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STEP 17 - Forecasting

Break-Even Analysis

Use this section to evaluate your business profitability. You can measure how close you are to achieving that break-even point when your expenses are covered by the amount of your sales and are on the brink of profitability.

All this information will be needed for your formal Business Plan

A break-even analysis can tell you what sales volume you are going to need in order to generate a profit. It can also be used as a guide for setting prices.

There are three basic ways to increase the profits of your business:

- generate more sales,
- raise prices,
- and/or lower costs.

All of these can impact your business:

- if you raise prices, you may no longer be competitive;
- if you generate more sales, you may need added personnel to service those sales which would increase your costs.
- Lowering the fixed costs your business must pay each month will have a greater impact on the profit margin than changing variable costs.

Fixed costs: Rent, insurance, salaries, etc.

Variable costs: The cost at which you buy products, supplies, etc.

Contribution Margin: This is the selling price minus the variable costs. It measures the money available to pay the fixed costs and make a profit.

Contribution Margin Ratio: This is the amount of total sales minus the variable costs, divided by the total sales. It measures the percentage of turnover required to pay fixed costs and make a profit.

Break-even Point: This is the amount when the total sales equals the total expenses. It represents the minimum turnover you need to reach before you make a profit.

Break-even Point in Units: For applicable businesses, this is the total of fixed costs divided by the unit selling price minus the variable costs per unit. It tells you how many units you need to sell before you make a profit.

Break-even Point in Cash: This is the total amount of fixed costs divided by the contribution margin ratio. It is a method of calculating the minimum turnover to reach before you make a profit.

Note: If the turnover is below the break-even point, your business is losing money!

Calculate (or Estimate) your -

Contribution Margin Ratio

Break-even Point

Break-even Point in Units (if applicable)

Break-even Point in Cash

Income Projection Forecast

The Income Projection Statement is closely related to the Cash Flow Forecast and is another management tool to preview the amount of income generated each month based on reasonable predictions of the monthly level of sales and costs/expenses.

In effect, while the Cash Flow Forecast monitors your *Working Capital* this technique forecasts your Profit & Loss Statement for the forthcoming period

As the monthly projections are developed and entered, these figures serve as goals to control operating expenses.

As actual results occur, a comparison with the predicted amounts should produce warning bells if costs are getting out of line so that steps can be taken to correct problems.

Use the **Forecast** and **Projection** spreadsheets provided in the pack to determine your income projection. **Watch Video A** for guidance

The **Industrial Percentage** (Ind. %) is calculated by dividing total expenses by total nett sales expressed as a percentage.

It indicates the total sales that are standard for a particular industry.

You may be able to get this information from trade associations, accountants, banks, or reference libraries.

You can then compare your results against the industry average - shown as 'Variance' on the spreadsheet.

Compare **your** annual percentage with the figure indicated in the industry percentage column.

The following is an explanation for some of the terms used in the table that follows:

Total Net Sales (Revenue): Enter your total estimated sales per month. Be as realistic as possible, taking into consideration seasonal trends, returns, allowances, and markdowns.

Cost of Sales: Enter realistic figures which must include all the costs involved in making a sale.

For example, where inventory is concerned, include the cost of transport and shipping. Any direct staff or sub-contractor costs should also be included.

Gross Profit: Subtracts the cost of sales from the total net sales.

Gross Profit Margin: Divides gross profits by total net sales.

Controllable Expenses: Enter the following variable costs where applicable -

- Salaries (basic plus overtime),
- Payroll expenses (including paid holidays, sick leave, pension contribution, health insurance, and NI), cost of outside services (including subcontracts, overflow work and special or one-time services),
- supplies (including all items and services purchased for use in the business),
- utilities (water, heat, light, communications, recycling, etc.),
- repair and maintenance (including both regular and periodic expenses, such as painting),
- advertising,
- travel, accommodation and vehicle expenses (including business use of personal car, parking, and business trips),
- accounting and legal costs and the cost of any other external professional services.
- Dues and subscriptions to professional bodies etc.
- Miscellaneous - other variable costs

Fixed Expenses: Enter the following fixed costs where applicable -

- Rent (only for property used in the business)
- depreciation (the amortization of capital assets)
- insurance (fire, liability on property or products, employee compensation, theft, etc.)
- Permits and licenses

- loan repayments (including the interest and principal payments on outstanding loans to the business)
- miscellaneous (unspecified, small expenditures not included under other accounts or headings that are not under your control)

Note: Apart from controllable costs generally being variable from year to year or month to month the prime consideration is that expenditure on these costs is *controlled by you*, the business. The 'Fixed' Costs (which may exhibit some variability) are *not under your direct control*.

Net Profit/Loss (Before Taxes): Subtracts total expenses from gross profit.

Taxation: Enter Corporation Tax, VAT paid and not recovered, council taxes and business rates, etc. Do not include any personal taxation when you are not operating as a Limited Company

Net Profit/Loss (After Tax): Subtracts tax from net profit before tax.

Annual Total: Adds all monthly figures across the table for each sales and expense item.

Annual Percentage: Divides the annual total by the total net sales figure and converts to a percentage.

Variance: Compares this with the researched industry percentage.

Cash Flow Forecast

The Cash Flow forecast is one of the most important and critical parts of operating your business. Unlike your 'Accounts' which record what has happened in the past, the CFF is used to predict and plan the future.

Because they deal with historical accounting most online accounting systems don't include a CFF and most accountants don't provide help with them either as they are primarily looking at where you've been with your business rather than where you are going!

It helps to set up your CFF so as to be consistent with the company Chart of Accounts with estimated monthly income and expenditure. Amend the Excel spreadsheet provided accordingly.

We will look at the Chart of Accounts (CoA) in more detail in Step 18.

The CFF should be maintained as a working document with actuals being substituted for estimates each month and adjustments to the plane made when necessary.

The objective of this forecast is to understand the current financial position at any time and to adjust targets where necessary to remain consistent with the Financial Targets you set out. This may necessitate changes to your Marketing Plan.

Let's look at the CFF spreadsheet in the PBCS Finance Pack you've downloaded.

Watch Video B to see how it works

It's divided into three parts, Bank Account, Cash Account and Card Account (for use if you use a credit card to cover business expenses - this can be a personal card, it doesn't have to be a special Business Credit Card)

On the left you can adjust, add or remove any of the Chart of Accounts categories by inserting or deleting rows or changing the descriptions.

When you've done this check that the total rows function correctly and adjust accordingly.

It may help you to add a unique code for each CoA category to assist with monitoring your activities.

The summary section below adds up all the figures and gives you a total for each CoA category which can then be entered into your final accounts.

Start with Month 1 as far back as you can (or want to) go with your records and name the month and year. Don't go back more than 12 months

Enter the bank balance, cash balance and credit card balance at the beginning of Month 1. As you enter other figures these balances will take care of themselves although you should check each month against your statement and correct any errors.

Enter the actual income and actual spend in each category and in each section up to the current month.

In the Bank section these figures should match those shown on your bank statement.

In the current month and in future months enter your target prediction of the income and expenditure for that month.

Some special notes to remember:

In the Bank Account, there's a line for HMRC credits and debits. This would include any tax refunds or payments made, including VAT if your company is VAT registered. In the Cash Account, 'Transfers' are cash transferred from the Bank Account, 'Receipts' is cash received from any other sources and used for business purposes. This would include sundry expenses paid for from personal cash and payments by customers in cash.

In the Credit Card Account enter the date when the card is due to be paid. 'Credits' are any credit adjustments made on your card such as refunds or 'cashback'.

Payments to the card will normally be made from the bank account but if these are paid from elsewhere the amount should be entered in the cash account and balanced by a receipt entry.

Where credit card payments are 'out of sync' with the calendar month items paid for by the card should be entered in the month when the card bill is *paid* rather than the month in which they were purchased. Sometimes this can be a little complicated and needs attention to detail!

Note that the last two entries in the expenses section of the Bank and Cash accounts are not part of the Chart of Accounts but intra account transfers to/from the Cash and Bank sections.

Once you have set it up maintain the CFF as a working document updated at the very least monthly.

