SOUTHLAND CHAMBER OF COMMERCE
Business Vitality

PREPARING YOUR PROFIT FORECAST

This publication is not intended to replace your Accountant. It is to assist with preliminary planning. When you have worked your way through you are urged to consult your Accountant.

The thought of profit forecasting usually sends shivers down the spines of prospective business people. Yet it need not. Profit forecasting really is a business 'life jacket'. In today's business environment failure to forecast is forecasting to fail. The forecast must be much more than a piece of paper to impress the Bank Manager. It must tell **you** what you have to do to achieve success. It is the document from which many other plans will grow.

FORECASTING SALES

Profit forecasting normally starts with a sales forecast. Sometimes however it is useful to forecast backwards – from the bottom up. That is – start with what you want or must take from the business and work back up to the sales. Then you can look and say, "Can I honestly achieve that level of sales?" Remember this important point. **A Profit forecast is a guide. It is not a straight jacket. It must be reviewed and updated regularly as conditions change.**

Now back to forecasting. Many people's minds go blank when it comes to forecasting sales. Large companies may use extraordinarily complex and expensive techniques. These are neither available to, nor necessary for the small business person.

If there are similar businesses in the area, or a similar area, the Statistics Department can provide absolutely invaluable information on turnover, gross profit and the like. Your Accountant may be able to assist. You can look at your hourly charge out rate and make informed guesstimates of the number of hours you can sell. You can hire a Consultant to research the market for you. Talk to your Business Development Board for more information and ideas.

Whichever approach you use, you will need to write forecasts for three options:

- That level of sales you honestly believe you can achieve.
- That level you would like to achieve.
- The worst situation you can envisage.

PROFIT AND LOSS VERSUS CASH FLOW FORECASTS

What's the difference and which do you need? You need both! The two are often confused, even in some books.

The difference is this:
The **Profit and Loss Forecast** tells you how much profit or loss you make in a period. Costs which occur only intermittently such as Insurance, ACC, Rates and Tax, must be borne by each period, e.g. monthly, even though they may only be paid once per year. **The Cash Flow Forecast** on the other hand tells you when you can expect to receive money (cash) and make payments. Therefore an item like ACC will appear once, probably in May.
You need both because it is quite possible to be accumulating money in the bank (i.e. a positive cash flow) while making a loss. For example you have large maintenance cost, insurance costs, etc. due in the future for which this month's cash will have to pay. Conversely, it is not uncommon to be profitable and have a cash shortage (in other words you need a credit facility such as an overdraft). A common example is when a business has increasing sales such as the run up to Christmas. The business may have to pay for the goods – whether retail or manufacturing – before they can be on-sold (i.e. cash recovered).
One essential difference between the two forecasts is that purchase and sale of capital items, i.e. plant and fixtures, etc. **do not** appear on your Profit and Loss Budget, but they **do** appear on the Cash Flow Forecast.
Capital items will be written into or off your balance sheet. Balance sheets are beyond the scope of this publication. Talk to your Accountant.

GST

You must register for GST if your annual turnover will be more than $30,000. However, it may be to your advantage to register anyway. This is quite a complex issue and should be made after discussions with your Accountant.
You must choose whether you will file your returns monthly, two monthly or six monthly. This will depend on the nature of your business and your Sales Revenue (=Turnover). If your turnover is less than $250,000 you may choose any of the options. If turnover exceeds 24,000,000 per annum you must file returns on a monthly basis.
You also have to decide whether you will use a cash or invoice basis. In simple terms, cash basis means you claim/pay GST in relation to your actual payments, i.e. you take $1/9^{th}$ of the difference between your total cash income and total eligible payments.
With the invoice basis you will declare income in the period received but may claim expenses against invoices received in the period. That is, you may claim some expenses before you make the payment. It is normal practice to prepare the Profit and Loss Forecast as GST **exclusive**, but this is optional. However, by removing the GST from all taxed items you can simply disregard GST. To remove the GST simply multiply by 8 and divide by 9.
On the other hand the Cash Flow Forecast must be GST inclusive, as it has to account for your GST payments. See the IRD publication 'GST Guide' - #GST 600.

THE CASH FLOW FORECAST

As mentioned earlier, this forecast is intended to show you when money will flow into and out of your business. Is particularly useful in planning for periods of cash shortfall such as start up or buying Christmas stock. It allows you to plan in advance when you will need additional money. Your Bank Manager will be much more receptive if you can negotiate in advance for overdraft facilities rather than at short notice when the need arises.

Its' layout is similar to thee Profit and Loss Forecast, but with some critical differences:

- It includes GST
- It maintains a running total of your business cash.
- It includes purchase and sale of capital items.

The income and expenditure categories should be the same as for the Profit and Loss Forecast.
In effect the **CASH BALANCE** attempts to predict your bank account balance.

THE PROFIT AND LOSS FORECAST

There are many forms that a set of financial accounts may take. For planning purposes perhaps the most useful is that set out in the attached foldout. This is known as the 'contribution' approach. Of course you will need to insert your own categories.

The layout is similar to the cash flow forecast with some critical differences:

- It is GST **exclusive**.
- It does not include sales and purchase of capital items.
- It does not include each months share of intermittent costs such as ACC, insurance, etc.

FIXED COSTS – VARIABLE COSTS – BREAKEVEN

More terms to send shivers down your spine? Again, really quite simple. **Fixed Costs** are those that your business will incur whether or not you have any customers – such as Rent, Insurance, and Staff Wages. Costs that don't change with the amount of business you do. **Variable costs** on the other hand increase directly with an increase in business. For example, if you are a retailer the cost to you of the goods you sell will change with the amount you sell. If you sell twice as much you would expect your cost of goods to double. Some items such as electricity can be fixed variable, or a mixture. If electricity is only used for heating then it will largely be fixed. On the other hand if you are a foundry, your electricity bills will vary mainly in proportion to the amount of work you do. Typical electricity bill has a supply charge (fixed) and unit rates (variable).

DRAWINGS

In the case of sole traders and partnerships your tax payments will be the same whether included above or below the line. In practice you pay all the tax as an individual. Therefore the net profit effectively equals your tax paid drawings.

In the case of companies, earnings may be taken as either wages or as profit, or a combination of both. This is a complicated issue beyond the scope of this publication. You should consult your Accountant for details.

DEBTORS AND CREDITORS

λ Debtors are customers who owe you money.
λ Creditors are the people to whom you owe money.

CALCULATIONS

λ **CONTRIBUTION**
This is quite literally the contribution your trading activities make towards your fixed costs.

Contribution = Total SR – Total VC
SR = Sales Revenue
VC = Variable Costs

λ **NET PROFIT**
Net Profit before Tax (NPBT) = (Contribution – FC – Depreciation).
FC = Fixed Costs

λ **DEPRECIATION**
Depreciation is the decline in value of your plant. It is calculated from tabled available from the Inland Revenue Department.

λ **TAX**
For Sole Traders and Partnerships use the Inland Revenue Department's tax tables.
For Companies use 31%
Net Profit – NPBT – Tax.
Write any assumptions that you make in preparing your budget in the **NOTES** Section.
Cash Balance = Total Cash In – Total Cash out.
Each month this total is carried forward to the next month as the 'Balance Forward'.

GST
To estimate your GST payments use the following formula:
(Taxable Goods/Services sold in period – Taxed Goods/ Services Purchased)*
Remember that the payment is due in the month immediately after the period in question. I.e. GST for January/February is paid in March.

* This formula applies to the cash basis. For the invoice basis substitute 'invoices received' for 'purchased'. Irrespective of the system you plan using however, planning on a cash basis is both simpler and more conservative (i.e. is a safer estimate).

λ Write any assumptions that you make in preparing your budget in the **NOTES** Section.