A QUICK START GUIDE TO FINANCIAL FORECASTING

Discover the secret to driving **growth**, **profitability**, and **cash flow** higher

PHILIP CAMPBELL

Foreword by
Steve Player

Look What Entrepreneurs, Business Owners, Investors, and Advisors Are Saying About This Gem of a Book

"Philip's approach to financial forecasting has helped us completely turn around our profitability and cash flow and get it moving in a positive direction. I love the way he speaks and writes in a way that is simple and easy-to-understand. The principles in *A Quick Start Guide to Financial Forecasting* have become an integral part of how we plan and manage our financial future every month."

—Andrea Sato, Chief Executive Officer,
Gary's Vacuflo, Inc.

"Cut out the chart **Building a Financially Strong Business** in the bonus chapter. Pin it, tape it, or post it where you can see it daily. Follow every step on there. Then use what Philip teaches in this book to make it happen. It will help turn your business into a secure, financially strong generator of CASH."

—Stan Touchstone, Owner,
Kissimmee Valley Feed and Ranch Supply, Inc.

"A Quick Start Guide to Financial Forecasting takes a natural law 'What you focus on you are more likely to achieve' and translates it into a practical tool for improving your financial performance in business. Philip is your expert guide to using this often-overlooked tool, a reliable financial forecast, to create the view through the financial windshield of your business. You are going to love the tips and tools he shares in the book."

—Larry Tyler, Business Advisor,
Author, *Romancing the Loan*

"Thought provoking and detailed. Not only does Philip explain how to prepare a financial forecast, but he also helps you to understand the value and benefits of forecasting."

—Joanna Vu, CPA

"Philip Campbell has a special knack for helping business owners uncover financial insights that others miss. *A Quick Start Guide to*

Financial Forecasting is a brilliant example of his talent for helping entrepreneurs use insightful, forward-looking financial information to develop a bigger and brighter financial future for their company."

—Ed Lette, Founder, President and CEO,
Business Bank of Texas

"This book provides an incredibly useful tool for entrepreneurs and finance people alike. It paints a compelling picture of the power of developing a more forward-thinking approach to financial performance. And I love the bonus chapter on how to assess the quality of a company's accounting department. Very enlightening!"

—Patrick Finn, CPA, Principal, Finnancial Group, LLC

"Many business owners and managers exhaust themselves and their employees trying to overcome strategic problems with brute force in their day-to-day efforts. They're working hard and moving fast, but they're moving in the wrong direction. As a CPA and consultant to small/medium-sized construction and manufacturing firms, I see this with nearly every new client. They've run themselves ragged trying to figure out what's been happening to their business in recent years. When they finally approach our firm and the first question from me is about their forward operational planning and not about their historical numbers it comes as a shock.

This is nearly always the case; businesses are trying to compensate for their lack of strategic planning and forecasting with short-term Band-Aids and feel-good, immediate solutions that at best prolongs the problem and at worse dooms the business to failure in the long term. That's why the principles and tools in *A Quick Start Guide to Financial Forecasting* are so important to business owners and managers. Whether this is your first exposure to forecasting or you're a seasoned CFO with a talented FP&A staff, reading and applying these principles will seriously sharpen your financial skillset.

By providing clear motivation for why any business over a couple million in revenue needs a forecast, a clear process to create a forecast, and removal of common barriers to forecasting, Mr. Campbell has penned a recipe for forecasting success and proven this recipe with examples throughout the book. Use what you learn from this book to speak with confidence to your lenders and investors when approaching expectations for coming months. Make better strategic decisions like expanding into new sales territories or shutting down an operation. Use a forecast as a bellwether to know if bad times are approaching.

I'm recommending *A Quick Start Guide to Financial Forecasting* to my clients and I highly recommend you read it too."

—James H. Johnson, CPA, CITP, CGMA, MBA,
Trainer, Wright, & Paterno CPAs

"The same way a pilot creates a flight plan and checks the weather forecast along their route, *A Quick Start Guide to Financial Forecasting* provides the view of where you want to take your business and helps you plan the route that will get you there safely and on time."

—Ali A. Mohammed,
Managing Director, Ramco International (U) Ltd

"Philip Campbell has a unique talent for taking complex financial subjects and simplifying them so that every business can benefit. His knowledge and background are apparent in his depth of understanding of such difficult financial subjects as cash flow and forecasting. I have added *A Quick Start Guide to Financial Forecasting* to my list of required reading for entrepreneurs and business owners—a list which already includes Philip's first book *Never Run Out of Cash*."

—Mark A. Adam B.A., B.Sc., M.B.A.,
Lecturer (Sessional) in Finance,
School of Business and Economics,
Thompson Rivers University

"I enjoyed the focus on simplicity and the value of treating the forecasting process as a top-down exercise. The book provides specific tips and tools for those new to forecasting as well as the seasoned forecaster."

—Jennie Enholm, CPA, CGMA

"I enjoyed and was challenged by the 'think top-down, not bottom-up' approach Philip Campbell teaches in this book. It will change the way you think as a business owner and help you drive different behavior throughout your company. *A Quick Start Guide to Financial Forecasting* is easy-to-read and provides engaging stories and examples you will find very relatable…and actionable.

I believe a business owner that is making some money, but not getting where he/she really wants to be, will benefit the most from this book. Sometimes business owners find themselves depressed for not having done 'all the right things'. This book will inspire you to buckle down, take steps to create a reliable, top down overview and forecast, then hone in on where your business is truly going. THEN you can align it to where YOU want it to go!

I also believe that business owners that might not be making money, those that may have overpaid for their business or are overleveraged, will discover that Philip's approach to financial forecasting will play a large role in their recovery."

—John Albers, President/CEO, The Albers Group, LLC

Chapter 3

10 Rules for Creating a Forecast You Can Trust

"The few things that work fantastically well should be identified, cultivated, nurtured, and multiplied."

—Richard Koch, *The 80/20 Principle*

The 10 rules I walk through in this chapter are incredibly important as you get started in forecasting. They form the foundation you will need to make sure you get started on the right foot. Please spend a few extra minutes to read (and re-read) each one. Put some serious thought into each rule. I promise you that the extra time you spend with these rules, or principles, will pay dividends and ensure you create a forecasting process you can trust.

1. It's all about decision making, not precision
2. Think top-down, not bottom-up
3. Model a full set of financial statements
4. First look back, then look forward
5. Understand the high-level company strategy and expectations
6. Simplify, simplify, simplify

7. Create a repeatable process
8. Be conservative
9. Condense the results to a 2-minute summary
10. Start for your eyes only

Let's look at each one.

Rule #1. It's All About Decision Making, Not Precision

One thing that may be stopping you from creating a forecast is that little voice in your head saying, "But I don't know exactly what the future holds—what if I'm wrong in my forecast?" That fear of being wrong is rooted in the mistaken idea that a forecast should be "accurate."

Transaction processing and creating historical financial statements is about being right. (Here, precision is your friend.) On the other hand, forecasting is about improving the company's ability to make wise decisions. (Here, precision is your enemy.)

Here is an example. Let's say at the beginning of the year you told your bank and outside investors that your plan was to increase pre-tax income to $1.1 million this year and reduce debt by $750,000. Results for the first half of the year had come in better than budget and you were feeling confident. Now it's mid-year and you are updating your monthly forecast for the remainder of the year.

From a decision-making perspective, the question is whether the company has a good shot at hitting the full year pre-tax income and debt reduction targets or not. If the company is likely to hit the targets, then your management team's focus should be on continuing to execute the existing plan. If the targets are in jeopardy, then you and your team need to evaluate what's not working and make changes now to get back on track to hit the financial targets.

After you review the forecast it becomes clear that the last half of the year is likely to come in far below the first half. Figure 3-1 is a summary of the resulting forecast compared to last year and the plan for this year.

Figure 3-1

FORECAST SUMMARY

(Amounts in Thousands)

	Last Year (Actual)	**This Year** (Plan)	**This Year** (Forecast)
Revenues	$6,250	$7,500	$7,000
Gross margin	23.4%	24.0%	23.0%
Pre-tax income	**$813**	**$1,125**	**$800**
Cash	$875	$1,000	$500
Accounts receivable	$1,113	$1,000	$1,300
Distributions to owners	$325	$450	$600
Debt	**$2,500**	**$1,750**	**$2,500**

Is a forecast always right? No. Is pre-tax income likely to come in at precisely $800,000? No.

From a precision perspective, lots of questions will arise such as what will actual revenues and expenses turn out to be, which of your current prospects will turn into actual customers, will there be employee turnover that could disrupt the business, will a specific customer pay their invoice by the due date, and a host of other detailed questions that you would need to know to arrive at a precise estimate of pre-tax income and cash available for debt reduction.

But what is very clear in the forecast is there is a substantial risk of missing the pre-tax income and debt reduction targets for the year. It is crystal clear based on the forecast that management attention is required in order to get the company back on track for the last half of the year.

Chasing precision will only serve to cloud the message and distract from the important work of getting the company back on track to meeting its financial goals.

> "Debating 'what is the right number' is a waste of management time. Instead, the focus should be on 'what is the range of possible outcomes.'"
>
> —Steve Morlidge and Steve Player, *Future Ready: How to Master Business Forecasting*

Rule #2. Think Top-Down, Not Bottom-Up

Although creating historical financial statements is a bottom-up process of gathering and recording thousands of transactions and reporting the results in the form of accurate financial statements, creating a financial forecast is a top-down exercise. You are connecting the company's vision and strategy to the likely financial implications of achieving that strategy.

Forecasting uses big-picture drivers and assumptions to create a model of what the financial statements may look like based on existing trends and plans. You have to take yourself up to the 30,000-foot level and look down on the business financially as you forecast. It's about painting a picture of what the financial results will likely be based on your knowledge and intuition rather than actual transactions. Your forecast looks at the strategic view and direction of where the company is going—not the nitty-gritty bottom-up details.

Consider the many assumptions that go into creating a fully modeled set of financial statements. In the income statement, you forecast revenues, cost of sales, operating expenses, and net income. On the balance sheet, you forecast monthly balances for cash, accounts receivable, inventory, property and equipment, accounts payable, accrued liabilities, debt, and equity balances. A bottom-up approach to create those assumptions is overly complex and counterproductive.

Thinking top-down will help you resist the temptation to drive your estimates and assumptions down to the lowest level.

Rule #3. Model a Full Set of Financial Statements

A reliable financial forecast is a living, breathing tool that is updated monthly. The basic format should track with your existing financial statements (income statement, balance sheet, and statement of cash flows in the same format you use for monthly financial reporting) for at least the next six to eighteen months. Figures 3-2 through 3-4 show a full set of monthly financial statements as an example. We'll talk more about ABC Construction Company as a real world forecasting example in Chapter 5.

Rule #4. First Look Back, Then Look Forward

One of the biggest mistakes entrepreneurs (and CFOs) make in creating a forecast is to start with a clean slate. They pull up a blank spreadsheet and begin thinking about what the first month in the forecast will look like. The problem is you unhook your forecast from reality when you do that.

The first step should be to drop in actual results for the last six to eighteen months (or more). Have the revenues and expenses been coming in the way you expected them to? Can you see a trend developing? Are you surprised by any of the numbers now that you are looking at the last six to eighteen months of actual results next to each other?

Once you have a good view of what the financial results have been over the last six to eighteen months, you want to look at some of the

Figure 3-2: **INCOME STATEMENTS – Prior Year**

ABC Construction Company	Actual Jan	Actual Feb	Actual Mar	Actual Apr	Actual May	Actual Jun	Actual Jul	Actual Aug	Actual Sep	Actual Oct	Actual Nov	Actual Dec	Actual Year
Number of projects	15	16	14	15	15	17	19	19	15	14	15	15	15
Average revenue per project	$129,550	$133,599	$155,738	$115,181	$132,477	$128,581	$109,294	$130,551	$143,284	$135,096	$119,785	$99,108	$1,602,864
Revenues	$1,943,256	$2,137,582	$2,180,333	$1,727,710	$1,987,156	$2,185,871	$2,076,578	$2,480,467	$2,149,258	$1,891,347	$1,796,780	$1,486,619	$24,042,956
Total	1,943,256	2,137,582	2,180,333	1,727,710	1,987,156	2,185,871	2,076,578	2,480,467	2,149,258	1,891,347	1,796,780	1,486,619	24,042,956
Cost of good sold	1,663,427	1,791,293	1,855,464	1,489,286	1,683,121	1,840,504	1,731,866	2,120,799	1,818,272	1,647,363	1,520,076	1,250,246	20,411,717
Gross profit	279,829	346,288	324,870	238,424	304,035	345,368	344,712	359,668	330,986	243,984	276,704	236,372	3,631,239
	14.4%	16.2%	14.9%	13.8%	15.3%	15.8%	16.6%	14.5%	15.4%	12.9%	15.4%	15.9%	15.1%
OPERATING EXPENSES													
Employee wages & taxes	101,467	104,638	121,978	110,638	127,252	112,612	110,490	111,441	116,897	116,870	103,625	110,690	1,348,598
Rent	14,750	14,820	14,760	15,357	17,663	14,800	14,800	14,800	14,800	14,800	14,800	14,800	180,950
Advertising & marketing	5,328	5,495	6,405	4,737	5,448	5,288	4,495	5,369	5,893	5,556	4,926	4,076	63,016
Insurance	12,480	12,870	15,003	11,096	12,762	12,387	10,529	12,576	13,803	13,014	11,539	9,547	147,606
Telephone & utilities	3,544	3,655	4,260	3,151	3,624	3,517	2,990	3,571	3,920	3,696	3,277	2,711	41,916
Travel, meals & entertainment	2,853	2,942	3,430	2,537	2,917	2,832	2,407	2,875	3,155	2,975	2,638	2,183	33,744
Professional fees	4,500	4,641	5,410	4,001	4,602	4,466	3,796	4,535	4,977	4,693	4,161	3,443	53,223
Office expenses	2,980	3,073	3,582	2,649	3,047	2,958	2,514	3,003	3,296	3,108	2,755	2,280	35,246
Depreciation & amortization	5,475	5,475	5,475	5,475	5,475	5,475	5,475	5,475	5,475	5,475	5,475	10,350	70,575
All other	5,496	5,668	6,607	4,886	5,620	5,455	4,637	5,538	6,079	5,731	5,082	4,205	65,003
Total	158,873	163,276	186,910	164,527	188,411	169,790	162,132	169,184	178,295	175,918	158,278	164,284	2,039,877
Operating income	120,956	183,012	137,960	73,897	115,624	175,578	182,580	190,484	152,691	68,066	118,426	72,088	1,591,362
Interest expense	8,237	8,162	8,087	8,012	7,937	7,862	7,787	7,712	7,637	7,562	7,487	7,412	93,900
Other expense (income)	0	0	0	0	0	0	0	0	0	0	0	0	0
Total	8,237	8,162	8,087	8,012	7,937	7,862	7,787	7,712	7,637	7,562	7,487	7,412	93,900
Pretax income	$112,718	$174,850	$129,872	$65,885	$107,686	$167,716	$174,792	$182,771	$145,054	$60,504	$110,938	$64,676	$1,497,462
As % of revenues	5.8%	8.2%	6.0%	3.8%	5.4%	7.7%	8.4%	7.4%	6.7%	3.2%	6.2%	4.4%	6.2%
EBITDA	126,431	188,487	143,435	79,372	121,099	181,053	188,055	195,959	158,166	73,541	123,901	82,438	$1,661,937

Figure 3-3: **BALANCE SHEETS – Prior Year**

ABC Construction Company	Actual Jan	Actual Feb	Actual Mar	Actual Apr	Actual May	Actual Jun	Actual Jul	Actual Aug	Actual Sep	Actual Oct	Actual Nov	Actual Dec
ASSETS												
Cash	$1,143,471	$1,340,165	$1,381,504	$1,024,989	$1,234,820	$1,445,426	$1,515,779	$2,053,095	$1,763,674	$1,470,734	$1,439,566	$826,313
Accounts receivable	2,946,231	2,924,855	2,968,462	2,916,631	2,876,887	2,920,605	2,858,308	2,932,722	2,975,707	3,013,534	2,959,630	2,915,032
Inventory	163,581	181,494	144,385	189,063	222,726	185,916	237,872	174,248	137,882	104,935	150,537	188,045
Costs & estimated earnings in excess of billings on uncompleted contracts	209,134	132,807	162,429	248,684	193,571	236,761	219,316	162,362	142,879	216,396	217,033	245,177
Other current assets	24,876	25,876	25,876	25,876	25,876	25,876	25,876	23,376	23,376	23,376	23,376	23,376
Total current assets	4,487,293	4,605,197	4,682,656	4,405,243	4,553,880	4,814,584	4,857,149	5,345,802	5,043,518	4,828,975	4,790,142	4,197,942
Machinery & equipment	202,333	202,333	217,878	217,878	221,468	221,468	221,468	245,457	245,457	249,927	249,927	249,927
Furniture, fixtures & equipment	251,590	251,590	251,590	251,590	251,590	251,590	251,590	251,590	251,590	251,590	251,590	251,590
Gross property	453,923	453,923	469,468	469,468	473,058	473,058	473,058	497,047	497,047	501,517	501,517	501,517
Less: accumulated depreciation	(150,000)	(155,475)	(160,950)	(166,425)	(171,900)	(177,375)	(182,850)	(188,325)	(193,800)	(199,275)	(204,750)	(215,100)
Net property	303,923	298,448	308,518	303,043	301,158	295,683	290,208	308,722	303,247	302,242	296,767	286,417
Total Assets	$4,791,216	$4,903,645	$4,991,174	$4,708,287	$4,855,038	$5,110,267	$5,147,358	$5,654,524	$5,346,765	$5,131,217	$5,086,910	$4,484,359
LIABILITIES & EQUITY												
Accounts payable & accrued liabilities	$1,684,389	$1,813,867	$1,878,845	$1,508,053	$1,704,331	$1,863,697	$1,753,690	$2,147,525	$1,841,185	$1,668,123	$1,539,231	$1,266,001
Short-term notes payable	478,250	468,250	458,250	448,250	438,250	428,250	418,250	408,250	398,250	388,250	378,250	368,250
Billings in excess of costs & estimated earnings on uncompleted contracts	679,321	577,423	560,100	672,120	604,908	623,055	685,361	705,922	649,448	636,459	700,105	721,108
Total current liabilities	2,841,960	2,859,539	2,897,196	2,628,424	2,747,489	2,915,002	2,857,301	3,261,697	2,888,883	2,692,832	2,617,586	2,355,360
Notes payable	1,169,245	1,164,245	1,159,245	1,154,245	1,149,245	1,144,245	1,139,245	1,134,245	1,129,245	1,124,245	1,119,245	1,114,245
Owner's investment	500,000	500,000	500,000	500,000	500,000	500,000	500,000	500,000	500,000	500,000	500,000	500,000
Owner distributions	(570,000)	(645,000)	(720,000)	(795,000)	(870,000)	(945,000)	(1,020,000)	(1,095,000)	(1,170,000)	(1,245,000)	(1,320,000)	(1,720,000)
Retained earnings	850,011	1,024,861	1,154,733	1,220,618	1,328,304	1,496,020	1,670,812	1,853,583	1,998,637	2,059,140	2,170,079	2,234,755
Total equity	780,011	879,861	934,733	925,618	958,304	1,051,020	1,150,812	1,258,583	1,328,637	1,314,140	1,350,079	1,014,755
Total liabilities & equity	$4,791,216	$4,903,645	$4,991,174	$4,708,287	$4,855,038	$5,110,267	$5,147,358	$5,654,524	$5,346,765	$5,131,217	$5,086,910	$4,484,359

Figure 3-4: **STATEMENTS OF CASH FLOWS – Prior Year**

ABC Construction Company	Actual Jan	Actual Feb	Actual Mar	Actual Apr	Actual May	Actual Jun	Actual Jul	Actual Aug	Actual Sep	Actual Oct	Actual Nov	Actual Dec	Actual Year
Pre-tax income	$112,718	$174,850	$129,872	$65,885	$107,686	$167,716	$174,792	$182,771	$145,054	$60,504	$110,938	$64,676	$1,497,462
Depreciation and amortization	5,475	5,475	5,475	5,475	5,475	5,475	5,475	5,475	5,475	5,475	5,475	10,350	70,575
Decrease (increase) in accounts receivable	(15,679)	21,376	(43,607)	51,831	39,743	(43,717)	62,297	(74,414)	(42,985)	(37,827)	53,903	44,599	15,520
Decrease (increase) in inventory	3,425	(17,913)	37,109	(44,679)	(33,662)	36,810	(51,956)	63,624	36,365	32,947	(45,602)	(37,507)	(21,039)
Decrease (increase) in costs & estimated earnings in excess of billings on uncompleted contracts	(11,745)	76,327	(29,622)	(86,255)	55,114	(43,190)	17,446	56,953	19,483	(73,518)	(636)	(28,144)	(47,788)
Decrease (increase) in other current assets	1,250	(1,000)	0	0	0	0	0	2,500	0	0	0	0	2,750
(Decrease) increase in accounts payable & accrued liabilities	(18,902)	129,478	64,979	(370,792)	196,278	159,366	(110,007)	393,835	(306,339)	(173,063)	(128,892)	(273,230)	(437,290)
(Decrease) increase in short-term notes payable	(10,000)	(10,000)	(10,000)	(10,000)	(10,000)	(10,000)	(10,000)	(10,000)	(10,000)	(10,000)	(10,000)	(10,000)	(120,000)
(Decrease) increase in billings in excess of costs & estimated earnings on uncompleted contracts	35,024	(101,898)	(17,323)	112,020	(67,212)	18,147	62,306	20,561	(56,474)	(12,989)	63,646	21,003	76,812
Net cash provided by operating activities	101,566	276,694	136,884	(276,515)	293,421	290,606	150,353	641,305	(209,421)	(208,470)	48,832	(208,254)	1,037,003
CASH FLOWS - INVESTING ACTIVITIES													
Purchase of property and equipment	(23,540)	0	(15,545)	0	(3,590)	0	0	(23,989)	0	(4,470)	0	0	(71,134)
Net cash provided (used) by investing activities	(23,540)	0	(15,545)	0	(3,590)	0	0	(23,989)	0	(4,470)	0	0	(71,134)
CASH FLOWS - FINANCING ACTIVITIES													
Payments on long-term debt	(5,000)	(5,000)	(5,000)	(5,000)	(5,000)	(5,000)	(5,000)	(5,000)	(5,000)	(5,000)	(5,000)	(5,000)	(60,000)
Distributions to owners	(175,000)	(75,000)	(75,000)	(75,000)	(75,000)	(75,000)	(75,000)	(75,000)	(75,000)	(75,000)	(75,000)	(400,000)	(1,325,000)
Net cash provided (used) by financiang activities	(180,000)	(80,000)	(80,000)	(80,000)	(80,000)	(80,000)	(80,000)	(80,000)	(80,000)	(80,000)	(80,000)	(405,000)	(1,385,000)
Increase (decrease) in cash	(101,974)	196,694	41,339	(356,515)	209,831	210,606	70,353	537,316	(289,421)	(292,940)	(31,168)	(613,254)	(419,131)
Cash at beginning of month	1,245,444	1,143,471	1,340,165	1,381,504	1,024,989	1,234,820	1,445,426	1,515,779	2,053,095	1,763,674	1,470,734	1,439,566	1,245,444
Cash at end of month	$1,143,471	$1,340,165	$1,381,504	$1,024,989	$1,234,820	$1,445,426	$1,515,779	$2,053,095	$1,763,674	$1,470,734	$1,439,566	$826,313	$826,313

factors that can make the next six to eighteen months vary from the historical results. That could include things like seasonality, a change in service or product mix, whether you will be expanding geographically, etc.

For example, if you owned a construction company, you would first review your most recent financial results to see trends in the number of existing projects, gross margins, working capital, and capital expenditures. Then you would consider what kinds of bids are outstanding. Are they targeted at construction projects similar to those in the past? Are they for smaller or larger projects? Are the gross margins consistent with current projects, or are they higher or lower? A construction company owner would want to think through the way the business is changing and the impact it's likely to have on financial results and cash flow. They would talk to project managers and others about what they are seeing in the market. Does customer activity seem to be picking up or slowing down? Management and others inside the company are a wealth of information that will shed light on what's changing and what's about to happen as a result.

Here is another example. I use a forecasting tool called SurvivalWare which I will talk more about shortly. It is a powerful tool for financial analysis and forecasting that I have used for well over ten years now. The really cool thing in SurvivalWare is we push a button to see a graph and now we have our forecast amounts next to actuals in a bar chart. Figure 3-5 is a great example of a forecast that has an obvious problem.

There are actually two problems with this forecast. First, sales go up almost $4 million in the first month of the forecast. Second, the projection shows sales going up consistently each month. But that trend is not at all consistent with the recent past. The actual results show that there is seasonality to the business. And you can bet that the seasonality of the business will not just magically disappear.

So I used the forecast tool in SurvivalWare to include the seasonality in the actuals in the projected sales levels. Figure 3-6 shows the result.

Figure 3-5

SALES: ACTUAL & FORECAST

(Without Seasonality)

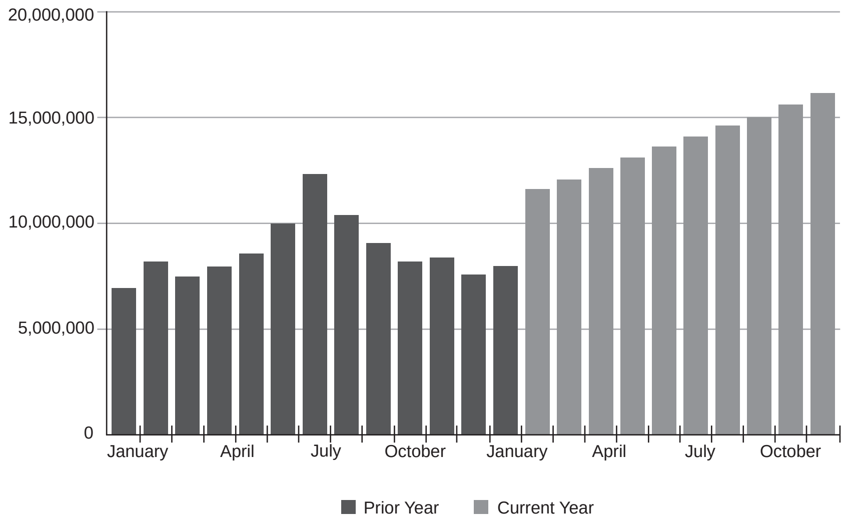
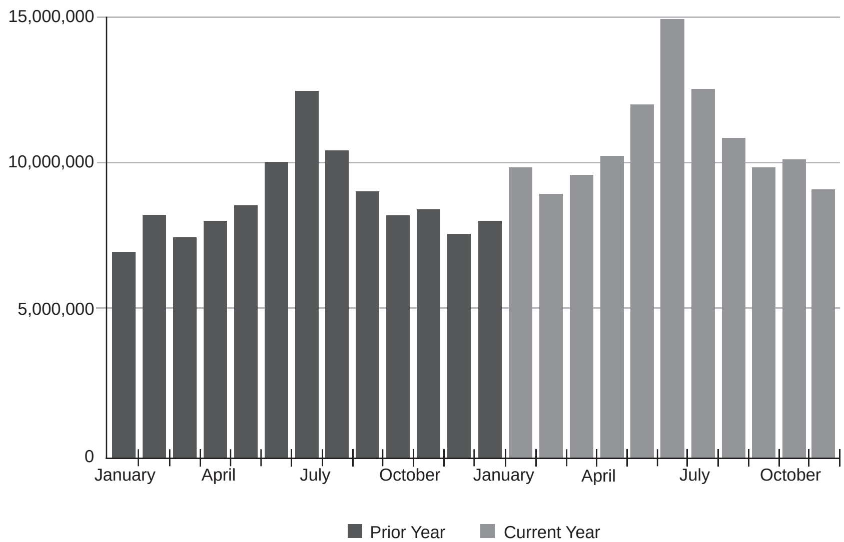


Figure 3-6

SALES: ACTUAL & FORECAST

(With Seasonality)



This is a much more reality-based view of the fact that sales bounce around a bit. I still have a sales increase in the forecast, but now it reflects the obvious seasonality of this business. You want to do this kind of review on each of the key line items in your forecast.

Rule #5. Understand the High-Level Company Strategy and Expectations

One of the benefits of forecasting is that it forces you to think about your company's vision and strategy more deeply. For example, what are the three most critical goals or initiatives for the coming year? Is the company planning to grow slowly or aggressively? Are there plans to move into new markets or attempt to attract new customer segments? Answering these types of strategic questions forces you to step back and think about the big picture. If you have a CFO it helps him or her "get out of the ledger" and talk to management about their division's goals or their department's strategies. It requires you to talk to your board and trusted advisors to get their input and perspective.

One thing I always do when I help a company put a reliable financial forecasting process in place is to surface the expectations of the CEO, the board, and others. I love to get a view of what they expect to happen financially in the business. Then I share with them what the forecast results reveal about what financial performance is likely to be and compare it to their expectations. It would shock you how often the reality and the expectations differ.

Rule #6. Simplify, Simplify, Simplify

One of my favorite quotes, known as Meyer's Law, says:

> "It's a simple matter to make things complex, but a complex matter to make things simple."

You will be surprised how difficult this advice is to implement once you begin creating, and regularly updating, your financial forecast. The number of potential rabbit holes you can dive into while forecasting is huge.

With all the assumptions you have to make in creating your forecast, it is very important to think about one of the more counter-intuitive facts about forecasting:

The more detail you bring into the forecasting process, the more error you will create.

I learned this very early in my career when forecasting revenues.

I was the CFO of an international franchisor. We had three retail concepts and 350 locations across the United States and Canada. We needed a reliable forecast of our combined revenues and cash flow. One of the larger obstacles was that we lacked real-time access to franchisee sales at the location level. The sales information was sent to us monthly (ten days after month end—this was in the early 1990s).

We considered having each franchisee forecast their sales and submit it to us at corporate. But that was met with resistance. Plus, there was no way we would have anywhere near full compliance with that many franchisees involved. We tried forecasting each location ourselves and summing it up for our overall forecast. But that process proved unreliable.

We tried having our regional managers provide their estimate by store because they were talking and meeting with franchisees frequently. But that proved unreliable as well and it put a lot of additional work on the regional managers.

I found the solution by estimating one number – comparable store sales increase/decrease. There was no need to estimate 350 different numbers. We only needed to estimate one number.

To get the forecast revenue number, I would review the comparable store sales change (expressed as a percentage up or down) for the last twelve months. Then I would talk to a couple regional managers to get some anecdotal feedback on whether they were hearing good things about sales or bad things. I would consider whether the revenues for the same month of the prior year were up or down. With that limited amount of information, I could estimate the comparable store sales percentage and arrive at my revenue forecast for each month.

It turned out to be amazingly reliable. Not perfect, but incredibly reliable…and dramatically simpler than the bottom-up alternative.

> "If you can't explain it simply, you don't understand it well enough."
>
> —Albert Einstein

Here's another example of the importance of simplification when you are forecasting.

An engineering company was beginning the financial forecasting process. The company began discussing how best to forecast revenues and gross profit. Most of its revenues were project related and based on a fixed price. Revenues bounced around from month to month, depending on how each project was progressing and when new projects began. It had 35 open projects, six about to start, and another five bids out. Individual projects ranged from $3,000 to $225,000, and each one was in a different phase of completion.

The company reasoned that the most accurate way to estimate revenues was to do it at the project level. Otherwise it couldn't support the forecast number. So, the company took the work in process (WIP) schedule and expanded it by adding columns for projected revenues and gross profit by month for each project over the next eighteen months. Then it added projects the company expected to start in the near future and ones it had bid on and expected to win. From there, the company created the projected revenue and gross profit for each month.

It was an impressive spreadsheet and tied nicely to the monthly revenue forecast. When the CEO or the board asked, "How did you arrive at the November revenue forecast?" they could pull up the detailed project schedule and say "Here's the revenue forecast by project."

But think about how many estimates were in that schedule: the timing and amount of possible change orders for each project, the timing and amount of changes to expected gross profit for each project, the timing and amount of cost and completion estimates for each project, the timing of new upcoming projects, the revenue and gross profit estimates for each new project, the timing of billings and monthly revenue, etc. The schedule covered 46 projects; the number of estimates for a single month of revenues was at least 108.

The challenge wasn't to answer the question: "What are the 108 different estimates we can use to arrive at a forecast of revenues for one month?" It was to figure out what *two* numbers can be multiplied to get the revenue forecast for the month. Here's the answer:

Number of open projects x Average monthly revenue per project = Revenues

A quick look at the company's historical results showed a surprisingly consistent overall average monthly revenue per project over the past 24 months, especially considering the wide variety of projects open at any given time. And the number of open projects during each of those months did not vary widely. The two-driver forecasting approach proved that it was more reliable…and dramatically simpler.

The key to success in forecasting is to be always thinking about how to simplify, simplify, simplify…and simplify some more. Simplify the key drivers, critical assumptions, and how you interpret and present the results of the forecast.

> "…Increasing the level of detail often leads to increased forecast error.… Indeed, more often than not, more detail means higher errors, not higher accuracy."
>
> —Steve Morlidge and Steve Player, *Future Ready: How to Master Business Forecasting*

Rule #7. Create a Repeatable Process

Because your forecast will be updated with actual results and the forecast adjusted every month based on current information, repeatability is very important to the forecasting process.

The software tool you choose will impact the success of your forecasting process. The tool must include the underlying logic for forecasting (modeling) a full set of financial statements and perform a number of additional functions. At a minimum, it should:

- Provide the ability to forecast with financial and nonfinancial data
- Import historical (actual) financial results
- Present both historical and forecast results in reports, report packages, and exports
- Be easy to update and maintain
- Make monthly financial reporting simple and fast
- Display graphical views of data and trends (this is a powerful feature for communicating insight)

Forecasting tools generally fall into two categories: homegrown spreadsheets and forecasting software. Creating a forecast in a spreadsheet can work well in a company with spreadsheet "power users," analysts on staff to maintain the financial model, or an organization that prefers "roll your own" solutions to acquiring software from outside vendors. Spreadsheets can be fully customized and are relatively inexpensive to get started.

However, spreadsheets are not ideal for a company in which a complex legal entity consolidation is required to present consolidated actual and forecast results, or one that is moving its system to a cloud-based solution with anytime, anywhere access to financial data. Spreadsheets can become clunky and difficult to maintain, involve a lot of manual input, and are prone to human error.

Forecasting software is specialized, dynamic, and built for mass amounts of data as well as the ability to import data and perform complex reporting. However, it can be a costly solution that requires professional assistance and extra time to set up and maintain.

We'll talk more about forecasting tools in Chapter 6.

Rule #8. Be Conservative

Because we know a forecast will not be perfectly accurate, the challenge is keeping it in the "ballpark" as a wildly inaccurate forecast will hurt your credibility. You do that by being conservative in your key assumptions.

It's like meeting someone for lunch. You agree to meet a good friend at a restaurant at noon. You set noon as the time to meet so you will both be there at about the same time. But despite the precise time you set, you know that both of you will not show up at exactly noon. The only question is whether you will be there a little before noon or a little after noon. Will you be early or will you be late?

It's the same for your forecast. Your estimates will not be perfectly accurate. You want to err on the side of being conservative. That way the surprises are pleasant rather than unpleasant.

Let's say you are working on the profitability component of your forecast. Last year the company generated $5.5 million of net income. This year, the economy is great and the company is growing nicely. If results continue the way they have been going, profits could hit the $8.0 million mark. Being conservative in your forecast of profitability means that you assume there could be some slips or slowdowns before year end. So your forecast might guide the profit estimate down to the $7.0 million to $7.5 million range. That way you provide some room for error or surprise. It recognizes that not every "at bat" results in a home run.

Rule #9. Condense the Results to a 2-Minute Summary

Creating a reliable forecast and effectively communicating it to your audience starts with making the forecast results simple and easy to understand. Here is a helpful exercise that works especially well when implementing a forecast process for the first time.

Imagine you will sit down with the CEO or board tomorrow morning. In that meeting, you will have two minutes to convey the essence of the forecast (key insights, implications, and assumptions) to him or her. That person will then step into another meeting with the company's key shareholders and lenders to share his or her insight about where the company is going financially. Your mission: Ensure they can share the insights from the forecast with confidence and clarity.

This exercise will force you to distill the insights and implications of the forecast down to what matters most so that you can clearly identify and communicate the most important high-level drivers and assumptions.

Here's an example:

Figure 3-7
THE 2-MINUTE SUMMARY

Based on our growth plan for the coming year, we will need to raise $1.1 million to $1.3 million in cash by June 30. The primary driver of the need to raise cash is the plan for launching a new division in Texas. The expansion is forecast at $3.0 to $3.5 million driven primarily by the capital expenditure and first-year operating losses.

In this example, there is one key insight because the expansion into Texas is a significant event. It will take about one minute to communicate that summary. The remainder of the meeting with the CEO will be spent answering his or her questions about the key assumptions and the conclusion. The number of questions the CEO has will be determined by the degree to which your conclusions or insights come as a surprise.

Rule #10. Start for Your Eyes Only

As you make progress in creating your forecast, it's natural to want to begin sharing it immediately. However, keep it "for your eyes only"—at least to start.

That means don't sell your leadership team on the value of having a forecast, don't talk to them about the assumptions or specifics as you create the forecast, and don't send the results of the forecast to them—yet.

Instead, spend a few months "beta testing" your forecast to learn from and experiment with the process before rolling it out to the management team or the board. Create assumptions at the highest level possible to prove to yourself that you don't need to forecast at the detail level. Create the forecast for the next three months, then compare the actual results each month. What worked out well? Are you surprised at the difference between your forecast and the actual results?

An important step in mitigating risk when creating a forecast is to give it a serious reality check, what I like to call a "smell test." You've created assumptions about profitability, the timing of collecting accounts receivable, inventory and payables, capital expenditures, borrowing or payments on debt, distributions to owners, and a number of other important drivers of financial results.

Once you have a completed draft of the forecast, step back and look at the resulting financial statements. Are they consistent with your general expectations? Are they in line with actual results and the plan? Do they make sense given your intuition and knowledge of the business?

One thing you learn real fast when forecasting a full set of financial statements is that the real bottom line is cash. Because every forecast assumption you make ultimately impacts the cash balance, you want to pay very close attention to the forecast cash balances to ensure nothing looks unusual. The smell test is a quick way to check that nothing unexpected has made its way into your numbers.

After running the forecast process for three months, you will become more confident and knowledgeable about the benefits of forecasting and how best to create and present the results. You will learn firsthand where the landmines are to avoid. You will develop a better sense of the kinds of monthly and strategic decisions that the forecast can help you answer and influence.

Figure 3-8

10 RULES FOR CREATING A FORECAST YOU CAN TRUST

1.	It's all about decision making, not precision
2.	Think top-down, not bottom-up
3.	Model a full set of financial statements
4.	First look back, then look forward
5.	Understand the high-level company strategy and expectations
6.	Simplify, simplify, simplify
7.	Create a repeatable process
8.	Be conservative
9.	Condense the results to a 2-minute summary
10.	Start for your eyes only

A Quick Start Guide to Financial Forecasting

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