# Developing Your Financial Forecasts

Small Business Success Series
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THE BUSINESSLINK
Business Service Centre

Financial Forecasts. Those words can seem very intimidating for a small business owner, however understanding where your business stands financially and where it is going are very important. Two tools that can help you manage your finances are Cash Flow Forecasting and Breakeven Analysis.

## Cash Flow Forecasting

Cash Flow forecasting is a tool to properly manage the financial aspects of your business. It helps you plan and prepare for future events and market changes.

Basically a cash flow forecast is a summary of the amount of cash coming ***into*** and flowing ***out of*** your business over a period of time. You can do this forecast in three easy steps.

**One:** Determine Your Cash Inflows
**Two:** Determine Your Cash Outflows
**Three:** Reconcile the Inflows and Outflows

A sample of a blank cash flow summary is included. Refer to this as you work through this part of the bulletin.

### *Step One: Determine Your Cash Inflows*

Cash Inflows are all the sources of cash coming into your business. These can include:

- Receipts from Cash Sales
- Accounts Receivable Collected
- Fees Collected
- Interest Collected
- GST Refunds Collected
- New Loan Proceeds
- Cash Sale of Assets

An important step in determining what cash you can expect to come into your business, is to estimate what your sales will be each month. If you are an existing business, past records can be used as a starting point for your estimates. Use the sales revenue figure from the same month in the previous year and add forecasted growth. For example, if you had cash sales of $5000 in July last year and your industry is expected to grow by 2% this year, you could forecast your sales as $5100 this year. Make sure when making your estimates you are only including sales that are in cash each month. Credit sales will be counted in the month they are actually paid.

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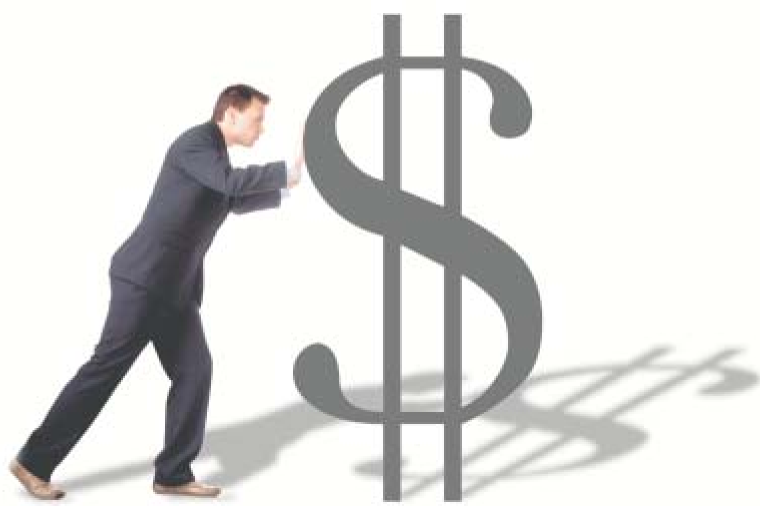
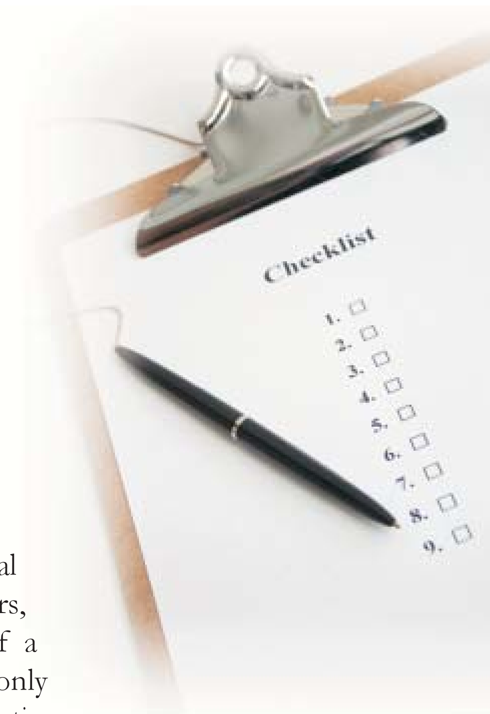
For new businesses, sales forecasting can be trickier. This is where your market research can help. You'll need to know the size of your market, how often and when your customers will buy from you, how much they will buy and at what price they will likely buy at. You will want to be realistic and conservative with your initial projections. It usually takes time for your market to come to know you. Show that your sales are slower initially but do grow as awareness of your business grows among your target market.

Remember that Cash Inflows are only about cash **directly** coming in during that month. If you sell on credit, only enter the part of each sale that is collectable in cash that month.



### *Step Two: Determine Your Cash Outflows*




Cash going out of your business is a cash outflow. These may include:

- Cash Purchase of Materials and Inventories
- Payments on Accounts Payable
- Wages
- Maintenance Expenses
- Lease Costs
- Utilities
- Insurance
- Supplies
- Loan Repayments
- Start-up Costs (for the first month of business)

Like the cash inflows, you only want to record for each month the actual cash payments you will make. If you are extended credit from your suppliers, only record the portion of the account payable you will be paying. If a yearly expense will be paid in installments, record the amount to be paid only in the months the cash will be leaving your business. If you will be estimating your expenses, be generous in estimating the amounts. Don't forget to include in your Cash Outflows how much you will be paying yourself and your employees.

### *Step Three: Reconcile the Inflows and Outflows*

Once you know what your cash coming in and going out is, the formula is very simple.

*Cash Inflows — Cash Outflows = Surplus or Deficit*

Add all your inflows together then subtract the total of your outflows. Whatever you are left with will be your net surplus or deficit.

Each month, you should reconcile the net cash flow with how much cash you have on hand. This is much like you would reconcile your personal cheque book. Just add your Net Cash Flow to your Beginning Cash Balance to get your End of Month Cash balance. That figure then gets used as the beginning balance of the next month.

## Using Your Cash Flow Summary

Now that you've done a cash flow summary, what benefits can you draw from this information? How should you use this record?

This forecast can be invaluable to you as a business owner. It will help you establish budgets, income statements and show how long term debt will be repaid. The cash flow summary can give you early warning if your expenses are running out of line or sales targets are not being met. You will see from the projection if a temporary line of credit will be required. Remember that this will have to be paid off from surplus cash in a future month.

You will need to examine your budget for low sales months...

There is more you can learn from the cash flow summary. It will show any cyclical, or seasonal, trends your business will face and if you will have enough sales overall to cover your expenses. If, for example, the bulk of your sales occur in the spring and fall and your expenses will be constant all year, you need to make sure that the cash you bring in from your sales in the good months can hold you over during the slow months. You will also need to examine your budget for low sales months to see if any adjustments can be made. Can you lower any expenses? For example, can you curtail buying unnecessary equipment or should you lay off staff or find a cheaper supplier?

## Ways to Improve Your Cash Flow

Obviously every businessperson would like to report a positive cash flow each month. Sometimes this may not be possible, especially for seasonal businesses. There are steps though that you can take to improve your cash flow.

1. **Increase Your Sales**
   More sales may increase cash inflows but remember that it could also increase your accounts receivables and require more

inventory purchases on your part. Use your cash flow plan to see if you can sustain a major increase in sales.

**2. Collect Your Receivables**

Revenue can be lost if you are not aggressive in collecting overdue accounts. You should have a clear process for pursuing collections. You may need to send out a series of letters to overdue customers informing them that their account is past due and what steps you will take if it is not paid. You can also reward customers that pay early with a small discount (2% for example) and charge a late payment fee for those that are past due.

**3. Invoice Immediately**

Don't wait until the end of the month to prepare and send out invoices. This could cause you to have to wait for an additional 30 days for payment. Prepare your invoices immediately upon delivery or as soon as the work has been done.

**4. Review Your Credit Terms**

Reduce the amount and time of credit given to customers. This should cause more customers to pay cash for their purchases and reduce the bad debt expenses for your company. Be cautious though, tight credit policies could seriously limit your customers' buying ability and sales may decrease. Try to find a balance between sales and limiting your unpaid receivables.

**5. Seek Deposits for Work in Progress**

Develop a policy that customers pay a certain percentage of the total invoice up front or at multiple stages of the project. Note: The province of Alberta requires that some prepaid contractors have a license and be bonded. For more information contact **The Business Link.**

Remember that your Cash Flow Summary is a valuable tool to you as a business owner. This cannot be overemphasized. Continually use it! Check your actual month end figures with your projected figures and see how accurate your estimate was. Make adjustments as necessary.

| | | jan | feb | mar | apr | may | june | july | aug | sept | oct | nov | dec | TOTALS |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| 1 | | | | | | | | | | | | | | |
| 2 | **ABC Company** | | | | | | | | | | | | | |
| 3 | **Forecasted Cash Flow Statement** | | | | | | | | | | | | | |
| 4 | **Monthly, 2005** | | | | | | | | | | | | | |
| 5 | | | | | | | | | | | | | | |
| 6 | | | | | | | | | | | | | | |
| 7 | | | | | | | | | | | | | | |
| 8 | Beginning Cash Balance (amount from Row 39) | | | | | | | | | | | | | |
| 9 | | | | | | | | | | | | | | |
| 10 | ***Cash Inflows*** | | | | | | | | | | | | | |
| 11 | | | | | | | | | | | | | | |
| 12 | Cash Receipts | | | | | | | | | | | | | |
| 13 | Collected Accounts Recievable | | | | | | | | | | | | | |
| 14 | New Loan Proceeds | | | | | | | | | | | | | |
| 15 | Cash Sale of Assets | | | | | | | | | | | | | |
| 16 | **Total Cash Inflows** (add rows 12-15) | | | | | | | | | | | | | |
| 17 | | | | | | | | | | | | | | |
| 18 | ***Cash Outflows*** | | | | | | | | | | | | | |
| 19 | | | | | | | | | | | | | | |
| 20 | Cash Purchase of Materials | | | | | | | | | | | | | |
| 21 | Wages | | | | | | | | | | | | | |
| 22 | Management Draws | | | | | | | | | | | | | |
| 23 | Maintenance and Cleaning | | | | | | | | | | | | | |
| 24 | Licences and Dues | | | | | | | | | | | | | |
| 25 | Rent/Lease | | | | | | | | | | | | | |
| 26 | Utilities | | | | | | | | | | | | | |
| 27 | Insurance | | | | | | | | | | | | | |
| 28 | Vehicle Expenses | | | | | | | | | | | | | |
| 29 | Travel Expenses | | | | | | | | | | | | | |
| 30 | Supplies | | | | | | | | | | | | | |
| 31 | Loan Repayment | | | | | | | | | | | | | |
| 32 | Payments on Accounts Payable | | | | | | | | | | | | | |
| 33 | Other Expenses | | | | | | | | | | | | | |
| 34 | **Total Cash Outflows** (add rows 20-33) | | | | | | | | | | | | | |
| 35 | | | | | | | | | | | | | | |
| 36 | ***Net Cash Flow*** (row 16 minus row 34) | | | | | | | | | | | | | |
| 37 | | | | | | | | | | | | | | |
| 38 | End of Month Cash Balance (row 8 +/- row 36) | | | | | | | | | | | | | |

*Note: This is an example of a cash flow summary. It should be completed for at least an entire year. Also, the Cash Inflows and Outflows are not all inclusive. You may have other accounts to add to either section.*

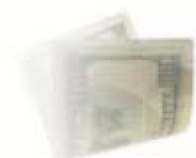
## Break Even Analysis

Another valuable management tool is the Break Even Analysis. This figure helps you determine what volume of sales is required to cover all of your costs. Once you cross the break even point, all sales are profit makers.

Three factors are incorporated in calculating your break even point.

1. **Fixed Costs**
   These are costs that remain the same regardless of how much you sell. They include things like your rent, insurance, taxes, utilities, loan repayments, advertising, etc.

2. **Variable Costs**
   These costs change based on how much product is produced or sold. They are sometimes referred to as "cost of goods sold". They include your materials, packaging, some labour costs, transportation and freight. You will want to know this on a per unit basis.



3. **Unit Price**
   The price at which you will sell your product or service.

You can calculate how many units you need to sell to break even or how many sales in dollars are required to break even. Here are the formulas you will need:

$$\textit{Break Even Units} = \frac{\textit{Total Fixed Costs}}{\textit{Unit Price} - \textit{Variable Costs per Unit}}$$

***Or***

$$\textit{Break Even Dollars} = \frac{\textit{Total Fixed Costs}}{(\textit{Unit Price} - \textit{Variable Cost per Unit}) \div \textit{Unit Price}}$$

Here's a simple example:

Let's assume your fixed costs are $5000 a month, variable costs are $10/unit and you plan to sell your product for $20.

*Break Even Units* = $\frac{5000}{20 - 10}$ = 500 Units

*Break Even Dollars* = $\frac{5000}{(20-10) \div 20}$ = $10,000 in sales

So we've learned that to break even, or just cover all of our costs, you would have to make $10,000 in sales that month which would equal 500 units sold.

If you find you are not breaking even, there are 3 adjustments you can make to rectify the issue.

1. **Lower Your Variable Costs**
   See if you can find a cheaper supplier, control your inventory, schedule staff more effectively or consider more efficient technology.

2. **Control Your Fixed Expenses**
   Examine to see if any budget cutbacks can be made.

3. **Raise Your Price**
   Unless you are in a very price sensitive market, customers won't particularly notice a small increase in price. Even 4-5% can have a positive impact on your profit.

Your investment may come directly from personal savings and by selling or mortgaging personal assets.

As the business owner, you can use this break even analysis to make key decisions. You know what your sales need to be at so you can now set goals and allocate your sales force and marketing initiatives accordingly. You can also determine the impact of price adjustments on your profit. Determining your break even also works well with your cash flow analysis. For slow months, you can monitor your expenses to keep losses to a minimum.

Determining your break even also works well with your cash flow analysis.

## Conclusion

As you can see, knowing the financial health of your business is very important to its success. It doesn't have to be difficult to plan for success. Knowing how your sales relate to your expenses is the foundation of any financial forecasts. Make developing your financial forecasts an ongoing part of your management.

**Other bulletins and guides in The Business Link's Small Business Success Series are available on-line at www.cbsc.org/alberta/successseriesguides.cfm.**

**For more details on this information and related topics, contact:**

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THE BUSINESSLINK Business Service Centre

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