How To Prepare A Financial Forecast

Introduction

For first-time and experienced entrepreneurs, this tool was created as a guide that walks you through the process of creating a financial forecast by using examples, offering insight, and providing links to helpful third party resources.

Please consider that throughout this document a financial forecast will also be referred to as "Financial Projections", "Financial Model" and "Pro Forma Financials".

Below is a list of reasons of why it is important for you to have financial projections for your business. In the example below, we will ask you to imagine that you plan to open a cupcake business.

<u>In the example scenario in which you open a cupcake shop, please assume the following:</u>
1) You will profit $5 on every cupcake that you sell.
2) Before your business opens its doors, you will need to buy an oven, some supplies and your initial ingredients.
3) You anticipate that for every existing customer you will gain 2 more new customers the next month.
4) Your goal is to hire your first employee by month 6.
5) Your goal is to rent a space for your shop for the first two years, but then you plan to be producing
   enough cupcakes that you will want to buy a facility for $500,000 sometime during year 3.

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A Financial Forecast Is Important For an Early-Stage Company Because It:

1. **Determines the feasibility** of how your company plans to make money to grow.
   - How many cupcakes would you need to sell in order to pay your monthly rent, pay yourself, and have enough money left over to hire an employee by month 6?
   - Is that amount of cupcakes feasible considering the constraints of time, money, space, number of potential customers, etc.?

2. **Forecasts the cash investment needs** your business will require (initially and in the future).
   - How much money will you need to initially spend to buy an oven and the supplies that you'll need in order to start making your cupcakes?
   - In what month will you be making enough cupcakes that you outgrow your rented space and need to buy a facility? How much money will you have in your bank account at this time?
   - If you don't have enough money in your bank account to buy the new facility with cash, how much money will you need to raise from a loan, grant, or venture capital?

3. **Offers you a "game plan"** to help you, your team, advisors, and investors understand your vision.
   - Everyone should be on the same page and working toward the same goals on the same timeline

4. **Provides you a "scorecard"** that you can refer to when comparing what you anticipated your financial performance to be at a given time versus the actual numbers at that time.
   - Fast-forward to 12 months after you opened your business. Are you making more or less money than you projected in your financial forecast? Why?

5. **Supplies you a "vital signs chart"** that you can use to access the health of your company so you can prescribe solutions that lead to success.
   - Fast-forward to 12 months after you opened your business. If you have done better than your initial projections, what caused your success? How can you do more of what has made you successful?
   - If you have not been as successful as your initial projections predicted, what caused the shortcomings? What can you do to improve?

6. **Gives investors insight into your assumptions** used to project how your company will succeed.
   - Some potential investors may know nothing about the cupcake business, but your financial projections will help them understand the industry.
   - If an investor is going to give you money to buy your cupcake facility, they're going to want to understand how your business is going to grow to the extent that they profit on their investment.
   - Investors want to understand the upside-potential and downside-risk of funding your business. For example, how will it affect your revenue if each of your customers attracts 3 new customers (as opposed to the original assumption of 2 new customers)? What if they only draw 1 new customer?

It's All About Assumptions!

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Assumptions are things that you assume are true or predict will happen. People make assumptions based on past knowledge or by educating themselves on a particular subject. For example, if the sky is blue with no clouds then one would assume that it is not raining.

Financial forecasts are never 100% accurate at predicting the future performance of your business. Unless you have a time machine, you will have to develop assumptions around how your business will grow.

A List of Common Assumptions Needed For Financial Projections
Please see below for a list of common assumptions that you might be expected to make when creating your financial projections. Not every assumption listed will be relevant to your specific business. The sentences are incomplete so you can imagine filling in the blanks to complete the assumptions for your business.

- It will take my business ____ months to reach a particular goal.
- _____ needs to be purchased in order to start my business *(ex: equipment, property lease, etc.)*
- The $_____ in startup money needed in order to start and grow my business will come from _____ *ex: personal funds, grant, loan, equity investor, etc.).*
- We will sell ____ *(ex: 100, 70,000, 4,000,000, etc.)* units of product by month _____ *(1, 12, 18, etc.)*
- Each month my sales will grow by ____% *(ex: 25%, 50%, 400%, etc.)*
- My business will grow by ____ *(ex: 100, 1000, 5000, etc.)* customers each month.
- My business will have monthly expenses of $_____.
- Expenses will increase/decrease each year by _____% *(ex: 5%, 10%, 20%, etc.).*
- My business will have ____ *(ex: 2, 4, 10, etc.)* employees by month ____ *(ex: 1, 6, 18, etc.)*
- Employees will be paid $____ per month and each year their wages will increase by ___% *(ex: 5%, 10%, 20%, etc.).* I will be paid $_____ each month.
- Every $____ spent on marketing will produce ___ *(ex: 1, 20, 100, etc.)* new customer(s).
- A salesperson can sell ____ *(ex: 2, 20, 400, etc.)* units each month.
- Sales commissions paid to the salespeople will be ___% *(ex: 5%, 10%, 25%, etc.)* of each sale.
- The sales cycle is ____ days/months *(ex: 1, 6, 12, etc.)*
- The cost of the goods I use to create each unit of my product costs $_____.
- The costs to acquire a new customer will be $_____.
- Customers will be billed on a _____ basis *(ex: one-time-basis, monthly, quarterly, annual, etc.)*
- It will take _____ *(ex: 1, 6, 12, etc.)* days/months to receive payment from customers
- Taxes will be $____ per month.
- My business will burn through $_____ before we make money in month ____ *(ex: 1, 6, 12, etc.)*
- If I decrease or increase any of the above assumptions by a ___% *(ex: 5%, 10%, 20%, etc.)*, it would affect the financial health of my company by _____.

Don't Be Intimidated–BE EXCITED To Create Your Assumptions!

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- **Be excited about this opportunity.** By creating your forecast, you will come to understand your business better than you ever have before. Like peering into a crystal ball, this will be your first glimpse into what the future holds.

- **No one expects you to know everything.** Great entrepreneurs accept what they know versus what they don't know. You might know how to bake the tastiest cupcake in the world, but maybe you have no idea how to market your product and how much those efforts will cost.

- **Leverage your team.** If you have business partners, make building a financial forecast a team exercise. It's very possible your partners know an aspect of the business better than you.

- **Seek outside help.** Friends, family, past co-workers, community organizations, etc. are all resources you can turn to for further insight on your assumptions.

- **Do your homework.** Thoroughly research every aspect of your business represented in your projections.
  - Many industries will have competitors that are publically traded. With a quick internet search you should be able to find the financial statements for some of the most established players in your industry. These companies have spent years and boatloads of money on creating their financial statements. You can access these documents for free and use them as guides when creating your own projections. Click here to search for public companies' filings with the SEC.
  - Do your own primary research [insert customer discovery tool]
  - Are you a Software as a Service (SaaS) startup looking for industry benchmarks?
    - Click here for Part 1 of the 2015 Pacific Crest SaaS Survey
    - Click here for Part 2 of the 2015 Pacific Crest SaaS Survey

- **Make several versions (aggressive, moderate, and conservative) of your forecast.**
  - Because no one can accurately predict the future, it's advised that you make several versions of your forecast to reflect the following scenarios:
    - Aggressive – this forecast reflects your business success exceeding your expectations. For example, say you rationally assume that your sales will grow by 10% each month. In your aggressive forecast you would have sales maybe growing at 20% or more.
    - Moderate – this forecast will reflect your rational predictions. For example, if you rationally predict 10% sales growth, this forecast will reflect sales growing at 10%.
    - Conservative – this forecast will reflect your business falling short of your expectations. For example, if you rationally predict 10% sales growth, this forecast will reflect sales growing at 5% or maybe less.
  - Being prepared for different scenarios will build your confidence

Be Able To Explain Each One Of Your Assumptions

- **Be very critical** of the assumptions you include in your forecast. Second guess each of your assumptions until you clearly understand why you chose them.

- **Record every assumption** that you use in your financials so you can easily refer back to them.

- **Explain your assumptions thoroughly** to yourself and others. It is often more important to able to successfully explain the thought process and logic that you used to determine your assumptions than it is to be accurate at predicting the future.

- **Have research and data to refer to** (whenever possible) to support your assumptions.

Click here to read more thoughts on making assumptions

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Projecting Expenses and Revenues

Expenses
Expenses are often the easiest piece of your forecast to predict.

Click here for historical data that gives insight into the percentage of revenue that certain industries allocate to various common expenses. Please note that these industry benchmarks may not be relevant to your specific business.

You can break your expenses into four categories:

1) One-Time Expenses
    - These are expenses that you will only incur once, very infrequently, and/or irregularly.
    - Many of these expenses will be paid at the beginning of the life of your business.
    - *Examples: purchase of a building, realtor fees, purchase of office furniture*
    - On a scrap sheet of paper create a table similar to the one below. In the table you created try to list all the one-time expenses you plan to incur.

Name of Expense	Dollar Amount	Date
Office Furniture	$1,000	1/1/2016
	$	__ / __ / ____
	$	__ / __ / ____
	$	__ / __ / ____

2) Variable Expenses
    - Tied directly and proportionately to changes in production amount or number of units sold.
    - For example, if the raw materials used to make your product cost $2.00 per unit, then the costs will be $200 if 100 units are sold and $200,000 if 100,000 units are sold.
    - The total amounts of these expenses will likely change over time.
    - *Examples: raw materials, packaging, hourly production wages, sales commissions, inventory, shipping costs.*
    - On a scrap sheet of paper create a table similar to the one below. In the table you created try to list all the variable expenses you plan to incur.
        - The "Driver" column is for you to list the aspect of the business that a particular cost is tied directly and proportionately to. For example, the amount of packaging that you will need to buy will be directly proportional to the amount of units you sell. For instance, if you sell 100 units then you will need to purchase 100 units worth of packaging.

Name of Expense	Cost Per Unit	Driver
Packaging	$3.00	Amount of units sold
	$	
	$	
	$	

3) Fixed Recurring Expenses (non-labor)
- Are not dependent on changes in production amount or number of units sold.
- Whether you sell 100 units or 100,000 units, these costs will remain the same.
- They will likely be the same amount each week, month, year, etc.
- *Examples: rent, insurance, dues and subscriptions, equipment leases, payments on loans, depreciation, and advertising.*
- On a scrap sheet of paper create a table similar to the one below. In the table you created try to list all the fixed expenses (non-labor) you plan to incur.
  - o The "Frequency of Charge" column is for you to list how often you will have to pay that particular expense. Most fixed charges listed on your forecast will be on a monthly basis, but some charges might be on a quarterly basis or a bi-annual basis (2 charges a year).

Name of Expense	Dollar Amount	Frequency of Charge
Rent	$700	Monthly
	$	
	$	
	$	
	$	

4) Fixed Recurring Expenses - Labor Costs
- Labor costs are often the highest costs for early-stage companies
- Most financial projections will include a "Salaries" or "Headcount" tab or section
- Typically, labor costs are listed on a monthly basis
- There are generally 2 metrics to consider when you are determining labor costs:
  1) The annual pay for a specific position (divide number by 12 to determine the monthly pay).
  2) The hire date for each individual
- Please see below for a simple example of a labor costs section.
- On a scrap piece of paper or in an excel doc, try to create your own table similar to the one below.
  - o Remember, you're just making assumptions! Make your best guesses regarding how much money you will have to pay each position and when you will be hiring them.
  - o Use this tool for guidance on what the average pay for certain positions is in the US

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Title	Annual Pay	Monthly Pay	Hire Date	Jan	Feb	Mar	Apr	May	Jun
CEO	$60,000	$5,000	1/1/2016	$5,000	$5,000	$5,000	$5,000	$5,000	$5,000
Salesperson	$48,000	$4,000	3/1/2016			$4,000	$4,000	$4,000	$4,000
Call Rep	$36,000	$3,000	5/1/2016					$3,000	$3,000
Call Rep 2	$36,000	$3,000	6/1/2016						$3,000
				$5,000	$5,000	$9,000	$9,000	$12,000	$15,000

Revenue

- Revenue or a sales forecast can be challenging to predict.
- Revenue doesn't just happen, it is driven. It follows the law of cause and effect.
- When forecasting revenue, it is important to understand the drivers of your revenue.
- [Here is a very detailed article on identifying your revenue drivers](#)
- There are many possible metrics that could drive your revenue. Below is a list of some common ones:
  - Salespeople
  - Marketing
  - Number of customers
  - Average frequency of purchase (how often a single customer buys your product)
  - Average purchase volume (how many products a single customer buys)
  - Variety of products
  - Amount sold of each product
  - Prices of each product
  - Sales cycle (how long from start to finish does it take a salesperson to close a sale)
- See the below example. It may not be 100% relevant to how your business will calculate revenue in your forecast, but it demonstrates how multiple metrics drive revenue
- **Again, it's all about assumptions!** Below is an example forecast for next year for a new company. Let's image that we were able to get into the head of the creator of this forecast while they walked us through the assumptions they used for this example revenue projection.
  - Assumption #1 - The "# of Salespeople" figures were chosen just by reasoning that the company will begin with 1 salesperson and will gradually build up its salesforce.
  - Assumption #2 - The average salesperson productivity (how much a salesperson will sell) is 20 new customers a month. This number was chosen because the founder was a sales manager in a similar industry so they had a good idea of how productive the average salesperson will be.
  - Assumption #3 - 70% of customers will buy Product #1 and 30% will buy Product #2. This split was reasoned by looking at the public financial statements of a large industry competitor.
  - Assumption #4 - The price of Product #1 will be $10.00 and price of Product #2 will be $40.00. These price points were determined by doing extensive in-store and online research into the prices that competitors are currently selling similar products.

	Jan	Feb	Mar	Apr	May	June
# of Salespeople	1	1	2	3	6	6
Average Salesperson Productivity	20	20	20	20	20	20
Number of Customers	20	20	40	60	120	120
% of Customers Who Buy Product #1	70%	70%	70%	70%	70%	70%
% of Customers Who Buy Product #2	30%	30%	30%	30%	30%	30%
# of Product #1 Sold	14	14	28	42	84	84
# of Product #2 Sold	6	6	12	18	36	36
Price of Product #1	$10.00	$10.00	$10.00	$10.00	$10.00	$10.00
Price of Product #2	$40.00	$40.00	$40.00	$40.00	$40.00	$40.00
Total Sales	$380.00	$380.00	$760.00	$1,140.00	$2,280.00	$2,280.00

([Click here for a graphic further explanation of the above table](#))

- Here's a walkthrough of how "Total Sales" is calculated in the example table above:
    1. On average, each salesperson will be productive enough to sell to 20 customers
    2. Of the 20 customers that each salesperson sells to, 70% of the 20 will buy Product #1 and 30% will buy Product #2. That means that 14 of the 20 customers will buy Product #1 and 6 of the 20 customers will buy Product #2.
    3. The 14 customers who buy Product #1 will pay $10.00 each which will total $140 (14 x $10.00)
       The 6 customers who buy Product #2 will pay $40.00 each which will total $240 (6 x $40.00)
    4. The Total Sales generated by 1 salesperson equals $380 ($140 + $240)
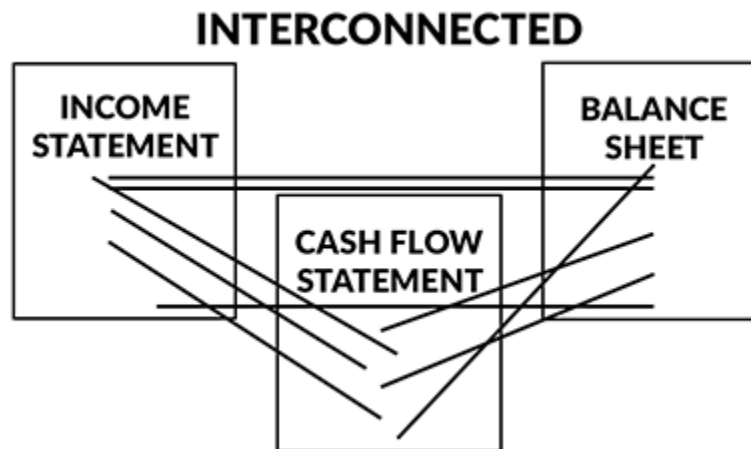
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The Three Financial Statements

The 3 common financial statements are:
1. The Income Statement
2. The Cash Flow Statement
3. The Balance Sheet

The most impactful financial forecasts will include all 3 statements.

The Statements Are Interconnected

- The Income Statement has numbers that flow into the Cash Flow Statement, the Cash Flow Statement has numbers that flow into the Balance Sheet, the Balance Sheet has numbers that flow into the Income Statement, etc.
- For example, the Income Statement calculates the net income or net loss for the month. That net income/loss is used at the top of the Cash Flow Statement to determine how much cash came into the bank account or went out of the bank account from operating activities for that month. The Cash Flow Statement uses the inflow/outflow of cash from operating activities in an equation to determine how much cash is left in the bank account at the end of the month. That ending cash balance from the Cash Flow Statement is then used as the month-end cash position at the top of the Balance Sheet.
  - Please do not be intimidated by the above example. It's just an example to further get across the point that the 3 statements are very much connected to each other.
- For those who are more familiar with the 3 statements but are looking for a refresher on how they are connected, click here for a graphic representation of the interconnectedness of the statements.
- If you plan to create your own financial forecast in excel from scratch, seek to use formulas that link interconnected cells found across the statements.
  - For example, the cell on the Cash Flow Statement for net income should be equal to the cell on the Income Statement that calculates the net income

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Income Statement

The income statement measures profitability over a period of time (month, quarter, year)

Profitability = revenue – expenses

- o Another word for "profit" is "net income" or "net profit"
- o If during one month you sold 500 cupcakes at $5.00 each then your <u>revenue = $2,500</u>
- o If your ingredients cost you $1.00 a cupcake then your cost of goods sold expense was $500
- o Let's say your monthly rent expense was $1,000, marketing expenses were $250, and your tax expenses were $250
- o If you had no other expenses that month, your <u>total expenses = $2,000</u> ($500+$1,000+$250+$250)
- o <u>Profitability = $2,500 - $2,000</u>
- o <u>Click here for some insight into common net profit margins for various industries</u>

Gross Margin is important

- o Gross margin is the dollar amount or percent of total sales revenue that the company retains after incurring the direct (variable) costs associated with producing the goods and services
- o Gross Margin = Sales Revenue – Cost of Goods Sold
- o In the above example, Gross Margin = $2,000 ($2,500-$500)
- o Gross Margin is often measured as a % of Sales Revenue
    - ▪ In the example above…$2,000/$2,500 = 80% gross margin.
- o <u>Click here for an article that explains the importance of paying attention to Gross Margin</u>
- o <u>Click here for an index of gross margins by industry</u>

- **Don't confuse profitability with cash**
    - o If you are practicing "accrual accounting (GAAP accepted)" versus "cash accounting", you will have to consider how long it takes you to collect money (accounts receivables) from your customers. <u>Click here for an article that further clarifies the Accrual vs Cash accounting methods</u>
        - ▪ For example, let's say you sell $2,000 worth of cupcakes to a restaurant on June 1. It is likely they are not going to hand you $2,000 in cash the day you deliver the cupcakes. It is likely that you will invoice the restaurant and they might not send you a check that you can cash for 30+ days. In summary, you are recording $2,000 in revenue at the top of your Income Statement for June, but you don't see any cash from that sale until possibly 30+ days later in July.
    - o If you receive investment dollars through equity investment, grant, or a loan the inflow of cash <u>does not</u> belong on the Income Statement
- **Examples of Income Statements**
    - o <u>Click here for an example of an income statement for a traditional company</u>
    - o <u>Click here for an example of an income statement for a software as a service (SaaS) company</u>

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Cash Flow Statement

The Cash Flow Statement reports the cash generated and used over a period of time (month, quarter, year). The statement allows you to understand how much cash is left in the bank at the end of a given month.

Since a business cannot survive without cash, a forecasted cash flow statement is a critical tool for a startup because it allows them to know how much cash they need to start with and how much they will need to raise from investors at any given point of time in order to achieve each milestone goal they've set for themselves.

Never run out of cash. To use an analogy: you can live a while without food, but you cannot live without constantly needing air. Think of profit as food and cash as air.

Burn Rate is vitally important. The Cash Flow Statement calculates the Burn Rate—the rate at which a company uses up its supply of cash over time. Click here to learn more about Burn Rate.
- Read a venture capitalist's opinion on "the right burn rate for a startup"

There are traditionally 3 sections of a Cash Flow Statement
1. Operating Activities – cash gained/lost from actual business operations.
   - Indicates the business' ability to generate sufficient cash from its continuing operations
2. Investing Activities – cash gained/lost from buying (and selling) property, plants, and equipment (PPE) and purchasing (and selling) long-term investments
   - Indicates how the business plans to expand
3. Financing Activities – cash gained/lost from issuance and reacquisition of a firm's debt and capital stock, and dividend payments
   - Indicates how the business plans to finance its expansion and/or reward shareholders.

Cash Flow Statement	
Example Company	
October 2016	
Cash Flow From Operations	
Net Income	$ 100,000
Sources of Cash	
Depreciation	$ 20,000
Decrease in Accounts Receivable	$ 15,000
Increase in Accounts Payable	$ 40,000
Increase in Taxes Payable	$ 2,000
Uses of Cash	
Increase in Inventory	$ (50,000)
Net Cash From Operations	$ 127,000
Cash Flow From Investing	
Purchase of Property	$ (100,000)
Purchase of Equipment	$ (40,000)
Net Cash From Investing	$ (140,000)
Cash Flow From Financing	
Sources of Cash	
Common Stock Investment	$ 20,000
Uses of Cash	
Payment of Loan	$ (5,000)
Net Cash From Financing	$ 15,000
Net Increase/Decrease in Cash	$ 2,000

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Balance Sheet

The Balance Sheet displays a company's assets, liabilities and shareholders' equity at a specific point in time.

- Assets – what a company owns
- Liability – what a company owes
- Shareholders' Equity – the amount invested in the company by shareholders

The total dollar value of your assets must equal the sum of your total liabilities + total shareholders' equity.

$$Assets = Liability + Shareholders' Equity$$

Startups should have a balance sheet
- You need a balance sheet to create a cash flow statement to ultimately understand how much cash you can forecast to have in your account at a given time in the future
- Balance sheets help owners understand how much money has been put into the company and what has been purchased with that money.

Examples of Balance Sheets
- [Click here to see an example of a traditional balance sheet along with explanations for each line item](#)
- [Click here for an example of what a forecasted balance sheet might look like for a SaaS startup business](#)

Templates and Resources

In additional to our list below of suggested templates, [click here for a larger index of resources (including templates) for financial modeling.](#)

Traditional Business Model

The below templates would work best for a company with a "traditional" business model. Some of the general characteristics of this type of business would be:
- Cost of goods sold
- No recurring subscription revenue
- [Direct variable expenses](#)

Templates for Traditional Business Model
1. [Click here for the SCORE Financial Projections Tool Guide](#) and [the SCORE Financial Projections Template Spreadsheet](#)
   - The guide and accompanying spreadsheet are great resources for entrepreneurs who have less experience with financial modeling
   - [Click here for a completed sample template](#) and [here for more SCORE Templates](#)

Software as a Service (SaaS) Business Model

Software as a Service (SaaS) businesses host applications that they make available to customers over a network, typically the Internet.
- Usually SaaS businesses will recognize recurring revenue through charging customers annual or monthly subscription fees.
- [Click here for a list of examples of SaaS companies and a helpful video further explaining the model](#)
- [Here is a detailed explanation of metrics a SaaS business should be paying attention to as it grows](#)

Templates for SaaS Business Models
1. [Download the free template found in this blog post.](#) Please read the instructions include in the post.
   - This model includes an Income Statement and a Cash Flow Statement but not a Balance Sheet.

Freemium Business Model

In a Freemium business model a company gives away a core product for free and then generates revenue by selling premium products to a small percentage of free users. [Click here to learn more about freemium.](#)

Templates for Freemium Business Models
1. [Click here for instructions and a free download of an excel spreadsheet freemium forecast](#)
2. Click here for a free downloadable template along with a detailed explanation of a freemium model.

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