NOVEMBER 2015 ISSUE 56

# Collins Forensic and Valuation Services

3600 American River Drive, Suite 147, Sacramento, CA 95864 Phone 916.756.5622

## Financial Projections

Financial projections are crucial in valuing a business with healthy growth prospects or decreasing revenues. Reliable projections allow us to more accurately value companies. Often companies are overly optimistic about their future prospects. This positive bias can lead to rosy projections that overstate revenues and understate expenses. Past projections should be compared to actual results to see if there are projection biases.

We consider the following items when evaluating a company's financial projections:

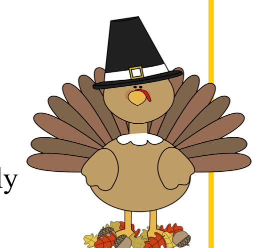
**1. WAS THE PROJECTION PREPARED BY A PARTY WITH AN INTEREST IN THE OUTCOME.** This is common when business projections are prepared for a business that is for sale. The projections may not reflect the company's historical rates of revenue growth or earnings growth. Additionally, the projections may not fully reflect the increased labor, supply and capital investment costs associated with a high revenue growth rate.

**2. PROJECTION ENDS ON THE PEAK OR THE TROUGH OF THE BUSINESS CYCLE.** Companies have a tendency to think the way things are now is the way they will always be in the future. If things are good now they expect things will get better and if things are bad now they expect things to remain bad or to slowly improve. It is helpful to review the company's historical revenue and earnings growth rates to mitigate this tendency.

**3. PROJECTIONS NEED TO BE ACCOMPANIED BY A LIST OF ASSUMPTIONS.** It is helpful to know the underlying assumptions and inputs that created the projected amounts. Such as what future revenue growth is expected from existing revenues and what revenue growth is expected from future acquisitions. Are the projected expenses based on historical experience or are they expected to change over time.

**4. PROJECTION OF REVENUES AND EXPENSES WITHOUT BALANCE SHEETS.** Projecting balance sheets may indicate additional funding in the form of cash or new debt is needed to finance future growth. Revenue growth requires increased investments in accounts receivable, inventory, property and equipment. Additional funding may not be available to support rapid revenue growth and therefore the projected revenue and earnings growth rates should be reduced.

**5. PROJECTION ASSUMES COMPANY WILL GROW RAPIDLY FOR A LONG PERIOD OF TIME.** This is probably the most common mistake we see. Some companies can grow rapidly for a few years or maybe several years but at some point their growth rate will slow and eventually their growth rate will decline to the rate of inflation. A company's historical growth rates can be helpful in projecting the company's future growth rates. More reliable projections may show a high growth rate for a few years, a medium growth rate for a few years followed by a lower long-term growth rate.



**6. PROJECTIONS ARE MORE RELIABLE IF THEY REPRESENT THE AVERAGE OF THE LIKELY OUTCOMES.** Projections should represent the possibility of a range of events from the best, most likely and worst case scenarios. By using projections that reflect a range of potential outcomes management can gain insight into the company's performance in different economic environments. A rapidly growing industry tends to attract new competitors which may reduce a company's future growth and profitability.

**COMMENTS**

Please call me with your comments at 756.5622.
— Thomas Collins, CPA / ABV, CFA