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 4

The Recipe for Financial Forecasting

"Money is a terrible master but an excellent servant."

—P.T. Barnum

Most people whip out a spreadsheet and start plugging numbers into a forecast only to realize there is more to the forecasting process than meets the eye. That's why I have organized the forecasting process into three phases—plan, create, and present.

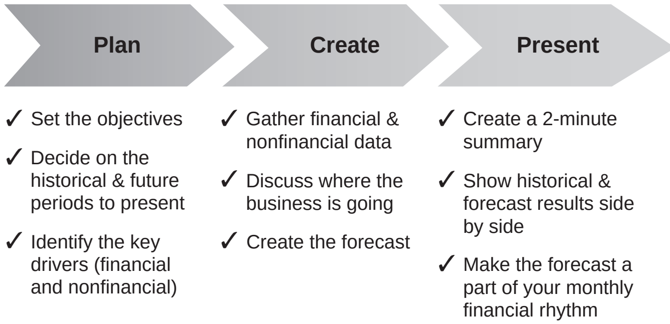
The **plan** phase is about putting the foundation in place so you can build a forecast that adds value for the company. The **create** phase is about the actual work of developing assumptions and putting numbers in the forecast. The **present** phase is about how you turn the forecast into insight for your leadership team and others interested in, or invested in, the financial success of your company.

Plan

In this phase, you'll plan and design the ultimate end product and build a foundation that will support your forecasting goals.

Figure 4-1

THE RECIPE FOR FINANCIAL FORECASTING



Here are the steps in the plan phase:

- Set the objectives.
- Decide on the historical and future periods to present.
- Identify the key drivers (financial and nonfinancial).

Set the Objectives

Step one is to write down the primary goals and objectives of the forecast you're about to create. This is the "begin with the end in mind" step. It helps you define what success will look like once your forecast is complete.

In my consulting work (whether internal or external), I always begin by having a discussion with my client about what they're trying to achieve. I write down the one to three big picture objectives we want to accomplish and get the client's buy-in that I've captured the essence of what we need to accomplish. There's something magical about narrowing the objectives to just one to three and actually writing them down and talking about them upfront.

For example, one company summarized its objectives as follows:

1. Implement a reliable financial forecasting/projections process.
2. Ensure the forecast can be easily updated and published monthly.

The company was growing and wanted to become a more metrics-driven organization. The forecast would help the CEO plan and manage the key drivers/metrics of financial performance at the overall company level. Then she planned to drive that same kind of focus down to the more operational levels of the different divisions of the company.

She was increasing the number of locations and taking on more debt to help finance the growth. She knew the company needed to become more focused on the key drivers of financial performance to ensure the growth was profitable and to help her manage the risk associated with taking on more debt. The forecast was a central part of how she would more closely manage both financial performance and risk on a monthly basis. The forecast would also help her plan and manage their different legal entities at the overall company/consolidated level.

The "easily updated and published monthly" part of the second objective was critical. The CEO had previously been through a forecasting exercise, but the result was too difficult to maintain and, therefore, provided limited benefits for only a couple months.

In another example, I was brought in to help a company that had grown nicely to over $75 million in annual revenues. The majority shareholder had built the business over time but never really put in place an experienced accountant as the controller or CFO. Then a combination of a tough economy, and intense competition, put a big squeeze on cash flow. The squeeze required the company to borrow everything it had available on their existing bank line and they violated a number of critical debt covenants.

The credit line was large (for both the company and the bank). And the owner had personally guaranteed the credit line as well. If the bank pulled the credit line, the company would fail and the owner would have to file personal bankruptcy because the debt would overwhelm his personal net worth. It was a big problem.

The bank was very nervous and was taking a somewhat activist role as a result. The bank was asking lots of questions about financial results and not getting timely answers. They wanted timely financial statements and reliable answers about what results would look like in the coming months so they could evaluate the company (and its credit risk—banks hate losing money).

Here is how we defined the primary objectives:

1. Establish confidence and credibility with the bank.
2. Produce timely and accurate financial statements.
3. Provide a monthly financial forecast for the next twelve months.

The written objectives helped keep everyone focused on what we were there to accomplish.

Decide on the Historical and Future Periods to Present

Consider how many months of historical financial statements to include in your forecast. When possible, two to three years of historical monthly results is ideal because they provide insight into the drivers of results, trends over time, month-to-month variations in results, etc. The numbers will help you assess where the company has been according to the actual results.

Forecast periods should be monthly for the upcoming twelve to eighteen months. Although there are times when you may want to forecast farther into the future (e.g., when presenting a long-term plan, raising capital, or attracting a lender), twelve to eighteen months is sufficient for month-to-month decision making.

It is important to maintain the twelve to eighteen month forecast horizon as each month goes by. For example, let's say you begin the process with eighteen months in your forecast. Once the first month goes by, you now have seventeen months in the forecast. The forecast horizon shrinks each month unless you regularly add months to the end of the forecast horizon. This process of maintaining the number of periods in the forecast is what makes the forecast a "rolling forecast."

A rolling forecast means that when a month is over you add a month to the end of the forecast period. That way you always have a defined period in your forecast.

I am a big fan of the rolling forecast because it helps you get out of the mindset of thinking only in terms of the calendar or fiscal year. It helps you think in terms of a more practical planning horizon rather than the traditional compliance driven reporting periods.

Having said that, it is not always necessary to adhere to the strict definition of a rolling forecast. I generally let three months or so go by before I add to the end of the forecast period. I allow the forecast period to "flex" a little bit from month-to-month unless there are meaningful changes going on in the business that will clearly impact the future periods. I allow some flexibility in defining and updating the forecast horizon. It really depends on what's going on in the business, the nature of the planning cycle, and the types of decisions the forecast informs.

When it comes to how frequently to update the numbers in the forecast period, I encourage you to look at the forecast period as consisting of the "near term" and the "longer term." The near term is the next three to nine months or so. The longer term would be the next twelve to eighteen months.

The near term is where you want to answer the question "What's about to happen?" You want your leadership team and other users of the forecast to have a clear view of what financial results are likely to be in the near future. As a result, pay very close attention to the next three to nine months in the forecast and update those numbers monthly.

The longer term is more about answering the question "What could happen?" This is more of a "What happens if" kind of question. What happens if we expand our operation in the northeast? What happens if a major competitor opens a new store near our flagship location? These numbers would generally be updated only when there is an event or something has happened in the business that makes it necessary to change the forecast. Or there is some planning or discussions going on in the business and you want to forecast a range of options or possibilities. Otherwise, I generally update these numbers in the forecast once a quarter or so.

Identify the Key Drivers (Financial and Nonfinancial)

Identify the key drivers that impact your results (and, therefore, your financial statements). Because the forecast doesn't consist of actual transactions, consider the larger influences that will drive expected results in the financial statements.

A retailer might consider:

- number of customers/transactions,
- customer traffic trends,
- competitive threats,
- average ticket,
- gross profit margin,
- current operating expense structure,
- company growth plans,
- lease expiration dates,
- the impact of seasonality on inventory levels,
- existing debt service requirements, and
- capital expenditure plans.

Next, consider what drives those balances at the highest level possible. Figure 4-2 lists the financial statement categories and suggestions for forecasting those balances that this same retailer might consider.

Figure 4-2
THE APPROACH TO FORECASTING

Financial Statement Categories	Forecast Approach
INCOME STATEMENT	
Revenues	Number of customers/transactions X average revenue per ticket
Gross profit	Gross margin X revenues
Operating expenses	Estimates by expense category based on trend, budget, etc.
BALANCE SHEET	
Cash	The net impact of all other assumptions
Accounts receivable	Days sales outstanding (DSO) X average daily revenues
Inventory	Days inventory outstanding (DIO) X average daily COGS
Property and equipment	Estimate based on growth and maintenance capital expenditure plans
Accounts payable	Days payables outstanding (DPO) X average daily expenses
Third party and related party debt (short-term and long-term)	Estimates based on debt service requirements and borrowing plans
Owner's equity related accounts	Estimates based on investment and owner distribution plans

You will be using these key drivers when you develop your forecast assumptions.

Create

In this phase of the forecasting process, you will insert historical financial and nonfinancial information into your forecasting tool. Then, use information about trends and metrics in those results, together with information from management and others, and begin creating the assumptions that will drive the forecast results.

Here are the steps:

- Gather financial and nonfinancial data
- Discuss where the business is going
- Create the forecast

Gather Financial and Nonfinancial Data

Most accounting systems have a feature for exporting financial statements that show each month in the range side-by-side so that information can be easily imported or pasted into your forecasting software or spreadsheet. I generally export an income statement and balance sheet for the historical periods and rely on the forecasting tool to create the statement of cash flows.

Also, gather and incorporate the nonfinancial data. For example, a retailer may have identified the number of customers or transactions and average ticket to be key drivers, because the number of customers/transactions multiplied by the average ticket = sales. You would go to your POS system and gather (or export) the number of customers/transactions for the period identified in the Plan phase.

A construction company might gather the number of open projects and average revenue per project. There is generally a handful or so of nonfinancial data to gather. Keep in mind that you want to be sure you create a repeatable process here because this will need to be exported each month going forward.

Discuss Where the Business Is Going

One of the benefits of the financial forecasting process is that it forces you to think deeply about your company's vision and strategy. 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 bid on projects similar to the ones in the past, or is the company moving into new markets or new customer segments?

Answering these types of strategic questions helps you think beyond the day to day work inside the business and encourages conversations with management about their goals, strategies, and expectations.

Create the Forecast

Now it is time to enter the assumptions that will create the forecast results. You will draw on a unique blend of historical results and trends, your understanding of the company's vision and strategy, and your intuition about what is most likely to happen financially.

In the forecasting process, we are going to use some "hacks," or shortcuts, to estimate what we believe the end results of cash flow and financial results will be. Here are my suggestions on the approach to forecasting each of these components of a full set of financial statements.

Revenues. Think for a minute at a very summary level about this question: What two numbers could you multiply together to arrive at revenues?

- For a retailer it might be number of customers × average ticket = revenues.
- For a law firm it might be hours incurred by attorneys × average billing rate = revenues.
- For a wholesaler of fuel it might be gallons of fuel sold × average selling price per gallon = revenues.

You want to do this exercise at the highest (most summary) level possible. Notice how the key drivers almost always include nonfinancial data (like number of customers in the retail example, hours worked in the law firm example, and gallons sold in the fuel wholesaler example).

Gross Margin. In most cases, it is best to use a single gross margin estimate to drive gross profit (and, therefore, cost of goods sold).

Operating and Nonoperating Expenses. I generally prefer to enter operating expenses by line item based on existing trends, budget, expectation, etc.

Days Sales Outstanding (DSO). DSO is the number of days of average sales sitting in accounts receivable (A/R). It is a good shortcut for forecasting A/R on the balance sheet each month. Accounts receivable at the end of a month is a function of the balance at the end of the prior month plus revenues minus collections. Rather than estimating the amount to be collected, using DSO multiplied by average daily revenues is a reliable way to estimate the ending balance. Then the forecast model can calculate how much was assumed to be collected during the month for the statement of cash flows.

Days Inventory Outstanding (DIO). DIO is the number of days of cost of goods sold sitting in inventory. It is a good shortcut for forecasting the inventory on the balance sheet each month. Inventory at the end of a month is a function of the balance at the end of the prior month plus purchases minus cost of goods sold. Rather than estimating the amount of inventory purchased during the month, multiply DIO by average daily cost of goods sold to estimate the ending inventory balance. Then the forecast model can calculate how much was assumed to be purchased during the month.

Capital Expenditures. This amount is used to estimate capital expenditures for each month, which are a function of management plans and expectations for capital expenditures.

Days Payable Outstanding (DPO). DPO is the number of days of expenses sitting in accounts payable (A/P). It is a good shortcut for forecasting A/P on the balance sheet each month. The model can then adjust cash according to the change in payables for the month.

Principal Payments on Debt. This is used to estimate principal payments on debt based on existing debt service requirements as well as any additional long-term plans for borrowing or paying debt down faster than the existing schedule. You need to look at your debt structure and whether you have long-term debt where you are making regular monthly payments and if you have, or also have, short-term debt like a bank line of credit or similar debt.

Other Asset and Liability Accounts. One of the main items to consider here is income taxes. This will depend on the kind of entity your business is in. If you are in an S corp or LLC or other pass-through type entity then one of the main items here is distributions to owners. These are very big assumptions so pay close attention to them.

Owner Distributions. Use a dollar amount to estimate owner distributions.

Now the Fun Part!

Now it's time to sit down and crank through all the assumptions necessary to create a forecast of the income statement, balance sheet, and cash flows for the coming months.

This is a *very* interative process. You will drop in some revenue estimates and then realize that the revenues for the year look way too big…or way too low. Same with your operating expenses. You will look back at the prior month's gross margins and see they have been bouncing around from month to month. So you will go a little deeper to see what's causing those changes. You will try to figure out if they will continue. Then once you begin making assumptions about balance sheet accounts, you may see that the balances each month don't make sense relative to historical balances. You will find yourself thinking about every component of the financial statements as you work through this process.

The key is to use the time you spend making assumptions and looking at the results of the forecast financial statements to deepen your understanding of what drives financial results in your business. Remember, this is a top-down, rather than a bottom-up, exercise. So try not to allow yourself to drive your forecast assumptions down to the lowest level possible. Stay up at the 30,000-foot level.

> "The key assumptions, those that have the greatest effect on forecasted cash flow, highlight where management competency is required and become the KPIs."
>
> —Robert H. Hacker, *Billion Dollar Company*

Once you've drafted your forecast, take some time to review your work. Here are some questions to consider:

- Given my knowledge of the business and existing trends, does the forecast make sense?
- Does it show the company as a net generator of cash or a net user of cash?
- When discussing the forecast results with the CEO, will he or she be surprised by the overall plan for the company's financial future?
- When discussing the critical assumptions and key drivers used to create the forecast with the CEO, will he or she agree that the assumptions and drivers seem reasonable?

In my consulting work, I review the highlights of the forecast with my client to get feedback on whether the big picture view of the forecast creates any surprises or concerns. We walk through the critical assumptions and the key drivers of performance. We look at the existing trends and talk about specific strategies being employed in the business that might alter those trends.

The last step in this phase is to make the necessary changes to the forecast based on the feedback you have received. Armed with input from management and others you can go back and make any changes necessary to create the "final" version of the forecast. There's almost always going to be some tweaking to do. Maybe margins are likely to go up two months from now because the company is rolling out a brand new, high margin product. Or there is a large capital expenditure being planned six months from now that you were not aware of.

Present

Presenting the forecast is more art than science. It's about how you turn the forecast into insight for your leadership team; how you present the key insights will ultimately determine the success of your forecast process.

Here are the steps:

- Create a 2-minute summary
- Show historical and forecast results side-by-side
- Make the forecast part of your Monthly Financial Rhythm

Create 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. I have found that getting laser focused on simplifying the results of the forecast pays big dividends. You want to present the assumptions and results at the highest level possible to start. Then be prepared to drill down and provide the next layer of information after the high level view is fully presented and understood.

Figure 4-3 is an example of a 2-minute summary. 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 or the board will be spent answering questions about the key assumptions and the conclusion. The number of questions will be determined by the degree to which your conclusions or insights come as a surprise.

Figure 4-3
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.

Show Historical and Forecast Results Side-by-Side

There's something almost magical about presenting financial results and financial statements where each month is shown side-by-side. It makes the trends and direction in the business jump off the page at you. And I always like to show actual months for the year next to the forecast months as a way to give the reader a view into actual and projected performance for the year.

After the 2-minute summary, this is one of the first views of the detailed forecast results I provide. It helps clarify the forecast results because you can see the forecast periods together with actual results. It highlights what has been happening in the recent past, educates the reader about the financial statements in general, and helps everyone get comfortable with the assumptions used to create the forecast.

Make the Forecast Part of Your Monthly Financial Rhythm

Life, business, and money all move in a rhythm or cycle. So does financial management and forecasting. The forecast is a key part of your monthly financial rhythm. You don't want all the benefits of having a forecast to be a one-time thing and then get put on a shelf somewhere or forgotten. Include it in your monthly financial reporting package. That way you make it a part of how you plan and manage the financial side of the business each month.

Figure 4-4

THE MONTHLY FINANCIAL RHYTHM

I refer to this natural financial rhythm in business as the TARGET, MONITOR, ADJUST cycle. It's about setting financial goals and TARGETS, MONITORING forecast and actual financial results, and making ADJUSTMENTS in strategy and execution inside the company when results differ from the target or expectation.

Business (and money) moves in a rhythm, a cycle. So does financial management.

It's a monthly rhythm designed to improve decision making and provide financial feedback inside your company. A fast feedback loop makes it possible to quickly identify strategies that need to change because financial results are not in line with expectations.

Target – The targets are the key financial and nonfinancial goals that drive from your vision and strategy. A company in restructuring mode would have different targets than a company trying to scale and grow. The targets can change as well depending on short-term financial goals. For example, one quarter you might have specific goals related to collecting receivables faster. Another quarter might include a focus on reducing certain expense categories. There will generally be three to five targets at any time. But the mix of targets/metrics will vary during the year.

Monitor – Monitoring is about creating financial forecasts (expected financial results) and actual results (historical financials). Forecasts are a fully modeled set of financial statements over at least the next six to eighteen months. Actuals are financial statements and the key drivers of financial performance. The combination of the forecast and actuals results is converted into insight (not just numbers or financial statements).

Adjust – You and your team then use insightful financial information to determine whether the specific action plans and strategies being executed throughout the company are working as expected. Your management team is on board because they understand the financial goals and the related metrics being tracked. You have helped them learn how to use the monthly financial information to compare the actions they are taking in the field to the implications in the financial statements. Now they have a tight link between their plans and the actual financial results. Adjustments to strategies and tactics in the field can be made quickly when the financial information suggests something is not working the way you intended.

The cycle continues every month by making any necessary changes to the financial goals and targets and the resulting forecast/expectations. It's a monthly financial rhythm designed to help you focus on what matters most. It's the key to turning financial information into insight.

> "The more often we forecast, the quicker we will be able to act to correct any problems with our process."
>
> —Steve Morlidge and Steve Player, *Future Ready: How to Master Business Forecasting*

Each month your forecast should be updated as follows:

- Load actual results when the month is over.
- Compare actuals to the forecast.
- Make any necessary changes to the forecast months.
- Add any necessary periods to the end of the forecast.
- Work closely with the leadership team to identify action items that can drive improvements in profitability and cash flow.

That's the recipe for creating a reliable financial forecast. Now let's walk through the plan, create, present process in a step-by-step fashion with a real world example in the next chapter. You will see how the process unfolds and look at the before and after results.

A Quick Start Guide to Financial Forecasting

I hope you enjoyed reading this complimentary chapter from the book **A Quick Start Guide to Financial Forecasting: Discover the Secret to Driving Growth, Profitability, and Cash Flow Higher.**

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