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Financial Forecasting

The Importance of Financial Forecasting

> *"We did sales projections to motivate the team and hit goals. We really had not seriously looked at the expenses underlying those sales. We were losing money on each sale. What made it worse is that the money we were making was stuck in accounts receivable for an eternity. We were horrible at collecting on invoices. It was killing us. We had a consultant come in, and she sat us down and took us through projecting our expenses—not just revenues. Using that same process, we went through our cash flow and balance sheet projections. It was like a light at the end of the tunnel to see that accounts receivable number getting under control by Year 3. Since then, we've been profitable."*

—U.S.-Based Entrepreneur

What is a Profit and Loss Statement?

Here are some key terms for you to review as you explore financial forecasting with Profit and Loss Statements.

- **Profit and Loss Statement (P and L):** also known as an **Income Statement**; measures net income or loss over a defined period of time.
- **Depreciation:** a calculation to show how your tangible assets lose value over time. While there are several ways to account for depreciation, the most basic is for an asset's salvage value subtracted from its cost to determine the amount to be depreciated.
- **Balance Sheet:** a statement that shows your company's assets, liabilities and owners' equity to indicate financial health at a specific point in time. The goal of a Balance Sheet is to make sure that your company's assets are equal to the combination of your liabilities and owners' equity, i.e., **Assets = Liabilities + Equity (Net Worth)**. As such, it shows your collection of total assets plus how they were paid for.

- **Gross Profit:** calculated by taking your income less cost of goods sold, providing a measure of profit before deducting your other expenses.
- **Cost of Goods Sold (COGS):** captures the direct cost of producing or purchasing your product or service. *COGS* is the general term, while some industries, such as retail, use the term *cost of sales*.
- **Revenue:** the total amount of money received from the sales of your products and/or services.
- **Net Income:** how much money your company is making or losing after all expenses (rent, outside services, utilities, etc.) and taxes are deducted, i.e., **Your Net Income = Revenue – Expenses.**

Why Forecast Financials

Combining the analysis of your business' internal historical data with predictions about your external markets helps you project your financial circumstances to test ideas and better plan for your business growth, including where and how to focus your future activities and investments.

Whether you're analyzing financial data like revenue growth rate or customer lifetime value, regularly evaluating financial information is important as it provides you with key insights about your business and its performance.

By staying on top of your business' financial data, you can:

- **Estimate your business' future financial flexibility.** For example, if you have the potential to exceed profit goals, you can pay out profit sharing to the team, stockpile cash for a future emergency, or reinvest in a business asset.
- **Test the financial consequences of strategic plans to reach your revenue goals.** In other words, if you have a plan to expand to another market, what does that look like financially? Is it a drain on your resources, or are profits able to fund the growth?
- **Indicate the health of your business to potential investors.** Historical (positive) sales data combined with knowledge of the market and a pattern of expense management can provide a compelling case to investors that future projections are more likely to become a reality.
- **Identify revenue and expense patterns or trends.** For example, is there a cyclicality to sales in certain seasons or with certain promotions? Do these sales spikes correlate with expense hikes? If so, are sales spikes able to create enough profit to fund patterns of increased expenses, or do you need a line of credit or financial partner?
- **Position your business to take advantage of market changes.** For example, a new law is about to pass that will impact your industry. You line up the resources and expertise as part of your plan to take advantage of this market change. Do you have the financial wherewithal to fund your plan?

An Income Statement projection is the example below; however, business owners can apply similar projection principles to the Balance Sheet and Cash Flow Statement.

Forecasting

EXAMPLE: JAYNE'S LOCKSMITH COMPANY (JLC)

GOAL: Double basic lock installation revenue from Y1 to Y2.

JLC is a small business that installs locks in commercial buildings. This example focuses on second-year (Y2) and third-year (Y3) projections.

JCL Revenue Projections

Revenue: JLC plans to grow its revenue stream considerably in the future through:

- **More installations**: Increasing the amount of commercial and residential installations by the addition of two part-time installers or one master installer (Y2 and Y3)
- **Selling biometric and basic locks**, which JLC has bought wholesale, to existing and new customers (Y2 and Y3)
- **Manufacturing** and selling its own basic locks (Y3)

JLC Expense Projections

- **Hiring:** New employees to do installations to accommodate the increased sales and installation volume
- **Overall Expenses:** Increase for payroll, insurance, utilities and transportation needs. JLC projects its expenses will roughly increase by $130,000 each year.
- **Inventory and Manufacturing:** In Y2, rent out a larger facility to accommodate inventory and in Y3, wants to add a manufacturing space

PART 1: REVIEW JLC'S INCOME STATEMENT PROJECTION

- As you go through the JLC projection, take notes on what your projections for revenue and expenses could be for the next two to three years.
- Where you are not sure, make an "information gap" list where data needs to be gathered (e.g., customer survey, talk with an accountant, etc.).

PART 2: DO YOUR OWN INCOME STATEMENT PROJECTION.

- The next step will be completing your own income statement projection.

Part 1: JCL Income Statement Projection

Revenue	Y1 Actual	Y2 Projection	Y3 Projection	Y2 Notes	Y3 Notes
Installation	$200,000	$400,000	$560,000	Projected growth = doubling sales. Trends for increase: Commercial development increasing in area. Additional installer helps with backlog. JLC buys locks, sells to customers. Average of $250 for install per basic lock x 1600 locks.	Projected 40% growth. Increased demand for locks due to development + manufacturing own locks. Average of $250 for install per basic lock x 2240.
Biometric locks	$0	$60,000	$75,000	Biometric locks trend on rise + customer demand (installed = $750/each)	Est. 25% increase: Biometric locks trend on rise (installed = $750/each)
Basic locks	$0	$0	$112,000		Projected amount of sales from selling our own locks—based on customer surveying. 2240 locks @ $50 each (locks cost to make = $40).
Total Revenue (Sales)	**$200,000**	**$460,000**	**$747,000**		
Cost of Goods Sold					
Basic locks	$0	$0	$89,600		Projected cost based on research. Cost of lock = $40 x 2,240 locks installed.
Biometric locks	$0	$8,000	$10,000	Projected based on research. 80 locks at $100/each (cost).	Projected based on research.100 locks at $100/each (cost).
Total Cost of Goods Sold	**$0**	**$8,000**	**$99,600**		
Gross Profit	**$200,000**	**$452,000**	**$647,400**		

Revenue	Y1 Actual	Y2 Projection	Y3 Projection	Y2 Notes	Y3 Notes
Expenses					
Salary Expenses	$100,000	$100,000	$100,000	Owner salary. No raise through Y4.	Owner salary. No raise through Y4, 2 years with a machine
Payroll Expenses	$0	$75,000	$125,000	Assumption = two part-time or one master installer	Assumption = two part-time or one master installer + equipment operator
Payroll taxes and benefits	$15,000	$26,250	$33,750	15% of FICA, workers comp., etc. (salary + payroll)	15% of FICA, workers comp., etc. (salary + payroll)
Outside Services	$0	$0	$0		
Supplies (office and operating)	$12,000	$15,000	$20,000	Expected increase with installer. Office cleaning, postage, printing, copier, etc.	Expected increase with the addition of ma-chine, machine parts, office cleaning, postage, printing, copier, etc.
Repairs and Maintenance	$0	$0	$0		
Advertising	$5,000	$5,000	$5,000	Have a good system for email list management and local advertising, do not anticipate an increase.	Have a good system for email list management and local advertising, do not anticipate an increase.
Car, delivery and travel	$5,200	$10,400	$10,400	Increased amount with installer(s). Travel allowance$200 per week to the owner for use of the vehicle.	Same amount, machinist does not travel. Travel allowance—$200 per week to the owner for use of the vehicle.
Accounting and legal	$0	$0	$0		
Rent and related costs	$6,000	$24,000	$48,000	Increase from Y1 with the addition of installer(s). $2,000/ per month for sublease. Based on a conversation with a real estate agent.	Increase from Y2 $4,000/per month for manufacturing space added. Based on a conversation with a real estate agent.
Telephone	$1,400	$3,380	$3,380	VoIP main number with forwarding to cell phones.	VoIP main number with forwarding to cell phones.

Revenue	Y1 Actual	Y2 Projection	Y3 Projection	Y2 Notes	Y3 Notes
Expenses					
Utilities	$0	$11,000	$21,000	Gas, electric and water	Gas, electric and water
Insurance	$8,000	$13,000	$24,000	Liability and individual health insurance	Liability and individual health insurance—insurance costs increased with manufacturing
Taxes (personal property tax, real estate, etc.)	$0	$0	$2,400		Personal property tax on the machine. Based on a conversation with the accountant.
Interest	$0	$0	$9,000		Interest on loan for the lock-making machine. Based on the payment schedule from the banker.
Depreciation	$0	$0	$12,500		Half-year of depreciation on basic lock manufacturing machine purchased by JLC July 1. (Based on a conversation with accountant who says ½ year for first and last, with a straight line in between.)
Other expenses (specify)					
Other expenses (specify)					
Other expenses (specify)					
Misc. (unspecified)					
Subtotal Expenses	**$152,640**	**$283,030**	**$414,030**		

Revenue	Y1 Actual	Y2 Projection	Y3 Projection	Y2 Notes	Y3 Notes
Expenses					
Reserve for Contingencies					
Total Expenses					
Net Profit before Taxes	$47,360	$168,970	$232,970		
Federal Income Taxes	$9,470	$33,794	$46,594	20% federal income taxes. Do not anticipate change.	20% federal income taxes. Do not anticipate change.
State Income Taxes	$2,368	$8,448.50	$11,648.50	5% state income taxes. Do not anticipate change.	5% state income taxes. Do not anticipate change.
Local Income Taxes	$0	$0	$0		
Net Income	$35,520	$126,727.50	$174,727.50	Net income 32% as a percentage of sales. Up from 18% last year. Assumption—installer pays for themselves + some.	Net income is 31% as a percentage of sales. Assumption = sales increase to cover major expenses associated with the addition of machine, plus depreciation, plus property tax.

Note: The example shown has been created using a modified **SCORE Excel template**.

Disclaimer: *The business appearing in this work is fictitious. Any resemblance to an actual business is purely coincidental.*

Part 2: My Income Statement Projection

As you start the financial forecasting process refer to the following suggestions as needed:

1. **Current year:** Start with your current revenue and expenses.

2. **Projections:** From there, project whatever part of the Income Statement is easiest for you.

   2a. Assumptions and predictions: What are trends within your industry, your company and other factors that could impact your revenue and expenses over the coming years? For example, if you have a sick relative and need to travel to care for them, you may have an additional expense of hiring a COO. If you plan to grow the business, to take advantage of new opportunities in the market, your revenue may increase more from year to year than in the past. Make a note of these assumptions as you prepare for the next steps in your forecast. Some entrepreneurs like to list assumptions in the column to the right of their projections (as listed above for JLC) as a reference point.

   2b. Tip: Start with fixed expenses (or whatever is easiest for you). Some entrepreneurs find it easier to start with fixed expenses (e.g., rent, utilities). If you are not changing locations, these known expenses are relatively easy to nail down.

   2c. Do "likely scenarios" analyses: Check out *Forecasting Best and Worst Case Financial Scenarios* for different variations of this process. However, here in projections, you'll be including "most likely" scenarios versus "wouldn't it be great" scenarios. **Check out the example below using Jayne's Locksmith Company.**

Year 1	Year 2
JLC did five installations of 100 basic locks at commercial client buildings (total of 500 locks installed and $125K in revenue).	In her projections for Y2, Jayne decides it is reasonable to assume revenue will double with the business she has had to turn down, new projects in her region, and two part-time installers or one master installer.
JLC did 12 installations of 25 locks at residential client homes ($75K of revenue).	
Jayne, during Y1, had to turn down approximately 10 jobs (half commercial, half residential) from her existing clients because she was at capacity.	

WHAT IS YOUR “LIKELY SCENARIO”?

2d. Expenses: Now, begin to fill in some of your additional expenses beyond the fixed costs from step 1.

- Start with marketing—how much does it cost to buy and curate the email list (fee/subscription)? Follow up with those leads (sales staff + marketing collateral and giveaways).
- Fill in with additional fees that you may pay for supplies and professional services (design work, legal advice, etc.).
- Look at the categories in the spreadsheet and customize to your business.

FINAL STEPS: COMPARE, PROJECT AND ASSESS

Compare your projections to similar companies.

- Run the projections by your accountant or a financially minded peer or advisor.
- Look at certain key financial ratios. If they are significantly different than industry averages, make sure you understand why and can back it up. To learn more about key financial ratios, check out the *Calculate & Analyze Your Financial Ratios* excursion.
- Set a regular time to assess your projections. Ask the challenging questions, and take note of action items that can help you reduce expenses and increase revenues.

Use the profit and loss projection planner provided to practice forecasting revenue and expenses for your business.

Conclusion:

Forecasting can be a great tool to project revenue and cash flow and uses, as well as assets and liabilities in the coming year, and to give you insights into where your business is headed in the near future.