

Creating Simple Financial *Pro Formas*

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A *pro forma* financial projection is a reasonable projection of the financial performance of a business or new venture.

A *pro forma* is not an audited financial statement - it is a projection of possible future results.

A *pro forma* developed during the early stages of creating a business concept package is an "educated, logical guess." **The *pro forma* is a set of reasonable assumptions that provides a defensible set of financial projections.**

The *pro forma* typically focuses on income statement / cash flow projections:

- 1) Revenues broken down to the projected number of customers (or transactions) multiplied by the revenue per purchase. A *pro forma* for a new venture would typically give monthly projections for the first 12 to 24 months, and then annual projections for two or three years after.
- 2) Expenses typically focused on cost of goods sold (COGS) and operating expenses. Because a *pro forma* is an educated guess, cost projections are typically made for only a few major cost categories. *Importantly, many new venture projections do not include owner compensation (other than a modest salary).* Investors assume that an entrepreneur / business owner will earn most of his / her compensation from the growth in the value of enterprise. This approach aligns the incentives of the entrepreneur / business owner with those of the investors.
- 3) Start-Up Funding Requirements are an optional part of a *pro forma*. Many new venture *pro formas* include projections of required funding levels to help prospective investors understand the magnitude of the financial commitment they might be asked to make.

Typical Financial Project (*Pro Forma*) Format

Revenues by service or type of customer

- (number of customers) x (typical purchase)
- anticipated monthly revenues for first two years

Expenses by category

- cost of goods sold (COGS)
- personnel costs (not including owner compensation)
- facility costs
- marketing / sales ("customer capture") costs
- overhead costs

Monthly Margin for debt interest, taxes, owner pay

The table below provides a quick set of recommendations on how to develop defensible business concept *pro formas*.

Develop Effective, Defensible Business Concept <i>Pro Formas</i>	
<i>Pro Forma "Dos"</i>	<i>Pro Forma "Don'ts"</i>
1a) Under-estimate revenues, over-estimate costs	1b) "Hockey stick" financial projections
2a) Focus on the first 12 to 24 months	2b) False levels of accuracy
3a) Assume competitive response	3b) Unrealistic upward pricing trends
4a) Develop insights on key success factors	4b) Focus exclusively on numbers
<i>Each of these "Dos" and "Dont's" is described in more detail on the next page</i>	

1a) Under-estimate revenues, over-estimate costs - the first few draft *pro formas* for a new business concept often end in projections of major deficits. In fact, your initial projections should *under-estimate* revenues and *over-estimate* costs. That way you can adjust your revenue and cost assumptions one at a time to see which assumptions are the most powerful - which have the greatest impact on the bottom line. *Creating a pro forma should be your first opportunity to learn what financial, operating, pricing and competitive assumptions will drive the future success of your venture.*

1b) Avoid "hockey stick" financial projections - one warning sign to investors is when they see a *pro forma* that shows an initial loss as the business starts up, but then growing profits every year after. This is called a "hockey stick" projection because the revenue growth line sort of looks like a hockey stick - flat at first, and then a straight line up. Seasonality, competitive reactions and the need to invest in new technologies / expansion markets should all be reasons why future profitability isn't necessarily always growing (even in the most optimistic of financial projections).

2a) Focus on the first 12 to 24 months - no one can predict the future. The farther out you go the less likely you are to be able to make accurate projections. Therefore, you should spend most of your time and effort determining what the month-to-month performance of your enterprise will be, providing more general annual guidance for the period after.

2b) Avoid false levels of accuracy - don't pretend that you can make your projections more accurate than is humanly possible. Billion-dollar investments for power plants or petrochemical refineries require 20 or 30-year *pro formas*. But small business *pro formas* can only realistically provide projections for a few years at most. Also: projections should be rounded to the nearest thousand dollars in a *pro forma*. It doesn't make sense to make projections down to dollars and cents. In fact, most experienced investors will take that as a sign that the *pro forma* was prepared by a "rookie."

3a) Assume competitive response - if your venture is successful you can expect competitors to take notice. They'll try to imitate your product or service . . . capture (or recapture) your customers . . . open new locations near yours. As you develop a *pro forma*, make sure you keep in mind the micro-economic law that success attracts competition. Absent some sort of legal protection (like a patent), a successful venture will need to budget marketing campaigns, new product development efforts and/or costs for opening up new locations to protect their initial victories.

3b) Avoid unrealistic upwards pricing trends - one form competition takes is pricing competition. If you have a successful business, competitors will try to take your customers. One tool they'll use is pricing. They can lower price, they can give discounts or they can provide "multiple purchase incentives" (like stores that give you a free ice cream cone after you buy eight or ten from them). Growth also sometimes requires pursuing customers who are more price-sensitive than your original, most-enthusiastic customers. *Realistic pro formas include pricing assumptions that are likely to be reactions to competitive forces.*

4a) Develop insights on key success factors - as you develop a *pro forma*, you should be learning about your business. Expanding into new products is a way to accelerate profits from your current customer base. Keeping food costs at 30% of revenues provides a steady stream of future margin. Make sure you understand the key factors that are critical to your enterprise's future success / profitability / viability.

4b) Avoid focusing exclusively on numbers - the first few draft *pro formas* for a new business concept often end in projections of major deficits. In fact, your initial projections should *under-estimate* revenues and *over-estimate* costs. That way you can adjust your revenue and cost assumptions one at a time to see which assumptions are the most powerful - which have the greatest impact on the bottom line. *Creating a pro forma should be your first opportunity to learn what financial, operating, pricing and competitive assumptions will drive the future success of your venture.*

Tips for Creating a *Pro Forma* Spreadsheet

1) Create a separate section for varying assumptions - the best *pro forma* spreadsheets don't require you to "dig into" the monthly and annual line items in order to change assumptions. Instead they provide a single section / worksheet of the spreadsheet for you to vary assumptions.

(Varying assumptions to create new scenarios that give you insights into your new venture / small business is called completing a "sensitivity analysis." You're finding out which assumptions are the most "sensitive," and have the greatest impact on your venture's future financial performance.)

Creating a separate section for varying assumptions avoids introducing errors into the *pro forma* spreadsheet. You can develop and debug your spreadsheet to make sure all calculations are correct. *Then you never have to worry that you'll be changing a formula or introducing an error into the formulae of your spreadsheet as you calculate new scenarios.*

2) Focus on "materiality" - "materiality" is a financial term that means "big enough to care about." An effective *pro forma* spreadsheet should only include line items that are big enough that they have a "material impact" on your overall financial projections.

One good example is the cost of a business license. You *know* that you're going to have to pay for one or more city and/or state business license. The cost will likely be a few hundred dollars a year. You can project this cost with great certainty. But it's not material - a few hundred dollars more or less won't make or break your venture. So it's better to lump together licenses, use taxes, insurance and utilities into "overhead costs" and round up to the nearest thousand dollars what you believe these costs will be in the aggregate.

3) Include major capital expenditures - even though capital expense items are balance sheet items, not income statement items, they are likely to be critical to any new venture / small business. Therefore, it is best if your *pro forma* spreadsheet is a hybrid financial tool that includes all operating income statement items as well as "material" capital expenditures that will need to be funded.

4) Track cumulative cash flow - it's important for the entrepreneur / business owner and investors both to understand how much cash is going to be necessary to keep a venture "afloat" while it becomes successful. Early on a very successful venture might "burn cash." "Burn cash" means the venture spends much more money than it takes in as it establishes its operations, "captures" its first customers, and launches the marketing efforts necessary to create a market presence. The entrepreneur / business owner might be confident that these investments will result in a vibrant, profitable business. But at first more cash will be used than the margins / profits generated by the venture.

Pro formas that track cumulative cash flow give investors an insight into how much cash will be "burned through" until the venture turns around and starts generating positive cash flow. The lowest point of cumulative cash flow - called the "nadir" or lowest point - is the minimum amount the venture will require in order to work through its early stages and emerge a vibrant, successful organization.

Resource 23-07 provides students with a hands-on opportunity to work with a pro forma spreadsheet that follows these rules. Over time, students should learn how to create their own pro forma spreadsheets.

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