PROFIT

promoting regional opportunities
for investment and trade

# Financial forecasting

FACTSHEET // NOVEMBER 2020

# Financial forecasting

## 1. Introduction

Preparing forecasts will help you to assess your likely sales income, costs, external financing needs and profitability. Financial forecasts are essential if you need to raise money from a third party, such as a bank. Businesses engaging in international trade usually need much higher levels of working capital than businesses operating purely domestically because of the longer lag before you are paid, so good forecasts will help you assess whether you need to raise additional finance even if you think that you are already well-funded. Forecasts also provide you with the means to monitor performance on, say, a monthly basis and thereby exercise effective financial control – arguably the second most important management function in running a business (marketing is the first).

## 2. Financial forecasts

There are three basic financial statements (the profit and loss account (P&L); the cash flow statement; and the balance sheet) that describe the activities and financial state of any business. These can be prepared on a historical basis – to show how a business performed during a defined period – or as forecasts – as estimates of how the business will perform in the future.

Businesses often start by forecasting their cash flow and then aim to derive other forecasts from it. It makes more sense, however, to start by forecasting the income and expenditure of the business – which will indicate whether you will make a profit. Then worry about when money will be received or paid out – to discover if you will have enough cash when it is needed. Income and expenditure is summarised in a profit and loss account.

You will also need to look at your likely sales for, say, the year ahead. This needs to relate back to your market research, if for example you are entering a new market, and to previous performance. The direct costs can then be estimated (usually as a percentage of sales) to give gross profit.

The next step is to estimate the likely overheads. Deducting these gives an operating profit forecast. If the net profit is too low, you will either need to assess whether you can achieve higher sales or whether you can reduce the overheads.

When preparing your forecasts, remember to allow for increased costs, for instance, due to inflation or future pay awards. When preparing to trade internationally, allow for all the additional costs including transport, insurance, tariffs, etc. If you need a loan, then you will also need to allow an amount for loan interest. If you use equipment or have other tangible assets, remember to allow for depreciation and amortisation.

## 2.1. Preparing cash flow forecasts

If you think that you need additional working capital, then the cash flow forecast will be an important requirement in persuading a financial institution. Think carefully about all your costs, about your price and likely sales at that price and about the timing of both receipts and payments.

As mentioned above, the first forecast that you set out should ideally be a profit and loss account – summarising the income and expenditure for, say, the year ahead. You might choose to do this monthly or just annually. The P&L is important from the point of view of demonstrating profitability; over the very short term, however, the key requirement is to generate cash and to know the business's working capital requirements. This can best be done by preparing a cash flow forecast which should set out all the information, month by month, regarding cash inflows and outflows. The cash flow forecast should include:

- receipts of cash from customers;
- payments for raw materials;
- payments for all other expenses;
- drawings and wages;
- capital expenditure;
- capital, loans or grants introduced;
- loan repayments;
- VAT receipts and payments (if VAT registered) in GMS or GST in India; and,
- tax payments.

All of these items should normally be shown separately and should be shown in the month in which the money will be paid into, or paid out of, your business.

For businesses with a modest turnover, and which demonstrate profitability in the year, it is normal only to forecast one year ahead, with a monthly cash flow (but note that the example shows only six months, due to space constraints). Larger businesses, especially those seeking equity investments and/or which do not show profitability in the year, may need to prepare forecasts for two or three years. The first-year cash flow is usually shown monthly, the second year quarterly and the third year just a single annual figure.

It is often helpful when preparing cash flow forecasts initially to ignore any finance that is available from the bank or other lenders. The cash flow forecast then shows the true position of the business. It can then be used to decide if the budget is viable and can be adjusted to reflect the true position and to assess the total funding requirement. Figure 1 illustrates a cash flow forecast though in practice you will have rather more rows to cover all your payments in detail.

### Figure 1: Cash flow forecast

| | January | February | March | April | May | June | Total | Accruals | Notes |
|---|---|---|---|---|---|---|---|---|---|
| SALES | | | | | | | | | |
| Chairs | 10,000 | 15,000 | 17,000 | 19,000 | 17,000 | 20,000 | 98,000 | | 1 |
| | | | | | | | | | |
| RECEIPTS | | | | | | | | | |
| Debtors | 8,000 | 10,000 | 15,000 | 17,000 | 19,000 | 17,000 | 86,000 | 20,000 | 2 |
| Loans | 25,000 | | | | | | 25,000 | | |
| VAT/GST | | | | | | | 0 | | 3 |
| Total | 33,000 | 10,000 | 15,000 | 17,000 | 19,000 | 17,000 | 111,000 | | |
| | | | | | | | | | |
| PAYMENTS | | | | | | | | | |
| Raw materials | 3,000 | 4,500 | 5,100 | 5,700 | 5,100 | 6,000 | 29,400 | | |
| Wages | 4,000 | 6,000 | 6,800 | 7,600 | 6,800 | 8,000 | 39,200 | | |
| Premises costs | | | 3,000 | | | 3,000 | 6,000 | | |
| Marketing costs | 1,000 | 1,000 | 1,000 | 1,000 | 1,000 | 1,000 | 6,000 | | |
| Equipment | 25,000 | | | | | | 25,000 | | 4 |
| VAT/GST | | | | | | | 0 | | 5 |
| Tax | | | | | | | 0 | | 6 |
| Total | 33,000 | 11,500 | 15,900 | 14,300 | 12,900 | 18,000 | 105,600 | | |
| Balance | 0 | (1,500) | (900) | 2,700 | 6,100 | (1,000) | 5,400 | | 7 |
| Cumulative balance | 0 | (1,500) | (2,400) | 300 | 6,400 | 5,400 | | | |

Notes:

1. Sales is not actually part of a cash flow forecast but it can be helpful to show the sales since the receipts from debtors is directly related to the sales.

2. The receipt from debtors in January relates to sales before the period starts. This cashflow assumes receipts arrive in the month after the sale so there is an accrual at the end of the period for sales in June

3/5. If you are registered for VAT or GST, is it sensible to show VAT or GST separately for both the output tax (tax on sales) and input tax (tax on purchases) as well as the payment of the net amount to the tax authorities.

4. The purchase of equipment is shown on the cash flow but remember that it does not appear in the profit and loss account; there you would show depreciation.

5. There may be tax payments on earlier profits to show as well.

6. You should calculate the cash flow for the month and the cumulative cash position. This will reflect the level of cash in the bank.

If you do not have sufficient money already available – which you will know if the cumulative cash position is negative – then you will need to seek loan finance or an equity investor. Most small businesses simply look for loan finance. Aim to match the term of the loan to the life of the asset for which it is required. It would be normal to look for a short-term loan, for example, to purchase equipment, or a long-term loan to purchase premises. You will also need to buy stock and pay overheads whilst awaiting payments from your customers. The money required for these very short-term requirements is called working capital and is typically funded by an overdraft or short-term credit.

If you have a term loan, the capital repayments will not figure in your profit and loss account – they are not a business expense – although the interest portion of the repayments will be charged as an expense. However, the repayments do need to be included in your cash flow forecast.

## 2.2. Balance sheet

As we mentioned earlier, the money in a business can only come from three sources:

- capital introduced by the owner(s);
- loans (whether from the bank or, effectively, from creditors); and,
- retained earnings; that is, profit which has been generated by and retained within the business.

That money is used to finance the fixed and current assets of the business.

Current liabilities include creditors, overdrafts, loans due within one year, money owed under hire purchase agreements, any amounts owed in VAT or tax, etc. In larger businesses, loans falling due in more than one year are usually shown separately. You will, however, have a better idea of your business's performance if you show all loans as current liabilities.

Current assets less current liabilities shows your working capital requirement. Since the balance sheet is merely a snapshot, however, it may be better to deduce your working capital requirement from the cash flow forecast.

The net assets are always equal to the capital introduced plus reserves; that is, the *net finance,* sometimes known as *net worth* or the equity of the business.

The net finance, together with any long-term loans, is called the capital employed. Since for smaller businesses short-term borrowing tends to be a large proportion of total borrowing. All borrowing should be included when calculating capital employed.

# 3. Sensitivity analysis

It is important to know how sensitive your forecast is to changes. Sensitivity analysis looks at 'what if?' questions. What happens to your cash position, for example, if sales fall by 10 per cent? What happens if your main supplier increases raw material prices by 12 per cent? Sensitivity analysis is particularly used by financial institutions when considering propositions for a loan. If your business is particularly susceptible to small changes, then you probably do not have a sufficiently large profit margin. You will thus be less likely to receive the loan required. You may find it difficult to cut costs. You may not be able simply to increase prices to improve your margins – that might deter customers. Are there other ways in which you can push up the margins – by increasing output, for example?

Having undertaken your sensitivity analysis, you may need to review elements of your forecast. Sensitivity analysis can help in making decisions. You may want to consider, for example, the effect of increased raw material, labour or overhead costs; of reducing prices, with constant volumes, to counteract competitors; or reducing volumes, with constant prices, due to over optimistic forecasts. Furthermore, if you are about to spend a large sum of money on equipment, you may want to look ahead several years if at all possible.

Including a sensitivity analysis in your business plan will demonstrate that you have thought about some of the potential risks – and that is half-way to avoiding them.

# 4. Conclusion

Some readers of your business plan will regard the financial forecasts as the most important component. It is where you summarise the expected income, dependent on your market research, and where you set out your expected costs. The forecasts need to demonstrate that the business is viable and that there is a sufficient margin of comfort to allow for fall in demand or increase in costs. Take care to prepare your financial forecasts as accurately as you can. Then compare your actual results with your forecasts and, if necessary, take corrective action at an early stage to keep yourself on course.

# 5. Further reading

If you would like to learn more about financial statements, forecasting and control, you may like to read Finance for Non-Financial Managers by David Irwin (available at http://businessadvocacy.net/dloads/bkFINCO.pdf)

website

contact@profit-accelerator.com

email

PROFIT is an initiative of the Asian Development Bank, managed by a partnership of IMC Worldwide, ASSIST Asia & Bombay Chamber of Commerce & Industry.