A Guide to Financial Projections For Startups

Starting out in business can be tough. Entrepreneurs, whether they're freelancers, micro-business owners, or sole proprietors, have a rough road to travel if they plan to survive long enough to grow. In addition to having a solid business plan and an understanding of the market for the goods and services you plan to sell, it's critical to master the financial ins and outs of doing business. And for small businesses—especially new business startups in need of funding—one of the most important financial tasks to master is *financial projections*.

They might sound daunting, particularly if you've never prepped a balance sheet or wooed potential investors. But financial projections for startups are easier to handle than you might think, provided you have the right approach, tools, and mindset.

What Are Financial Projections?

As they strive for profit and fight to ensure they have the capital they need to cover their expenses, businesses need a roadmap for navigating the future. Financial projections are part of that roadmap, because they are, in essence, a forecast of future expenses and revenue.

This forecast helps you craft a spending strategy, cash flow management approach, strategic sourcing, and investment planning for growth, innovation, etc.

It also shows potential creditors and investors how your company is likely to perform, so ensuring it's accurate and complete is crucial to securing external funding.

You can think of financial projections as a kind of budget. They're essential to creating a business plan for a new business or, for established businesses, building a new strategic plan to improve the financial performance and health of your company.

Financial projections come in two varieties:

Short-term projections generally cover a year, broken out by month.

Long-term projections generally cover a period of three to five years and are most useful in strategic planning or providing long-range financial performance data for potential investors.

Whether you're securing additional funding, pivoting your business toward new markets, or taking your first steps toward entrepreneurship, the primary purpose of financial projections is to secure funding, credit, or a loan. Financial projections are commonly used in:

- Business plans.
- Financial performance projections for potential investors.
- Loan or line of credit applications.
- Internal process optimization (e.g., revamping your budgeting process).

Established businesses with a rich trove of historical performance and spend data to fall back on generally use this data as a guideline when drafting their financial projections. It's a trickier prospect for startups, particularly small businesses, because they don't have any spend or performance data yet.

In-depth research, a clear understanding of their target market and products, and a well-developed and considered business model help entrepreneurs craft financial projections for their startups that lead to funding and investment vital to starting, and maintaining, a successful business.

> *Your potential investors want to see you're serious about your business, and have invested the time and research necessary to craft realistic financial projections for revenue growth, operating expenses, startup costs, etc.*

Why Financial Projections Matter—Especially for Small Businesses

Today's interconnected, always-on global economy has made entrepreneurship more attractive than perhaps any other period of time in history. The United States alone has nearly 32 million small businesses, selling everything from software to candy to custom bowling shirts.

Knowing you'll be in such diverse and ambitious company might make the idea of a startup even more compelling. But the U.S. Small Business Administration (SBA) reports that around 20% of small businesses fail within their first year. After five years, that number climbs to nearly 50%. And only about a third of small businesses survive long enough to celebrate a decade.

And while, yes, external factors such as the COVID-19 pandemic have made life tough for both new and existing businesses, the hard truth is that most startups are planning to fail by failing to plan.

In studying 20 reasons why small business startups fail, research firm CBInsights found starting a business whose offerings didn't have an established or potential demand contributed to collapse in 42% of failed businesses. Cash flow problems helped kill just under 30% of startups, 18% had pricing and cost issues, and 17% were effectively flying by the seat of their figurative pants by selling products without a business model.

Failing to do your homework (so to speak) can kill your startup before it can really get its feet underneath it. That's why business-critical tasks like accurate and complete financial projections are so important to startups in particular. Your potential investors want to see you're serious about your business, and have invested the time and research necessary to craft realistic financial projections for revenue growth, operating expenses, startup costs, etc.

Essential Components of Effective Startup Financial Projections

Most financial models fall into one of two categories:

- **Top-down financial modeling**, which starts at the macro level and uses marketing, industry, and other external data as a starting point for building financial projections
- **Bottom-up financial modeling**, which starts at the micro level (company specific) and then builds up to create financial projections.

The top-down approach is generally better than the bottom-up model for startups because they are in the early stages of existence and most often do not have the trove of existing data required for the latter.

All that said, financial forecasting doesn't have to be terribly complex. To prepare financial projections, all you need is an income statement, cash flow statement, and balance sheet. These are the "big three" documents directly related to financial performance and essential to the preparation of accurate and complete financial projections.

- **The income statement**, also known as your *profit and loss statement* or simply *P&L*, contains all revenue, expenses, and profits for a specific financial period. This document provides valuable insight into a company's actual or projected operational efficiency. For investors, it's a handy yardstick for both financial health and competitive strength. The income statement will include:
    - Revenue
    - Expenses (both variable costs and fixed costs within direct and indirect spend).
    - Earnings before interest, taxes, depreciation, and amortization (EBITDA)
    - Income taxes.
    - Net income (total income after cost of goods sold (COGS), taxes, etc.)
- **The cash flow statement** documents (unsurprisingly) the flow of cash in and out of the business. Management relies on the cash flow statement to

track and manage debt and make intelligent spending and sourcing decisions to manage cash flow risk, preserve working capital for covering expenses, investing in innovation, covering emergencies, etc.
Cash flow is especially important for startups, because it's tied directly to burn rate. If you don't have a clear idea of, or control over, your cash flow, you'll find yourself up the proverbial creek *sans* paddle more quickly than you can imagine.
The cash flow statement has three parts:

    - Operational cash flow (changes in cash flow affected by essential business operations, i.e. revenue and expenses).
    - Investment cash flow (changes caused by investment in equipment and other assets, e.g. inflow from selling assets and outflow from purchasing assets. The latter is more common in startups).
    - Financial cash flow (changes caused by fundraising and/or financing activities, e.g. loans for inflow and interest payments for outflow).

- **The balance sheet** contains all company assets and liabilities. It provides a useful point of comparison with the income statement, given the different timeframes on which these two documents operate (i.e., ownership of assets and liabilities likely extends beyond the financial period recorded on an income statement).
  The balance sheet establishes a company's assets as the sum of its liabilities and shareholder's equity (where said equity is the net value of the company, or the amount distributed to shareholders after the company is liquidated and has paid its debts.)

How to Prepare Realistic Financial Projections

If you're starting a new business, you most likely don't have your financial statements at hand, and so you'll need to create them—ideally as part of a business plan. You can build them from any number of existing templates; the Service Corps of Retired Executives (SCORE), for example, has a free, comprehensive financial projections toolkit on its website.

In doing so, remember your numbers must be not only accurate and complete, but *sustainable*. That's part of why financial planning requires you to "do your homework" and sometimes meticulous research to ensure you know how (for example) a typical business in your industry performs.

If you're at the starting point and don't have historical data available, be sure to tap resources such as your local SBA office, SCORE group, market research firms, or industry-specific organizations to get the information you need to develop realistic (but still optimistic!) projections.

Over time, as you accumulate historical data, you can leverage it to increase the accuracy of your projections and better secure funding while simultaneously identifying opportunities for further process improvement, innovation, or growth.

Let's take a closer look at a five-step approach to developing your financial projections:

Step One: Sales Forecast

Startup businesses without access to historical data can examine healthy businesses in their industry to identify average revenue projections, as well as seasonal trends, potential issues created by upcoming industry or economic changes, etc.

Step Two: Expenses Projection

Anticipating expenses can be challenging for startups, particularly since it's next to impossible to predict potentially catastrophic costs from a worst-case scenario (e.g., natural disasters, force majeure, etc.). As will sales, however, it's useful to examine healthy competitors and use their numbers as a guide until you have time to accumulate your own data.

Step Three: Balance Sheet Projection

Your balance sheet's accuracy will rely on the accuracy of your sales and expenses projections, so make sure you've

Step Four: Income Statement Projection

Another projection that will most likely benefit from some in-depth marketing and industry research, the income statement projection is especially important for estimating long-term EBITDA and providing potential investors with evidence you’ve done your “homework” with regard to financial performance. Given that 73% of small businesses seek some form of financing, it quite literally pays to do so.

Step Five: Cash Flow Projection

In-depth research and a close look at healthy businesses in your industry will help you get a grip on cash flow projections and help manage burn rate with optimal efficiency.

Best Practices for Effective Financial Modeling

No two businesses are the same, but you can improve your chances for comprehensive, accurate, and investor-friendly financial projections by following a few basic best practices.

- Create multiple financial models, including your best case scenario, a middle-of-the-road scenario, and a scorched earth, worst case scenario. Doing so will provide invaluable perspective and may also reveal opportunities to adjust your business plan to better meet both your own goals and the realities of the marketplace.
- Research, a solid business plan, and a willingness to temper your optimism with realism are non-optional when starting a business. Make sure your financial forecast is well-researched and aligns with your business plan. Refine it as many times as necessary to enhance sustainability.
- The first step to being great at something is being an absolute novice. Don’t be afraid or ashamed to take advantage of the powerful resources offered to startup businesses by government agencies, industry organizations, etc. Embrace mentorship so you can avoid the mistakes of those who’ve already traveled the path you’re about to travel—or at least

make the same mistakes in interesting new ways!

Craft Better Projections and Reduce Your Burn Rate with Procure-to-Pay Software

Whether you're starting a brand new business or have a trove of historical data you want to use to improve your business planning and process optimization, you can improve your financial projections through the use of procure-to-pay software like PLANERGY.

Why? Because you'll gain full control over all your data, along with complete data transparency. Starting with complete and accurate data improves all your financial reporting and forecasting. Mobile-friendly, role-appropriate access to data means it's easier to create financial projections on demand to meet changing market, industry, or economic conditions, whether you're at the office or in a pitch meeting.

For startups, you can easily incorporate data from multiple sources into your database and create optimal financial projections using the powerful built-in data analysis tools. Create multiple financial models, from the aggressively optimistic to the dreaded worse-case scenario, and then fine-tune your projections based on your own research and current market conditions.

Starting with the best possible projections helps you attract the right kind of investors, secure funding when you need it most, and develop a cash flow management plan that keeps burn rate in check so you and your investors can rest easier even in an uncertain economy.

Accurate and Credible Financial Projections Pave the Way for Business Success

Starting a small business can be hard enough without struggling for capital you need to survive. With a proactive approach and by choosing the right procure-to-pay software platform, you can ensure your financial projections are credible, accurate, and readily accessible. With all the information they need at hand, creditors and investors will readily understand your commitment to success—and take a much keener interest in sharing it.

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