**TRAINING IN FINANCIAL AND BUSINESS MANAGEMENT FOR ROAD CONTRACTORS**

**MODULE TWO: SESSION FOUR: PARTICIPANTS’ NOTES**

**SHORT TERM FINANCIAL PROJECTION**

1. **Objectives**

By the end of the session, participants will be able to:

1. Make short term income statement projections.
2. Formulate short term cash projections.
3. Evaluate projected statements and identify short term financing requirements.
4. Suggest changes to the model to improve results.
5. **Role of short term planning**
6. Having a short term financial plan allows the construction business owner to track *actual events against the financial plan and make adjustments as the year passes*. This is invaluable to the owner in order to keep the business out of financial trouble in a changing economic environment.
7. If the business firm needs a bank loan or other financing, these pro forma financial statements are usually required. Small businesses can develop their pro forma financial statements for varying time periods. The most common time periods are either six months or one year.
8. The pro forma financial statements will assist the business to assess whether it will meet its performance targets and also to ascertain its cash needs during the period.
9. **Pro forma income statement**

The pro forma income statement provides a projection of how much revenue the firm anticipates to earn over a given time period and the costs that will go into producing the output and managing the business. The net of revenue and costs will be the profit or loss. Generally, a small business owner follows four steps to develop the pro forma income statement:

1. Set up a construction work size and costs plan.
2. Establish a revenue projection basing on historic trends and expected contracts expected at an estimated price.
3. Determine the cost of construction service by computing and projecting direct costs for the contract.
4. Determine gross operating profit.
5. Calculate overhead costs and offset them against the gross margin.
6. Compute other operating costs (administration) and taxes where applicable.
7. **General format of an income statement:**

|  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- |
| Expected revenues | m 1 | m2 | m3 | m4-m12 | Total |
| Revenues |  |  |  |  |  |
| Revenues from other sources |  |  |  |  |  |
| Total |  |  |  |  |  |
| Planned expenditure: |  |  |  |  |  |
| Materials |  |  |  |  |  |
| Administration and overheads |  |  |  |  |  |
| Labour |  |  |  |  |  |
| Equipment hire/running |  |  |  |  |  |
| Depreciation |  |  |  |  |  |
| Finance costs |  |  |  |  |  |
| Total |  |  |  |  |  |
| Projected Profit/loss |  |  |  |  |  |

The income statement projection for Munaku for the twelve months is attached to the notes.

1. **Analysis of income statement**

The income statement will be analysed to assess whether it meets the profitability targets of the business generally. If it does not, adjustments will have to be suggested in order to improve performance such as being more aggressive to increase revenue or possibly adjusting gross profit margins. Other changes that could be considered are to reduce the direct costs of materials and labour and cost of administration and other operating overheads.

1. **Projected cash flow**

Business may **fail even when it is making profits**. Forecast profit is not the same as cash. Cash on hand is necessary to operate day to day operations. Entrepreneurs must therefore have a projected cash flow in order to ensure that they will have adequate cash in the future to operate their firm. It is possible for a business to collapse even when it has been making profits.

*Every month the construction firm owner should calculate if there will be enough cash to meet the minimum cash balance and the firm's cash needs for the month. If not, the owner will have to borrow or to re-organise his operations to fit within the anticipated cash flow. If there is excess cash, the owner can repay past loans. In this way, the business owner can keep a good handle on the cash position of the firm.*

The pro forma cash flow projection will be made by considering when the revenue will be received and when costs will be paid. Cash flow is not determined by accounting conventions and concepts. What is considered is when is the cash received or paid.

Cash flow does not distinguish between current and capital items as long as they take out or bring in cash. Cash flow projection only considers transactions that affect cash and disregards such charges as depreciation and amortization. In order to arrive at a cash flow projection the following should be considered:

* 1. Receipts from:

1. Customers
2. Sale of fixed assets
3. Sale of investments or dividends from them
4. Loans
5. New capital injected
6. Other sources such as rent or hire of equipment.
   1. Payments to:
7. Suppliers of goods
8. Suppliers of services
9. Employees
10. Finance institutions
11. Tax authorities
12. Owners of the business
13. Suppliers of fixed assets

For every month, starting with the balance of cash brought from the previous month, the receipts are added and the payments subtracted to arrive at the balance of cash at the end of the period. Below is a cash flow projection format.

1. **General format of a cash projection statement**

|  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- |
| **Expected cash receipts** | **m 1** | **m2** | **m3** | **M4 –m12** | **Total** |
| Receipts from clients |  |  |  |  |  |
| Other cash sources e.g. loans |  |  |  |  |  |
| Receipt from rent |  |  |  |  |  |
| Total |  |  |  |  |  |
| Planned cash payments: |  |  |  |  |  |
| Material suppliers |  |  |  |  |  |
| Administration and overheads |  |  |  |  |  |
| Salaries and wages paid |  |  |  |  |  |
| Equipment hire/running |  |  |  |  |  |
| Loan repayment |  |  |  |  |  |
| Drawings or dividends paid |  |  |  |  |  |
| Tax payment |  |  |  |  |  |
| Total |  |  |  |  |  |
| Net change in cash |  |  |  |  |  |
| Add balance from previous period |  |  |  |  |  |
| Balance to next period |  |  |  |  |  |

The projected cash flow for Munaku Contractor is attached to the notes.

1. **Analysis of cash flow projection**

After deriving the projected cash flow, it is examined to see the pattern and assessed to determine whether it could meet the obligations of the business as they fall due. It the cash flow is short of expectations, consideration should be made to see how to eliminate the short fall. The timing of transactions such as purchase of assets, drawings and the like may have to be altered or done away with altogether. If this is not able to eliminate the gap, fresh capital in form of equity or a term loan may be called for if the deficit is for a long period. It the cash flow deficit is for short periods, short term bank facilities such as an overdraft should be obtained.

**9. Group activity for all**

1. Basing on the case study develop an income statement for the first year (See Appendix one on the Attachment).
2. Develop a cash flow projection for the initial one year (See Appendix 2 on the attachment).
3. Discuss the similarities or differences between the two statements.
4. Advise Munaku on what strategy he could adopt to manage liquidity.