What is Forecasting?

I was visiting with some small business CEOs at an informal SCORE discussion last week and a great point was raised, Dean, you have been writing about “knowing your business numbers” but you haven’t talked about what one can do to help predict the financial future of my business”. Ok, so that’s the topic of my column today.

The business gurus and accounting people would call this “financial forecasting”. This endeavor helps you predict the cost of your products or services, the amount of sales revenue, and profit you can anticipate. If your business is not already off the ground, financial forecasting will explain/determine how much you'll have to invest or borrow.

Obviously, financial forecasting depends on your type of business. That is, whether you are a retail business, service business, manufacturing or wholesale business, or a project development business (that's a business like real estate rehabilitation in which you work on one house at a time).

Forecasting is always easier if you've been in business for a little while, because you have months (or years) of actual revenue and expenses upon which to base your forecasts. If you haven't got any history this process can help you get started.

Don't be intimidated. Financial forecasting is not so bad. It's a matter of making realistic, educated guesses as to how much money you'll take in and how much you'll need to spend, then using these estimates to calculate how and when your business will be profitable.

I will start this discussion with one of three common techniques. The first is commonly called the Break-Even Analysis and I will discuss the other two next week.

The Break-Even Analysis tells you how much revenue you'll need each week or month to break even. To calculate it, you need to make two estimates:

- **Fixed costs.** This is also known as overhead. These costs usually include rent, insurance, and other regular, set expenses. (Loan repayments and the costs you pay for any goods you will resell are not included as fixed costs.)
• **Gross profit percentage.** Start with your gross profit. That is, what's left after you deduct the direct costs for each sale. For example, if your business sold bicycles and you paid $150 for each bicycle and sold it for $250, your gross profit is $100. In order to determine your gross profit percentage, you divide your profit by the selling price. In this case 40 ($100/250).

To calculate your break-even, divide your monthly overhead expenses by your profit percentage (as a decimal). For example, if your bicycle shop has fixed monthly costs of $4,000, and your profit percentage is 40, then you need sales of $10,000 a month to break even ($4,000 divided by .40).

Here is what that forecasting analysis tells you. In terms of this bike store, if you were selling bicycles at $250 a bicycle, you would need to sell 40 bikes a month to break even. If this amount is below your anticipated sales revenue, then you're facing a loss and you'll need to lower expenses or increase sales to break even.

This is vital information for a new business or an established business. Do this break-even analysis to guide the management of your business. Knowing your business numbers is important to your success.

____________________
Dean L. Swanson
Southeast Minnesota SCORE
c/o Rochester Area Chamber of Commerce
220 South Broadway, Suite 100
Rochester, MN 55904
*Dean is a volunteer SCORE Mentor and District Director of SCORE Minnesota*