Time to plan

The art and science of financial forecasts

By Don Sadler

OF ALL THE financial tasks performed by small businesses, preparing accurate financial forecasts may be the most important. All major business decisions flow from these forecasts: decisions about hiring, borrowing, spending and investing in new equipment, facilities and product lines, for example.

"Time spent forecasting is time well spent," says Gene Siciliano, a Costco member and the president of Western Management Associates (*www.cfoforrent.com*) in Los Angeles. "Forecasting helps you determine ahead of time whether you'll be able to take advantage of potential opportunities or need to take steps to mitigate potential problems. It gives you more time to think through how you'll react to certain financial situations."

Art or science?

Creating financial forecasts is both an art and a science: art in the sense that it involves some creativity in making future assumptions, and science in the sense that the exercise is based in part on historical data. "The science comes from recognizing that the future is uncertain, and then measuring and handling these uncertainties in a quantitative manner," says Gerald A. Bush, a Costco member and the chairman of Decision Strategies (*www.decisionstrategies.com*) in Atlanta.

Due to its inherent uncertainty, financial forecasting is less about coming up with exact figures and more about projecting a realistic range of possible numbers. "Good forecasting creates bookends around a reasonable range of possible outcomes," says Bush. "It uses the knowledge of subject-matter experts to talk through what factors could create upside or downside results."

Siciliano points to several potential benefits of forecasting, including more accurate and consistent pricing, higher profitability (even during sales slowdowns) and the ability to avoid cash-flow crunches. A financial forecast is also usually required in order to obtain bank financing, he notes.

"Banks want to lend to businesses that can demonstrate the ability to generate enough revenue to pay expenses, earn a profit and repay the loan," he says. "Therefore, they generally want to see financial forecasts for the next two to three years, including a sales forecast, anticipated cash inflows and outflows, and a realistic cash-flow budget."

Start by looking back

The best way to start the financial forecasting process is by looking backward at your company's recent financial history—specifically, the past six to 12 months. Then make pro forma revenue and expense projections on your financial statements.

"In projecting revenue, start with your sales from the prior year and adjust these up or down," says Howard Goldman, a Costco member and partner with CFO Edge (*www.cfoedge.com*) in Los Angeles, a provider of outsourced chief financial officer (CFO) services. "Based on economic and market conditions and your planned sales and marketing efforts, do you expect sales to be higher or lower, and by what percentage, in the coming year?"

The next step is to project your company's income (or cash flow) for each month of the upcoming year. "This is critical," says Goldman, "because sales and income are two different things. If your company offers 30-day vendor terms, for example, sales made in March should become cash receipts in April."

On the other side of the ledger are your business expenses, which Goldman says fall into three broad categories. Fixed expenses, aka overhead, stay fairly consistent from month to month, and include things such as rent or mortgage, utilities, payroll and other selling, general and administrative expenses. Variable expenses, meanwhile, fluctuate based on sales volume and marketing efforts. These include commissions, advertising and marketing, and travel and entertainment.

Finally, there are the direct costs incurred in the manufacture and/or delivery of products or services; these are referred to as "cost of goods sold," or CGS. "For example, inventory and raw materials would be considered CGS for a typical manufacturing company," says Goldman.

Pulling everything together

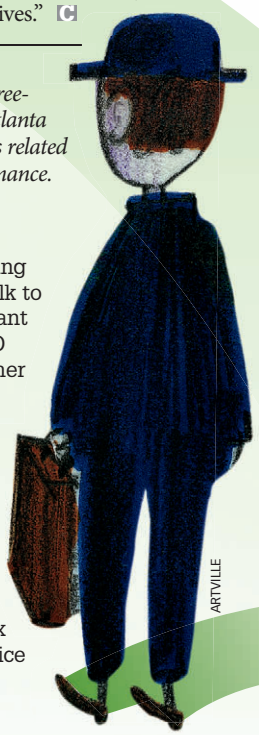
With these pro formas in hand, you can now make profitability projections. Subtracting CGS from total sales will yield projected gross profit, while subtracting fixed and variable expenses and taxes from gross profit will yield net profit, or your projected bottom line.

"The most useful aspect of financial forecasting is the ability to make better business decisions," says Bush. "A forecast doesn't need to 'boil the ocean' by being overly detailed. It only needs to provide sufficient information to help business owners confidently select between viable alternatives." C

Don Sadler, don@donsadlerwriter.com, *is a freelance writer based in Atlanta who specializes in topics related to small business and finance.*

Resources

FOR HELP IN preparing financial forecasts, talk to your banker, accountant or an outsourced CFO services provider. Other sources of assistance include Small Business Development Centers (SBDCs) and the Service Corps of Retired Executives (SCORE); go to *www.sba.gov* and click on the "Find Resources" box to locate an SBDC office or SCORE executive near you.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