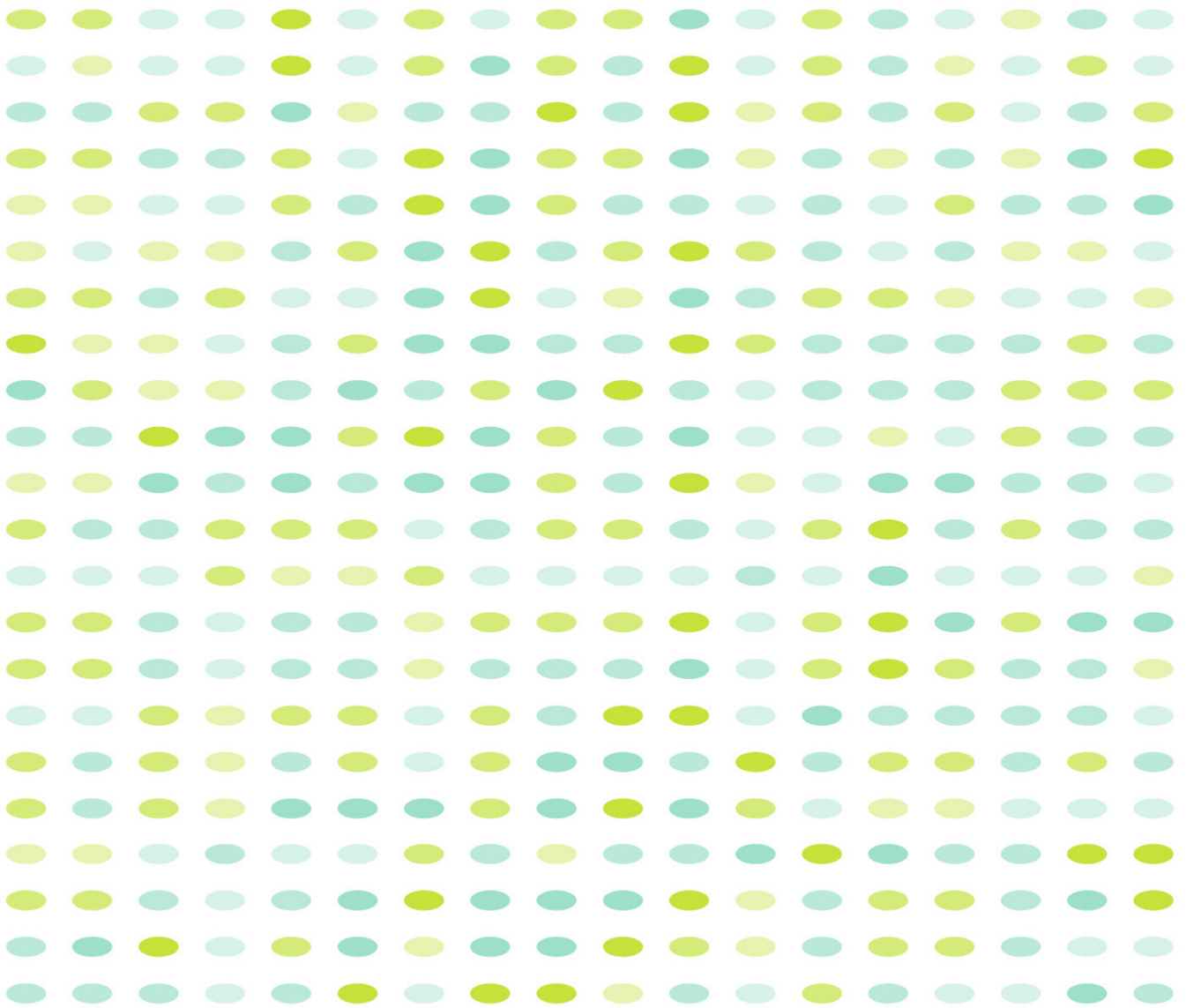


The SWAIN guide to getting the best from financial projections



In conjunction with:

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The South West Angel and Investor Network (SWAIN) connects private investors or “Business Angels” with companies looking for investments.

SWAIN specialises in helping small and medium sized companies to find equity finance, and assists private investors in the South West to search for investment opportunities in businesses with growth potential.

Financial projections are a key factor in establishing whether a business is investment attractive and typically form a basis for establishing a valuation. Unrealistic or badly constructed projections will almost certainly put an investor off continuing discussions.

Financial projections – why bother?

Good question! Which could be answered by reference to headline on BBC Website on 2 February 2007 which read ‘No budget ‘risks’ Olympic success: The government’s failure to set a budget for London’s Olympic Games is a “major risk” to success, Whitehall’s spending watchdog has warned.’

Two of the main reasons put forward for not producing financial projections are:

- ‘Time’
- Degree of estimation required (‘Crystal ball gazing’)

In this guide we will aim to show the fallacy of using ‘time’ as a reason/ excuse for not preparing projections. We will also illustrate some tools and techniques for reducing the time involved in preparing a set of projections and refining the estimation involved.

Acknowledgment: every business is different

All businesses are different – consequently there is no universal template to apply to financial projections. Each entity is individual in its current circumstances including internal finances and performance and external market influences and activities. A business is also unique in its vision for the future.

The approach to the preparation of financial projections needs to encompass the ‘individuality’ of the business and the owner/ manager if they are to be considered ‘relevant’ post any immediate requirement for finance (see below).

‘Preparing financial projections is a bit like cramming for exams’

In some cases the achievement of the businesses goals may only be achievable with the aid of external finance. In these cases financial projections are often a ‘prerequisite’ within any business plan before approaching potential financiers. Unfortunately, all too often the projections (and the business plan) are not used post finance being achieved: their purpose being seen as limited to ‘necessary evil’ in the securing of finance as opposed to valued tool for continual financial management. We will aim to show why not using the projections post finance being obtained is a ‘waste’ and how this can be avoided.

Context = one of the 'keys'

In terms of what constitutes a 'good set of financial projections' there will be certain elements in preparation and presentation that will underpin any set of financial projections. These will be overviewed in some of the sections that follow.

One of the fundamentals that need to be fully thought through before starting to pull figures together is 'what is the purpose of the financial projections?' As we acknowledged above, a number of businesses are prompted to prepare projections by an external (finance) requirement.

Projections prepared for an external financier have to consider that financiers needs as well as those of the preparer – at a simple level projections for grant finance need to demonstrate (or illustrate) a 'finance gap'. At the more 'complex' end; projections for a Venture Capitalist will probably need to demonstrate a required Internal Rate of Return (IRR). It is essential therefore to understand your target audience. This is one area where professional assistance can be useful as your advisors may have experience of similar applications and/or have contacts at specific financiers (see below).

Seeking external advice

Some of you may have considerable experience in preparing financial projections and/or have in-house expertise to assist you pulling together financial projections/ budgets. Depending on the use(s) to which the financial projections are to put, it may be that no/ very little assistance is required for 3rd party accountants/ advisors.

However, particularly when the projections will be used for obtaining external finance application, we would strongly recommend using accountants/ advisors to assist. There are 3 key areas where a 3rd party should bring expertise to the fore in the preparation of projections to assist in finance application:

'Robustness' checks/ cold review: do the figures (and the underlying assumptions) stand up to external scrutiny i.e., do they make sense?

- a) What are key general considerations of the specific external financier (see 'context' above) e.g., will the financier be expecting to see a specific IRR?
- b) What are the specific concerns/ issues that the recipient of the projections may have with your business model and how are these managed in the projections?

We have found that dialogue between us and a potential financier at an early stage can help to identify their specific issues – we, for example, sometimes do this by submitting a 'one page' summary of the finance proposal with specific questions to potential financier before anyone has committed to preparation of financial projections (or business plan). Therefore, it is important to receive professional assistance during the planning stage of a finance application.

Projections must be yours!

We cannot stress enough however that the projections must be 'your document' – whilst external accountants/ advisors can provide tools to assist in preparation of the financial projections you have to believe in the underlying assumptions and feel that the projections are aligned with your goals. You provide the insight into your business, your goals etc: we accountants can project the financial implications.

Making your strategy real

Projections can provide a vital business mapping tool but if you don't know your destination then any map is ineffective. Therefore as part of the initial planning process, prior to undertaking any projection analysis, it is vital you have an objective. Objectives may be to 'sell within 4 years' or 'bring management in to allow you to spend less time in the business'.

Any objective then needs to be converted into quantifiable targets within a specified time frame. One approach that we have found works is to think what your business must look like in say 4-5 years (in terms of turnover, staffing, profit etc) for the objective to be attained. Once this is quantified (approximately) you can work backwards to ascertain how the business must develop over the intervening period. This provides the co-ordinates of which the projections will endeavour to reach.

Doing the above, not only provides the basis for the projections. It also stimulates and refines thoughts of what steps need to follow and how these may be achieved. It also gives you a working target, giving both yourselves and employees something to work towards which can be integrated into budgets or allows for the advance planning of potential contingencies.

Risk and risk management

During the planning process for preparing financial projections there are two critical assessments which require resolution in order to consider/manage any elements of risk related to the businesses future.

- What must happen for this plan to succeed?
- What could prevent success and what can be done to mitigate and manage that risk?

The answers to the above questions provide the key components within the plan/ strategy that underpin the financial projections.

Create a framework

To ensure that Owner/ Manager objectives and risk management are both incorporated in the financial projections it will be useful to document the outcome of discussions in these areas: either in business plan (particularly if required as part of package of documents required by potential financier) or as a one page document. This 'strategy and risk' document will be a point of reference as the projections are constructed and more detailed assumptions and made (and documented).

At all times it should be appreciated that projections are a 'best guess' – as they necessarily involve prediction of future events. We consider below some of the tools for assessing whether assumptions made are 'reasonable' (in the context of information available at the time) and for creating projections against which actual performance can be meaningfully monitored below.

Projection techniques

We tend to use a specific piece of forecasting software for preparing financial projections as opposed to excel; the reasons for this can be summarised as follows:

The software produces integrated profit and loss, balance sheet and cash flow projections

- a) the internal 'integrity' of the software is 'validated'
- b) the software is designed to look at 'what if' scenarios

The choice of package for those looking to produce their own projections should we feel encompass the above. In

addition, you should consider interaction between you and your accountants/ advisors i.e., what involvement will they have in the preparation of the financial projections and any subsequent revisions (including the period post finance application).

Document assumptions

The one aspect we would say is essential whatever package is used is for the assumptions to be clearly documented e.g., the basis for sales figures (in terms of monthly units and prices); salary costs (in terms of employees and salary), fixed assets (what do we need to acquire, when and how much) and when will we collect debtors etc. We tend to have 2 to 3 pages of word narrative (bullet point in format), accompanied with spreadsheets for significant variables e.g., sales and wages.

This assumptions document will provide the key to both external scrutiny (robustness checks) and the ongoing use of the financial projections (see below).

Be wary of over optimism

Optimism can often come to play when it comes to the preparation of projections! A way of ensuring this is 'managed' is to look cold at the assumptions document, asking oneself:

- Is the assumption credible given the business' historic performance, size of market etc?
- Do the projections include all costs necessary to make a 'step change' in the business' performance e.g., if sales are to increase by a substantial percentage have we factored into the costs, additional marketing spend and/or additional warehousing (if applicable) etc or if debtors days are to decrease from 90 to 60 will this require another person employed on credit control/ debt collection?

Projections – construction from profit and loss account

We find that most owner/ managers feel 'comfortable' in projecting profit and loss account and often we receive summarised profit and loss accounts (annual figures) with narrative assumptions as to phasing of income across the year and cash collection etc. This may in part be to the experience of the owner/ manager in looking at business' profit and loss report (monthly/ annually?) and the availability of historic information to benchmark projections.

Cash is king

'Cash is king' is often the mantra as poor cash management can quickly lead to disastrous consequences, even for a profitable business and therefore prior identification of 'pressure points' on cash resources can facilitate proactive planning. In terms of projecting cash flows, a few tips are set out below:

Credit Terms

These require the credit term calculation to be incorporated to be realistic of that in practice. Therefore if officially the credit term is thirty days but on average it takes forty five days, it is the forty five days which is integrated into the projections. To a certain degree it is favourable to include an element of pessimism in order to ensure the projections are to be beneficial.

Capital expenditure

Do not forget to include the cost of additional equipment in order to produce the products necessary to meet the increased sales figures or achieve the projected efficiency savings. Consider whether what lead-time is required for construction of machinery/ facilities and whether any training time will be required for new asset to become fully operational.

Stock

What stock levels are required? And what are payment terms for stock items?

One off costs

In certain areas where projections are required such as business start up and business growth and development there is likely to be additional one off expenditure which must be accounted for in order to be appropriately reflected within the projections. Such costs include, research and feasibility studies, legal and professional fees, investment in assets and so forth.

Tax

Do not forget that profits = tax liabilities. When will these fall due?

Opening balances

Projections have to start somewhere: for existing business it is essential that the opening balances are 'credible' (specifically they include all liabilities). Moreover the projections need to factor in cash flows

arising from debtors and creditors included in these opening balances. I.e., the omission of a payment significant opening creditor will mean the projections are almost immediately overstating the cash position.

Balance sheet: much undervalued tool in reasonableness testing

After producing a first draft of integrated profit and loss account, cash flow and balance sheet; the first question is to assess whether the figures appear reasonable.

We find that Owner/ Managers often look only at profit and loss account and cash flow – we find that the balance sheet is often the key to ascertaining whether some assumptions correctly applied and/or 'reasonable' in the context of historic performance. E.g., if creditors are substantially higher (i.e. higher than one would expect based on growth of business alone) at the end of a year than the beginning we should check everything paid for and the terms are consistent with those we should expect.

In carrying out the reasonableness review one should also try and evaluate expectations before looking to see whether these are substantiated by the figures (as opposed to looking at what has been projected and trying to rationalise why it must be 'right').

Last checks before submission to potential financier

Having looked at internal logic of projections that 'last check' (rechecks) will include:

- Consistency with business plan e.g., if we say in business plan we will taking on additional staff are these costs reflected in financial projections?
- Are the general consideration and specific issues raised by potential financier dealt with (see seeking advice)?
- Are the projections consistent with your goals?
- Do you believe in the figures? And are the figures defensible with 'hard evidence'?

Projections as a management tool

As we set out at the start in some ways the 'real value' of projections should be in their capacity as a management tool.

.By looking at the actual performance and positions against those projected, you can identify and analyse why such variances have occurred. The key to getting meaningful information from such a comparison is the 'sophistication' of the underlying assumptions (see projection techniques) and the information recorded in the businesses accounts package.

Consequently, we would advise that:

- a) System be established for actual performance to be recorded against projections that profit and loss and balance sheet
- b) The businesses Management Information System (MIS) encompass collection of information which underpins 'key performance indicators' e.g., if sales units are key then does the system collect sales units.

What is required timely information to enable Owner/ Manager to assess is the 'business on track', assess the reasons for any discrepancy and consider corrective action.

In the context of corrective action it may be useful for Owner/ Manager further 'what if scenarios'.

Conclusion

As indicated projections can be a very valuable tool in investing and developing a business. However, in order to reap maximum benefit you have to make sure you use them beyond their initial use as part of package to obtain finance. While sound projections cannot guarantee success, time invested in their preparation can ensure that the financial performance of the business is targeted to delivery of the Owner/ Manager's objectives, with risks and financial pressure points pre-empted and proactively managed.

In all cases you should take early and appropriate professional advice. Please visit our website for a list of well established Westcountry professional firms.

www.swain.org.uk

If you would like to discuss any of the issues raised in this guidance note, please contact any of the following at Winter Rule, Chartered Accountants and Business Advisors, which have prepared this guide:

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