

How to Forecast Your Revenue and Sales

A Step by Step Guide to Revenue and Sales Forecasting in a Small Business

By BizMove Management Training Institute

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1. Introduction

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.

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2. 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.

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3. 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.

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4. 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.

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5. 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 Specialties 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.

THE SMALL-BUSINESS SPECIALTIES CO.		
Condensed Income Statement		
For year ending Dec.31,XXX1		
Net sales (60,000 units @ \$20 per unit)		\$1,200,000
Less cost of goods sold:		
Direct material	\$195,000	
Direct labor	215,000	
Manufacturing expenses (Schedule A)	300,000	
Total	710,000	
Gross profit		490,000
Less operating expenses:		
Selling expenses (Schedule B)	\$200,000	
General and administrative expenses (Schedule C)	210,000	
Total	410,000	
Net Income		\$ 80,000

Supporting Schedules of Expenses Other Than Direct Material and Labor

	Total	Schedule A manufacturing expenses	Schedule B selling expenses	Schedule C administrative expenses
Rent	\$ 60,000	\$ 30,000	\$ 8,000	\$ 22,000
Insurance	11,000	9,000	1,000	1,000
Commissions	120,000		120,000	
Property tax	12,000	10,000	1,000	1,000
Telephone	7,000	1,000	5,000	1,000
Depreciation	80,000	70,000	5,000	5,000
Power	100,000	100,000		
Light	60,000	30,000	10,000	20,000
Officers' salaries	260,000	50,000	50,000	160,000
Total	\$ 710,000	\$ 300,000	\$ 200,000	\$ 210,000

Classification of Expenses

	Total	Variable	Fixed
Direct material	\$ 195,000	195,000	
Direct labor	215,000	215,000	
Manufacturing expenses	300,000	100,000	\$200,000
Selling expenses	200,000		50,000
General and administrative expenses	210,000	60,000	150,000
Total	1,120,000	720,000	400,000

where:

$S = F + V$ (Sales at the break-even point)

F = Fixed expenses

V = Variable expenses expressed as a percentage of sales.

This formula means that when sales revenues equal the fixed expenses and variable expenses incurred in producing the sales revenues, there will be no profit or loss. At this

point, revenue from sales is just sufficient to cover the fixed and the variable expenses. In this formula "S" is the break-even point.

For the Small Business Specialties Co., the break-even point (using the basic formula and data) may be calculated as follows:

$$S = F + V$$

$$S = \$400,000 + 0.605$$

$$10S = \$4,000,000 + 6S^*$$

$$10S - 6S = \$4,000,000$$

$$4S = \$4,000,000$$

$$S = \$1,000,000$$

*Both sides of the equation were multiplied by 10 to eliminate decimal fractions.

Proof that this calculation is correct follows:

Sales at break-even point per calculation	\$1,000,000
Less variable expenses (60 percent of sales)	600,000
	<hr/>
Marginal income	400,000
Less fixed expenses	400,000
	<hr/>
Equals neither profit nor loss	\$ 0

Modification: Break-Even Point to Obtain Desired Net Income

The first break-even formula can be modified to show the dollar sales required to obtain a certain amount of desired net income. To do this, let "S" mean the sales required to obtain a certain amount of net income, say \$80,000. The formula then reads:

$$S = F + V + \text{Desired Net Income}$$

$$S = \$400,000 + 0.605 + \$80,000$$

$$10S = \$4,000,000 + 6S + 800,000^*$$

$$4S = \$4,800,000$$

$$S = \$1,200,000$$

*Both sides of the equation were multiplied by 10 to eliminate decimal fractions.

Break-Even Point in Units to be Sold

You may want to calculate the break-even point in terms of units to be sold instead of sales dollars. If so, a second formula (in which "S" means units to be sold to break even) may be used:

$$\begin{aligned} \text{Break-even Sales} &= \frac{\text{Fix Expenses}}{\text{Unit sales price} - \text{Unit variable expenses}} \\ (\text{S} = \text{Units}) & \\ \text{S} &= \frac{\$400,000}{\$20 - \$12} = \frac{\$400,000}{\$8} \\ \text{S} &= 50,000 \text{ units} \end{aligned}$$

The Small Business Specialties Co. must sell 50,000 units at \$20 per unit to break even under the assumptions contained in this illustration. The sale of 50,000 units at \$20 each equals \$1 million, the break-even sales volume in dollars calculated in the basic formula. This formula indicates there is \$8 per unit of sales that can be used to cover the \$400,000 fixed expense. Then \$400,000 divided by \$8 gives the number of units required to break even.

Modification: Break-Even Point in Units to be Sold to Obtain Desired Net Income

The second formula can be modified to show the number of units required to obtain a certain amount of net income. In this case, let S mean the number of units required to obtain a certain amount of net income, again say \$80,000. The formula then reads as follows:

$$S = \frac{\text{Fixed expenses} + \text{Net income}}{\text{Unit sales price} - \text{Unit variable expense}}$$

$$S = \frac{\$400,000 + \$80,000}{\$20 - \$12} = \frac{\$480,000}{\$8}$$

$$S = 60,000 \text{ units}$$

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.

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Bonus Guides:

6. Essentials of Financial Planning

There is one simple reason to understand and observe financial planning in your business - to avoid failure. Eight of ten new businesses fail primarily because of the lack of good financial planning.

Financial planning affects how and on what terms you will be able to attract the funding required to establish, maintain, and expand your business. Financial planning determines the raw materials you can afford to buy, the products you will be able to produce, and whether or not you will be able to market them efficiently. It affects the human and physical resources you will be able to acquire to operate your business. It will be a major determinant of whether or not you will be able to make your hard work profitable.

This section provides an overview of the essential components of financial planning and management. Used wisely, it will make the reader - the small business owner/manager - familiar enough with the fundamentals to have a fighting chance of success in today's highly competitive business environment.

A clearly conceived, well documented financial plan, establishing goals and including the use of Pro Forma Statements and Budgets to ensure financial control, will demonstrate not only that you know what you want to do, but that you know how to

accomplish it. This demonstration is essential to attract the capital required by your business from creditors and investors.

What Is Financial Management?

Very simply stated, financial management is the use of financial statements that reflect the financial condition of a business to identify its relative strengths and weaknesses. It enables you to plan, using projections, future financial performance for capital, asset, and personnel requirements to maximize the return on shareholders' investment.

Tools of Financial Planning

This section introduces the tools required to prepare a financial plan for your business's development, including the following:

Basic Financial Statements - the Balance Sheet and Statement of Income

Ratio Analysis - a means by which individual business performance is compared to similar businesses in the same category

The Pro Forma Statement of Income - a method used to forecast future profitability

Break-Even Analysis - a method allowing the small business person to calculate the sales level at which a business recovers all its costs or expenses

The Cash Flow Statement - also known as the Budget identifies the flow of cash into and out of the business

Pricing formulas and policies - used to calculate profitable selling prices for products and services

Types and sources of capital available to finance business operations

Short- and long-term planning considerations necessary to maximize profits

The business owner/manager who understands these concepts and uses them effectively to control the evolution of the business is practicing sound financial management thereby increasing the likelihood of success.

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