Plan for profit: The forecasting and budgeting process

The importance of forecasting in business, how it's done and how it helps in planning

Forecasting

The importance of forecasting

Planning and working on your business' financial projections each year can seem both overwhelming and time-consuming, but it could be a vital component for overall growth and success.

Strategic financial planning allows you to step away from the daily problems of running a business and take stock of where the company is and where it's going and to establish a course of action.

Having a projected financial plan helps to do the following:

- Translate goals into targets with specific criteria for successful outcomes and which milestones need to be reached accordingly.
- Provide vital feedback and control as changes from projections provide an early warning of problems. If they occur, the plan can provide a

framework for determining the financial impact and effects of corrective actions.

- Anticipate problems e.g., if rapid growth will create a cash shortage because you have over-invested in receivables and inventory, the forecast will show this. It will also show you which milestones need to be met this year to meet next year's projections.

It's also worth noting that the results of forecasting (the formal projections) are often less important than the process itself, which helps you to critically review your business.

Budgets vs forecasting

Before you begin your forecasts, understand the relationship between budgeting and forecasting.

Forecasting is a planning tool that helps management cope with the uncertainty of the future. It is an expectation that relies mainly on data from the past as well as assumed figures. A **budget is a financial document** that is used by a business to project future income and expenses.

Budgeting	**Forecasting**
● Control and measurement ● Once finalised, it's fixed ● Based on performance targets ● Everyone understands the direction of the company	● Enhances the decision-making process ● Allows businesses to prepare and react to future expectations ● Is constantly being adjusted

● Resources are allocated and linked to a strategic plan ● The focus is on the result of the budget period (i.e. meeting an overall financial goal)	● Contributes to the improvement of business activities and processes ● Is proactive rather than reactive

Types of projections

Depending on your business' objectives and situation, you'll more than likely need to develop several types of projections. There are four main types of financial projections: current year or rolling 12-month periods by month; a long-range, strategic plan looking at three to five years; annual budgets and cash forecasts.

Forecasts should be updated regularly, and they should have a rolling component. This means that as a month or quarter ends, another month or quarter is added to the forecast. Updates can be monthly, quarterly or even six-monthly, depending on the type of forecast and the company's needs.

1. The current year or rolling 12-month model

This forecast should be updated on at least a monthly basis. It's your business' main planning and monitoring vehicle, and this information is the base for other projections.

2. The three-to-five-year long-range strategic model

The 12-month forecast above reflects short-term expectations and can be used for tactical plans. This long-range model takes that a step further and incorporates the strategic goals of the company. This should not be a simple extrapolation of the numbers of the current year but should accompany development of the ‘out year’ projections.

3. Budgets

Budgets typically cover one year, and they translate goals into interim targets and detailed actions. They should include specific details, such as staffing plans and line-item expenditures, and be consistent with the goals of the business’ long-range plan. Whether or not the same model can be used to prepare a 12-month forecast as well as the budget depends on the size of the business. However, unlike forecasts, budgets should be frozen at the time of approval.

4. Cash forecasts

Cash forecasts break the budget and 12-month forecasts down into even greater detail. The focus here is cash flow, not accounting profit. This forecast needs to be able to capture fluctuations within a month, and in order to do this, periods as short as a week are needed.

All projections should be broken down into months for at least one year and should include a balance sheet and an income statement. Expenses can be summarised by either department or major expense category (line-item details are reserved for the budget and unnecessary in this forecast). Cash needs to be clearly identified, and you could add a separate statement of cash flows. If your financial statements report financial rations or expenses as a percentage of sales, calculate and report these as well.

Getting started

Once you’re familiar with the basics, you can implement more in-depth forecasts that can then be used for high-level strategy planning.

1. Start with expenses, not revenues

It’s easier to forecast with expenses instead of revenue, so start with estimates of the most common categories of expenses.

Fixed costs/overheads	Variable costs
Rent Utilities Technology and communication infrastructure Bookkeeping Legal, insurance and licensing fees Advertising and marketing	Cost of goods sold: Materials, supplies and packaging Direct labour costs: Customer service, direct sales and marketing

- Once you have estimated advertising and marketing costs, double them. These are two expenses that always escalate beyond expectations.
- Legal, insurance and licensing fees are difficult to predict, so triple them.

- Keep track of customer service and direct sales as a direct labour expense.

2. Be both aggressive and conservative in forecasting

It’s important to be realistic and conservative but to become big, you need to think big, so build at least one set of projections based on aggressive assumptions.

Conservative revenue projections	Aggressive revenue projections
● Two marketing channels ● Low price points ● Minimal sales staff ● One new product or service introduced annually	● Three to four marketing channels managed by a marketing manager ● Low price point for base products, a higher price for premium products ● A full sales staff complement ● Several products/services introduced per marketing segment per year

Budgeting

The basics

Effective financial budgets include a short-term month-to-month plan that generally lasts one calendar year, as well as a long-range quarter-to-quarter plan. This is needed for financial statement reporting, and you should always start preparing your next budget two months before the fiscal year-end to allow enough time for information gathering.

The long-range plan

The long-range plan should cover at least three years, although many go up to five years. They can be quarterly or annual and should be updated each time a short-range plan is prepared.

The short-term plan

This is an annual month-to-month plan. Some business owners prefer leaving the budget fixed while others adjust the budget according to financial occurrences that happen throughout the year. Whichever you prefer, don't get so wrapped up in your budgeting process that you forget to do business. Financial management is important, but it's a planning tool, not the function of the business.

The income statement and balance sheet

It's important to budget for both the income statement and the balance sheet. This will enable you to consider potential cash flow needs for the entire business—not just as they pertain to expenses and income.

An example is a business that purchases machinery to extend a product line; how does this impact your cash flow? Budgeting on the income statement alone does not allow a detailed analysis of the impact of potential capital expenditures on the business' financial picture.

Getting started

Step one is setting up a plan for the following year. This should be done on a month-to-month basis, and you should begin by establishing specific budgeted amounts for the various categories.

Sales numbers are critical in this respect as they're needed to compute gross profit margin, which in turn will be needed to determine operating expenses, as well as the inventory levels and accounts receivable needed to support the business for the year.

Areas covered in a budget:

- Sales: To determine your sales figures, study your market to determine the potential demand for what you're offering, who else is offering it and what the production cost percentage is compared to market-related selling prices.
- Operating expenses: Determine the cost of advertising, transport, depreciation, insurance, salaries, rent etc. You then need to factor in a tax rate as well, which your accountant can apply for.
- Inventory, accounts receivable and payable: Determine total amounts based on the projected number of days on hand. Each specific item categorised as a fixed asset should be broken down for equipment, property, plant, etc. Each loan should be broken down separately, as should shareholders' ordinary shares, preference shares and loans.

The process

Income statement budgets must be prepared first, followed by the balance sheet and then the cash flow statement. This is because you can’t prepare a pro forma balance sheet without an income figure, and cash flow projections require both income statement and balance sheet numbers.

Creating a budget

1. Analyse your current budget and the prior year’s budget

You need to know where your starting point is. Use a simple format for your budget based on the profit/loss formula: income less cost of sale, less overhead expenses net income (profit).

2. Use budgeting tools to assist you

Use programs and apps that help you compile a budget based on profit/loss and comes ready to use.

3. Realistically assess your budget

Have an objective third-party review your work. Business owners tend to overestimate income and underestimate expenses, and an impartial eye could pick this up. You must also document how you arrived at your estimated numbers and your predictions must have substance. This will allow better variance analysis when the real figures vary from projected figures.

4. Compare your actual activities with budgeted activities

This should be done on a monthly basis as the comparison is where your budget's real value lies.

Hot tip: Budgeting is a precaution. It allows you to risk-proof your business by recognising whether sales are going down or expenses are going up so that you can identify course corrections. Budgeting is about the process, not only the numbers. It's about watching expenses so that you can ensure sales outweigh expenses to make a profit.

Developing a great budget

Here are eight tips that will help you develop an excellent budget:

1. All budgets are wrong; yours will be too

Budgeting is, at its core, guesswork. It's calculated but still only an estimation. What's important to remember is that it doesn't need to be a 100% accurate guess to be vital to management. Budgets are there to help you correct course when you need to.

2. The review process is crucial

Budgeting itself is not what makes this a worthwhile business tool; it’s the regular reviews that compare budgeted expenses to actual expenses that make it valuable.

3. The review schedule is vital

Always set a schedule for a budget review once it’s complete, which includes when, where and who will attend. Including everyone working on the budget builds a peer process and incentivises sticking to the budget.

4. Keep assumptions visible

Your first agenda item in review meetings should be to question what’s changed. Sticking to a budget isn’t as important as choosing the right course of action based on changes that arise.

5. Keep it simple

Budgets should be summarised, simple to read and visible, providing you with a comprehensive look at the whole picture.

6. Use tools

Make use of the great tools that programs such as Pastel have to offer, but don’t forget that budgeting is about the process of formulating a plan, and then having the discipline to stick to it.

7. Match accounting reports to key management items

It’s called a chart of accounts, and it means categories that match control and responsibility, and the information you can manage later. Accounting is detailed, budget management needs summaries of categories and more aggregation. You can set up your budget so that you can see strategic priorities and break it up into areas of control and responsibility so that everyone knows what’s important and what they’re responsible for.

8. Consistency matters

When you stick to categories over time, it’s easier to see trends. By changing too frequently, you’ll lose where you started from, and you won’t be able to measure progress well.

Profitability

Determining profitability

Don’t make the mistake of bringing a product or service to market without fully understanding the total costs involved, particularly regarding the prices you can charge for what you’re offering.

Before you launch a new offering, you should determine how profitable it will be. The same break-even analysis tool that evaluates new products or services can also be used to analyse existing offerings.

The break-even analysis

Break-even analysis is a simple way of determining how much of a product or service must be sold in order to generate a profit.

Here are three key points to keep in mind before you get started:

- Every business has fixed costs that must be paid every month, regardless of whether sales take place.
- All products and services have variable costs that are incurred during the production and delivery process.
- Semi-variable costs are costs that go up and down, depending on the level of business activity.

Note: after all costs have been deducted, the product or service yields a profit. This profit contribution must then be divided into the fixed costs described above to determine how many units the business must sell to break even.

Understanding expenses

Before you can conduct an accurate break-even analysis, you need to carefully examine the costs and prices within your business. This includes understanding exactly how much a product or service costs to deliver, as well as how much you charge for it. You should also always include and deduct all miscellaneous operating expenses.

Step 1: Analyse every product and service you regularly sell

Make a list, starting with your largest volume seller to your smallest. Calculate each unit's average sales price as well as its total cost.

Step 2: Determine your return/profit percentage

Calculate your net profit on each unit as well as the cost of investment to produce and sell it. What is the percentage of profit of each sale?

Step 3: Organise your products by priority

Analyse each product or service in terms of its profitability to determine whether the offering is worthwhile, or it would be better to invest time and money elsewhere. Conduct a profitability analysis by:

- ranking each product from most to least profitable,
- establishing the volume of sales of each offering,
- identifying the total profit per unit sold, after deductions (direct and indirect expenses), and
- calculating the total profit contribution of each offering.