Financial Projections: What to look for in a financial modeling tool

A White Paper

Executive Summary

Doing financial projections provides enormous value to business owners and managers. The value arises from an increased probability of survival, improved profitability through better decisions, and help with raising capital or borrowing money.

There are a number of features to look for in a financial projection model. These include the ability to handle history, do financial analysis, and automatically load external data; the ability to do near term projections (months) *and* long term projections (years); and a robust set of analysis, reporting, and graphing tools. These features are in addition to a good solid financial model that approximates how your business operates.

The value of doing financial projections

Size of the business, complexity, and the need for affordability drive the make or buy decision.

Financial projections help illuminate the path ahead. Like using headlights when you drive your car at night, financial projections help make it safe to travel 65 MPH when the way is clear. Financial projections also help you avoid running into the ditch when traversing the back roads of volatile sales and cash flow.

The discipline of doing financial projections on a regular basis improves decision making, and helps you avoid surprises.

What happens when you hire someone? You're making a statement: that you need the fruits of their labor. But also, that you will generate sufficient sales and gross profit to cover their salary, payroll taxes, benefits, office related expenses, telephone, computer, etc.

What about upgrading a computer system? Moving to larger quarters? Buying larger quantities of inventory to get quantity discounts? Buying from a more expensive supplier to get access to credit? Paying a fee to increase your credit line? There are dozens of decisions to be made each week. It helps when you have an overall framework to analyze these decisions. A financial model can provide this framework.

The value of financial projections are many fold:

- Survival when things are tough
- Better decision making because you are not operating in the dark
- Improved chances of landing a bank loan or raising capital

How much time and money should you spend? I saw one study that said larger companies spend about 0.35% of revenues on budgeting and financial planning.

It depends on your situation. If yours is a stable company with minimal growth, it probably isn't worth a whole lot. 0.35% of revenues might be the maximum. That would translate to $350 per year to $3,500 per year for companies in the $100,000 to $1,000,000 range for annual sales.

If you are applying for a bank loan, it might be worth 1% or 2% of the amount of money you are trying to borrow.

If you run a volatile company, and don't have a lot of cushion, it may be worth a huge amount to avoid running out of cash and going under. At the risk of sounding like a cost / benefit analysis where you have to put a price on a life, you might look at avoiding $10,000 to $30,000 in fees for a bankruptcy attorney.

If you run a company on the go, the case is even more compelling. Things change quickly, and you are constantly experimenting to see what works and what doesn't. Knowing what is working early, and being able to simulate the impact of big decisions can make the difference between losing 5% on sales, and making 10%. The value is huge. You can afford to spend at least a portion of that on management time and software.

The bottom line is that doing financial projections provides tremendous value in better decision making. Even for a smaller company, this can amount to thousands of dollars a year.

What to look for in a financial projection model

Financial projections are not done in a vacuum. You need a starting point, and a decent model. Following are some things to look for when choosing financial modeling tool.

History and Projections together in one model

You need a starting point, and by that we mean items from you balance sheet. How much cash do you have? Inventory? Receivables? How much do you owe?

Having several months of operating history at your fingertips is also helpful. What have sales been the last 3 months? What are your margins? How much space do you need per person? How long does it take on average to collect money from a sale? How quickly have you been paying your vendors? Room for history and projections together in the same model make it easier to analyze what has happened in the past, and make thoughtful assumptions about the future.

Loading Historical Data

For the history part, you need an efficient way to load data as you close each month. This implies a strong link to your general ledger and possibly other data sources. You want to minimize the work it takes each month to have your projection model updated with the latest results.

Forecasting

For the projections, you want to be able to enter your assumptions numerically (i.e., sales will be $X next month), or base an assumption on history (use the Year to Date average for Supplies, use a statistical forecast for Widget Sales).

Drilldowns

By their nature, projections are done at a different level of detail than the accounts in a general ledger. It is helpful to be able to do drilldowns so that you can see what is behind a certain number in months past.

Viewing logic

A model is only as good as the faith you have in its calculations. When you are putting together the projections, you need to be able to look at how any variable is calculated. It would be nice if this information was available in English instead of Spreadsheet-ese.

Months vs. Years

For short term projections, it is appropriate to use months as the basic unit of time. This is true for filling out the rest of the current year, or preparing a budget / plan for next year. For longer term, strategic planning, it really makes sense to use years as the unit of time. You want to make sure your projection model can handle either. Also, you don't want to fall into the trap of using two different models. You may spend most of your planning time just reconciling the two.

Graphing

A picture is worth a thousand words – as long as you don't have to do a lot of work to create it. Smart, quick graphing is an essential tool in a projection model. Not only can you visualize relationships between variables, but also you can judge whether your projections make sense. A graph combining history and projection instantly points to disconnects when they exist.

Reporting

Professional looking printed reports are necessary to communicate past performance and future plans to stakeholders such as bankers, investors, and employees. They are not just dumps of the screens you used to create the projection, but rather thoughtful presentation of the key elements that went into the projection.

Analysis

How does today's projection compare to the one made last month? What are the top 10 expense categories based on a percentage of total expenses year to date? You need some basic analytical tools help you poke at your projections, and improve their accuracy.

Peer Group Comparisons

How are you doing compared to other companies of the same size and/or in the same line of business? Are your projected margins reasonable? Is your productivity up to snuff? Having some mechanism to do peer group comparisons is yet another valuable feature to look for in your projection model.

Exporting Data

Is it easy to export assumptions and results to Excel and other packages? How about getting data back in – e.g. from a sub-model done outside the main projection model?

The Make or Buy Decision

If you've got the time and the money, a custom built model - built by someone who knows both modeling and your business - is the way to go. Using Excel as the underlying modeling tool is fine. A specialized modeling language like ENCORE! is even better. Expect to spend $10,000 up to $100,000 or more depending on the size and complexity of your business.

For the small to mid-sized company, the custom built solution is probably too expensive. There are ready built models available for anywhere between free (for basic Excel templates) to a few thousand dollars. If possible, find one specialized for your particular industry. Another approach is to find a good all purpose model that can be customized for your particular business – as long as you have access to someone to do the customization for you.

It is not just the cost of developing or purchasing a projection model to consider. You also need to look at the ongoing costs of loading data, running the model, and making changes to the model as your business changes.