was incurred. Cash flow statements may be done weekly or monthly, depending on how closely an organization needs to monitor the flow of revenues and expenses.

A cash flow statement provides important information not available in the statement of activities. For example, a 12-month statement of activities may show \$621,150 in income and \$614,964 in expenses. Without looking at cash flow, the business owner may think that everything is fine. But what happens if the expenses were due before the income was received? A cash flow statement helps identify when there is a cash management problem by breaking down the flow of resources in and out of the organization.

Cash flow is very important to lenders because they want to be sure there will be more than enough cash at the end of each month to pay the debt service.

B. Components of a cash flow statement

There is no universal format for a cash flow statement, so businesses should establish one that meets their needs and the expectations of their funders. A sample cash flow statement for a child care business can be found on page 26. A cash flow statement should include the following components:

Cash receipts:

This includes cash coming into the business from parent fees, loan or cash injections, food programs, public subsidies, private sources, foundation grants, and fundraisers. **Total cash received** is the sum of all the cash receipts. **Total cash available** is the sum of total cash received plus the beginning cash balance from a previously recorded period.

Cash paid out/disbursements:

This category includes purchases, gross wages, payroll expenses, outside services, supplies, repairs and maintenance, advertising, accounting, legal expenses, rent, phone, utilities, insurance, taxes, and interest. It also includes any payments that will be made to retire any debts or loans.

Cash balance/deficiency:

This is total cash available minus total cash paid out. The ending cash balance from one month is then carried forward to the next month's **beginning cash balance**. Cash balance should be positive. If the ending cash balance is negative, there is a cash flow management problem. The following are some strategies for addressing a negative cash balance.

- Speed up collection of receivables
- Require fees to be paid in advance

- Change the timing of planning fundraising events or campaigns
- Finance (obtain loans for) the purchase of equipment
- Apply for a line of credit at a local bank
- Liquidate investments
- Work with funders for a more favorable payment schedule
- Negotiate a payment schedule with vendors

If cash flow is a recurring problem, a business may also consider setting aside funds each year to build a cash reserve. However, nonprofit centers should be sure to consult with an accountant on the appropriate way to record this reserve in audited financial statements.

C. What to look for when reviewing a cash flow statement

- Is the cash balance positive?
- Is there a particular time of year when cash flow is a recurring problem?
- Is revenue received in a timely and consistent manner?
- Can the timing of receipts and expenses be improved to increase the monthly cash balance?



EXAMPLE E: CASH FLOW STATEMENT

Happyland Child Care Center
Cash Flow Statement for Twelve Month Period Ending June 30, 2003

	July	August	September	October	November	December	January	February	March	April	May	June
Beginning Cash Balance	\$5,000	\$3,650	\$3,050	\$3,950	\$5,100	\$6,000	\$7,900	\$9,050	\$11,450	\$16,350	\$21,000	\$24,900
Cash Receipts												
Parent Fees	\$150,000	\$10,000	\$11,000	\$11,500	\$11,500	\$12,000	\$13,000	\$14,000	\$15,000	\$15,000	\$15,000	\$12,000
Child Care Food Program	\$12,000	\$1,000	\$1,000	\$1,000	\$1,000	\$1,000	\$1,000	\$1,000	\$1,000	\$1,000	\$1,000	\$1,000
Total Cash Received	\$162,000	\$11,000	\$12,000	\$12,500	\$12,500	\$13,000	\$14,000	\$15,000	\$16,000	\$16,000	\$16,000	\$13,000
Total Cash Available	\$16,000	\$14,650	\$15,050	\$16,450	\$17,600	\$19,000	\$21,900	\$24,050	\$27,450	\$32,350	\$37,000	\$37,900
Cash Paid Out												
Payroll	\$96,000	\$8,000	\$8,000	\$8,000	\$8,000	\$8,000	\$8,000	\$8,000	\$8,000	\$8,000	\$8,000	\$8,000
Educational Supplies	\$1,500	\$500			\$500			\$500				
Office Cleaning				\$250						\$250		
Supplies	\$1,000	\$250					\$250					
Advertising	\$2,000	\$1,000					\$1,000					
Food	\$24,000	\$2,000	\$2,000	\$2,000	\$2,000	\$2,000	\$2,000	\$2,000	\$2,000	\$2,000	\$2,000	\$2,000
Travel	\$3,600	\$300	\$300	\$300	\$300	\$300	\$300	\$300	\$300	\$300	\$300	\$300
Insurance	\$6,000	\$500	\$500	\$500	\$500	\$500	\$500	\$500	\$500	\$500	\$500	\$500
Phone	\$3,600	\$300	\$300	\$300	\$300	\$300	\$300	\$300	\$300	\$300	\$300	\$300
Dues	\$500						\$500					
Tax Accountant								\$1,000			\$1,000	
Total Cash Needed	\$140,200	\$12,350	\$11,100	\$11,350	\$11,600	\$11,100	\$12,850	\$12,600	\$11,100	\$11,350	\$12,100	\$11,100
Cash Balance (deficiency) at month's end	\$3,650	\$3,050	\$3,950	\$5,100	\$6,000	\$7,900	\$9,050	\$11,450	\$16,350	\$21,000	\$24,900	\$26,800

CHAPTER TWO:

**Developing Pro Formas
and
Determining Debt Capacity**

Chapter Two: Developing Pro Formas and Determining Debt Capacity

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Introduction

This chapter is devoted to developing *pro formas* (financial projections) and discussing the basic financial criteria used to determine the capacity of a child care business to carry debt. Understanding financial projections and debt capacity helps in the planning of large expenditures such as a facilities development project. It will also make a business a more informed and attractive consumer of financing packages.

The goal of this chapter is to help child care business owners become more comfortable discussing their financial projections and capacity to carry debt with financing professionals. It is not intended as a substitute for professional financial assistance.

The chapter builds upon the materials discussed in Chapter One: *Budgeting and Basic Financial Statements*. It is recommended that readers not familiar with these subject areas read Chapter One.

Sections One, Two, and Three of this chapter introduce the concept of *pro formas*, detailing cash flow as well as income and expense projections.

Section Four looks at several financial factors that must be considered when determining the capacity of a child care business to carry debt. This material is written for nonprofit child care centers, but much of it is applicable to the for-profit sector as well.

Section One: Pro Forma Statements

A. What are pro forma statements?

Pro forma statements are projections of a business' future financial status. *Pro formas* detail both revenue and expense projections and are required by most lenders. There are two basic *pro forma* statements: the **cash flow projection** and the **income and expense projection**.

B. Five general principles for developing pro forma statements:

1. All assumptions used in developing the data must be disclosed.

All financial projections are based upon a certain set of assumptions such as: the vacancy rate for a child care business; the number of days a business is open; reimbursement rates for government contracts; and seasonal enrollment fluctuations. These assumptions have a significant impact on projections so it is important to (a) be conservative in making assumptions and (b) clearly state the assumptions being used. It is also important to provide a narrative description of each assumption, as lenders will require verifiable figures.

2. Pro formas must be related to the past performance of a business, or in the case of start-ups, to similar businesses.

According to most lenders, the best predictor of future financial performance is past performance. Therefore, lenders look to see that projections are reasonable when compared to past financial statements. Since lenders rely on historical statements to help predict future profits, they are more reluctant to loan to new child care businesses with no historical financial statements. If a business is new, projections should be based on the performance of other similarly situated centers and solid research of the local child care market. For a discussion of market research, see Chapter Three: *Developing a Child Care Business Plan*.

3. Projections must reflect industry and economic considerations.

A child care business is influenced by trends in the child care sector as well as in the broader economic community. For example, if child care enrollment is increasing across the industry, projections should reflect this trend. Similarly, if new regulations regarding child care have been passed that require child care businesses to make certain changes, the expenses required for making the changes should be included in projections. In addition, overall economic considerations such as high or low regional unemployment rates should be considered.

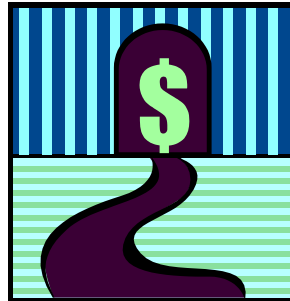
4. Pro formas should allow for "start-up" time.

When opening a new center, it may take a business several months or longer before it can reach its intended capacity for enrollment. When renovating an existing facility, the program may need to temporarily relocate while construction activities occur. This start-up time or potential reduced enrollment due to construction should be reflected in both revenue and expense projections.

5. Pro formas must be understood by those who are applying for financing.

A lender wants a loan applicant to understand the financial side, as well as the child care side, of the business. Professional assistance will probably be needed in the preparation of *pro forma* financial statements. Furthermore, involvement of the executive staff in developing and understanding these

financial statements insures that operational details and program concerns are accurately reflected in the budget.



Section Two: Cash Flow Projection

As discussed in Chapter One, cash flow is the difference between the amount of actual cash coming into a business and the amount of actual cash going out in the form of expenses. Cash flow is the greatest challenge businesses face because it is not always easy to coordinate times when cash is received with times when bills must be paid. Difficulties in cash flow management often result when income lags behind expenditures.

A. What is a cash flow projection?

A cash flow projection is similar to a cash flow statement, except that rather than recording actual events, a cash flow projection tries to predict the future. A cash flow projection provides important planning information not available in a budget. For example, a budget may show \$10,000 in income and \$10,000 in expenses. Without looking at cash flow, a child care provider may think that accounts are balanced. But what happens if the expenses are due before the income is received? How will those expenses be paid? A cash flow projection allows a business to anticipate when cash is expected to be received and when bills must be paid. In a cash flow projection, the focus is on the timing of receipt and disbursement of cash, regardless of when the income was earned or the expense was incurred. Cash flow projections may be done weekly or monthly, depending on the amount of cash a business has available. Once a projected cash flow statement has been completed, it should be periodically compared with actual cash flow.

A cash flow projection is very important to a lender because a lender wants to be sure there will be more than enough cash at the end of each month to pay the debt service (loan payment).

B. Components of a cash flow projection

There is no universal format for cash flow projections, so a business should establish one that meets its needs. A sample cash flow projection from a child care business can be found on page 33. Although the format may vary for each business, a cash flow projection should include the following components:

Cash receipts: This should include anticipated cash coming into the business from parent fees, loan or cash injections, income from the Child Care Food Program, public subsidies, private sources, foundation grants, and fundraising. **Total cash received** is the sum of all the cash receipts. **Total cash available** is the sum of total cash received and the beginning cash balance.

Cash paid out/disbursements: This includes anticipated purchases, gross wages, payroll expenses, outside services, supplies, repairs and maintenance, advertising, accounting, legal expenses, rent, phone, utilities, insurance, taxes and interest. Also included are any payments that will be needed to retire debts or loans.

Cash balance/deficiency: This is total cash available minus total cash paid out. The ending cash balance from one month is then carried forward to the next month's **beginning cash balance**. Cash balance should be positive. If the ending cash balance is negative, there is a cash flow management problem. The following are some suggestions for addressing a projected negative cash balance.

- Speed up collection of receivables
- Require fees to be paid in advance
- Change the timing of planned fundraising events or campaigns
- Finance (obtain loans for) the purchase of equipment

- Apply for a line of credit at a local bank
- Liquidate investments, or transfer investments to cash form
- Work with funders for a more favorable payment schedule
- Negotiate a payment schedule with vendors

If cash flow has been a recurring problem based on previous cash flow statements, consider setting aside funds each year to build a cash reserve. However, nonprofit businesses should be sure to consult with an accountant on the appropriate way to record this reserve in audited financial statements.

C. Compare actual cash flow with projected cash flow

Once a projected cash flow statement is completed, monthly projected cash flow figures should be compared with the previous year's actual cash flow figures to ensure accuracy of the projected amount.

D. What to look for when reviewing a cash flow projection

- Are the assumptions used to develop the projections reasonable and realistic? Can they be supported by past financial statements or extensive market research?
- Is the cash balance positive?
- How do the projections compare with the actual statements?

EXAMPLE A: Cash Flow Projection
 Happyland Child Care Center Cash Flow Projections
 July 2002- June 2003

	July	August	September	October	November	December	January	February	March	April	May	June
Beginning Cash Balance	\$3,252	\$11,971	\$5,100	\$25,377	\$5,593	\$24,880	\$14,294	\$29,761	\$11,500	\$37,185	\$16,874	\$41,586
Cash Receipts												
Parent Fees	\$432,300	\$36,025	\$36,025	\$36,025	\$36,025	\$36,025	\$36,025	\$36,025	\$36,025	\$36,025	\$36,025	\$36,025
State Contracts	\$226,998	\$37,833	\$37,833	\$37,833	\$37,833	\$37,833	\$37,833	\$37,833	\$37,833	\$37,833	\$37,833	\$37,833
CalWorks	\$255,000	\$21,250	\$21,250	\$21,250	\$21,250	\$21,250	\$21,250	\$21,250	\$21,250	\$21,250	\$21,250	\$21,250
Child Care Food Program	\$45,000	\$3,750	\$3,750	\$3,750	\$3,750	\$3,750	\$3,750	\$3,750	\$3,750	\$3,750	\$3,750	\$3,750
Total Program Receipts	\$959,298	\$98,858	\$98,858	\$98,858	\$98,858	\$98,858	\$98,858	\$98,858	\$98,858	\$98,858	\$98,858	\$98,858
Less Vacancy Loss (3%)	(\$28,779)	(\$1,831)	(\$2,966)	(\$1,831)	(\$2,966)	(\$1,831)	(\$2,966)	(\$1,831)	(\$2,966)	(\$1,831)	(\$2,966)	(\$1,831)
Fundraising	\$25,000	\$10,000		\$6,000		\$6,000			\$5,000		\$4,000	
Total Cash Received	\$955,519	\$95,992	\$95,892	\$95,194	\$95,892	\$95,194	\$95,892	\$95,194	\$100,892	\$59,194	\$99,892	\$59,194
Total Cash Available	\$99,144	\$81,165	\$100,992	\$84,571	\$101,485	\$90,074	\$110,186	\$88,955	\$112,392	\$96,379	\$116,766	\$100,780
Cash Paid Out												
Net Payroll	\$623,796	\$51,983	\$51,983	\$51,983	\$51,983	\$51,983	\$51,983	\$51,983	\$51,983	\$51,983	\$51,983	\$51,983
Payroll Taxes and Benefits	\$97,860	\$8,155	\$8,155	\$8,155	\$8,155	\$8,155	\$8,155	\$8,155	\$8,155	\$8,155	\$8,155	\$8,155
Classroom/office supplies	\$17,004	\$1,417	\$1,417	\$1,417	\$1,417	\$1,417	\$1,417	\$1,417	\$1,417	\$1,417	\$1,417	\$1,417
Advertising	\$4,200	\$1,400		\$1,400			\$1,400					
Contract Service/Meals	\$50,004	\$4,167	\$4,167	\$4,167	\$4,167	\$4,167	\$4,167	\$4,167	\$4,167	\$4,167	\$4,167	\$4,167
Travel	\$776		\$176				\$200			\$200		\$200
Facility Repairs	\$1,900		\$900				\$1,000					\$450
Insurance	\$15,450	\$3,750		\$3,750								
Holiday Party	\$500					\$500						
Rent/Lease	\$100,000	\$8,333	\$8,333	\$8,333	\$8,333	\$8,333	\$8,333	\$8,333	\$8,333	\$8,333	\$8,333	\$8,333
Professional Services (e.g. Audit)	\$2,200		\$300				\$1,300			\$300		\$300
Utilities	\$11,325	\$1,033	\$910	\$973	\$950	\$1,025	\$916	\$800	\$952	\$1,000	\$925	\$957
Phone	\$2,400	\$200	\$200	\$200	\$200	\$200	\$200	\$200	\$200	\$200	\$200	\$200
Equipment Purchase	\$6,735	\$6,735										
Total Cash Needed	\$934,150	\$87,173	\$76,065	\$78,978	\$76,605	\$75,780	\$80,425	\$77,455	\$75,207	\$79,505	\$75,180	\$76,162
Cash Balance (deficiency) at month's end	\$11,971	\$5,100	\$25,377	\$5,593	\$24,880	\$14,294	\$29,761	\$11,500	\$37,185	\$16,874	\$41,586	\$24,618

Section Three: Income and Expense Projection

A. What is an income and expense projection?

The income and expense projection is similar to the statement of activities (the income statement) discussed in Chapter One, but instead of recording actual income and expenses it focuses on projected income and expenses. An income and expense projection helps develop a preview of the amount of income expected each month and for the business year, based on reasonable predictions of revenues and expenses. Depending upon the requirements of a potential lender, the income and expense projection may include projections for up to three to five years into the future.

An income and expense projection is different from a cash flow projection. An income projection recognizes sales when made (the accrual method of accounting) rather than when collected. The cash flow projection statement, on the other hand, anticipates receipts at the time they are processed, regardless of when they originated, just as it only anticipates payments when they will be made, regardless of when the liability for the expenditure arose.

Income statements are also different from cash flow statements because, for those expenses that involve depreciation or an interest payment, only the depreciation or interest portion of the expense is recorded. For example, if a business plans to buy new equipment, the full amount is recorded on the cash flow statement. But, since the equipment is a depreciable asset, only the projected depreciation for the year will be recorded on the income and expense projection.

B. Key components of the income and expense projection

A sample income and expense projection is provided on page 38. Each child care business' income and expense projection may look slightly different, but each should contain the following components:

Revenue: Total amount anticipated from parent fees, state contracts, grants or foundation awards. Revenue is often classified by source and nature in order to reflect the change in revenue composition.

Expenses: All expenditures a business expects to incur. Expenses should be broken down by various categories such as salaries and wages, direct program costs, rent, utilities, and loan payments.

Depreciation: A sum representing presumed loss in the value of real estate or equipment, resulting from physical wear and economic obsolescence.

Change in net assets: This equals total revenues minus total expenses.

C. What to look for when reviewing an income and expense projection

- Are the assumptions used to develop the projections conservative and clearly stated?
- Are the projections reasonable when compared to past statements?
- Is the change in anticipated net assets a positive one?

EXAMPLE B: Income and Expense Projection

Happyland Child Care Center Income and Expense Projections

Summary of Assumptions:

Program Income Increase	3%
Operating Expense Increase	3%
Vacancy Loss	3%

	Year 1	Year 2	Year 3	Year 4	Year 5
Revenue					
Parent Fees	\$432,300	\$445,269	\$458,627	\$472,386	\$486,557
State Contracts	226,998	233,808	240,822	248,047	255,488
CalWorks	255,000	262,650	270,530	278,645	287,005
Food Program	45,000	46,350	47,741	49,173	50,648
Total Program Revenue	959,298	988,077	1,017,720	1,048,251	1,079,698
Less Vacancy Loss	(28,779)	(29,642)	(30,532)	(31,448)	(32,391)
Fundraising	35,000	36,050	37,132	38,245	39,393
Total Revenue	\$965,519	\$994,485	\$1,024,320	\$1,055,049	\$1,086,700
Expenses					
Wages and Salaries Current	\$623,792	\$642,506	\$661,781	\$681,634	\$702,083
Payroll Taxes & Benefits	97,864	100,800	103,824	106,939	110,147
Classroom/Office Supplies	17,000	17,510	18,035	18,576	19,134
Advertising	4,200	4,326	4,456	4,589	4,727
Contract Services-Meals	50,000	51,500	53,045	54,636	56,275
Travel	776	799	823	848	873
Facility Repairs	1,900	1,957	2,016	2,076	2,138
Insurance	15,450	15,914	16,391	16,883	17,398
Holiday Party	500	515	530	546	563
Telephone	2,400	2,472	2,546	2,623	2,701
Rent	100,000	103,000	106,090	109,273	112,551
Utilities (Water & PG&E)	11,325	11,665	12,015	12,375	12,746
Depreciation Expense	5,000	5,000	5,000	5,000	5,000
Total Expenses	\$930,207	\$957,964	\$986,552	\$1,015,998	\$1,046,336
Change in Net Assets	\$35,312	\$36,521	\$37,768	\$39,051	\$40,364

Section Four: Understanding Debt Capacity

Debt capacity is the amount of debt a child care business is able to repay from its income. When planning what size loan a business can apply for it is important to understand the business' debt capacity. A lender determines debt capacity based upon several financial factors such as cash flow, debt service coverage ratio, collateral, loan to value ratios, equity, and the debt to equity ratio. The following paragraphs define and describe these measures.

Although not discussed here, there are many other factors beyond the financial position of a business that a lender will look at when considering a loan application. For example, the lender will also be interested in the strength of the current management of the center, knowledge of the industry, community reputation, and information articulated in a business plan.

A. Cash flow/debt service coverage

Lenders want to know that the cash balance at the end of each month is sufficient to meet a monthly loan payment (debt service). In fact, most lenders require that the cash balance at the end of the month be larger than the debt service so that if income is less than anticipated, debt service payments can still be made.

The purpose of the **debt service coverage ratio** (DSC ratio) is to determine by what percent the cash available for debt service exceeds the debt service. The DSC ratio is calculated using cash flow projections and the following formula:

$$\text{DSC Ratio} = \frac{\text{Cash available for debt service (loan payments)}}{\text{Annual debt service loan payments}}$$

The DSC ratio can be calculated monthly and annually. Annual DSC ratios will reveal the overall ability of a business to carry debt, whereas the monthly DSC indicates the ability of a business to meet a monthly loan payment.

A sample five year cash flow projection and DSC ratio is provided on page 38. Year One income and expense figures were taken from the sample cash flow projections developed in previous sections of this chapter. Projections for Year Two through Year Five are listed in columns and are based upon the assumption that income and expenses will both increase by three percent. When calculating the DSC ratio, building and/or land lease expenses were not included, since it is anticipated that those costs will be replaced by the debt service payment each month. The projected expenses are subtracted from the projected income to determine the amount of cash that is available for debt service. The amount of cash available for debt service is then divided by the debt service payment to determine the debt service coverage (DSC) ratio.

Although the DSC ratio expectation requirements vary among lenders, it is generally between 1.10 and 1.25. For a DSC ratio of 1.15, the cash available for debt service exceeds the debt service by 15%. In other words, for every \$1.00 of debt service to be repaid, \$1.15 must be available by the business to pay the debt service. The higher the DSC ratio a business is able to show, the more confident a lender will be that the business has an adequate cushion above the amount required for a debt payment.

Computing debt service coverage (DSC) ratio

Step #1:

Income (\$100,000) - Expenses (\$75,000) = Cash available for Debt Service (\$25,000)

Step #2:

Available for Debt Service (\$25,000) / Debt Payment (\$20,000) = 1.25

DSC ratio = 1.25

To estimate the amount of annual debt service a business may qualify for based upon a given debt service coverage ratio, simply take the ending cash balance and divide by a given DSC ratio. For example, if ending cash balance (not including rental/mortgage payments) is \$25,000 a year, and the lender requires a DSC ratio of 1.25, a business will qualify to carry \$20,000 a year in debt service.

Computing debt service qualification if DSC ratio = 1.25

Step #1:

Income (\$100,000) - Expenses (\$75,000) = Available for Debt Service (\$25,000)

Step #2:

Ending Cash Balance (\$25,000) /DSC Ratio Required (1.25) =\$20,000 per year

EXAMPLE C: Cash Flow Analysis

Happyland Child Care Center Cash Flow Analysis

Summary of Assumptions

Program Income Increase	3%
Operating Expense Increase	3%
Vacancy Loss	3%

	Year 1	Year 2	Year 3	Year 4	Year 5
Income					
Parent Fees	\$432,300	\$445,269	\$458,627	\$472,386	\$486,557
State Contracts	226,998	233,808	240,822	248,047	255,488
CalWorks	255,000	262,650	270,530	278,645	287,005
Food Program	45,000	46,350	47,741	49,173	50,648
Total Program Income	959,298	988,077	1,017,720	1,048,251	1,079,698
Less Vacancy Loss	(\$28,779)	(\$29,642)	(\$30,532)	(\$31,448)	(\$32,391)
Fundraising	35,000	36,050	37,132	38,245	39,393
Total Program Income	\$965,519	\$994,485	\$1,024,320	\$1,055,048	\$1,086,700
Less Operating Expenses	827,207	852,023	877,584	903,911	931,029
Cash Available for Debt Service	\$138,312	\$142,462	\$146,736	\$151,137	\$155,671
Less Debt Service	120,000	120,000	120,000	120,000	120,000
Debt Service Coverage Ratio (DSC)	1.15	1.19	1.22	1.26	1.30

B. Collateral

Collateral is an asset that a borrower pledges to secure a loan. If the borrower defaults, the lender has the right to sell the collateral to liquidate the loan.

Lenders will typically use the building being developed, and/or the land it is being built on, as collateral. When lenders use the land as collateral, it will be secured by a "deed of trust." Lenders determine the value of collateral based upon the appraised value, not the amount of money being invested in a construction or renovation project. This is an important factor for child care businesses to understand, because the proposed improvements often will not be valued in the general real estate market. For example, installing special child size toilets is an important improvement to a child care center, but will not be valuable to future occupants of the building who are not in the child care business.

The building and the land may not be enough collateral for the lender. In such cases, a business may have to identify other assets or resources that could be used as collateral.

C. Loan-to-value ratio (LTV)

When financing a renovation or construction project, a bank will not lend a business the entire cost of the project. Instead, financial institutions use a loan-to-value ratio (LTV), based on collateral, to determine how much they are able to lend. For example, if the LTV is 85%, a lender will lend 85% of the value of the collateral.

D. Equity

Equity is the amount of capital a business contributes toward financing the entire project. Lenders are concerned about equity because lending money is a risk and they want to ensure that the business has a stake in the project as well. The amount of equity needed is the difference between the maximum loan amount available and the total project cost.

E. Debt-to-equity (net worth) ratio

The purpose of this ratio is to consider a business' existing long-term debt relative to its net worth. If a child care business already has a considerable amount of long-term debt relative to its net worth, a bank will be reluctant to make an additional loan. The lower the ratio, the more equity "buffer" there is in the event the business is unable to meet its loan obligations. The higher this ratio is, the greater the risk that the business may be unable to meet its maturing obligations. This ratio will not be significant to a child care business considering financing that has little or no existing long-term debt.

F. The lender's perspective

In attempting to qualify for a loan, it is vital to understand the perspective of the lender, and to ask the question: What does a loan officer look for in a credit application? While every lending institution has its own specific criteria, nearly every lender is guided by the **5 C's of Credit**. The 5 C's are:

Cash Flow (Capacity to Repay the Loan):

An organization's existing and/or projected cash flow directly reflects its ability to carry debt. In other words, lenders use cash flow to identify whether an agency will be able to meet its monthly payments to repay a loan. Lenders look at projected versus historic cash flow. Most lenders have a minimum debt service coverage (DSC) ratio requirement. Note that cash flow does not always reflect profit. Lenders are concerned with a borrower's capacity to meet a monthly payment rather than its end-of-year profits.

Character (Capacity to Execute the Project Successfully):

Lenders want to ensure that the borrower can plan and execute the business successfully. A lender will want to examine the borrower's business plan and/or resume. They may want to make a site visit and will probably want to check some references to measure the borrower's credibility in the community. Also, they will want to meet or get information about the business' management team and board.

Capital (Equity Investment in the Project):

Many lenders view a business owner's capital investment as a measurement of the level of owner commitment. Some community lenders may be amenable to substituting cash equity with "sweat equity," an owner's work investment in the business. However, most lenders want to see some capital investment as well.

Collateral:

As mentioned earlier, lenders require collateral and use it to determine the Loan to Value (LTV) ratio. Internal collateral comes from the business itself, whereas external collateral uses assets outside the business.

Credit History:

Lenders examine the credit history of both the business and the owner. They consider any patterns, both good and bad. They look for any history of bankruptcy in the past, and evaluate the borrower on his/her potential for future bankruptcy.

CHAPTER THREE:

Developing a Child Care Business Plan

Chapter Three: Developing a Child Care Business Plan

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Introduction

This chapter introduces the concept of a business plan and describes how to write a business plan for a child care business. This chapter is intended to meet the needs of both for-profit and nonprofit child care centers.

A. What is a business plan?

A business plan is a concisely written summary of a child care business, including a proposed facility development project. It contains key financial statements, market information, and management profiles.

B. Why develop a business plan?

Writing a business plan is an important step towards managing any business more effectively. Writing a business plan is also a key element of applying for loans or grants.

Internal planning and management:

A business plan helps ensure that sound business decisions are made as it encourages strategic thinking. The process of writing a business plan is a useful exercise because the business, including any proposed development project, must be looked at objectively in its entirety. A completed business plan can provide a road map for a business to follow for future organizational and financial development.

External communication:

A comprehensive business plan is an important tool for communicating a business' mission and goals to funders. It provides a lender or funder with detailed organizational information and credibly explains how the proposed funding will further the business' goals. Business plans are commonly required when applying for small business loans or financing from a commercial bank. Lenders and grant makers who do not require a formal business plan will instead ask questions or require written documentation on many of the same topics covered in a business plan.

This publication focuses on developing a business plan for the purpose of securing funding for a child care facility development project. However, the information is designed to be helpful for any child care provider who wishes to think and operate more like a business or who wants to begin planning for business growth.

C. What is *in* a business plan?

There are many different ways to organize a business plan. Regardless of the structure or design chosen, every business plan should include the following sections:

- Cover Sheet
- Executive Summary
- Organizational Capacity
- Description of the Proposed Project
- Market Analysis
- Marketing Plan
- Operations Plan
- Financial Analysis
- Supporting Documents



The following sections of this chapter provide more detailed information about each of these components.

General Tips for Developing a Business Plan

1. Presentation matters.

Never underestimate the value of a professional-looking document. Bank and grant officers look at hundreds of business plans and appreciate a plan that is easy to read and well-presented. Creating a professional looking business plan shows that the management is serious about the business.

To make the document easy to read

- Use headers.
- Leave plenty of white space on each page.
- Include a table of contents.

2. Be concise.

A short, well-written plan is better than a long, drawn out one.

3. Update the business plan regularly.

Because a business plan relies heavily on time-sensitive financial material, it is a continually evolving document. An outdated business plan reduces the credibility of a loan or grant application.

4. Present a balanced view.

In addition to highlighting the strengths of the child care business, a business plan should demonstrate an understanding of the challenges the business faces. After a challenge has been identified, be sure to discuss a plan for overcoming it. For example, if competition from a neighboring child care provider is identified in the market feasibility analysis, the plan should explain how the proposed business will serve a different market niche or how it will collaborate with the neighboring business to meet the community's child care needs.

5. Seek professional assistance.

While this chapter provides a good understanding of how to approach the business planning process for a child care program, there is nothing more valuable in that process than receiving assistance from an expert in the field. In Appendix A of this Manual there is more information available about where child care center professionals can turn for further assistance (usually free of charge) on the topics of developing financial statements, business planning, and accessing financial resources for facilities development projects.

Section One: Cover Sheet

The cover sheet is the first part of a business plan that a funder sees. It is important that it appear neat and professional, and contain relevant information that is easily visible. A cover sheet should include the following:

- Name of the child care business
- Address
- Phone number
- Logo (if applicable)
- Names, titles, addresses, and phone numbers of key contacts
- Month and year in which plan was developed and/or revised
- Name of plan preparer/writer

The business name, address, and phone number should appear in the top third of the page.

Information regarding the contact name should appear in the center of the page.

The date the document was completed and the name of the preparer should appear towards the bottom of the page.

EXAMPLE A: Business Plan Cover Sheet

HAPPYLAND CHILD CARE CENTER

123 Main Street

Anywhere, CA 91111

919/555-1234~voice 919/555-1235~fax

Happyland@email.com ~ email

BUSINESS PLAN

Dr. Jane Doe, Executive Director

Rev. Jon Deare, Board Chair

Prepared by: Francis Jones, Board Member

June 1, 2003

Section Two: Executive Summary

The executive summary is a brief one- or two-page synopsis of the business plan. Although the Executive Summary appears at the front of the business plan, it should be written last. This ensures that all the necessary information has already been compiled and reviewed.

The executive summary should include the following information:

- Names, titles, addresses, and phone numbers of key contacts;
- Description of the child care business including: how many children are served; the organizational and legal structure (i.e. for-profit, nonprofit, family child care), and how long the business has operated with a child care license;
- Address;
- Description of the proposed project and its goals;
- Skills and experience of management and senior staff, and
- (If applying for funding) Why the loan is needed, the amount of money being requested, and the amount and source of other funds that are being leveraged by the request for funding.



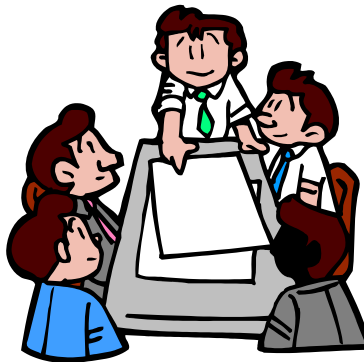
Section Three: Organizational Capacity

The organizational capacity section presents a brief overview of the child care business, including its history, structure, and community connections. The information should convey the following points:

- The business has a proven track record of programmatic success;
- The business has demonstrated evidence of fiscal soundness and has met financial obligations in the past;
- The business has a clear, consistent philosophy (i.e. National Association for the Education of Young Children standard, Montessori or Reggio Emilia) on early childhood education;
- The business employs high quality staff with experience, managerial competence, accreditations, permits, and early childhood education credentials;
- The business has strong local support;
- (If applicable) There is a strong, experienced board of directors that is representative of the community served, and
- The child care program is accredited.

The status of any state contracts should also be described in the Organizational Capacity Section of the Business Plan.

This section of the business plan can be enhanced by referring readers to any supporting documents included at the end of the plan. See page 61 for more information on supporting documents.



Section Four: Description of the Proposed Project

This section should include the following three components: project goals, a description of the project, and a plan for managing the facility development process.

A. Project goals

When describing the facility development project, it is important to state clear goals that can be easily understood by funders. The following are examples of such goals:

- To create a more age - and developmentally appropriate environment in which to serve young children;
- To stabilize facility's expenses or avoid yearly rent increases;
- To enable the business to remain in a particular community or retain child care services for low-income families;
- To acquire a facility with special features key to the success of the business' early childhood program. (Sometimes appropriate buildings are not available on the rental market, or if available, require substantial tenant improvements), and
- To expand the business' capacity to serve a growing market or meet a growing need.

In this section of the business plan, it is particularly important to discuss how the project is related to the business' mission statement. A mission statement identifies why the business exists, who it will serve, and how it will operate. For example, the mission of Happyland Child Care Center is "to provide high-quality, affordable child care to residents in the town of Happyville."

B. Description of the new or renovated facility

The following points should be addressed in this description:

- Whether a new site is being purchased or leased, or an existing site is being renovated;
- The community or market area that the business will serve;
- The number of children that will be served in the new facility;
- The (new) hours of operation;
- The programs to be offered;
- The general design of the new facility, including:
 - The number of square feet indoors and outdoors
 - Whether it has an expanded outdoor play area
 - Whether it has separate areas for age-specific activities
- The attributes of the business location that make it especially appropriate for child care, and
- (If a site has not yet been selected) The kind of site and location that is being sought.

C. Plan for managing the facility development process

There are seven key roles that must be considered during the development process:

1. Project Manager
2. Developer
3. Financial Planner

4. Architect
5. Accountant
6. Lawyer
7. General Contractor

A detailed plan to manage the facility development process is essential; otherwise important tasks may be overlooked, increasing the likelihood of project delays and cost overruns. Funders are very concerned that the process be well managed and organized. Therefore, this section should describe how the organization will manage each element of the facility development process, including:

- Which consultants have already been hired;
- How and when additional consultants will be hired;
- The level of involvement of the board, and
- The percent of the executive director's or other lead staff person's time that is going into the project.

It is important to describe all forms of assistance being received from architects, consultants, contractors, or any other experts involved in the project, and to indicate whether they have any prior child care-related project experience.



Section Five: Market Feasibility Analysis

A market feasibility analysis has several objectives:

- To define the geographic boundaries of the market area of the proposed business;
- To estimate and analyze the demand for the proposed child care business, including the flow of subsidies into the market area;
- To evaluate the existing supply of child care;
- To highlight segments of the market for which there may be strong demand, and
- To provide a tool for decision-making.

A. Understanding need vs. demand

The issue of child care is often discussed in terms of need because of the vast number of children *needing* child care services. Many children who need care cannot get it because their families cannot afford it or waiting lists are too long. This may, in fact, be the starting point for a project concept. However, the existence of *need* does not establish that there is sufficient *demand*. Demand is established by finding out if there are enough families who not only need child care services, but have **the capacity and willingness to pay fees at rates sufficient to generate the income stream necessary to satisfy the center's operating budget.**

A strong market feasibility analysis for a facility development project would prove that there is a market demand for child care at rates sufficient to generate revenues to cover not only operating expenses, but also debt service on any loans incurred to develop the facility. In the case of low-income communities, demand can also be measured by the availability of government contracts to provide subsidized care or the ability of parents to obtain child care vouchers.

The scope and complexity of the market feasibility analysis will depend on the size of the proposed project, the extent of available child care subsidies, and the degree to which the child care subsidies are pre-committed. The following scenarios illustrate how the type of market analysis can vary.

Scenario 1: Happyland Child Care Center (with NO state contract to serve low-income children) plans to serve 60 children on a fee-for-service, sliding scale basis in a low and moderate-income neighborhood. It hopes to attract some children with voucher subsidies. This center lacks a guaranteed revenue stream and must carefully test the willingness and ability of parents in that particular market area to pay the proposed fees or use their vouchers at the center.

Scenario 2: ABC Child Care Center has pre-committed funds from a California Department of Education center-based contract to serve 50 low-income families. The facility is being developed specifically to service that contract. Thus, the market feasibility analysis is less critical because the revenue stream is guaranteed as long as income eligible parents elect to use the center (though a financial feasibility analysis is still crucial).

B. Basic elements of market feasibility analysis

A market feasibility analysis requires careful strategizing and information gathering about the potential market for the proposed business. Listed below are six steps that should be taken in preparing the market feasibility analysis.

1. Define the geographic area from which families are expected to be drawn.

Research its demographics in order to determine if there is a strong demand for child care in that geographic area.

- What are its boundaries?
- How many young children and families reside in the area?
- Are there couples or single adults in the area who are expecting children?
- What is the average age in the area?
- What is the average family income?
- What are the birth rates in the area?

Sources of information:

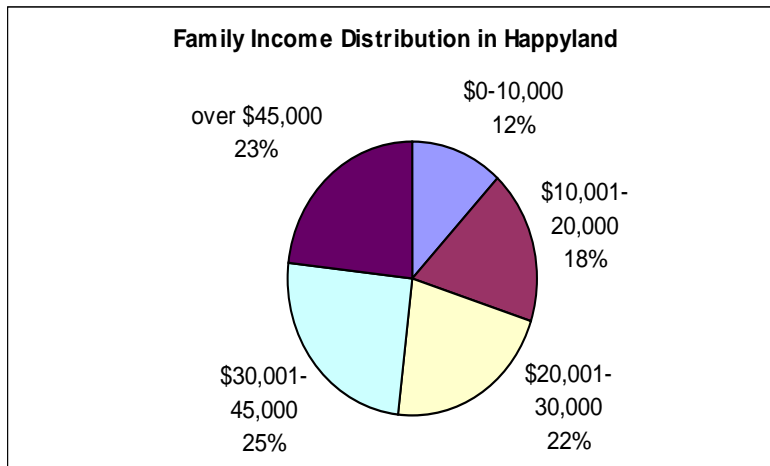
Contact one of the following local government offices: the Local Planning Department, the Development Commission, or Council of Governments. It is likely that they will have this type of information, since it is often used for planning purposes. Be sure to request information that is as specific to your geographic area as possible. For example, rather than requesting information for the entire city, seek information for the neighborhood being served.

The U.S. Census Bureau also maintains an Internet site (<http://govinfo.library.orst.edu/cgi-bin>) that has data available for each city. This site contains official statistics from the U.S. Census Bureau as well as a wide variety of demographic information. Searches can be done by topic or by a search engine. A search for the subject "Population Topics" is particularly helpful in finding demographic information.

Contacting the local Child Care Resource and Referral agency and the Local Child Care Planning Council are steps in finding out where demand for child care is greatest. In particular, these local resources provide needs assessment data and other relevant information on the topic of the existing market for child care services in the community.

Gathering informal information is also very useful. Talk to people in the neighborhood and find out how they would describe the demographics of the community. Also, talk to parents with young children in particular to find out if they would be interested in using your child care services.

EXAMPLE B:
Local Income Chart



2. Identify the segment of the market being targeted.

This section should indicate what kinds of families are expected to bring their children to the new child care business. Are families that live in the neighborhood expected to use the services, or families that work nearby? Are CalWorks families with child care vouchers being targeted? Once the segment being targeted is identified, figure out its potential child care needs. For example, identify common work schedules, different cultures and languages spoken, and the ages of the children.

Sources of information:

Contact the local Child Care Resource and Referral agency to learn about the information it has gathered formally or informally about parents' child care needs in the community. Ask existing providers about the needs of the families they serve.

3. Research the existing supply of child care.

People reading a business plan will be particularly interested in an analysis of the competition. Research in this area should include:

- The number of other child care programs (both center and family based) that already exist in the community;
- The number of child care spaces already provided in the area;
- The vacancy rate of other programs in the area;
- The average cost of care;
- The length of current waiting lists that other market-area child care programs currently have;
- (For existing programs) the length of the business' waiting list;
- Age groups that are being served (infants, toddlers, preschoolers, school-age, or a combination) or that are NOT being served by other programs;
- Locations of existing child care businesses in your vicinity;
- The services your proposed business or expansion can provide that other child care providers are not offering, and
- Types of services offered by existing child care businesses.

Sample questions to ask of existing child care businesses:

- Are they open only during the traditional work day?
- Do they offer after-school, evening, or night care?
- Do they serve children with special needs?
- Do they offer sick care?
- What languages are spoken?
- How culturally diverse are they?
- Are there any existing immersion programs?

Sources of information:

Contact the local Child Care Resource and Referral agency for useful information about existing providers, their rates and vacancies. Also, contact and visit existing providers to find out about their vacancy rates and the kinds of services they offer.

4. Analyze the land use surrounding the business.

The area surrounding the business can have a significant impact on how families perceive the business. For example, an elementary school nearby is probably a great asset, whereas a liquor store as a neighbor may deter potential families from using the business. Be sure to answer questions such as these when analyzing the land use surrounding the business:

- How are the adjacent properties currently being used? What kinds of businesses are allowed under current zoning laws?
- Are any new developments being planned in the area?
- How might these current or proposed uses attract or deter potential families?

Sources of information:

Take a walk around the neighborhood and discover who the potential business and residential neighbors are. Contact the Local Planning Department to learn of any new construction or building permits that have been approved in the area.

5. Consider how current and projected economic and political conditions could affect the business.

Child care needs vary notably with changes in the economy, so it is important to take the local economic environment into consideration when planning a facility. Changes at the political level can also affect your business.

Sources of information:

Contact the local Child Care Resource and Referral agency for updates on legislation. In addition, contact state representatives to find out about new or potential legislation concerning child care.

6. Determine how accessible the facility is for commuting parents.

An important factor for many parents in selecting child care is whether the facility is conveniently situated relative to their daily commute from home to the workplace. Identifying whether your proposed customers will be commuting, what methods of transport they are likely to use, and whether public transportation and/or a highway interchange are near.

Sources of information:

Determine how accessible the business is from various areas of town. Ask nearby providers how the families they serve get to and from the child care center. Gather information about nearby public transportation for those parents who need to use public transit.

Section Six: Marketing Plan

Once the market demand for the child care business has been demonstrated, a plan to attract potential customers to the business must be devised. This is called a marketing plan.

Developing a marketing plan requires an investment in dollars, time, and effort. However, particularly when expanding a business, a good marketing plan can make the difference between success and failure.

The marketing plan requires two essential steps:

- Creating a unique message about the business
- Devising an effective plan to promote the message

A. The unique message

A good message clearly and concisely describes to potential customers the qualities that are special about the child care business. This message may include years of service, staff qualifications and experience, capabilities, location, and the child development philosophy or mission statement.

One way to generate ideas is to ask existing customers what adjectives they might use to describe the child care business.

A short, descriptive message should clearly identify the services provided, the location and the price (if appropriate). Catchy phrases can spark the interest of readers or listeners.

The uniqueness and benefits of the business resonate through all promotional materials, and consequently help develop the image.

The following is an example of a brief description that can be used in promotional activities.

Happyland Child Care Center offers a warm, nurturing learning environment and a trained, caring staff. We have nutritious meals, a central location in the community, and a large outdoor play area.

B. The promotional plan

A promotional plan will differ depending on what works most effectively for a particular area and the families being targeted. Set aside an advertising budget and determine how to get the most out of that budget.

The following is a list of potential strategies that are often used by child care businesses to attract new families. A business plan should detail which activities the business plans to pursue.

Word of mouth:

Word of mouth is the most important resource for new families. This means it is very important that current parents are satisfied with the service they receive. Do a survey or determine through informal conversations if parents are satisfied. Give parents flyers or brochures and ask them to distribute them to other parents they might know. One incentive to use is to offer a "referral reward" such as a free day of care or a free night out to any parents who refer a new client to your program.

Networking:

Go out and meet with people and groups in your community who may work with families. Examples include: pediatricians; hospitals; schools, and family resource centers. Provide them with business cards, flyers, and brochures so they can knowledgeably talk to prospective clients.

An attractive facility:

Keeping up the appearance of the child care facility is an important form of promotion.

A memorable, consistent, and distinctive logo:

An effective logo helps get the business' message and image across.

Business cards:

This is the least expensive way of creating a business-like image. Distribute cards to anyone who works with families.

Flyers:

Flyers are an inexpensive way to advertise. Post them in community centers, markets, laundromats, libraries and schools. Be sure to post them regularly.

Brochure:

A brochure allows a business owner to describe the most important features of the business in a professional and visually pleasing manner.

Signs:

The sign on a child care facility should be easy to read and appealing. In addition, a plastic magnetic sign on the door of a car or van will attract a lot of attention at a low cost. (Check with the local Business License Division for any possible use restrictions).

Community involvement:

Through participation in community events recognition of the business can increase. For example, if the town has a street fair, consider hosting a table.

Direct mail:

While a mailing can reach many people, it can be expensive. People who use a direct mail approach only expect a 2% response. Consider ways of targeting a direct mailing to families needing child care.

Promotional items:

These are a popular and low-cost method of promoting the name and image of a child care business. Examples include: mugs; t-shirts; key chains; pens, and bumper stickers.

Web page:

Consider creating a web page for the child care business with the help of a parent or other volunteer. Be sure to put the web address on business cards. Explore how to create links between your page and other community-based web pages.

Free media coverage:

When holding a special event, be sure to send out a press release. Publicity can increase name recognition and overall business credibility. It can be more valuable than an advertisement because it is not self-promotion, and suggests that the business plays an important role in the local community.

On-site workshop or evening lecture:

Host a workshop or lecture on early childhood development topics for parents in the community.

An open house:

This allows prospective customers to tour the facility and meet staff.

A good first impression:

This is by far the most important component of marketing your services. If parents don't get a good feeling about a program the first time they visit it or call it on the phone, it doesn't matter how extensively the program is advertised. Answering the phones professionally and in a friendly manner helps to create a good first impression. Offer to send written materials describing the program. Also, always present a clean and well-ordered facility to visiting parents.

Section Seven: Operations Plan

This section describes how the child care business is (or will be) run on a day-to-day basis. It should include answers to the following questions:

- How is the business managed? (Include any pertinent printed materials, such as organizational charts and a schedule of staff meetings).
- What is the adult to child ratio?
- Who develops the curriculum?
- Who develops the policies and procedures for the program?
- How are staff hired and supervised?
- How is the billing done? What kinds of accounting procedures are used?
- What are the safety procedures for the facility? Include emergency evacuation and disaster plans.
- What kind of insurance does the business have?
- Are volunteers used? How?
- Are parents involved in any of the business or program activities? How?
- Is there a Board of Directors? (If so, provide a list of members and a meeting schedule).

Section Eight: Financial Analysis

This section of a business plan describes how the funds being requested will be used. It should also demonstrate that the proposed project is a good investment, and it shows that the business is financially sound and well managed. The financial analysis section contains four components:

A. Summary of financial needs

This summary briefly describes why funding is needed, the type of funding being applied for, the total amount needed, and how the funds will be used.

B. Development budget

A well-prepared development budget shows that the costs involved in this project have been carefully considered. The development budget should include both the line item costs of the project and the known or anticipated sources of funding. A funder will be interested in seeing sources of funds in addition to its own resources.

C. Financial projections

Financial projections are financial statements used to predict the future profitability of a business. Projections should be based on realistic research and reasonable assumptions. A business plan should include cash flow projections and income and expense projections. Each of these financial projections is described in Chapter Two of this manual, *Developing Pro Formas and Determining Debt Capacity*.

Projections must match the funding requests. Funders will be on the lookout for inconsistencies.

D. Financial statements

It is necessary to include financial statements that reflect the business' past financial activity. A business plan should include a statement of financial activity, a statement of financial position, and a cash flow statement. Generally, it is sufficient to include financial statements from the prior three years. However, check with the funder to determine how many prior years it requires. Individuals starting a new child care business need not include any existing financial statements; instead, the financial section will consist of projected statements.

Section Nine: Supporting Documents

Supporting documents are records that support the information in the business plan. They should be arranged neatly at the end of the plan. It may be helpful to include a list of supporting documents at the beginning of this section to help the reader locate specific documents. Supporting documents may include:

- Consultant contracts
- Funding contracts (current loan contracts, California Department of Education contracts)
- Legal documents (articles of incorporation, child care license, deed or lease to property)
- Location studies – from market feasibility study
- A recently updated waiting list of parents who want to use additional slots if the program expands.
- Letters of support from:
 - Resource and Referral Agencies
 - Parents
 - Other community groups



CHAPTER FOUR:

The Facilities Development Process

Chapter Four: The Facilities Development Process

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Introduction

This chapter in the *Child Care Center Financial Planning and Facilities Development Manual* is devoted specifically to providing a step-by-step overview of the facilities development process for child care centers. Information about specific sequential steps that an organization should consider when planning a facilities development project is included. However, while the steps are laid out sequentially, some may occur simultaneously while others not at all, depending on the type and scale of the project.

In addition to each step in the facilities development process, human resource roles and financial considerations will vary from project to project depending on:

- Whether it is a construction or renovation project
- Whether the project is small-scale or large-scale
- The location and quality of the site and its environment
- The type of program the planned facility will house
- How the project will be financed

These and other issues affect the degree of complexity of a project, as well as the order in which certain issues in the facilities development process should be addressed. When beginning to plan a facilities development project, whatever the type, an organization should think through the entire process by breaking down the activities into four phases: **planning, predevelopment, development, and start-up**.

Within each phase there is a series of steps (each detailed in this chapter) that help a child care business to plan for a successful development project.

Section One: Planning Phase

The planning stage is perhaps the most essential in any facilities development process, because the more time and attention that goes into planning the project, the less likely it is that you'll face costly mistakes in the later stages. Additionally, careful attention to the steps in the planning stage allows the business owner to learn early on if the business is not ready to take on the financial risk of a facilities development project.

A. Market demand

Studies show that the need for increasing the capacity of child care in communities across the U.S. is tremendous. In planning to acquire, build, or expand a child care facility it is extremely important, however, to understand the difference between a given community's **need** and **demand** for child care because to assess the market feasibility of the development project, it is the *demand* for services, not the *need*, that must be determined.

Demand is established by finding out if there are enough families who not only need child care services, but also have the capacity and willingness to pay fees at rates sufficient to generate the income stream (cash flow) necessary to satisfy the center's operating budget. Consequently, the existence of **need** does not necessarily always mean that there is sufficient **demand** in the community. It is also important to consider though that in low-income communities demand can be measured by the availability of government contracts to provide subsidized care or the ability of parents to obtain child care vouchers.

In order to establish whether or not there is a demand for your projected services the following steps need to be taken:

1. Estimate the number of families demanding services in your area at the rates to be charged. Contact the local Resource and Referral Agency and the Local Child Care Planning Council in your community to find out about the demand and highest need for care in your area, as well as information about the existing supply of child care services in the community.
2. Decide whether your services will target low-income, middle-income, and/or affluent families. This decision affects both the rates charged and the business' eligibility for subsidy programs.
3. Decide what age group(s) the program will cater to. This affects an assessment of local supply and demand. Keep in mind that different age groups have different requirements for both staff and room size, which impacts both the business' operational budget and site selection.
4. Assess whether or not the intended parent fees will generate enough revenues to meet the costs of operating expenses and the debt incurred by the facility development project.

Conducting a thorough market feasibility analysis is essential to help identify whether revenues will be able to cover the costs of the child care business. To learn more about a market feasibility analysis refer back to Chapter Three, *Developing a Child Care Business Plan*.

Depending on the scale and type of project, it may be beneficial to hire an expert to prepare a market feasibility study. However, in the early stages of planning any facilities development project, the development team should always conduct a *preliminary* market feasibility study that identifies the geographic boundaries families will be drawn from, the supply of child care, and the flow of subsidies within the boundaries. This information helps justify the soundness of the project concept and provides critical information to potential funders.

B. Organizational capacity

Analyzing a business' capacity to take on a development project should occur early in the planning process. The facility development process is best managed by a development team. This team consists of a group of individuals that meet regularly and possess the technical skills necessary to cover all aspects of the process. Members of a development team can be drawn from multiple sources, including a business' own staff, its Board of Directors, parents using the services of the child care program, community members, local technical assistance resources, and others. Board members and volunteers can be great assets to the development process if they have the appropriate technical expertise. However, it is important to be sure they are committed to seeing the development process through in its entirety.

The volunteer, *pro bono* or in-kind human resources discussed above should be thoroughly explored before seeking paid consultants to help with the project. Nevertheless, typically the development team cannot be solely made up of volunteers from within the organization or community; therefore, the development team must hire consultants. In hiring a consultant, it is important to enter into a mutually agreed-upon written contract that clearly defines the terms, scope of work, fee for service and payment schedule for each consultant.

The following is a list of roles that should be covered by a development team:

- Project manager
- Legal adviser
- Financial officer
- Real estate agent/broker (sales and/or leasing expert)
- Marketing consultant
- Child care coordinator
- Developer/contractor
- Architect/design consultant
- Capital campaign consultant
- Child care licensing expert

Once these experts, and the staff members assigned to the project, become members of the development team, it is time to begin assigning tasks to the team members, drafting a realistic timetable of activities, and developing a project concept consistent with the organization's mission and program philosophy. Some issues to consider when developing a project concept include:

- Population being served (infant, toddler, preschooler, school-aged, and-or children with special needs);
- Type of care (traditional hours, non-traditional hours, 24-hour care, and/or drop-in), and
- Availability of labor pool (consultants, construction team, teachers).

Once the project concept is clear and there is consensus within the development team, the organization must determine the feasibility of providing the new services within the community. Primarily this involves an assessment of the **market demand** for services. In the planning phase it is important to establish support beyond just the early care and education field, and to make sure that the community understands what your program has to offer.

After identifying the demand for the proposed project, the development team needs to assess the **financial feasibility** of the organization to take on such a project. An initial way to do this is to identify red and green flags that respectively indicate whether or not a business is in the position to move forward with the proposed project.

Red flags: difficulty paying bills, deficits in recent years, large amounts of uncollected receivables such as parent fees, and a lack of any cushion or cash reserve.

Green flags: services are constrained by a lack of space, the provider and/or business are in a financially strong and growing position, and there is a clear *demand* for the proposed services.

C. Financial feasibility

The development team must consider the organization's fiscal capability to support a facilities development project. Because this step will differ for pre-existing programs and start-up programs, this chapter tries to specify which components of the financial feasibility assessment pertain to which type of project. In general, the development team will need to take the following steps to assess the financial feasibility of a facilities development project:

1. Estimate the overall start-up or capital cost of the facility development process and divide this into
 - i. "Soft costs" (design, permits, legal and financing fees)
 - ii. "Hard costs" (acquisition, construction, equipment)
 - iii. "Hidden costs" (staff and board time and attention)
 - iv. "Contingency costs" (a portion of construction costs set aside to cover unexpected "hard" costs)

A contractor can typically help in the process of estimating these overall costs.

2. Design an operating budget for the child care business if it is a new program; or, if it is an expanding program, make necessary changes to the projected operating budget. Note that in identifying expected revenues (incoming money from parent fees, vouchers, state subsidies, etc.) it is important not to project that the program will ever be more than 90% full because it usually takes, at minimum, six months to reach capacity for a new program; and even for an existing program. It is quite common for enrollments to fluctuate throughout the year.
3. Identify the financing necessary to cover the start-up and operating budgets. Budget projections may need to be adjusted as more specific details about incoming revenues become clear.
4. Analyze the organization's capability to apply for financing (i.e. loans) by determining debt capacity, or debt service coverage.
5. Assess the projected costs, operating budget and financing streams to determine whether or not the new facility, or facility expansion, will generate enough income to pay operating expenses, service existing debt (as well as debt incurred as a result of the development project), pay an appropriate share of the organization's overhead, and generate operating reserves.
6. Ensure that the business will have enough working capital (cash available to fill in the gap between revenue and expenses) at the end of the facility development process to cover at minimum three months operating expenses as revenues take time to come in since the program will be building up its enrollment. It is best to have an even larger cash reserve, if possible, in order to prepare for any cash flow problems that may occur, especially if the program is just starting-up.
7. Identify donor relationships and look into new ones for development grants and especially for donations of toys, equipment, furniture, dress-up clothes, building supplies, etc. Also try to identify potential partnerships with other community organizations like churches, hospitals, and schools that might be able to collaborate with your business to provide certain services and share some expenses.

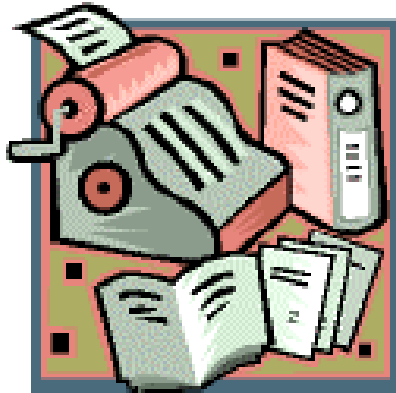
8. Determine the program's legal status as a nonprofit or for profit child care business if it is a new program. This will directly affect the program's approach to obtaining financing.

Certain financial statements must be developed in order to complete the steps listed above.

These statements include:

- A detailed operating budget for the entire organization;
- A detailed operating budget for the new site, or the existing site after the renovation or expansion;
- An annual cash flow statement that includes details of the organization's monthly income and expenses, and
- A monthly income and expense projection that provides information on the organization's ability to carry debt over a certain period of time.

For more information and step-by-step methods for reviewing an organization's fiscal capacity to take on a facilities development project, refer back to Chapter One, *Budgeting and Basic Financial Statements* and Chapter Two, *Developing Pro Formas and Determining Debt Capacity*.



Section Two: Predevelopment Phase

A. Site selection

There are generally two types of child care facilities development projects:

1. Renovation and/or expansion of an existing facility
2. Construction of a new facility

Both situations call for careful consideration before any structural work can begin.

1. Renovating and/or expanding an existing facility:

If the project concept calls for renovating the existing child care facility the first step is to determine whether the existing building and site are feasible for the planned development. A **construction or development consultant**, **child care licensing expert**, and **architect** should be members of the development team at this point in the development process. The contractor or developer may be the team's choice for the duration of the development process or just an expert who provides technical advice during the predevelopment phase. Whatever the case, these three experts should inspect the building and site and determine if the project concept is feasible by considering the following issues:

- Size of the lot;
- Zoning (conditional use permit requirements);
- Licensing requirements (indoor and outdoor square footage, fire, health and safety, accessibility);
- Quality of the existing structure;
- Repair or renovation costs;
- Design and engineering costs, and
- Recent or upcoming changes in the neighborhood.

If the existing site is deemed feasible, the development team can move forward in selecting and securing a contractor for the development phase. The process for selecting and securing a contractor is described later in this section.

2. Constructing a new site:

If the project concept calls for identifying a new site for the child care program, it is important that the development team solicit the help of a **real estate sales or leasing expert**. When choosing a real estate expert, the development team should consider someone who has experience with child care, early childhood development, educational, or family support organizations. The real estate expert should understand the sales and/or leasing market and the community in which the development team is planning to locate the new facility. This expert should also understand the project concept, preliminary development budget limits, and ideal property characteristics. When evaluating potential sites, the real estate expert and development team should consider the following:

- Compatibility with project concept;
- Site costs (direct and indirect);
- Quality of the surrounding neighborhood;
- Licensing requirements (indoor and outdoor square footage, fire, health and safety, accessibility);

- Zoning and land use restrictions;
- Infrastructure (utilities, roads, easements);
- Transportation, parking, access to building and other necessary services;
- Size of the lot;
- Recent and upcoming changes in the neighborhood, including plans for new developments in the area, and
- Traffic patterns

The most cost-efficient site may be equipped with an existing structure in need of minor or major renovations. In other circumstances, a vacant site, or a site requiring demolition may be the most cost effective. Whatever the case, the situation requires the **child care licensing expert, construction or development consultant, and architect** to inspect the site and determine its suitability based on the issues listed above.

A realtor or leasing expert should work with the development team to review recent, comparable sales or leases. If purchasing a site, the development team should pay for a written appraisal that analyzes a fair market price based on a strategic formula. It is important that the development team compile accurate documentation that justifies a fair market price. Public, private, and philanthropic funding organizations will require this verification.

If the development team is planning to raise capital while searching for a site, it may be beneficial to negotiate with the seller to carry back financing and agree to a lengthy escrow period. If this option is considered, the organization should expect to be flexible when the final sales price is negotiated.

Another strategy is to recommend a discounted sale from a private owner. In this case, the seller receives a tax deduction for the difference between the discounted sales price and the fair market price when selling to a charitable tax-exempt organization. Discounted sales do not net the seller as much as a fair market sales price. However, some sellers are motivated to sell because of a desire to benefit the child care organization, because they are having difficulty selling the particular property at the appraised fair market price, because they are interested in the tax write-off, or because they are interested in an expedient sale.

B. Land use and zoning

Land use controls and zoning usually create the most significant constraints for child care centers. When a potential site has been identified, it is important to resolve zoning issues early in the predevelopment process. Local codes and standards may also constrain the development of child care centers. Design regulations such as height limits, setback requirements, subdivision standards, street-width minimums, lot coverage maximums, cumbersome review or approval processes, and extensive public hearing requirements may deter, slow, or prevent the development. Additionally, parking, open space and other requirements can significantly raise costs. Careful planning can help avoid unexpected costs and delays.

The first step is to determine which public approvals are necessary. The next step is to begin securing those approvals.

Required Public Approvals:

- Land use (zoning): Is the proposed use authorized, or will there be a need for a zoning ordinance amendment, variance, or conditional use permit?
- Utility approvals
- Access road approvals

- Public financing approvals
- Building, health and safety code approvals
- Community Care Licensing approvals
- Fire code approvals
- Properties within earthquake, flood, and coastal zones may require special approvals (the Seller is required to inform a Buyer if the property is in such a zone)
- Local moratoria (laws prohibiting water and sewer hookups without approval)

Steps for Securing Public Approvals:

- Set up a calendar for pursuing the needed public approvals
- Identify the development team member who will coordinate and be responsible for all public approvals
- Analyze the standards that will be applied in the public approval process
- Analyze risks, out-of-pocket costs, and timing of public approvals
- Identify politically sensitive issues in the public approval process and develop a community base of support
- Coordinate and track the public approval strategies using the development calendar
- Be prepared to negotiate

C. Site control

If securing a new site or changing the terms of an existing tenancy is part of the project concept, the development team should consider the multitude of site control options before committing to just one. For example, if the team has decided to purchase a site, it may not be feasible to buy the site outright. There may be unresolved issues relating to project feasibility such as zoning requirements or securing necessary acquisition financing.

While searching for the right site these site control alternatives should be considered:

1. An option to purchase
2. A conditional purchase contract
3. A joint venture with the existing owner or with another organization that shares a similar mission

1. Using an option to purchase:

An option is a contractual right (but not the obligation) to obtain title to a property during a specified period at a fixed purchase price. Once the option has expired and is not exercised, the option price is usually lost. If the option is exercised, the option price may or may not be applied to the purchase price. The buyer may obtain the right to extend the option by payments of additional amounts or by agreeing to increase the purchase price if the option is extended and then exercised.

The following issues should be covered in the option:

- Option price;
- Option period (the organization probably wants at least six months);
- Purchase price and other terms of sale;
- How the option is exercised;
- Preliminary title report and condition of title;
- Right of entry for inspection;
- What happens to the option payment if the option is exercised and the purchase agreement is

- signed;
- How to extend the option;
- Right to assignment, and
- Recording the option to prevent sales during the option period.

2. Using a conditional purchase contract:

A conditional purchase contract is an agreement to purchase property within a specified period at a fixed purchase price, subject to certain specified contingencies (i.e., condition of title, satisfactory physical inspection, public approvals, financing, etc.). A conditional purchase contract often requires a nonrefundable deposit on the purchase price. However, the buyer can negotiate to make all or part of the deposit refundable if certain agreed-upon contingencies prevent the sale.

The difference between an option and a conditional purchase contract is that an option is a unilateral right to buy or not to buy the property. With an option, the buyer doesn't have to give any reasons for not going forward with the purchase. On the other hand, a conditional purchase contract creates a binding agreement between both parties to move forward. In this case the buyer can get out only on the basis of certain agreed-upon contingencies.

A seller may insist on setting up a contract rather than an option to insure the buyer's commitment and capacity to follow through with the purchase. A contract is a reasonable method to secure a site, provided the buyer carefully defines any and all contingencies.

Typical contingencies include but are not limited to:

Condition of title: If the buyer does not approve of all the exceptions that show up on a preliminary title report, the seller must remove them prior to the close of escrow or the buyer will not be obligated to move forward with the purchase.

Physical inspection: If the buyer is not satisfied with the physical condition of the property, there is no obligation to move forward with the purchase.

Public approvals: If the buyer is not able to secure all of the necessary public approvals, the buyer is not obligated to move forward with the purchase.

Financing: If the buyer is not able to obtain specified financing commitments, the buyer is not obligated to move forward with the purchase. However, it is necessary for the buyer to be as specific as possible about the terms required, as the seller may be able to locate financing alternatives for the buyer or offer to finance the purchase independently.

Board approval: Nonprofit organizations (and others) will typically include a board approval contingency in a contract. However, this may be a tough contingency for the seller to agree upon, as it gives the buyer a broad loophole in following through with the purchase for reasons not specified in the contract.

Items to include in a purchase contract:

- Purchase price and how it will be paid, including all deposits;
- Closing date and the process for extension;
- Closing costs and how they will be shared, if at all;
- Broker's fee and who is responsible for paying this;
- Any existing leases or contracts affecting the property;
- Any existing easements affecting the property;

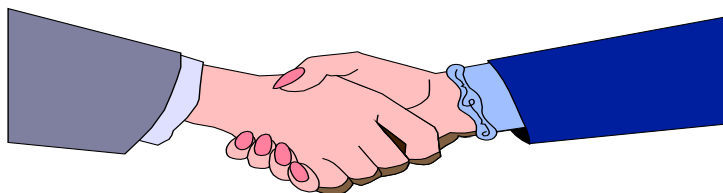
- Prorated taxes, insurance, rents, etc.;
- Liquidated damages (a limit on the amount the organization will pay in the event the contract is terminated without cause);
- Seller's obligation to disclose any and all defects;
- Buyer's rights if the property has defects discovered after the close of escrow (remember to secure all warranties from the seller that are active at the close of escrow), and
- Right to assign contract to another party.

3. Using a joint venture agreement:

A joint venture agreement is a great way to obtain site control when the owner or another organization is interested in participating in the development project. Joint venture agreements must cover the entire development process and not be limited to site control. The agreement should address issues of ongoing management, division of net profits and losses, and the organization's ability to sell its interest or buy the interest of its joint venture partner.

Items to include in a joint venture agreement:

- If with the existing owner, that he/she/it has a good and marketable title to the property;
- If with the existing owner or new partner, that he/she/it agrees to contribute property to the joint venture for a specified percentage of interest or else sell the property for a specified price within a specified period of time. The agreement should include all the contingencies that would be in a purchase agreement. Each party should have the right to back out of the joint venture agreement if careful investigation proves that the property or partnership is not feasible.



D. Project design

Before securing a contractor for the development phase of the project, the development team must solicit the help of an architect to translate the project concept into a physical design that meets the organization's program goals, budget constraints, and public approval requirements.

When designing the project, an architect should consider both *required* and *recommended* elements of design. Visiting similar facilities in and around the community, and talking with other child care providers to identify successful designs, as well as mistakes to avoid, can be extremely helpful.

It is also essential to research the most cost-effective design options available, and when doing so, to take into account the initial costs *and* the long-term quality and maintenance consequences of using certain materials and equipment. For example, choosing one type of carpeting because it is the least expensive up front may mean that it does not last very long and has to be replaced a lot sooner than a higher quality carpet, or one that has separate, replaceable tiles.

An agreement with the project architect may cover the following areas:

- Schematic design: translating the project concept into a general scheme of development with a rough estimate of construction costs;

- Design development: more detailed drawings and documents that describe the project and a more refined estimate of construction costs;
- Construction documents: detailed plans and specifications for construction;
- Bidding and negotiation assistance;
- Construction supervision, and
- Assistance in obtaining public approvals.

E. Securing a contractor

Building contractors are generally secured in one of two ways:

1. Guaranteed maximum price
2. Lump sum bid

In the “guaranteed maximum price” method, the organization selects a building contractor early in the development process based on a previous relationship or personal referral. The “lump sum bid” is a competitive bidding process. Whichever process is used, before selecting a contractor, his or her license, references and insurance should always be verified.

Guaranteed Maximum Price	Lump Sum Bid (or) Competitive Bidding Process
Contractor selected based on Qualifications	Architect prepares drawings and technical specifications
Contractor provides input during design process	Using drawings and specifications, bids are solicited from multiple contractors
Contractor provides a guaranteed price based on drawings and technical specifications	Based on bids, preferred contractor is selected

Once the development team has selected a contractor, the assistance of a legal expert should be secured to develop a construction contract. Asking an attorney to draw up a construction contract will help avoid any mishaps during the development phase. Additionally, the contract will contain provisions and responsibilities that the development team will need to manage during the development phase. Such provisions and responsibilities may include:

- Funders’ requirements;
- Securing a performance bond;
- The Davis Bacon Act (requires the contractor to pay employees a predetermined wage);
- Materials list;
- List of subcontractors;
- Disbursement schedule, and
- Liquidated damages clause (compensation for delays).



F. Securing financing

Nonprofit child care centers can sometimes look to local government, community, and foundation grant programs for assistance with financing for facilities development costs. However, because facility development projects are typically much more costly than the average grant can cover, loan financing, if used wisely, is one of the most viable options for providers looking to build, purchase, renovate or expand a child care facility.

In researching different financing options it is key to look into a range of loan resources including those designed to support community development, small business development, and in some cases child care projects in particular, and to find the best overall rates and terms for the business' needs. (For more information on child care-friendly loan resources see the *Matrix of Financial Resources for Child Care Facilities Development in California*).

In order to obtain financing to move forward with the development stage, and the construction process, the first step necessary is to finalize the **Business Plan** with all the following components:

- Cover Sheet
- Executive Summary
- Objective of the Development Project
- Market Analysis
- Marketing Plan
- Operations Plan
- Financial Management Plan
- Supporting Documents

For more information about the business plan refer back to Chapter Three of this Manual. Additionally, the Small Business Administration (SBA) offers one-on-one assistance and workshops on the topic of business planning through their Small Business Development Centers (SBDC's) and Service Corps of Retired Executives (SCORE) offices. To find contact information for the SBDC and SCORE office in your community call 1-800-8-ASK-SBA or look online at www.sba.gov.

To prepare for the process of applying for a loan from any lender it is essential that all financial statements outlined in the previous chapters be in order to demonstrate that the business will have the financial capacity to pay back any money borrowed. **Repayment capability** is the most important factor in the review of any loan application.

The next step in the process is to determine final figures of both how much money the business will need to complete the renovation or expansion process, and how much debt the business can afford to carry. Largely, the cost estimate will be determined based on the contractors' bids, while the capacity to carry debt will be

determined by the business' current and/or projected cash flow.

With the business plan, estimated budget and debt capacity information in order, it is time to identify and approach likely funding sources. If the business is a for-profit child care center, most construction and renovation costs will be paid for using internal resources and debt (loans). Nonprofit child care centers typically also need to rely on loan financing for facilities development costs, but they may also have access to grant resources from local, state, or government programs as well as private, community, or corporate foundations that serve their communities.

While there are various sources to explore for development funding (public, nonprofit, philanthropic, and commercial), there are three basic financing categories for facilities development activities: **predevelopment**, **construction**, and **permanent**.

PREDEVELOPMENT FINANCING:

Predevelopment financing can be secured from various sources - public, private and philanthropic - and terms can range from grants, recoverable grants, and deferred loans with little/no interest to market rate short-term loans.

Predevelopment financing allows an organization to finance the costs incurred during the planning and predevelopment phases of the project. Areas that are funded by predevelopment financing may include:

- Legal consulting;
- Market feasibility study;
- Real estate fees (lease, purchase, etc.);
- Architectural consulting;
- Construction or renovation consulting;
- Permit and licensing fees;
- Utility fees, and
- Environmental reports.

While there are various sources for predevelopment financing, typically the best source is in capital grants secured early in the planning phase.

CONSTRUCTION FINANCING:

Construction financing covers all items in the contract with the building contractor as well as any contingencies (unforeseen changes in the scope of work). Construction financing can also be used to pay off a predevelopment loan. A construction loan is usually short-term (e.g. a six-month construction term means a six-month development loan), and requires a method of repayment when the construction is complete. Typically, these repayment funds come from permanent financing.

PERMANENT FINANCING:

Permanent financing, otherwise known as refinancing, take-out financing, or long-term financing, refers to financing that repays construction financing and may include acquisition financing. There are several different types of permanent financing:

Seller financing: Buyer borrows from the Seller instead of, or in addition to, a bank. This method is sometimes used when a buyer cannot qualify for a bank loan for the full amount. It is also called "owner financing" or "purchase-money mortgage."

Lease with option to purchase: Buyer acquires possession of property and defers payment of purchase.

Conventional financing: Conventional lenders (banks, savings & loans, etc.) typically require a first

position deed of trust and offer market rate terms. Equity is *required* in order to secure conventional financing. A conventional lender also requires documented proof, from defensible sources, that the organization can repay the loan with revenue generated from a stable source.

Non-conventional financing: Typically this refers to below-market-rate loans that offer modified loan terms, collateral and eligibility requirements, and/or guarantees in order to meet the financing needs of borrowers who may not qualify for conventional financing. This type of financing usually originates from public agencies, foundations, religious institutions, corporations, community loan funds, or insurance companies.

Capital campaign: Depending on the organization's ability to carry debt, coupled with the extent of local public sector support for the development, a capital campaign may be necessary to raise grants from individuals, corporations, or foundations.

While some organizations may have extensive experience in raising capital, others may find it necessary to hire a consultant to coordinate the market feasibility study with the priorities and objectives of different funders in order to develop a polished capital-raising proposal. NEDLC's publication, *The Matrix of Financial Resources for Child Care Facilities Development in California*, has additional information about financial resources, especially non-conventional financing, that may be available.

Before any construction begins it is essential that all necessary financial commitments are secured, loans are closed, and cash is in hand.



Section Three: Development Phase

The development phase is the time it takes to implement the work the development team has prepared for during the planning and predevelopment phases.

A. Managing the development process

At this point in the process a contractor has been secured and all the necessary funding is in place to begin construction. This is a good time to re-evaluate the roles of the various development team members. The most important team member during the development process is the **project manager**. The project manager may be the architect, the organization's facilities manager, or a consultant hired by the organization. This person:

- Has experience in the field of construction, preferably child care construction;
- Is responsible for managing the construction contract on behalf of the organization;
- Coordinates all members of the development team involved in the development process;
- Facilitates bi-weekly development team meetings, and develops and updates the construction calendar;
- Has decision-making authority;
- Is the primary line of communication between the contractor and the development team, and
- Coordinates site visits with necessary individuals such as building, fire, and licensing officials

While the project manager is the critical point person during the development phase, some tasks may be assigned to other development team members. Ultimately though, it is the project manager who coordinates the delegation and insures that follow-through occurs.

Because the project manager is critical to a successful development process and outcome, this person should be selected carefully. Although a board member or community volunteer may have the organization's best interest at heart when offering to take on the role of project manager, this role requires considerably dedication, experience, and - most importantly - a full-time commitment.

Once the project manager has been selected, managing the development process generally consists of regularly scheduled meetings with updates from the project manager. It also includes insuring that funders (banks, public agencies, foundations) are kept informed of the progress, either by joining the development team or with formal updates.

B. Preparing to move in

It is imperative that, during the development phase, the organization prepare for occupancy. The following steps must be dealt with during the development phase, if not before, in order to prepare for the ultimate start of the program once construction is completed:

1. **Equip the classroom.** When purchasing appropriate furniture and curriculum specific materials for the classroom(s), make sure that the timing of this step correlates with the timeline established for developing and opening the facility. It is also important to develop a specific plan for receiving, installing and taking inventory of all supplies and equipment to keep track of exactly what has been ordered and when it arrives.
2. **Obtain license approval for the facility.** Though extensive communication with Community Care Licensing should already have taken place with regard to the design and construction of the facility, the final step to obtain a license is to submit a completed application and pay fees to your local Community

Care Licensing office. The completed application should include fingerprint cards, a child abuse index check and a fire inspection clearance.

3. **Hire personnel.** Similarly to equipping the classroom, it is essential that the staffing of the center be lined up before opening it to children and families. To begin this process, identify how many staff members will be needed, when they will work, what their responsibilities will be, and how much they will be paid, including benefits and staff training opportunities. These logistics should already be outlined in the business plan. The next step is to begin advertising for staff at least 60 days in advance of the program's anticipated start date. Some ideas for advertising include contacting local teachers, college placement offices, vocational high schools, the state licensing office, the local Resource and Referral Agency, and the local employment agency. Also, placing job advertisements in local papers and posting them at grocery stores and laundromats can be very effective.

Advertisements should include a job title, brief job description, required qualifications, application deadline, resume request, your telephone number, address and name. Make sure that when staff members are hired the personnel expectations are clearly laid out. In order to save staff time and costs it is also a good idea, when applicable, to recruit volunteers who can help with clerical and administrative tasks.

4. **Market the program in the community.** Chapter Three, *Developing a Child Care Business Plan*, provides some additional information about this step, but overall it is very important to create a unique message about the business that clearly and concisely describes what is special about your child care services. This message should be based on research about what parents look for in the child care services they seek, and what the highest needs for in your community are. It is best to start marketing your services about three months before the business opens, or before the expansion is complete. Your marketing plan will depend on the type of organization you are promoting, and the community to which you promote it, and may include any of the following:

- Word of mouth networking;
- A distinctive logo;
- Distribution of business cards, flyers, signs and Brochures;
- Participation in community events;
- Free media coverage;
- On-site workshops and lectures;
- A listing in the Yellow Pages;
- An open house, and
- An overall effort to make a good first impression!

C. Coordinating the steps

Coordinating site-specific tasks, the process of securing financing, and management of construction can be chaotic. However, the process will run more smoothly if the development team members meet frequently to discuss roles, responsibilities, and deadlines. The development timeline below provides a basic snapshot of the development process.

Child Care Facilities Development Timeline

	Planning Phase	Predevelopment Phase	Development Phase
Feasibility	Organizational Capacity Market Demand Financial Feasibility	Site Selection Site Control	
Permits/ Licensing	Zoning/Building/ Environmental/ Traffic/Site Control and Approval/ Community Care Licensing		
Design/ Construction	Schematics	Project Design Securing a Contractor	Construction Preparing to Move In
Financing	Secure Planning & Predevelopment Financing	Secure Financing for Development	Gap/Bridge and Start-up Financing
Costs			

Section Four: Start-up Phase

The start-up phase is the time to launch the program, or the expanded services, once the facility project is complete.

A. Phase-in staffing and children

If the business is just starting, or if it has just completed an expansion, it is important to remember that the program will need to build up to full capacity. In other words, it won't start with a full staff or full enrollment the day its doors open.

One way to encourage higher enrollment early on is to start up in the early fall (August/September) or at the beginning of a new year, because these are times when parents are most likely to make changes in care arrangements since they correlate with breaks in the school schedule.

As enrollment builds up it is imperative to maintain the program's image and publicity efforts, even after the facility is up and running. For example, bring business cards with you whenever you go out with the children, make T-shirts for the children to wear on field trips, and make sure your services are well known throughout the community. If the program does reach full enrollment, a waiting list should be established because child care enrollment can fluctuate easily and it is important to fill vacancies as quickly as possible to ensure regular cash flow for the business.

B. Program sustainability

Even after the facility project is complete, it is essential to maintain relationships with funders and to build relationships with new funders consistently. This is important even when the program doesn't need money, because down the road it will be easier to raise money based on preexisting, or maintained relationships rather than on new ones.

To ensure the sustainability of a program it is best to establish an operating reserves budget to prepare for unexpected expenses and cash flow inconsistencies.

Also, though it can be difficult, especially after developing close relationships with families, it is crucial to be realistic about the fees charged for care and to adjust them over time as the program's expenses change.

Above all, program sustainability hinges on balancing service obligations with business obligations. Simply put, without attending to the business matters of a child care program high quality services cannot be maintained.

Though the financial piece plays a particularly large role in the facilities development process, without maintaining and continuing to develop the financial side of a child care program once it is up and running, it won't be able to survive as a viable business.

Appendix A: Where to Go for Help

There are a variety of resources, from books to individual counseling, available in California to offer assistance in budgeting, developing pro formas, determining debt capacity, business planning, and facilities development. Though some of the resources listed below are specific to the State of California, out-of-state readers can use this section as a guide to the types of assistance that may be available in other states as well.

Building Child Care

Building Child Care (BCC), a collaborative funded by the California Department of Education, is designed to improve child care providers' access to financial resources for facilities development projects in California. Along with the assistance and input of many others across the state, the four collaborative partners on this project have combined their experience, resources, and expertise to build a clearinghouse of information and assistance specifically for people interested in acquiring, building, renovating, or expanding child care center and family child care facilities. To learn more about BCC and its services call 888-411-3535, or visit www.buildingchildcare.org.

Nonprofit Support Centers

Nonprofit support centers, which exist throughout the country, are dedicated to providing management and financial training as well as consulting services to other nonprofit organizations. To find a nonprofit support center near you, contact the Alliance for Nonprofit Management at (202) 955-8406 or visit www.allianceonline.org.

Small Business Administration (SBA)

The SBA has a variety of management and technical assistance programs to assist both new and expanding businesses. Its primary mission is to serve for-profit businesses, but some of its services are available to nonprofits as well. The SBA has offices located throughout the country. For the nearest location, look in the telephone directory under U.S. Government, or call (800) 8-ASK-SBA. The SBA also maintains an extensive Internet site at www.sba.gov. Below are four examples of SBA programs that exist throughout the country and can offer you assistance in your local community.

Service Corps of Retired Executives (SCORE)

SCORE is an SBA-sponsored, management counseling program comprised of active and retired business executives who volunteer their time counseling and advising small business owners on how to start and manage their businesses. SCORE volunteers offer a free one-on-one counseling session about financial statements. SCORE services are available for both for-profit and nonprofit organizations. There are SCORE offices located throughout the country. To find a local office, call (800) 634-0245 or visit www.score.org.

Small Business Development Centers (SBDCs)

The purpose of the SBDC program is to further economic development by providing management and technical assistance to small businesses. SBDCs provide current and prospective business owners with counseling, management training, conferences, referrals, and reference libraries. They also frequently offer workshops on developing business plans. For information on the nearest location of an SBDC office, contact the SBA at (800) 8-ASK-SBA or visit www.sba.gov/sbdc.

Women's Business Centers (WBCs)

WBCs provide a wide range of services to women entrepreneurs at all levels of business development. Their purpose is to teach women about the principles of finance, management, marketing and how to start a home-based business. The WBC maintains an excellent Internet site (www.onlinewbc.gov) that has helpful information on financial management, marketing, developing a business plan, and a specific section about starting or expanding a child care business. More information about Women's Business Centers can be obtained by contacting the Office of Women's Business Ownership at (202) 205-6673, or by visiting www.sba.gov/womeninbusiness/wbcs.html.

Business Information Centers (BICs)

BICs provide a one-stop resource where current and future small business owners can receive assistance and advice. BICs have the latest computer technology (hardware and software) with an extensive small business reference library of hard copy books and publications and current management video tapes to help entrepreneurs plan their businesses, expand an existing business or venture into new business areas. Most BICs are stand-alone centers in Empowerment Zones. In addition to the self-help hardware, software, and reference materials, BICs have on-site counseling provided by SCORE. More information about BICs can be obtained by visiting www.sba.gov/bi/bics, or by calling (202) 205-6665.

Community Colleges and Universities

Check with your local community college or university for courses on budgeting, accounting, or basic financial statements. Some programs may offer courses specifically for nonprofits. Some SBDC's are located on college campuses.

Regional Resource Centers (RRCs), funded by the California Department of Education, provide assistance to new and established child care providers intended to increase their capacity to deliver services to children and their families. The RRCs are located in ten different regions across the state. Your RRC can provide training, technical assistance and information about how to access sources of public and private funding and other forms of support in your community. To find the RRC that covers your county call (916) 323-4601, or visit www.buildingchildcare.org and look at the Community Resources section of the site.

Resource and Referral (R&R) Agencies, funded by the state Department of Education, are community-based organizations charged with the mission of serving parents, providers, policy makers, businesses and communities throughout California by providing information, data, and support to build and improve the supply of quality child care. There is at least one R&R in every county of California. Your local R&R can provide county-specific information about the current supply of licensed child care, local demographics, the local demand for care, and market rates for child care costs and staff wages. R&R agencies also help providers with licensing and help make their services known in the community. They also provide low-cost or free trainings on a range of subjects. To find the R&R in your community call 1-800-KIDS-793, or visit www.rrnetwork.org.

Local Child Care Planning Councils (LPCs) are responsible for determining local community child care needs, identifying priorities for the **allocation of Federal Child Care and Development Block Grant Funds, and preparing county wide** child care plans. For the purpose of writing a business plan, Local Planning Councils can be particularly helpful in providing information about the greatest needs for child care in the county and about the local priorities designed to meet those needs. To find the LPC in your area you can call (916) 322-6233, or visit www.buildingchildcare.org/community.htm.

Appendix B: Glossary of Terms

The Players: In any loan transaction there are at least two parties. A "Borrower" applies for a loan. If determined eligible, a "Lender" provides a loan. There are many types of Lenders including banks, savings and loans, nonprofit organizations, public agencies and even relatives. In some cases, a third party, the "Guarantor" will also be included in the transaction (see Guarantee).

Amortization: The period of time on which the repayment of loan principal and interest is based. Loans have different amortization schedules and terms. There are three basic ways to repay a loan.

1. In equal installments, each containing a blend of principal and interest
2. In varying but regular installments, each containing a blend of principal and interest
3. In irregular installments of principal or interest only with a large final payment (see Balloon Payment)

Balloon Payment: The final payment of a loan with an amortization period that is longer than the loan term. For example, if the loan amortization period is 10 years but the loan term is 5 years the unpaid principal at year 5 is the Balloon Payment. This type of loan is awarded to borrowers who need a smaller or more affordable monthly loan payment but have the capacity to refinance at the end of their loan term.

Bridge Loan: Short-term loan made in anticipation of long-term funding or financing.

Building and Real Estate Costs:

Soft Costs – Expenses, other than Hard Costs, incurred in developing a real estate project, including legal and lending fees, architectural and design fees, permits, etc.

Hard Costs – The direct costs to construct a building or structure, otherwise known as "bricks and mortar" costs, including acquisition of property, construction, equipment, etc.

Hidden Costs – Less visible costs associated with the facilities development process, such as staff and board time and attention.

Contingency Costs – A portion of the construction costs set aside to cover unexpected "hard" or "soft" costs.

Building Reserve: A capital improvement reserve fund. Money set aside to pay for facilities upkeep: where the amounts can be large, the ultimate need a certainty, but where the exact timing is uncertain. These are often big-ticket items, like replacing the roof, which are difficult to accommodate in a single year's budget.

Collateral: The property a borrower pledges to a Lender to secure repayment of the loan. Collateral could include: a lien on your house, equipment from your business, or a bank account. If the borrower defaults, the lender has the legal right to seize the collateral and sell it to pay off the loan.

Debt: Money, goods or services that one party is obligated to pay another in accordance with an expressed or implied agreement.

Debt Service Coverage or Debt Coverage Ratio: A calculation a Lender uses to determine ability to repay a loan. This calculation is typically expressed as a ratio. Most Lenders have minimum debt service coverage requirements ranging from 1.05: 1.00 (i.e. the net income must be 5% in excess of the loan payment) to 1.25: 1.00 (i.e. the net income must be 25% in excess of the loan payment).

$$\text{DSC or DCR} = \frac{\text{Net Income (after all expenses excluding debt service)}}{\text{Total Loan Payment}} = 1.10: 1.00$$

Default: Failure to pay a debt or meet an obligation.

Equity: Represents the difference between an asset's current market value and the amount of debt or other liabilities. In terms of a child care equity that is provided through internal assets, savings, grants, individual donors, collaborative resources and other sources can be used to assist in funding some of the facilities development costs. It is best to use equity funding for the planning and predevelopment stages of developing child care facilities, while debt (loan financing) is more fitting for the real estate acquisition and construction costs incurred during the development stage.

Fees: Charges by a Lender for making the loan. Fees can include a range of costs. Such as a loan origination fee, service fee and monitoring fee (also see "Points").

Forgivable loan: A loan made with the understanding that if the borrower meets certain requirements, repayment of the loan will not be required. A requirement example could be if the property use continues to be child care for the term of the loan.

Guarantee: A promise by one party to pay a debt or perform an obligation contracted by another if the original party fails to pay or perform according to a contract. Loan guarantee or loan insurance programs are designed to make certain loans less risky for lenders, such as loans for community economic development projects and for small businesses like child care.

Interest: The cost of using loaned money, usually expressed as an annual percentage that a lender charges a borrower for the use of the principal over time.

Interest Rate: The amount a Lender will charge for the use of their funds. Interest rates vary greatly from loan to loan and are frequently tied to industry measures such as Prime Rate. For example, if Prime Rate is 4.75%, then a "Prime Plus Two Percent" rate would mean a loan with a 6.75% interest rate.

Leasehold Improvements: Renovations to leased space to suit the renter's needs. These may be paid for either by the landlord or the tenant.

Lien: A claim a Lender placed on property in return for making a loan. If a borrower is unable to make loan payments as agreed, it gives the Lender the right to collect repayment of the loan through selling the borrower's property. If the lien is placed on real property such as a house, this lien is often referred to a "Mortgage."

Line of Credit: A set amount of money available for the Borrower to use. The borrowed amounts are then paid back in installments determined by the Lender. A line of credit is distinct from a loan because after the money is paid back a borrower can use it again, which makes it similar to a credit card.

Loan: Transaction wherein a Lender allows a Borrower the use of a sum of money for a specified period of time at a specified rate of interest.

Loan Amount: The amount of a loan is determined by how much the Borrower needs to complete the project and the Lender's assessment of the Borrower's ability to repay. Lenders have minimum and maximum loan amounts.

Loan-to-Value Ratio: The ratio of money a Lender is willing to loan relative to the current appraised value of the property or other security.

Mortgage: Security instrument by which the Borrower (mortgagor) gives the Lender (mortgagee) a lien on property as collateral for the repayment of a loan.

Operating Reserves: Funds set aside annually to be used to offset possible operating losses due to unexpectedly low revenues or unusually high expenses.

Points: An up front fee a Lender may charge for a loan, expressed as a percentage of the loan amount. "One point" equals one percentage of the loan amount. Thus, one point on a \$10,000 loan is \$100 ($\$10,000 \times .01$).

Prime Rate: The rate of interest that serves as a benchmark for the interest rates banks will charge. (See Interest Rate). Banks typically lend at an Interest Rate that is Prime Rate plus an additional percentage based on the loan type and borrower.

Principal: The original amount of money borrowed, and the amount that the Borrower must pay back, not including interest.

Term: The agreed upon period of time for which a loan is made. A loan provided for 10 years has "a 10 year term."

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