

Forecasting the Income Statement

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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.



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.

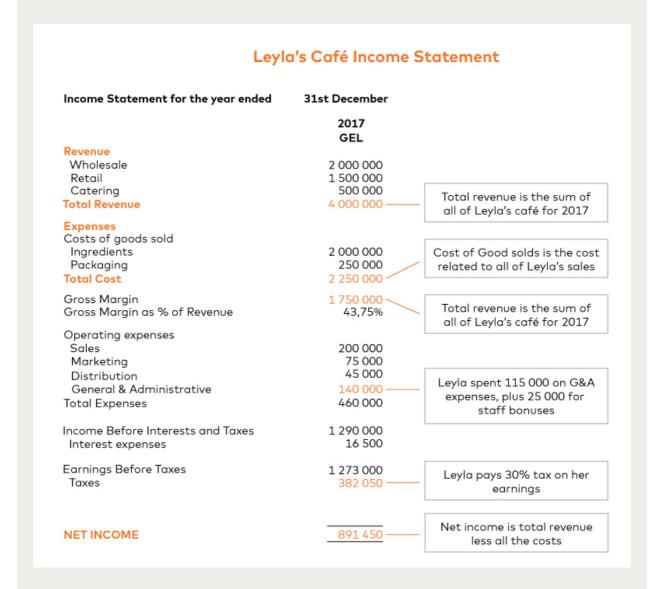
After that, there is a section for deducting for financing costs, income tax expenses, and any other irregular items.

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.



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.



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!

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TERMS TO KNOW

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