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Why is sales forecasting important?

> **Sales forecasting** is the process of estimating future sales. Accurate sales forecasts enable companies to make informed business decisions and predict short-term and long-term performance. Companies can base their forecasts on past sales data, industry-wide comparisons, and economic trends. — TrackMaven

Skip to How to Build Sales Forecast Model

Cash Is King

"Cash is the lifeblood of all businesses – it provides working capital which can be put to productive use. For most businesses costs are incurred up front, following which there's a time lag as you wait for the cash to flow in from your customers. There will be uncertainty over the level of sales you'll achieve, as well as when you'll actually get paid.

Consequently, businesses need to prepare forecasts so they can anticipate when cash is likely to run short. Startups can then arrange an overdraft extension, loan or other finance to tide them over.

It is perfectly normal for startups or even mature businesses to need financial support with cash flow, due to delayed payments, uncertain demands or investments in assets with longer-term payoffs." — Courtesy of Startup Donut

Forecasting Reduces the Angst of Uncertainty

Starting a new business is simultaneously exciting and nerve-racking.

As a result, excitement grows as you anticipate achieving hopes and dreams of being your own boss; determining your destiny; generating wealth for your family, etc.

But, there are no guarantees in business. And, this uncertainty about the future success of your business venture can add to the anxiety you may feel as a new business owner.

One way to reduce the angst caused by uncertainty is to be able to reliably predict or forecast sales for the future. Knowing how to forecast expenses and create revenue forecasting models is not hard to do.

However, forecasting how many people will buy your product(s) or pay for the services you provide as a new business, can be a much tougher task.

Prior to opening the business the sales forecast on paper indicates that revenues will flow, cash will be available and profits will be made. The new business owner is giddy about the possibilities.

But once a business opens, the need to produce sales becomes a reality. Actual earnings can be quite different from the projections in the business plan.

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The question is, how to realistically forecast revenue estimates.

How to Build a Sales Forecast Model

Step 1 is to define your business. What need or problem does my product/service solve? How is it different than others that solve the same problem? Who is the customer, etc.?

Next is to research the business idea. In other words, learn as much as possible about the type of business you are starting: how the industry works, and the market for your product/service.

The next step is to plan the business. There are 3 common components of planning.

- Marketing Plan
- Operations Plan
- Financial Plan

Case Study: Helen & Dorothy’s Salon/Spa

Recently, I met with Helen and Dorothy about their hair salon and spa startup. Helen is a hair stylist and has several years of experience in the business. Dorothy is an experienced administrative and financial manager.

They decided to combine their skills to bring that synergy to the business venture.

Because of Helen’s experience as a stylist, she has a great deal of first-hand knowledge as a practitioner. Knowing that they could not rely solely on Helen’s experience, they interviewed other business owners, consumers and gathered secondary research from industry data and reports available through their local library and reports available on the Internet.

Using this information, Helen and Dorothy completed the marketing and operations sections of their business plan and were in the process of writing the financial plan.

Like many new businesses, start-up cost and monthly operating expenses were relatively easy to identify. The challenge came when attempting to forecast sales and revenue.

Salon/Spa Sales Forecast

Helen and Dorothy plan for 6 stylists (including Helen) in the salon. They projected —

- First-year sales of $405,000
- Start-up cost is $25,000
- Monthly operating expenses are $6000
- and the gross profit margin is 50% (what is gross profit margin-hyperlinked)

Here is an excerpt from our conversation.

Earl: How will you generate $405,000? Describe your assumptions.

Helen & Dorothy: We will have 6 stylist; each stylist will service 5 clients per day at an avg. of $45 per client = $225 per stylist, $225 x 6 days = $1350 per week; $1350 x 6 stylist = $8100 x 50 weeks = $405,000.

READ Startup Sales Projections

Earl: On paper, this looks good but once that sign on the door says, “Open,” it’s not about what’s on paper, it’s all about how many are consumers are walking through the door. Have you identified the other stylists, and if so, what level of sales are they generating now?

Helen & Dorothy: We have identified the stylists, we know one of them is generating around $90,000 per year, but we don’t know kind of revenue the others are making.

Earl: How many are definitely committed to work in your shop?

Helen & Dorothy: Two of the stylists are definitely coming– the one with the $90,000 in sales and one other. The other three have said they are strongly interested in coming.

Earl: Does your projected profit margin include other costs (products, styling supplies, etc.) other than the amount paid to the stylist?

Helen & Dorothy: As we were talking I was thinking about that. Let's assume the gross profit margin is 45%.

Earl: Here's what you should consider. You are investing at least $25,000 (and probably more) in your business and you have forecast your sales based on a perfect world scenario. I am sure you want a successful business and a return on your investment. Therefore, you should create a forecast based on more realistic and known information.

We then developed a more realistic sales forecast.

- Operating expenses are $8,000 per month, $96,000 per year.
- Profit margin is 45%.
- Revenue required to breakeven is $17,778 per month ($8000/.45%) or $213,334 per year ($96,000/45%).

Helen (stylist #1) generates approximately $100,000 in annual sales working at another salon. If she maintains the same rate of sales in her own salon, her sales will contribute $45,000 ($100,000 sales x 45% profit margin) toward the business's operating expense budget of $96,000.

Instead of assuming the salon will employ five stylists when it opens, Helen and Dorothy decide to only include the two stylists who previously committed to working in their salon.

They also decided to be more conservative in their revenue expectations of these two stylists.

First of all, they assumed stylist #2 and stylist #3 would not begin until the third month of operation (just in case).

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Second, rather than using a sales forecast of $90,000 per year for stylist #2, they would forecast 80% ($72,000 per year).

Since they did not have sales information for stylist #3, until they had an opportunity to speak with her, they forecasted her sales at 50% ($45,000 per year) of stylist #2's original $90,000.

Total sales forecast for the three stylist in year 1 is: $217,000. [$100,000 (stylist #1) + $72,000 (stylist #2) + $45,000 (stylist #3)].

The sales needed to breakeven are $213,334.

Now based on the forecast, let's see how much Helen and Dorothy need to start the business.

	Start-Up	Month 1	Month 2	Month 3	Month 4	Month 5	Month 6
Begin Cash		-25,000	-29,250	-33,500	-33,362	-33,224	-33,086
Sales #1		8,334	8,334	8,334	8,334	8,334	8,334
Sales #2				6,000	6,000	6,000	6,000
Sales #3				3,750	3,750	3,750	3,750
COG/COS (55%)		4,584	4,584	9,946	9,946	9,946	9,946
Oper. Exp.	25,000	8,000	8,000	8,000	8,000	8,000	8,000
End Cash	-25,000	-29,250	-33,500	-33,362	-33,224	-33,086	32,948

***Please note:** The above forecast is for illustration purposes only. The sales amounts shown are the same every month to simplify the example.

What Helen & Dorothy Learned From the Sales Forecast

1. The amount needed to start the business is at least $33,500 (see month 2 above) since this represents the highest cash shortfall.

2. They have a roadmap for making the business work financially.
3. In order to realize a significant net profit in the business, additional sources of revenue are required (i.e. increased sales from stylist 2 and stylist 3, additional stylists, other products/services).

The takeaway from this case study is to base your sales forecast on the most realistic information you can acquire and not on a scenario that just works on paper.

Remember, the business is about money. If the money does not work, the business will fail. Know what your business needs financially to operate and develop a realistic plan to achieve it.

Successful business owners are willing to study business concepts and equip themselves with the necessary knowledge and with proven methods of success.

Photo by **Lukas** from **Pexels**