

Financial Projections

Introduction

Any business plan must include a section detailing the financial projections, because these projections are a forecast of the future economic-financial results of the company's operations.

In addition, based on the financial projections several scenarios can be generated in which the company goes through different situations, resulting in different results estimates. This modelling helps the entrepreneur identify the possible risks that may impact the business and implement, subsequently, the different strategies that can ameliorate the negative effects.

Financial projections have, amongst others, the following functions and uses:

- Demonstrate the reliability and stability of the project in terms of obtaining financing from third parties (banks, credit entities, the state, etc. Having a financial projection is essential in the business world, especially for the small and medium enterprises because, provided they can show there is a business opportunity, it facilitates acquiring the necessary resources to implement the project.
- Looking for other partners to launch new projects or expand the existing one.
- Looking for state subsidies or private entity subsidies.

The length of the financial projections depends on the type of business and markets in which the activity is going to be developed. In mature and stable markets, the projection periods are lengthier, since they have to span a period inclusive enough as to give a full image of the business and its operational activity. For instance, energy companies measures the projection periods in 8-10 years intervals. More flexible or cyclic markets support shorter projection periods (between 3, 5 and 7 years, which are the periods most often used).

Key Questions to Draft the Financial Projection

The entrepreneur must base the financial projections in realistic figures and analysis encompassing the environment, the sector, the competition, clients, etc. once the following questions have been addressed the entrepreneur will have a starting point to begin the calculations. Elements to consider are:

◆ Macroeconomic aspects

- Am I considering the country's economic situation and evolution?
- Are the current economic conditions favourable for the implementation of my business project?

◆ Sector evolution

- Have I considered the history of the sector?
- Have I contrasted the hypothesis of my company's projection against the market forecasts?

◆ Business evolution

- Have I done an exhaustive analysis of the financial statement history of my business?
- Are the projections realistic and can I live with them? Do they incorporate reasonable variations?
- What impact do the different policies and strategies on the financial projections?
- Have I considered the market agents (competition, client, providers)?
- ◆ Historical evolution (once the business has been launched)
 - Is the historical market behaviour consistent and/or coherent?
 - What are the main deviations of my business from the market? Is the evolution presented by my business coherent/consistent?

Financial projections must be accompanied by a report explaining the starting hypothesis posed by the model so the coherency and consistency of the project can be verified against them.

PROFIT AND LOSS ACCOUNT

A financial statement that reflects the differences between revenue generated and expenses during a given period. It is a tool to establish if there are losses or benefits.

The analysis of the various accounting entries that encompass the profit and loss account is essential to evaluate the progress and evolution of the company:

♦ Sales

This is a relevant entry in the context of financial projections because it is a starting point for the development of the profit and loss account. Therefore, before calculating the projections the entrepreneur must build over a solid base of financial projections.

To project the sales, the entrepreneur must answer the following questions:

- What criteria are going to be used to project sales? Are the criteria consistent with the business plan?
- Are the sales suited to the market needs?
The entrepreneur must prospect the market, have a client-oriented approach, and be flexible and realistic before the changes in the market demands.

Are the projected growth rates higher than the projections for the whole sector? If so, explain the reasons for projecting a growth above the sector's average and the average time the company foresees that can maintain higher growth rates.

What method have you used to estimate growth?

There are several methods available to the entrepreneur to estimate growth rates, such as regression models and market or company information.

- What is the maximum limit for sales growth the company can finance with the available resources?
- What is the average growth rate of our direct competitors?
The entrepreneur can analyze his sales strategy by comparing with the competitor's, are they following the same trend? Does your business compete in a different manner?
- What is the average concentration of my potential clients?
The entrepreneur must know the company's main potential clients.
An increase in the client concentration level can lead a business to lose its negotiation leverage (impacting the prices and payment periods).
- How are my clients evolving? Have I considered their evolution when projecting my sales figures?

Projecting the sales is not an easy task. It requires integrating diverse variable that are subject to variations. If, however, the entrepreneur projects reasonable figures he or she will have also reasonable expectations and estimations of the evolution of the business.

The main hypothesis and aspects that must not be left out when projecting sales are as follows:

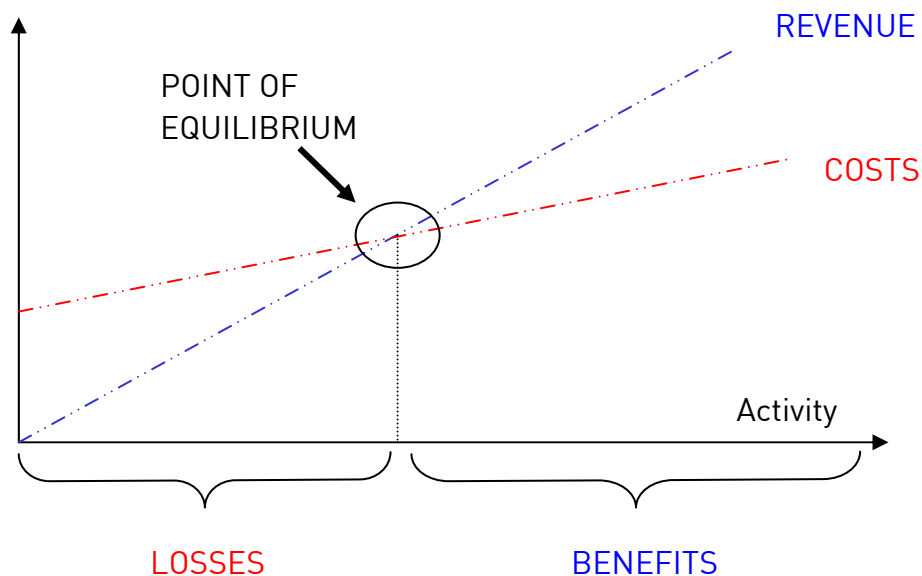
- Business lines
- Product lines
- Potential clients and their evolution
- Collection status of potential clients (payment delinquency)
- Historical evolution of the sales prices (sector)
- Exchange rate

VARIABLE COSTS

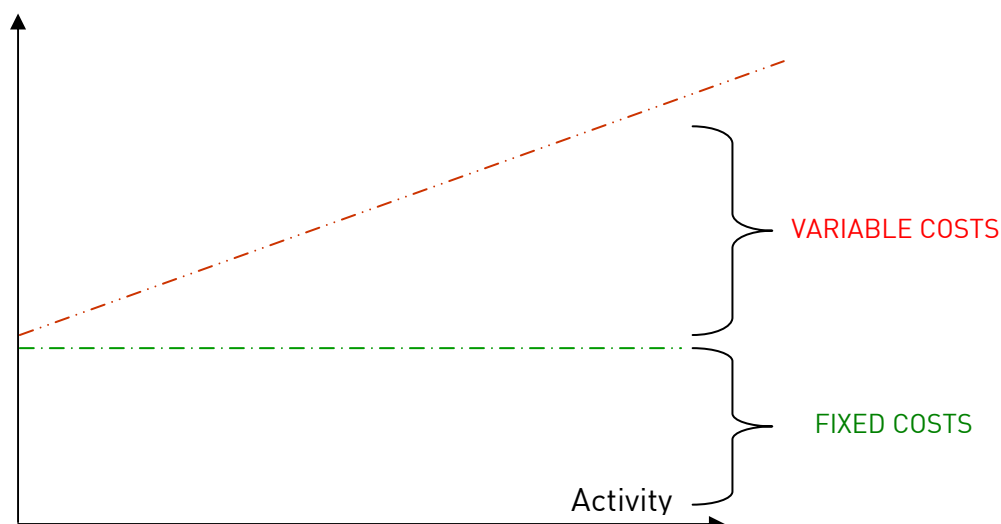
This account integrates the raw materials consumption, direct labour and other manufacturing overhead entries. Variable costs are those that depend on the level of operation and activity, for instance: in a bar the cost of the drinks depends on the number of drinks served.

The structure of fixed and variable expenses varies according to the type of business activity. What for some companies is a fixed expense is a variable expense for other type of business. The entrepreneur must, therefore, have special care in classifying the costs because each type of cost will receive a different treatment.

The level of activity at which the business can cover costs (fixed and variable), with zero benefits is known as the point of equilibrium. Below the point of equilibrium the company will incur losses and above that point it will garner benefits.



The expenses lines represent the total fixed and variable costs. The following graph shows the costs structure



Cost management is a necessary tool for decision-making and activity projection. Expenses are a fundamental variable in the business because of their direct relationship to the economic results, and therefore, to define the products/services to be provided the entrepreneur must first do a cost-benefit analysis based on the following notions:

- Whether the product/service generates value
- Whether the product/service is cost-effective for the company's cost structure
- A cost-benefit analysis of the production process
- Detection of improvements in the productive processes
- Cost-effectiveness of the client segments the company caters to
- Business opportunities at the strategic level

One indicator that is used to evaluate cost-effectiveness of the product/service to be marketed is the gross margin, or the difference between the sales and the costs variable.

It must be considered that the gross margin of companies that commercialize products is lower than that of the companies that commercialize services, because service providers, having no physical production, have higher profit margins on sales.

When projecting the variable costs and the gross margin the following must be considered:

- The entries corresponding solely to variable costs.
The entrepreneur must exercise special care not to confuse expenses and costs and variable and fixed costs, because this misperception would distort the margin projections.
- Is it a capital or labour intensive product/service?
- Is the value added of our product/service low or high? Is this added value reflected in the variable costs?
- Which method is used to assess inventories, LIFO, FIFO or weighted average?
- Has Research and Development planned the investment?
- Is there any possibility to improve the efficiency of the business productivity? Which is going to be the impact of the improvements on the gross margins of sales?
- What is the concentration and the negotiation leverage of my potential clients?
When projecting the cost of sales the entrepreneur must consider the potential clients with high negotiation leverage can apply pressure to lower the prices, which would have a direct impact on the margins.
- What is the concentration and the negotiation leverage of my potential providers?
High negotiation leverage on the provider's part may impact the costs of sales and decrease the margin.

Once the entrepreneur has answered these questions, he or she can proceed to the formulation of hypothesis necessary to Project the variable costs. It is essential to consider the following:

- Raw materials
- Direct labour
- Forecasts of the utilization of the productive capacity
- Increments of Research and Development (productivity improvement)
- Impact on the margin derived from lowered prices
- Impact on the margin derived from increased costs of sales

PERSONNEL

Human capital is one of the most important assets of a company. The companies that are successful in their management of human resources can create a competitive edge hard to imitate.

Before calculating the projections the entrepreneur must consider the following;

- What are the job positions that must be filled to operate the company?
- Have I defined the functions of each position (job descriptions)?
The entrepreneur must go through an analysis process to define the different job descriptions or profiles required for each position. This will facilitate the selection and hiring process, increasing the possibility of efficiency at each post.
- Have I defined the salary policies? Do they correspond to those of the sector?
- Are there recruiting, selection, hiring, training and contract termination policies in place?
More and more the companies are paying attention to the selection process. Attracting and retaining skilled human capital can be the key to create a competitive advantage that can be sustained through time and increased the cost-benefit ration of the business.
- What is the projected sales return per employee?

The entrepreneur must base the projections on the personnel needs in order not to waste resources. It is more important to invest in fewer specialized personnel than in more less skilled personnel.

When projecting, it is important to classify the personnel by categories and average salaries because salary increases will be dictated by the industry and inflation. The personnel costs are influenced by salary increases and the variation in the number and quality of employees through the business year.

The table below shows a sample of personnel classification

	Gross salary (€)	Nº of Employees	Average Salary (€)
Management	2.600	2	1.300
Administrative personnel	8.500	10	850
Production personnel	20.000	25	800
Other personnel	4.000	5	800
TOTAL	35.100	42	3.750

OTHER EXPLOITATION EXPENSES

This account may include different sub-accounts depending on the type of business. This account includes entries that are easier to control by the entrepreneur.

Following the same methodology or answering key questions to formulate the projections, the next step is to itemize the more general entries and/or accounts:

- Rents: This account encompasses the total of active rental payments incurred to effect the operation of the business.
- Have I estimated the rent increases? Have I contrasted it with the market forecasts?
- Are the assets rented sufficient to launch the business plan? Are there possibilities to increase these assets?

The entrepreneur should be able to plan and quantify this issue to incorporate it to the projection

- Communication: This account reflects the advertising and marketing expenses.
- Which criteria have been followed to allocate the communication budget? Generally, communication expenses are calculated as a percentage of the sales depending on the brand or product positioning. It is important to plan ahead, because this is one of the accounts more affected by expense cuts.

Are there specific positioning policies for the product/service in place?
What is the impact they will have on sales on the medium term?

- Power/utilities: This account includes telephone, water, electricity, power expenses and similar expenses.
 - Is the production estimate consistent with the power/utilities expenses? If there is an increase in production have we provided enough to accommodate the power/utility supply?
 - Have the fluctuations of power/utilities prices been incorporated in the projected periods?
- Repairs and maintenance: this is an account influenced by the utilized productive capacity. The entrepreneur must know the conditions offered by the providers of fixed assets and the maintenance contracts that are generally contracted.
- Amortizations: amortization is the depreciation or loss of value suffered by investments in fixed assets (equipment, machinery, etc.). It is a good and cautious accounting practice to include this systematic losses suffered by the fixed assets in the accounting records.
The entrepreneur should answer the following questions to design an amortization plan:
 - What is the useful life of a fixed asset? And of the new fixed assets during the projected period?
Useful life means the period of time said fixed assets are cost-effective. This period may not coincide with the actual physical life of the asset.
 - What is the amortization schedule of the fixed assets?
 - What is the amortization allotment of the fixed assets? What method is used to calculate it? What effects does this have on the cash flow?

FINANCIAL PROFITS

This entry encompasses the financial expenses and revenues. Expenses in this context are the expenses associated to the payment of interests on the debt. The revenue is generated by the deposit and financial investments of the company. The entrepreneur must have a clear understanding of the interest rates paid on the debt and calculate the projection accordingly.

BALANCE SHEET

The balance sheet is a financial statement that reflects the financial situation of the company on a given date. The general balance sheet has only real accounts. A balance sheet must be done yearly, at least, on December 31st and be signed by the responsible parties.

To properly do the balance sheet projections, the entrepreneur must consider the main entries of the balance sheet and answer the following questions:

➤ **Asset:**

The set of economic resources owned by the company and available to it.

◆ **Fixed assets:** This account includes land, constructions, machinery and facilities, furniture and office furnishings, and computer equipment.

- Is the investment in fixed assets consistent with the business plan?
- Is there a plan for new investments in fixed assets? Is it consistent with the projected growth for the next periods?
- Is there a replacement investment in place?

◆ **Stock:**

- Is the inventory management planned?
- What is the method used to assess inventories? Why was that method chosen? How does it affect the consumption of raw materials?
- Is there an estimate of the rotation of inventory days?
Something to consider is that the possible increase of the rotation period increases the costs.

◆ **Debtors:**

- Has the type of client been considered when doing the projections?
The collection period (in days) varies according to the client. For instance, a supermarket has a longer collection period.
- How has the collection period been estimated? Has the weight of the client in terms of sales volume been considered?

◆ **Cash:**

- Has there been any assessment of the projects' revenue generation capacity and their feasibility?

- Can the internal source flow and treasury positions of the company be quantified?
- ◆ Financing needs:
 - Can I launch the business plan according to the planned financing?
 - How are the new business investments going to be financed?
 - Is the working capital positive or negative? AND, How much is it?

The financial projections show the feasibility, cost-effectiveness and the opportunities for success of the business. It is a letter of presentation for the financing institutions, new investors and projects.

Financial projections are, in short, a tool for the management and planning of the business, since they set the objectives and serve to monitor which have been achieved.