A Foolproof Guide to (Realistic) Financial Forecasting

As your small business grows, you'll eventually need a major cash inflow to take your company to the next level. Aside from looking at past numbers, investors and lenders are particularly interested in your projections for your balance sheet, income statement, and cash flow statement. Let's review key steps in performing realistic financial forecasting for these three documents.

Get Started With These Free Templates

To save you time on financial forecasting, download our free templates that you can use as a jumping off point:

- Cash Flow Statement Template: Provides a breakdown of the cash inflows and outflows of your business, and shows how much actual cash on hand you have at the end of a given period.
- Income Statement Template: Presents the profitability of your business by subtracting all applicable expenses from your total income. The result is a net profit (or net loss).
- Balance Sheet Template: Shows the assets, such as cash, inventory, and equipment, of your small business and how much of them are owned by you (equity) and your lenders (liabilities). A balance sheet provides you with a snapshot of your business's financial position (what you have and where it came from).

Throughout this article, we will reference back to these templates. If you need a primer on how to fill out these financial documents, here are two useful resources:

- A Guide to Balance Sheets and Income Statements
- How to Do a Cash Flow Analysis (The Right Way)

Using invoices, receipts, bank and credit card statements, and other business documents, you can input the information to gauge the financial situation of your operation for a set period of time—past or current. But, what about if you're still in pre-launch phase, or trying to project for future periods? Let's tackle the process to perform realistic financial forecasting for each one of these statements.

Financial Forecasting: Your Cash Flow Statement

Start with you the most readily available information that you can gather: costs.

Think of a cell phone or Internet plan for your small business; you can gather pricing data for a series of plans up to the next 36 months, and choose a reliable estimate for the next three to five years. If you have been in business for a couple of years already, you may even be able to provide an educated guess of the annual price increase of certain expenses (if any).

On the cash flow statement template that you downloaded above, look under Operating Expenses (Lines 11 through 25) for some common business expenses, such as accounting fees, advertising costs, wages, insurance premiums, and rent charges. Ideally, you'll want to break down your projections for expenses into months for the next three to five years. If you feel that you can only accurately forecast for the first year, then it's alright to present a total for the next two to four years instead.

As you're gathering your cost data, you'll find yourself pondering about the following type of scenarios:

- "If the rumors about the Home Depot warehouse opening nearby within a year are true, I may want to bump up my advertising budget up 30% this and next year to make more aware about my local hardware store."
- "Over the next two summers, I'm counting on the increasing influx of visiting foreign students that shopped for imported food items at my bodega. That's why I'm spending an extra 20% on stocking up on that type of inventory over the same period. If immigration laws were to dramatically reduce the amount of visiting foreign students, how would I be affected?"
- "My small business in Oregon doesn't offer a retirement plan to our 11 employees. However, the state-mandated retirement plan OregonSaves may require me to enroll some or all of my employees in this state-sponsored retirement plan as early as May 15, 2018. Depending on how many of my employees enroll or opt out of the plan, I will incur additional operating costs."

You'll need to create three scenarios for the financial forecasting of your expenses:

- **Regular Scenario**: Assumes that things are going to happen as planned or within an expected range.
- **Best Scenario:** Shows the effects of the best possible things that could happen, such as cancellation of the big box store opening in your area, continuation in influx of visiting foreign students, and the cost of retirement plan being one third of what you originally expected.
- **Worst Scenario:** Provides a glimpse into your business operation when it gets hit with

the kitchen sink…and then some.

It’s a good practice to keep a list of the assumptions for each scenario so that you can have the context for applicable changes in some of the numbers. This is living, breathing document; don’t be afraid to adjust the assumptions and make changes to your forecasts as necessary.

By forecasting both a best-case and a worst-case scenario, you won’t be *completely* blindsided if something unexpected throws a wrench in your original game plan. You’ll also be able to provide articulate answers to the questions that potential lenders and investors have when evaluating the sustainability of your business.

Estimate Sales and Costs of Sales

Now that you have three scenarios, you’re in a better position for financial forecasting for your sales (line 6 from cash flow statement template) and corresponding costs of sales (line 7) under those three scenarios. While it’s easy to get excited about your “baby” (a.k.a. your small business), keep your enthusiasm in check by sticking to the assumptions that you laid out originally. Your best case scenario can have a “to the moon!” attitude; your worst case scenario, not so much.

Use your revenue projections to double-check expenses. If you were to project your sales to increase by 50% by offering credit to your clients under the best case scenario, double-check that you have a realistic number of employees or contract workers to handle the extra orders, account for the extra hours or fees needed to keep track of accounts receivables, and make an allowance for payments that you won’t be able to collect from clients. This information is going to come in handy when completing financial forecasting for your balance sheet.

If your small business manufactures products or purchases them for resale, you have the option of including eligible expenses, such as costs of raw materials, storage expenses, and direct labor costs, in your cost of sales (also known as Cost of Goods Sold or COGS for short). As a reminder, the formula for COGS is:

COGS = Beginning Inventory + Purchases – Ending Inventory

Depending on your type of operation and industry, you may need to breakdown cost of sales to keep track of key charges. Just remember: no double-dipping. Once you include certain expenses in your COGS, those costs can't be listed again under operating expenses.

By keeping track of total operating expenses and total cost of sales, you're also preparing for tax season.

To complete the cash flow statement starting on line 29 use the guidelines set here. For additional tips on identifying and using cash flows from operating, investing, and financing activities, refer to our guide on cash flow analysis.

Financial Forecasting: Your Income Statement

By completing the forecasting for three to five years of your cash flow statement, you've completed most of the necessary legwork for your income statement and balance sheet for the same period.

On the income statement template that you downloaded above, input the same amounts for revenue (lines 9 through 12) and costs (lines 16 through 22). To save you time for future updates, refer cells on the income statement back to the appropriate revenue or cost on your cash flow statement. This way, any updates made on the cash flow statement will be automatically transferred to the income statement. Edit the document as necessary to account for the specific revenues and costs from your small business.

Note: On the cash flow statement we included taxes (line 19) under operating expenses. On the income statement, you want to calculate your net income *before* taxes and account for your tax expense on line 26.

The income statement template is setup to automatically add up your total revenue (line 13), total costs (not including taxes, line 23), and net income (line 26). Complete the forecast of your income statement for the next three to five years.

Financial Forecasting: Your Balance Sheet

On the balance sheet template that you downloaded above, you'll list the assets, liabilities, and owner's equity from your small business. Here you'll leverage data from your cash flow and income statement to forecast amounts for these three items.

During cash flow analysis that you completed during the development of your cash flow statement, you establish the cash flows from operating activities (lines 31-32), financing activities (lines 34-37), and investing activities (lines 38-39). This analysis will provide some guidelines for the numbers to input on your balance sheet for:

- Current Assets (lines 9-13);
- Fixed Assets (lines 17-21);
- Other Assets (lines 25-27);
- Current Liabilities (lines 34-40);
- Long-Term Liabilities (lines 44-47); and
- Owner's Equity (lines 51-53).

When making assumptions about debts or capital that you will secure in the future, make sure that you're able to backup your data with as many facts as possible. For example, a startup enrolled in an accelerator program with an initial investment of $25,000 from investors could safely forecast that is expecting to receive up to $75,000 in follow on funding from those same investors over the next one to two years. However, a small business owner without a business credit score and a FICO score in the 500's could have a hard time proving that he's going to secure a $200,000 business loan—unless that business owner could show ownership of an adequate collateral for the loan.

The balance sheet is setup to automatically add up all totals for each one of these six categories. Complete the balance sheet for the next three to five years, as needed.

Putting It All Together

It should be clear that your cash flow statement, income statement, and balance sheet tell a consistent story. Financial forecasting is a dynamic process that you should revisit at least once every quarter, or whenever a major event takes place.

One way to check for the consistency of your numbers is to use key financial ratios, which your investors and lenders would use to evaluate your statements. Here are two examples:

- **Quick Ratio**

$$\text{Quick Ratio} = \frac{\text{Cash + Cash Equivalents + Short-term Investments + Accounts Receivable}}{\text{Current Liabilities}}$$

Also known as the acid-test ratio, the quick ratio measures the ability of a business to use its most liquid assets to cover its current liabilities. A very low quick ratio is a red flag that a cash crunch could be a major stumbling block for a business.

- **Gross Profit Margin**

$$\text{Gross Profit Margin} = \frac{\text{Gross Profit}}{\text{Net Revenue}}$$

This ratio measures the efficiency of a business in using its raw materials, labor, and manufacturing-related assets to generate the bottom line. The gross profit margin is a useful test for your best-case scenario. A gross margin that makes a dramatic jump from the regular scenario to the best-case scenario could be an indication that the estimates for expenses are off.

There are dozens of financial ratios and some of them aren’t applicable to some industries. Don’t try to use every single one and stick to the ones that make the most sense to your operation and that your investors and lender are most interested in. By focusing on a handful of financial ratios, you’ll become more aware of the effects of business decisions on the profitability of your business and have useful benchmarks to evaluate the performance of your small business.

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