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Forecasting the Income Statement

by Sophia

WHAT'S COVERED

In this lesson, you will learn about the process for forecasting the income statement. Specifically, this lesson will cover:

1. Pro Forma Income Statement

Our forecast starts with what we call a pro forma income statement. Pro forma financial statements are prepared in advance of a planned transaction, merger, acquisition, or new capital investment. It is also done before the next accounting period.

The **pro forma income statement** is the company's estimate on how it plans to convert its revenue into net income, which is the result after all expenses have been accounted for.

HINT

Net income is also called the bottom line.

As mentioned in a previous lesson, the starting point for a pro forma income statement is the sales forecast. After setting the gross sales forecast, there are adjustments for returns, refunds, discounts, and other non-standard items. This brings us from gross sales to net sales.

The next item to be forecast is the cost of goods sold or COGS. This is the inventory cost of the goods that a business has sold. It includes all the cost of purchase, conversion, and other costs incurred – like freight and labor and allocated overhead – if a business is selling physical goods.

Next, an estimate needs to be made for selling, general and administrative expenses or SGA. These are costs including combined payroll costs and the major portion of non-production related costs. We also deduct depreciation and amortization on fixed assets, along with research and development costs.

After that, there is a section for deducting for financing costs, income tax expenses, and any other irregular items.

This brings us to the projected bottom line, the forecasted net income.

Each item that is part of the pro forma income statement forecast is largely determined by a ratio or comparison to the sales forecast that started the process. Each expense item is projected to be the same percentage of sales as it was in the previous period. When finalizing the forecast income statement, these expensed items are adjusted for managerial forecast changes in the external environment and in the market.

IN CONTEXT

Here is a pro forma income statement for Leyla's Cafe.

Leyla's Café Income Statement

Income Statement for the year ended	31st December 2017 GEL	
Revenue		
Wholesale	2 000 000	
Retail	1 500 000	
Catering	500 000	
Total Revenue	4 000 000	Total revenue is the sum of all of Leyla's café for 2017
Expenses		
Costs of goods sold		
Ingredients	2 000 000	
Packaging	250 000	
Total Cost	2 250 000	Cost of Good solds is the cost related to all of Leyla's sales
Gross Margin	1 750 000	Total revenue is the sum of all of Leyla's café for 2017
Gross Margin as % of Revenue	43,75%	
Operating expenses		
Sales	200 000	
Marketing	75 000	
Distribution	45 000	
General & Administrative	140 000	Leyla spent 115 000 on G&A expenses, plus 25 000 for staff bonuses
Total Expenses	460 000	
Income Before Interests and Taxes	1 290 000	
Interest expenses	16 500	
Earnings Before Taxes	1 273 000	
Taxes	382 050	Leyla pays 30% tax on her earnings
NET INCOME	891 450	Net income is total revenue less all the costs

She has projected total revenue of $4,000,000. Some of that is from wholesale, some from retail, and some from her catering business.

The next step she took was calculating the cost of goods sold, which comes to $2,250,000. This brings her to a gross margin of $1,750,000, or 43.75%.

Then she deducts the operating expenses, including SGA. The total expenses sum up to $460,000. So, her income before interest and taxes is $290,000.

After interest and after taxes, the bottom line, or her net income, is $891,450.

TERM TO KNOW

Pro Forma Income Statement

A statement of the company's estimate on how they plan to convert its revenue into net income.

SUMMARY

In this lesson, we learned that the financial forecast begins with a **pro forma income statement**. The starting point for this type of income statement is the sales forecast. Once this forecast is set, expense items can be calculated and forecast.

Best of luck in your learning!

TERMS TO KNOW

Pro Forma Income Statement

A statement of the company's estimate on how they plan to convert its revenue into net income.