How to Forecast Sales

Business Information Factsheet
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Introduction

Forecasting future sales is a crucial part of setting up and running a business as well as an essential part of business planning. The future is always uncertain but you need to be able to make credible, evidence-based sales projections in order to plan your business strategy.

This factsheet explains the importance of sales forecasting and why you need to carry it out. It describes various methods of forecasting sales and shows how to interpret and use the results. It also provides a checklist on how to avoid pitfalls when forecasting and contains hints and tips and sources of further information.

What is a sales forecast?

A sales forecast is a financial projection of the amount of revenue your business will generate from the sales of its products or services. Sales forecasting is not an exact science but is a balance between:

- Facts that can be gleaned from your market research, or previous sales figures, such as how often customers might buy your product or service and what they will pay for it.
- Judgement of market conditions and other uncontrollable factors that may affect your business, such as the economic and political climate, seasonal factors or trends.

A sales forecast can stand alone, but it should be closely connected with your marketing plan. It is an integral and fundamental part of your business planning process, as it is central to the projections you put into your profit and loss and cash flow forecasts.

Why do you need to forecast sales?

Forecasting sales is necessary for a number of reasons:

- Cash flow management - this is central to the success of your business, so it is essential that you understand how sales forecasting affects your cash flow forecast.
- Planning cash flow - this is important information to include in your business plan and can also help prevent cash flow problems by highlighting if and when the business may need additional capital.
- Planning future resource requirements - for example, the number of staff needed to produce sufficient orders to meet demand or provide a certain level of service.
- Planning purchasing, production and marketing activities - and the consequent financial strategies arising from these.

Detailed market research should always be the foundation of your business plan. If you have a start-up business, the sales forecasts that result from your research will help to establish whether or not your idea is financially viable.

If your business is already trading, your sales forecast and ongoing market research will enable you to plan for future growth, review your business strategy and maintain a competitive edge.

Whatever the situation, it is essential that you scrutinise expected sales regularly and realistically, and take appropriate action to review your strategy. The sales forecast is the benchmark against which you should continually measure what actually happens in your business in terms of sales - the important thing is to understand the variations and why they occur, and to incorporate what you have learned into future forecasts.

Factors to consider when preparing a sales forecast

A sales forecast should show expected sales by month for at least the next twelve months, and then by year for the following two years. Three years in total is generally sufficient for most business plans.

The sales forecast should be prepared after consideration of the following issues:

Market awareness

- Is there an established market for your product or service?
- What is the size of the market?
- Is the market growing or declining, and if so, by what percentage each year?
- What factors are currently influencing that market?
- What may influence it in future?
- How do seasonal factors affect sales of your product or service?
- What trends or fashions are relevant to the sector?

Customer knowledge

- Do you have a clear picture of your existing and potential customers?
- Realistically, how many of these customers will actually buy your product or service?
- Do you have detailed customer knowledge to help you determine your strategy on any issues that will affect your pricing policy and sales forecasts?

Capacity

- Is the sales forecast within the limits of your capacity and capability to produce your product or deliver your service?
- How would changes in personnel impact on your business' future capacity?

Competition

- How many competitors do you have? Even if your business appears to be unique, new competitors are likely to enter the market once you have done the groundwork to raise market awareness. If there are already many competitors in your market it probably indicates that there is an established market for your product or services.
- How do your products or services fit into the marketplace? How can you differentiate your business from what your competitors offer?
- Do you have flexibility with regard to pricing and the range of products or services offered?

External factors

- How do political, economic, socio-cultural, technological, environmental and legal (PESTEL) factors such as oil prices, seasonal trends, interest rates, legislation, political and health issues impact on your business?
- How do the economic climate and other external factors impact on your business and on your customers' attitudes?
- What might arise in future that will have either a positive or negative effect on your sales projections?

It is often difficult to predict sales precisely but a good forecast allows for the factors that affect expected sales and builds in a margin for error.

Preparing a forecast

The approach you adopt when preparing a forecast depends on how mature your business is. However, all forecasts should be based on accurate and up-to-date market research.

New businesses

A new business has no previous sales history on which to base a forecast. Many formal methods of estimating future sales are useful only if your business has been running for some time and you have a history of sales trends to work from. Accurate information from market research is crucial for anyone making and justifying projections for a start-up business.

Secondary (desk) market research can be helpful - for instance, if you are considering opening a bed and breakfast business you can obtain historical data on bed occupancy levels or visitor numbers from VisitBritain, the national tourism agency (www.visitbritain.org). By multiplying average occupancy levels by price per person per night, while allowing for seasonality, sales projections can be calculated more easily.

If no suitable secondary research is available, you can still carry out primary (field) research among your target customer group. Interviewing potential customers, obtaining 'letters of intent' and testing the market with your initial products or services can provide information with which to estimate potential future sales.

For instance, someone opening a restaurant/café could approach potential customers to ask:

- How often do you eat out?

- On average how much do you spend on a meal?

After that, they should try to calculate how many customers who fit their target customer profile live in the local area. The restaurant/café owner could then estimate:

- How often their products will be bought.
- How much they can charge for the products.

From this information, the restaurant/café owner can estimate the total number of sales they expect per week/month/year for their business and the value of those sales. These can be saved in a spreadsheet and plotted on a simple graph against high, medium and low monthly sales expectations.

Existing businesses

If your business is already trading, you will have historical sales data on which to base your forecast, as well as a clearer picture of the market as a whole. You should keep accurate and up-to-date figures of previous sales on a monthly basis, and compare these with the targets you have set.

Future sales can be estimated on the basis of current trading levels, that is, on existing customers continuing to buy from your business for the foreseeable future.

On the other hand, your business may be in a position where sales have been growing, or even declining, steadily. In this case, you should identify the main trend in past sales, and then project this forward to give an estimate of expected future sales.

You should talk to key customers about any potential changes in their purchasing patterns and review market trends regularly. It is also important to take into account the likely effect of any changes in your sales strategy, such as new marketing campaigns and price increases or decreases.

You should continue to carry out market research and incorporate this information in your sales forecast. This is crucial to retaining a competitive edge and ensuring that your forecasting process is based on current information and market intelligence.

Impact of pricing strategy on sales forecasts

If you sell more than one product or service, you should prepare a separate forecast for each item in your range, and forecast:

- By volume (for example, units of the product sold per month).
- By value (for example, total revenue gained from each product or service sold).
- By a combination of both value and volume.

By considering both volume and value, you can decide on a pricing strategy. Is your business going to sell a large volume at low prices (for example a fast food restaurant) or a low volume at premium prices (for example an exclusive French restaurant)? You should consider what prices the market will bear, the costs to produce your goods or services and what you need to charge in order to make a profit.

It may be that raising or lowering your price could impact significantly on sales. When preparing your forecast, you need to consider the impact of any decisions on total revenue and profitability.

It is important to compare forecasts (and sales records if appropriate) against potential capacity to ensure that what you are forecasting is achievable. You need to be sure that you have enough staff and resources to meet the expected production and sales targets or to provide the level of service required.

Other considerations, such as the target market, the location of your business and the quality of the product or service offered, will also contribute to decisions on your pricing strategy.

Choosing a forecasting method

The forecasting method you choose will depend on the information you wish to gain from the process. If you have been trading for some time you can use data from past sales periods as a starting point and base your forecasts on these.

If you're just starting up, you will be able to use these techniques after the first few weeks or months of trading and can then compare your actual sales figures with the projections you made after carrying out your market research.

Graphical analysis

A useful first step is to plot past sales data on a line graph to give a visual representation of seasonal patterns and general trends. In this way different sales figures can be plotted for different scenarios, enabling you to see clearly what would happen if sales grew or declined, and how different pricing strategies might impact on your forecasts.

You can also choose to plot sales levels by volume or value, or to calculate a percentage increase for annual sales.

Moving averages

A moving average is an indicator that shows the average level of sales over a given period of time. It can be a useful tool for forecasting, but does require the use of historical sales data to predict future increases or decreases. It is then possible to forecast sales for the year ahead so that a three-month and twelve-month moving average can be calculated and plotted on a line graph (see below).

The three-month moving average smoothes out large monthly fluctuations but still gives seasonal variations. The twelve-month moving average, however, gives a general trend line.

Three-month moving average

The forecast three-month moving average for each month can be obtained by adding the sales figures from the current and previous two months and dividing by three. For example, the forecast three-month moving average for July (below) will be:

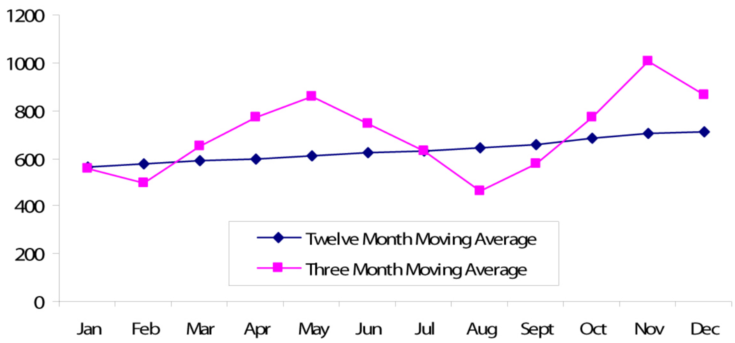
$$\frac{\text{May} + \text{June} + \text{July}}{3} = \frac{920 + 520 + 460}{3} = 633$$

Twelve-month moving average

The twelve-month moving average can be calculated by adding the forecast sales figures from the current month to the previous eleven months and dividing by twelve:

Month	Previous Year	Forecast	Twelve-month Moving Average	Three-month Moving Average
January	350	420	564	557
February	550	670	574	497
March	700	860	588	650
April	650	790	599	773
May	750	920	613	857
June	400	520	623	743
July	350	460	633	633
August	300	410	642	463
September	650	860	659	577
October	750	1,050	684	773
November	850	1,100	705	1,003
December	400	440	708	863

Sales forecast using moving averages



Correlations

Because customer purchasing depends on a range of factors, one method of making forecasts is to compare relevant variables. For example, look at the relationship between your promotional expenditure and sales. If you have undertaken past promotions, historical sales data will help you to assess how far this expenditure influenced customer choices. Projecting forward can give you a picture of how it might work in the future.

It may be worth plotting a scatter graph of sales against expenditure and using it to identify patterns. You can then make predictions for a number of different scenarios. It is important to remember that, just as you will have a finite number of potential customers, there may be a maximum level of effective promotional spend. Above this level, the market is saturated and your business is unlikely to make further sales.

If you produce forecasts by both volume and value, it will be possible to use this data to analyse a pricing strategy. Do you sell a large volume at low prices, or a low volume but at premium price?

It may be that raising or lowering the price of your product or service could impact significantly on your sales.

Checklist for avoiding pitfalls when forecasting sales

Many of the elements involved in sales forecasting are linked with other parts of the business planning process, so be careful how you arrive at your assumptions:

- Make sure your forecast is based on verifiable, realistic and unbiased market research information.
- Don't be tempted to ignore your research if it shows negative results.
- Don't make projections solely on the basis of historical performance. Be aware of what else might affect your sales in the future and adjust your forecast accordingly.
- Make sure you understand your capacity limits. Is it physically possible to produce the amount of sales being forecast with the personnel, equipment and financial resources available to you?
- Does the pricing strategy you have used in calculating your sales forecast relate to what is really achievable, or on the other hand, have your prices been set too low so that either way your forecast is potentially unrealistic?
- Remember that if you have just started up in business it may take longer for your business to become established, and you need to set realistic sales targets.
- Have you allowed for the possibility that high sales based on an initial promotional surge may drop off, leading to a need for more intensive marketing and higher ongoing costs once initial interest has peaked?
- Can you identify and justify the assumptions you have made in reaching the forecast, and explain them to interested parties if necessary?

Hints and tips

- Don't be tempted to overestimate your forecasts - make sure any assumptions you make are reasonable and achievable.
- Once you have created a sales forecast, you can use it to set targets, prepare budgets, raise finance and analyse staff and other resource requirements. Your forecast can also give you clues about how your business can shape its future strategy by correlating sales with promotional spending or pricing.
- You should compare actual sales results with your forecast, revise your forecast regularly as a result of this comparison, and carry out sensitivity analyses to consider the 'what if?' scenarios - such as what would happen to the forecast if customer numbers dropped by 10%, or you increased prices by 5%. This will also help you to anticipate cash flow requirements and will be useful when adjusting future forecasts.
- Computer spreadsheets and specialist software packages can make the forecasting process much easier.

Further information

For practical start up and small business tips, ideas and news, go to:
Website: www.enterprisequest.com

To access hundreds of practical factsheets, market reports and small business guides, go to:
Website: www.scavenger.net

BIF 58 How to Forecast Cash Flow
BIF 185 A Checklist for Start Up Market Research
BIF 260 An Introduction to Preparing a Budget

Useful contacts

The Institute of Chartered Accountants in England and Wales (ICAEW) is a membership organisation for accountants. There is a searchable directory of accountants on its website.
Tel: (01908) 248250
Website: www.icaew.com

The Institute of Chartered Accountants of Scotland (ICAS) is a membership organisation for accountants in Scotland. Its website includes a directory of Chartered Accountants in Scotland.
Tel: (0131) 347 0100
Website: www.icas.org.uk

Chartered Accountants Ireland represents accountants in Ireland and offers a 'find a member' facility on its website.
Tel: (028) 9043 5840 (Northern Ireland office)
Website: www.charteredaccountants.ie

The Association of Chartered Certified Accountants (ACCA) is a membership association for accountants. It offers a 'find an accountant' facility on its website.
Tel: (020) 7059 5000
Website: www.acca.org.uk

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