

Forecasting Sales

Development of your profit plan should usually begin with a forecast of your expected sales and gross profit for the coming year.

The sales and gross profit must be considered together since they are so closely interrelated. Gross profit percentages are determined by pricing policy, which also affects expected sales volume. A decision to increase the expected gross profit percentage will usually tend to decrease expected sales, while reducing the expected gross profit percentage should increase sales.

- A second major reason for beginning the profit plan with a sales forecast is that the volume of expected sales often determines a number of other factors such as the following:
- Expected changes in variable expenses, those expenses that tend to change in direct proportion to changes in sales. These could include expenses such as sales commissions or delivery costs.
- The impact of the added sales volume on the various fixed costs of operating your business. These costs, by definition, do not tend to vary in direct proportion to changes in sales volume. However, substantial increases in sales over an extended period can force an increase in many fixed expenses. For example, a sales increase realized through the addition of many new accounts could affect bookkeeping and credit costs.
- The ability of present resources such as storage space, display area, delivery capability, or supervisory personnel to accommodate the added volume.
- The need for funds to invest in increased inventory or accounts receivable to accommodate sales increases.
- Cash generated from operations to meet current operating needs as well as expansion requirements, debt repayments, and owners' compensation.

Realism

A realistic sales forecast must rely on careful analysis of market potential and the ability of your business to capture its share of this potential. The forecast should not be based upon "what you would like to do" or "what you hope to do." It must be "what you can do" and "what you will do."

Any forecast of a sales increase must be supported by realistic expectations for stronger market demand and specific marketing steps that will be taken to capture a share of this market.

The key to successful forecasting is realism. You only fool yourself if you reject reality in forecasting. Such forecasts serve neither as a realistic planning basis nor as a reliable means of performance evaluation.

Your forecast can be the basis for important decisions such as decisions to add personnel, lease additional facilities, or increase promotional costs. If these decisions are based upon unrealistic sales expectations, any money expended on them will be wasted.

Forecasts are often presented to lenders or potential investors to guide them in their decisions. If they lack confidence in your forecast, they will certainly be reluctant to commit their funds to your business.

Every forecast should be supported by carefully considered specific action plans. It is inadequate to forecast a sales increase of 20% or 30% without plans for specific actions to achieve the increase. These actions could include the introduction of new products, opening of new branches, market expansion, commitments from new customers, increased requirements from existing customers, additional salesmen, or an intensified promotional effort to attract new customers.

Analyzing Current Sales and Gross Profit

Your sales and gross profit forecast begins with analysis of current performance. Sales are usually divided into various categories. Each category is examined individually to determine expected sales for the coming year.

Selecting Sales Categories

The selection of categories will depend upon the nature of your business. For example, a food broker selling to a large number of relatively small accounts might be interested primarily in analyzing sales by product. The owner of a single retail store might choose to analyze sales by selling department, while the owner of a retail chain would probably be interested in analyzing sales by outlet. An insurance broker with several agents might categorize sales by agent. An individual wholesaler might consider sales by sales territory.

Factors Affecting Sales

After categories have been selected and current sales divided among them, the various factors that can affect sales in each category must be considered. These factors could be either internal or external. Internal factors are those that you can

influence. External factors are those that affect the market served by your business, but are generally beyond your control.

Internal Factors

The following are typical internal factors that could influence your sales forecast:

- Promotional plans
- Expansion plans
- Capacity restrictions
- New product introductions
- Product cancellations
- Sales force changes
- Pricing policy
- Profit expectations
- Market expansion to new customers or territories

External Factors

Among the external factors that must be considered are the following:

- Business trends
- Government policies
- Inflation
- Changes in population characteristics
- Economic fortunes of customers
- Changes in buying habits
- Competitive pressures

Analyzing Gross Profit Percentages

It is often useful to begin a sales forecast with an examination of your current gross profit percentage (markup percentage or gross profit percentage). The gross profit percentage is usually the best indicator of pricing policy that can have significant impact on sales volume. To some extent, the gross profit percentage will also reflect the buying economies of your business. However, the range over which costs of purchased goods will vary is not ordinarily as wide as the possible range of prices you may seek for your products.

Three Bases of Comparison

Examination of current gross profit percentages can indicate the need for pricing policy revisions to meet competition or closer attention to purchasing costs in order to provide extra gross profit without increasing prices.

The evaluation of gross profit percentages requires comparison of current performance with three bases:

- Objectives originally set for the current year, if available
- Other businesses in the same industry
- Results of prior years

Comparison with objectives permits you to determine how well you have done compared with your original expectations. Assuming that these objectives were realistic, this is often the best single performance indicator. Deviations from objectives can quickly be identified and explored in detail to determine the cause of the deviation.

Comparison with industry averages permits identification of areas where the experience of similar businesses indicates room for improvement in your own.

Unfortunately, businesses are often too quick to dismiss the applicability of industry averages to their own operation, claiming that "Our circumstances are different." Such an attitude is self-defeating. It prevents you from taking advantage of the experience of others to improve your own sales and profit. A far more productive attitude is to say, "If everybody else can realize a gross profit of x percent, then we should be able to." Until specific circumstances are identified that make it impossible for your business to be consistent with industry averages, every attempt should be made to bring performance in line with the experience of others.

Comparison of current operations with performance in prior periods permits detection of trends so that progress, or the lack of it, can be identified. It also permits evaluation in light of those specific considerations that may be unique to your business. For example, if your gross profit as a percentage of sales is low compared with the industry, analysis of your historic performance may reveal the cause of this apparent deficiency such as reliance upon a major customer where severe competition restricts the available gross profit percentage.

Conflicts

Sometimes financial analysis can lead to conflicting conclusions derived from identical facts. Comparing gross profit with the industry average could raise questions.

If the company were more competitive in its pricing, could it capture a larger market share? A reasonable answer to this question would depend upon thorough knowledge of their operations and the experience of their sales personnel in dealing with specific customers.

On the other hand, if their gross profit percentage is below that of the industry, a number of other questions would be raised, such as the following:

- Are they purchasing at prices that are too high to provide an adequate gross profit?
- Is their pricing structure so low that adequate gross profit margins cannot be attained?
- Are salesmen too quick to cut prices?
- Is their marketing effort too heavily concentrated in those product lines that offer a relatively low gross profit percentage?
- Is their marketing effort directed toward those high-volume accounts that are so highly competitive that gross profit must be trimmed to an unrealistically low level?