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

Bonus Chapter 1

A Three-Part Plan to Breathe Financial Life Back into Your Business

"The function of a business is to create money, not consume it, and the longer you postpone this the harder it gets to fix."

—Gary Sutton, *The Six-Month Fix*

In this bonus chapter, I'll show you a three-part plan for breathing financial life back into your business. It will give you a sensible plan, a roadmap, you can follow that will guide you on your path to building a strong, wealth generating business.

I like to look at the path to creating a company that is financially strong as a three-part, 10-step process that you see in Figure B1-1.

This plan is designed to guide you through the full financial life cycle of your business, and it has three parts.

- Part 1 is about confronting the financial reality of your business.
- Part 2 is about how you create a financial safety net within your business.
- Part 3 is how to go about the process of growing and enjoying financial success in your business.

Figure B1-1

BUILDING A FINANCIALLY STRONG BUSINESS

Keys you can apply today to promote solid financial growth!

Confront your financial reality **1**	STEP 1	Build your cash balance to 1 month of operating expenses
	STEP 2	Put aside enough cash to pay your income taxes
	STEP 3	Diagnose your profitability and cash flow weaknesses (then fix them)
	STEP 4	Create a reliable financial forecast for the next 6 to 18 months
Create a financial safety net **2**	STEP 5	Pay your bank line down to zero (even if it s temporary)
	STEP 6	Reduce your personal guarantees (begin the process)
	STEP 7	Build your cash balance to 3 months of operating expenses
Grow and enjoy financial success **3**	STEP 8	Use existing cash flow for capital expenditures and growth capital
	STEP 9	Pay down your remaining debt on an accelerated schedule
	STEP 10	Reward the owners of the business with cash

It's a simple system you can implement in baby steps. It's a system that will help you move toward financial health, wealth, and freedom. (Yes, freedom. One of the reasons to improve your profitability and cash flow is to give you the freedom to run your business in a way that fits with your lifestyle and your goals in life.)

It will provide you with the clarity of knowing what your next steps are. That way you can shift your focus to specific action plans and away from the fuzziness that too often creates struggle and confusion in business.

Part 1: Confront Your Financial Reality

This part of the three-part plan is about assessing, then improving, the financial health of your business. Confronting the reality of your financial situation is a vital first step.

It's similar to the approach you would take if you were not feeling well physically. If you didn't feel well for an extended period of time, you would eventually decide to go see the doctor. You would want to find out what's wrong and find out what you need to do to start feeling better. The doctor would ask a number of questions about your symptoms. He or she would take your blood pressure and possibly take blood (ouch). The doctor is making an assessment of what kind of problem you have and how serious it might be. A treatment plan cannot be made until the problem is properly diagnosed.

The process is similar when it comes to improving the financial health of your business. We first look at the symptoms. Then we work on the diagnosis and treatment plan.

> "Have you ever worked for an unprofitable business? If you have, you probably learned that it's not much fun. Perhaps people who work at unprofitable businesses should consider putting signs in their offices that say, 'It ain't fun if it ain't profitable.'
>
> If you have worked for both profitable and unprofitable businesses, we think you would agree it's more fun when the enterprise is actually making money. We have never heard anybody complain about excessive frugality in successful businesses; but we sure have heard about 'the need to tighten up' in an unprofitable one."
>
> —Lawrence L. Steinmetz, PhD., and William T. Brooks,
> *How to Sell at Margins Higher Than Your Competitors*

I break the process down into four steps. These four steps are a unique combination of small steps (baby steps) that will help you quickly assess your financial health. You will be surprised how fast you begin to hone in on the solution once you clear away the fog that is clouding your vision.

Here are the four steps.

Step 1: Build your cash balance to one month of expenses

If you have less than one month of operating expenses in the bank, you are probably experiencing unnecessary stress, angering your vendors, irritating your employees, ignoring the financial reality of your business, and generally making your life harder than it needs to be. Maintaining a very small bank balance in business turns otherwise simple decisions and processes into complicated and time-consuming hassles.

To implement step 1, you first need to determine the number that approximates one month of operating expenses. I exclude cost of goods sold (unless you have employee expenses or other operating type expenses in cost of goods sold). With that number defined, you can determine whether you already have one month of operating expenses in the bank. If you do, then check step 1 as complete.

If you are short of the one-month target, then put a dollar amount on how much cash you need to "find." Let's say your monthly operating expenses are in the $1,000,000 range and your bank balance has been hovering around $750,000. So your goal in this example is to add $250,000 to your cash balance.

Now you have to ask yourself two thought-provoking questions (in this order):

1. How *fast* can I come up with an extra $250,000?
2. *Where* is the $250,000 going to come from?

I love these two questions because they generate fascinating reactions and thoughts in your mind. The first question forces you to consider just how long it might take you to achieve your goal. One month? Two months? Twelve months? The second question puts your focus on where you're going to generate the cash from. Sometimes the goal looks easy and the answer is obvious. Other times it creates dread and fear.

Either way, there's no need to solve the problem just yet. Just spend a little time thinking about how you are going to build your cash balance. Then on to step 2.

[NOTE: If you have a bank line of credit, and use your cash to pay down the line daily, it's OK to move directly to step 2. You will dig deeper into how you are using the line (and your availability under the line) in steps 3, 4, and 5.]

Step 2: Put aside enough cash to pay your income taxes

Taxes should be set aside during the year, not at the end of the year. The government yields way too big a stick to make a mistake when it comes to paying your income taxes. This is one of those "unforced errors" that plagues smaller businesses more so than larger ones. Income tax payments should never be a surprise.

To implement step 2, you need to:

- Estimate your income tax expense for the year.
- Look at how much cash you have already put aside for income taxes.
- Determine the amount of cash, if any, that still needs to be put aside.

Let's say it's November and your tax year ends in December. You estimate that your taxable income for the year will be $1,000,000.

Using 40% as an estimate of the tax rate, your tax expense is estimated at $400,000. What you have put aside already (in this case through estimated tax payments) is $325,000.

That means you have $75,000 of cash that needs to be set aside so you have a total of $400,000 put away for income taxes.

Step 3: Diagnose your profitability and cash flow weaknesses (then fix them)

Financial struggle in business has its roots in profitability challenges and/or the way in which you monitor and manage your cash flow. The secret to keeping this step simple is to think strategically and high level about your financial performance before you begin diving into the details. Why? Because there is probably more work involved in this step than any other step in the process.

It is very easy to get lost in the weeds as you work to diagnose (then fix) your profitability and cash weaknesses. For example, when you begin assessing your profitability, you will have lots of questions run through your mind. Questions like:

- Could I be more profitable?
- By how much?
- Says who?
- Based on what?
- Do I have a revenue problem?
- Do I have an expense problem?
- Should I raise my prices?

The way you combat the problem of getting lost in the weeds is to begin by looking at the big picture first. Let's go up and get the 30,000-foot view of how your business is performing financially. That approach will help you create some interesting insights that will guide you on the path to a clearer view of your current financial reality.

The work in this step is broken up into three components.

Understand and articulate the three largest drivers of cash for the last six months (in a 2-minute conversation). The first thing you do is "follow the money." You do that by answering one question: "What happened to the cash?" Specifically, you want to answer that question for the last six-month period. I like to answer this question using the Cash Flow Focus Report. It is a super-fast way to highlight the three largest drivers of cash, provide a one-line description for each driver (for each of the large changes in cash), and decide whether each change is good or bad. You can learn more about the Cash Flow Focus Report at www.ILoveForecasting.com.

Create the 5-Minute Profitability Assessment (to determine what your profitability should be). The purpose of this analysis is to quickly determine if your business is as profitable as it should be.

For example, in one company the owner was frustrated because cash was always tight despite the fact that they had made big strides in becoming profitable over the last two years. After completing the analysis, it turns out that profits were only 4% of sales in a business where the norm is closer to 10%. At $4,000,000 in revenues, that meant their Profitability Gap was $240,000 (10% – 4% × $4,000,000). Now that they had put a number on the profit improvement target (the opportunity), the mission became "closing the profitability gap."

The goal of this 5-minute assessment is to come up with an estimate of what your annual profit should be (or could be). Your estimate doesn't have to be *right*. It just needs to be a number you can write down. You will have plenty of time later to explore your estimate in more detail to determine if it should become your new profitability target.

Here's the exercise. Take 5 minutes to come up with an estimate of how much money you should make each year in your business. Here are the steps:

- Look at your pre-tax income (your profit before income taxes) for the last twelve months. Divide that number by your revenues (total sales). Jot that percentage down. Let's say that revenues are $10,000,000 and pre-tax profit is $500,000. So the percentage is 5%.
- Look at your gross margin (gross profit dollars divided by revenues). Use that percentage to lookup your pre-tax profit target range in Figure B1-2. Let's say gross profit is $4,200,000. So

Figure B1-2

PRE-TAX PROFIT TARGET RANGE

Gross Margin	Pre-Tax Profit Target Range
5% to 25%	1% to 10% of revenues
25% to 40%	10% to 15% of revenues
40% and above	15% to 20% of revenues

the gross margin is 42%. The pre-tax profit range in the table would be 15% to 20% of revenues.

- Choose a pre-tax profit percentage in the range and multiply that times revenues. Write that number down. In my example, I'll choose 15% (to be conservative). That number times $10,000,000 in revenues is a pre-tax profit target of $1,500,000.

In my example the profit target is $1,500,000 and the actual profit is $500,000. The Profitability Gap is the difference, or $1,000,000. Remember, it's just an estimate . . . for now. You will have time to more fully analyze that number later.

> "When it comes to pretax profit, here's what I've found to be true for the vast majority of businesses:
> - 5 percent or less of pretax profit means your business is on life support.
> - 10 percent of pretax profit means you have a good business.
> - 15 percent or more of pretax profit means you have a great business."
>
> —Greg Crabtree, *Simple Numbers, Straight Talk, Big Profits!*

Discover where cash is being "trapped" in the business. The primary focus here is on inventory, accounts receivable, and accounts payable. These "working capital" related accounts oftentimes hide opportunities and problems (and cash) because most entrepreneurs pay little attention to them month-to-month.

I like to measure the days of inventory outstanding (DIO) when evaluating inventory levels, days of sales outstanding (DSO) when evaluating accounts receivable balances, and days of payables (DPO) when evaluating accounts payable. I evaluate the trend to see if it looks like there might be some cash hiding in there (or problems hiding in accounts payable).

You would be surprised how paying closer attention to these accounts, and the metrics that drive the balances, can highlight sloppiness that can be fixed quickly. And "fixing" the problem produces instant cash!

Step 4: Create a reliable financial forecast for the next six to eighteen months

By *reliable*, I mean the forecast is a tool for strategic decision making. It is a tool for making *better* business decisions. By *forecast*, I'm referring to a fully modeled set of financial statements including the income statement, balance sheet, and statement of cash flows in the same format you use for monthly financial reporting.

One of the most powerful tools in business is a reliable financial forecast.

A reliable financial forecast is meant to help you:

- Define where your business is going financially (and where you want it to go).
- Shine a light on the dangers and opportunities that lie ahead of you on your journey.
- Create a roadmap to get you there safely and on time.
- Monitor your pace and progress on your journey to success.

It's a tool for hooking your vision and strategy for the business up to the likely financial implications of achieving your plan. It's your view through the financial windshield of your business.

When you know where you are going and you have a plan to get you there safely and on time, you will feel a sense of courage, confidence, and peace of mind. This is why financial forecasting is such a powerful tool in business. In essence, it forces you to think strategically about your business and where you want your business to go. It encourages you to paint a picture of what business and financial success look like in a way that is revealing and enlightening.

You will be pleasantly surprised by the confidence and courage you feel once you have a reliable financial forecast at work in your business.

Part 2: Create a Financial Safety Net

Wikipedia says a safety net is "a net to protect people from injury after falling from heights by limiting the distance they fall, and deflecting to dissipate the impact energy." A safety net helps the circus performer on the high wire avoid death (and protects the audience from watching them splat on the ground) if they make a mistake during a performance.

The safety net also frees the performer up to take more chances. They can learn more difficult and advanced "moves" knowing they are protected from the inevitable falls that come with learning and experimenting. That way they can put on an amazing performance for their audience.

In business, a financial safety net is created by having some money (cash in the bank) and less debt.

And it provides you the same two benefits: it protects you when financial surprises hit (avoiding the splat on the ground) and it allows you to take measured risks (learning and experimenting) to grow your company.

A financial surprise could be a sudden reduction in sales, a large customer that pays late, or an unexpected expense that blows a hole in your budget. Without a safety net, you have to scramble to avoid disaster or embarrassment with vendors or employees. With a safety net, you simply deal with the surprise and move on. No drama. No losing sleep.

Taking a measured risk could be hiring that new sales manager you think can double sales. The risk is the new sales manager might not land any new sales. You might lose money because you are paying them a base salary to get started. It could be a total flop. Without a safety net, you might have to reduce other expenses to make up for the shortfall. Or you might have to borrow money just to get by. With a safety net, you know in advance that if the worst case happens you can live with it. You can write the check and move on. No drama. No losing sleep.

Step 5: Pay your bank line down to zero (even if temporary)

A revolving line of credit is meant to, well, *revolve*. You borrow on the line in order to meet seasonal demands or address other short-term cash needs. Then the bank line should be paid back down to zero.

A good example of a revolving line of credit is a company that carries inventory and whose sales are highly seasonal. Ahead of the busy selling season it has to increase inventory levels. The bank line can be drawn on to fund the inventory purchases. As the seasonal selling comes to a close, and the increase in inventory has been sold and converted to cash, the company can pay down the line. It had a temporary need to borrow money and the bank line gave the company the flexibility to meet its cash needs.

The problem is that many businesses borrow on their bank line for other than temporary cash needs. Sometimes it's used for capital expenditures. Sometimes to fund losses. Sometimes to fund owner distributions. The availability of cash from the line can easily lead to decisions that have serious consequences later. The discipline of forcing yourself to pay off your bank line at least once a year (or more) will help ensure you are using the bank line the way it was intended.

Step 6: Reduce your personal guarantees (begin the process)

In the early days of building a business it can be difficult to avoid personal guarantees. But as you grow and become more successful, you have more leverage, and more reason, to purposefully begin reducing your personal guarantees. Most businesses are run inside a legal entity like a corporation or limited liability company (LLC) in order to provide some liability protection for its owners. Legal entities have assets and liabilities separate and apart from those who own the entities.

A personal guarantee is you agreeing to take personal responsibility as an owner for a specific debt or obligation of the business. So if the company files bankruptcy, or fails to pay the obligation, you are personally responsible to make the payment.

Most entrepreneurs and business owners rarely consider how much they have personally guaranteed. And they are shocked at the total dollar amount they are personally responsible for. One reason the number is so surprising, and so big, is because the guarantees have occurred over a number of years as the business has grown. You finance some new equipment and the loan requires you to sign a personal guarantee. You sign a new lease or renew an agreement with an important supplier and a personal guarantee is part of the deal. Over time, as your business grows, the number and amount of obligations you've guaranteed goes up.

But as you grow your business and become more successful, it's wise to think more strategically and thoughtfully about how you handle personal guarantees. You do that in two ways. First, quantify the amount of your existing guarantees.

Figure B1-3 is a format to help you list and quantify your existing personal guarantees.

Figure B1-3

YOUR PERSONAL GUARANTEES

Obligations I Have Personally Guaranteed	
Bank or lender debt I have guaranteed	$ ______
Lease or related obligations I have guaranteed	$ ______
Supply agreements/obligations I have guaranteed	$ ______
Vendor contracts/obligations I have guaranteed	$ ______
Franchise agreements/obligations I have guaranteed	$ ______
Other commitments/obligations I have guaranteed	$ ______
Total amount I have personally guaranteed	$ ______

Second, slowly begin reducing the number of guarantees. One of the best places to start is to refuse to sign any new vendor or supplier guarantees. Most vendors put the guarantee on their credit form but that doesn't mean you have to sign it. They will almost always set up credit with the business as the only responsible party.

Step 7: Build your cash balance to three months of operating expenses

Building your bank balance to three months of operating expenses creates a cash cushion against surprises. And it provides "dry powder" so you can quickly jump on unique business opportunities that might come your way. Not to mention the fact that there's nothing like a healthy cash balance to help you sleep well at night.

Part 3: Grow and Enjoy Financial Success

Growing a successful business is much harder than most people realize. Only a small number of people have the unique talents and drive to build and manage a company through the many ups and downs inherent in business. Even fewer people can grow while at the same time making the company worth more and more money along the way.

Ultimately, your financial goal in business is to create wealth and freedom.

I like to define wealth as having a strong net worth (assets greater than your liabilities – both in the business and personally). For one person, that might be a $1,000,000 net worth. To another person that might be a $25,000,000 net worth. Or put another way, having a strong net worth is about "having money." Money helps make a lot of things in life just a little bit easier. It gives you options. It makes it easier to help other people by sharing a portion of the financial resources you have accumulated.

Of course, money isn't necessarily the only prize in business. There is the pride of accomplishing something very challenging. There is the knowledge that you helped your customers and team members along the way. There is the freedom and peace of mind that comes from taking a risk and winning.

These last three steps in the process help you set the stage for a future that is even bigger and brighter than your past.

Step 8: Use existing cash flow for capital expenditures and growth capital

Capital expenditures generally take two forms. The first I refer to as "maintenance capital expenditures." These are expenditures, or investments, that maintain your existing fixed asset base. Generally speaking, they help prevent decline. The second is "growth-related capital expenditures." These are meant to add new income-producing assets. They are designed to add to your ability to serve more customers, drive revenues higher, and increase profitability and cash flow. You are wise to fund both with internally generated cash as you grow and become stronger financially.

Step 9: Pay down your remaining debt on an accelerated schedule

Debt can be an important tool in helping you build your business. But with financial success comes the ability to pay your debt down on an accelerated schedule. Use a portion of your existing cash flow and allocate it to a more aggressive payment plan. It will feel weird at first. But you will come to love the feeling of strength and accomplishment watching your debt levels shrink.

Step 10: Reward the owners of the business with cash

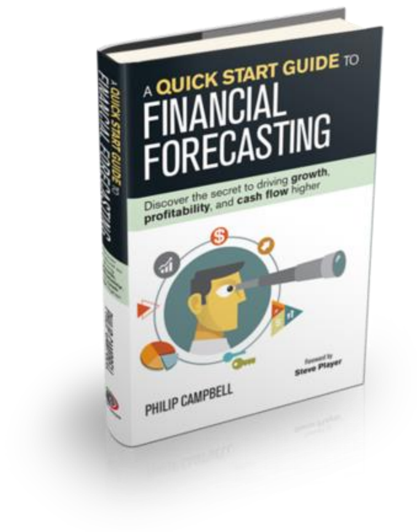
The ultimate financial reward for a business owner is receiving healthy distributions of the company's excess cash. It's your reward as an investor. It's your reward for building a successful company. It's cash you can invest in other assets or ventures as part of building a sizable net worth for you and your family. It's a fantastic way to enjoy the fruits of financial success.

Start Slow

When you have a step-by-step plan to follow you'll find that managing your business gets easier. Start slow. No need to speed through the three-part plan. I designed it so you can implement it in small steps. One foot in front of the other.

Start by implementing step 1. You will begin to see progress much faster than you might imagine. Then you can begin thinking through each of the other steps in the process.

A Quick Start Guide to Financial Forecasting



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