### Forecasting Profits

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Forecasting, particularly on a short-term basis (one year to three years), is essential to planning for business success. This process, estimating future business performance based on the actual results from prior periods, enables the business owner/manager to modify the operation of the business on a timely basis. This allows the business to avoid losses or major financial problems should some future results from operations not conform with reasonable expectations. Forecasts - or Pro Forma Income Statements and Cash Flow Statements as they are usually called - also provide the most persuasive management tools to apply for loans or attract investor money. As a business expands, there will inevitably be a need for more money than can be internally generated from profits.

## Facts Affecting Pro Forma Statements

Preparation of Forecasts (Pro Forma Statements) requires assembling a wide array of pertinent, verifiable facts affecting your business and its past performance. These include:

**Data from prior financial statements, particularly:**

a. Previous sales levels and trends

b. Past gross percentages

c. Average past general, administrative, and selling expenses necessary to generate your former sales volumes

d. Trends in the company's need to borrow (supplier, trade credit, and bank credit) to support various levels of inventory and trends in accounts receivable required to achieve previous sales volumes

**Unique company data, particularly:**

a. Plant capacity

b. Competition

c. Financial constraints

d. Personnel availability

**Industry-wide factors, including:**

a. Overall state of the economy

b. Economic status of your industry within the economy

c. Population growth

d. Elasticity of demand for the product or service your business provides ( Demand is said to be "elastic" if it decreases as prices increase, a demonstration that consumers can do without or with less of the goods or service. If demand for something is relatively steady as prices increase, it is "inelastic.")

e. Availability of raw materials

Once these factors are identified, they may be used in Pro Formas, which estimate the level of sales, expense, and profitability that seem possible in a future period of operations.

## The Pro Forma Income Statement

In preparing the Pro Forma Income Statement, the estimate of total sales during a selected period is the most critical "guesstimate:" Employ business experience from past financial statements. Get help from management and salespeople in developing this all-important number.

Then assume, for example, that a 10 percent increase in sales volume is a realistic and attainable goal. Multiply last year's net sales by 1.10 to get this year's estimate of total net sales. Next, break down this total, month by month, by looking at the historical monthly sales volume. From this you can determine what percentage of total annual sales fell on the average in each of those months over a minimum of the past three years. You may find that 75 percent of total annual sales volume was realized during the six months from July through December in each of those years and that the remaining 25 percent of sales was spread fairly evenly over the first six months of the year.

Next, estimate the cost of goods sold by analyzing operating data to determine on a monthly basis what percentage of sales has gone into cost of goods sold in the past. This percentage can then be adjusted for expected variations in costs, price trends, and efficiency of operations.

Operating expenses (sales, general and administrative expenses, depreciation, and interest), other expenses, other income, and taxes can then be estimated through detailed analysis and adjustment of what they were in the past and what you expect them to be in the future.

**Comparison with Actual Monthly Performance**

Putting together this information month by month for a year into the future will result in your business's Pro Forma Statement of Income. Use it to compare with the actual monthly results from operations. Preparation of the information is summarized below:

**Revenue (Sales)**

* List the departments within the business. For example, if your business is appliance sales and service, the departments would include new appliances, used appliances, parts, in-shop service, on-site service.
* In the "Estimate" columns, enter a reasonable projection of monthly sales for each department of the business. Include cash and on-account sales. In the "Actual" columns, enter the actual sales for the month as they become available.
* Exclude from the Revenue section any revenue not strictly related to the business.

**Cost of Sales**

* Cite costs by department of the business, as above.
* In the "Estimate" columns, enter the cost of sales estimated for each month for each department. For product inventory, calculate the cost of the goods sold for each department (beginning inventory plus purchases and transportation costs during the month minus the inventory). Enter "Actual" costs each month as they accrue.

**Gross Profit**

Subtract the total cost of sales from the total revenue.

**Expenses**

* Salary Expenses: Base pay plus overtime.
* Payroll Expenses: Include paid vacations, sick leave, health insurance, unemployment insurance, Social Security taxes.
* Outside Services: Include costs of subcontracts, overflow work farmed-out, special or one-time services.
* Supplies: Services and items purchased for use in the business, not for resale.
* Repairs and Maintenance: Regular maintenance and repair, including periodic large expenditures, such as painting or decorating.
* Advertising: Include desired sales volume, classified directory listing expense, etc.
* Car, Delivery and Travel: Include charges if personal car is used in the business. Include parking, tolls, mileage on buying trips, repairs, etc.
* Accounting and Legal: Outside professional services.
* Rent: List only real estate used in the business.
* Telephone.
* Utilities: Water, heat, light, etc.
* Insurance: Fire or liability on property or products, worker's compensation.
* Taxes: Inventory, sales, excise, real estate, others.
* Interest.
* Depreciation: Amortization of capital assets.
* Other Expenses (specify each): Tools, leased equipment, etc.
* Miscellaneous (unspecified): Small expenditures without separate accounts.

**Net Profit**

To find net profit, subtract total expenses from gross profit.

The Pro Forma Statement of Income, prepared on a monthly basis and culminating in an annual projection for the next business fiscal year, should be revised not less than quarterly. It must reflect the actual performance achieved in the immediately preceding three months to ensure its continuing usefulness as one of the two most valuable planning tools available to management.

Should the Pro Forma reveal that the business will likely not generate a profit from operations, plans must immediately be developed to identify what to do to at least break even - increase volume, decrease expenses, or put more owner capital in to pay some debts and reduce interest expenses.

## Break-Even Analysis

"Break-Even" means a level of operations at which a business neither makes a profit nor sustains a loss. At this point, revenue is just enough to cover expenses. Break-Even Analysis enables you to study the relationship of volume, costs, and revenue.

Break-Even requires the business owner/manager to define a sales level - either in terms of revenue dollars to be earned or in units to be sold within a given accounting period - at which the business would earn a before tax net profit of zero.

This may be done by employing one of various formula calculations to the business estimated sales volume, estimated fixed costs, and estimated variable costs.

Generally, the volume and cost estimates assume the following conditions:

* A change in sales volume will not affect the selling price per unit;
* Fixed expenses (rent, salaries, administrative and office expenses, interest, and depreciation) will remain the same at all volume levels; and
* Variable expenses (cost of goods sold, variable labor costs, including overtime wages and sales commissions) will increase or decrease in direct proportion to any increase or decrease in sales volume.

Two methods are generally employed in Break-Even Analysis, depending on whether the break-even point is calculated in terms of sales dollar volume or in number of units that must be sold.

**Break-Even Point in Sales Dollars**

The steps for calculating the first method are shown below:

* Obtain a list of expenses incurred by the company during its past fiscal year.
* Separate the expenses listed in Step 1 into either a variable or a fixed expense classification. (See sample below under "Classification of Expenses.")
* Express the variable expenses as a percentage of sales. In the condensed income statement of the Small Business Specialities Co. ( below), net sales were $1,200,000. In Step 2, variable expenses were found to amount to $720,000. Therefore, variable expenses are 60 percent of net sales ($720,000 divided by $1,200,000). This means that 60 cents of every sales dollar is required to cover variable expenses. Only the remainder, 40 cents of every dollar, is available for fixed expenses and profit.
* Substitute the information gathered in the preceding steps in the following basic break-even formula to calculate the break-even point.

Remember: Increased sales do not necessarily mean increased profits. If you know your company's break-even point, you will know how to price your product to make a profit. If you cannot make an acceptable profit, alter or sell your business before you lose your retained earnings