

Financial forecasting

Financial forecasting is a very important part of a businesses planning for the future. It allows the company to see how much they can spend and they can then compare that to what they need to buy or use money for.

Financial forecasting has a wide range of uses. It is used by the company:

- to help in decision making
- as a management tool to aid control
- to assess the profitability of the business
- to plan strategies
- to control resources
- to measure the efficiency of the business
- to forecast possible future trends

For a business to be able to plan how to use it's finances it needs to forecast what is likely to happen in a specific amount of time e.g. the next 6 months, year or 5 years.

Three tools are used to aid financial planning:

- Calculation of unit cost of production

This shows the company how much the average cost will be to them to produce 1 item. It is calculated by working out how much it costs to make a batch of products, including materials and labour and then dividing it by the amount of individual items produced. It is useful to the company because they can work out the eventual selling price from the cost price by adding a % mark up e.g. 10% which will give them their profit.

- Break even analysis

This shows the company when their costs are covered and where they begin to make profit. It is usually shown in the format of a graph. It can be used to identify when prices need to be raised, fixed or dropped depending on the company's income.

- Cash flow forecasting

This is a very important part of financial forecasting. It involves looking forward and looking at the cash flow in and out of the company. By using this tool the company can predict how much money they will have from month to month and they can tell when an overdraft may be needed.

Brief

Lesley Jerome wants to set up her own business as a soul trader. She is very artistic and wants to design and make silk scarves, scrunchies and jewellery.

There is a large craft show being held near to where she lives, so she decides to rent a stand and make only scarves to sell at the show. In this way she can see if people like her ideas and will buy them. Before she goes to the show she has to do some financial planning. The first thing she needs to do is to work out the unit cost of production. This will help decide what price she will sell at.

Unit cost of production and price

Based on the following information the table below shows the cost of producing one scarf.

Fixed Costs :-

- Rental of the stand £150
- Overheads including electricity and water £60

Variable costs :-

- Silk material for the scarves is £3.00 per meter and is 90 cm wide. Each scarf is 30 cm wide by one meter long.
- Other materials including thread £15.00
- Paint 10 litres (10 different colours) @ £15.00 per litre.
- Labour - Lesley allows herself a wage of £4.00 per hour and it take an average of one hour to make one scarf.

| | UNIT COST £ |
|-------------------------------------|----------------|
| FIXED COSTS | |
| Rental | £1.00 |
| Overheads (electricity, water etc.) | £0.40 |
| VARIABLE COSTS | |
| Material | £1.00 |
| Thread | £0.10 |
| Paint | £1.00 |
| Labour | £4.00 |
| Total cost per scarf is: | £7.50 |
| Profit margin | £2.50 |
| selling price | £10.00 |

This will help Lesley Jerome because she now has an insight into what her costs are going to be. She now knows the full extent of all of her costs and can fix a selling price that will cover them all and not leave her short or in debt.

Other things that need to be taken into consideration when fixing prices are to take notice of what the consumers are willing to pay and what other competitors are charging for their scarves because if they are cheaper elsewhere then people will go there instead and Lesley will lose her trade.

Break even analysis

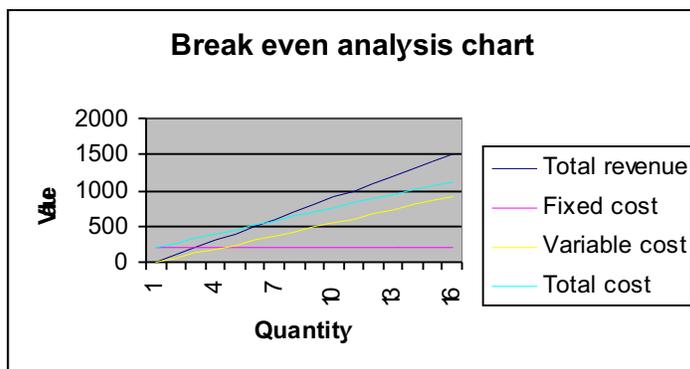
Lesley now knows the price she intends to charge. As she is only intending to make 150 scarves she needs to know how many scarves she needs to sell in order to break even. She will now have to carry out a breakeven analysis.

Break even analysis can be presented in the form of a chart or a graph. The other way of calculating the break even point is to use the contribution to fixed cost method.

Below is a table showing Lesley Jerome's Break even point.

| Sales of scarves | Total revenue £ | Fixed costs £ | Variable costs £ | Total Cost £ | Profit / Loss £ |
|------------------|-----------------|---------------|------------------|--------------|-----------------|
| 0 | 0 | 210 | 0 | 210 | -210 |
| 10 | 100 | 210 | 61 | 271 | -171 |
| 20 | 200 | 210 | 122 | 332 | -132 |
| 30 | 300 | 210 | 183 | 393 | -93 |
| 40 | 400 | 210 | 244 | 454 | -54 |
| 50 | 500 | 210 | 305 | 515 | -15 |
| 60 | 600 | 210 | 366 | 576 | 24 |
| 70 | 700 | 210 | 427 | 637 | 63 |
| 80 | 800 | 210 | 488 | 698 | 102 |
| 90 | 900 | 210 | 549 | 759 | 141 |
| 100 | 1000 | 210 | 610 | 820 | 180 |
| 110 | 1100 | 210 | 671 | 881 | 219 |
| 120 | 1200 | 210 | 732 | 942 | 258 |
| 130 | 1300 | 210 | 793 | 1003 | 297 |
| 140 | 1400 | 210 | 854 | 1064 | 336 |
| 150 | 1500 | 210 | 915 | 1125 | 375 |

This is a graph showing Lesley's Break even point.



On the next page is a hand drawn graph of Lesleys break even analysis.

Cash flow forecasting

Lesley wants to be certain that she is going to have sufficient cash to pay her bills as and when they arise. She needs to produce a cash flow forecast.

Shown below is a cash flow forecast for a 6 month period.

| | January | february | March | April | May | June |
|----------------------------|---------|----------|-------|-------|-------|-------|
| Receipts (cash inflow) | 5,000 | 4,500 | 5,000 | 6,000 | 6,500 | 7,000 |
| Payments (cash outflow) | 3,300 | 6,000 | 3,500 | 4,400 | 4,300 | 4,500 |
| Net Cash Flow | 1,700 | -1,500 | 1,500 | 1,600 | 2,200 | 2,500 |
| Opening bank balance (+/-) | 500 | 2,200 | 700 | 2,200 | 3,800 | 6,000 |
| Closing bank balance (+/-) | 2,200 | 700 | 2,200 | 3,800 | 6,000 | 8,500 |