Futurecast

The Nature of Sales Forecasts

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So What?

Though we might take them for granted, we rely on weather forecasts all the time. We use them when making plans for the weekend. Farmers depend on them when planting and harvesting their crops. And, everyone certainly needs them when severe weather, such as a snowstorm or a tornado, threatens. Weather forecasts aren't always 100-percent accurate, but they're reliable enough to benefit those who use them. In the same way, sales forecasts help businesses to predict and plan for what's next. It's impossible to perfectly foretell the future, but when a business has realistic expectations for sales, all its other planning and management activities can fall into line. Learn more about the benefits of sales forecasts!

Objectives

A Explain how sales forecasts work.

B Discuss the use of sales forecasts in business.

A Glimpse of the Future

Just as a weather forecast predicts future climate conditions, a **sales forecast** predicts a company's sales for the next week, month, quarter, year, etc. Most sales forecasts are based on past sales performances as well as expected **market conditions**. Like weather forecasts, they are educated guesses—they don't have to be completely perfect to be helpful. For example, a meteorologist may tell you to expect rain around 3:00 p.m. on Wednesday. Even if the rain doesn't actually begin until 4:00 or 5:00 p.m., the forecast was still useful to you as you made your plans for the afternoon and evening. Similarly, a sales forecast may not be accurate down to the exact numbers, but, if it has been carefully developed, it will be of enormous use to the business in its planning and management activities.

▲ While never perfect, sales forecasts help managers to plan a variety of activities, including promotional campaigns, sales quotas, and much more.

Though we won't go over it in this LAP, the math involved in creating a sales forecast is actually pretty simple. The bulk of the work, then, is wrapped up in gathering all the necessary information to make it as precise and reliable as possible. It takes some time and effort, but creating sales forecasts can benefit a business by:

- Increasing revenue
- Increasing customer retention
- Increasing efficiency
- Decreasing costs

For more on the importance of sales forecasting, watch the video here—http://smallbusiness.chron.com/effective-sales-forecasting-72313.html.

Feelings and facts

There are two main approaches that businesses take to sales forecasting. Both **qualitative forecasting** and **quantitative forecasting** have their own unique advantages and disadvantages, and companies often combine both methods when developing their sales forecasts. Let's learn a little about each.

Qualitative forecasting. Qualitative sales forecasting is based on expert opinion and personal experience. When using this approach, businesses talk to knowledgeable people who have a good "feel" for the marketplace. These sources may include experienced managers, suppliers, and other industry experts. They offer insights and opinions based on what they've seen happen in the past, in addition to their current observations about the economy, the industry, etc. Consider a farmer who has lived and worked in the same area for many years. Based on all his observations and experience, he would probably be a great qualitative source for forecasting the upcoming season's weather.

Qualitative sales forecasting certainly has its advantages. It allows businesses to gather a wide variety of viewpoints. It's relatively inexpensive compared to other methods of forecasting. And, it's ideal in situations where there aren't a lot of hard facts available—when starting a new business or launching a new product, for instance. Its main disadvantage, however, is that it lacks a high level of accuracy due to potential **bias** or "clouded" opinions.

For more on qualitative forecasting, read Thomas Metcalf's article "The Advantages of Qualitative Forecasting" at http://yourbusiness.azcentral.com/advantages-qualitative-forecasting-13636.html.

Quantitative forecasting. Quantitative sales forecasting is based on the analysis of hard facts or numerical data. For a weather forecast, these data would come from sources such as weather balloons, radar, etc. For a business, the information comes from both internal and external sources. **Internal information** may come in forms such as:

- Past sales records
- Accounting records
- Financial statements
- Market research
- Customer surveys
- Product research

External information for sales forecasting may come from government reports, industry **periodicals**, trade-association publications, **mass media**, etc. Businesses use these sources to gather data regarding economic trends, population changes, shifts in consumer demand and spending, and more.

Quantitative sales forecasting is advantageous because it is reliable and **objective** (neutral). However, it can be much more costly than qualitative forecasting when you add up the expenses of purchasing survey results, subscribing to publications, etc.

For more on the benefits of quantitative sales forecasting, read "Advantages for Quantitative Techniques in Forecasting" by Jared Lewis at http://www.ehow.com/info_12116753_advantages-quantitative-techniques-forecasting.html.

When a business is determining which method of sales forecasting to use, managers should ask the following questions:

- How much will it cost?
- How accurate will it be?
- How accurate do we *need* it to be?
- How long will it take to develop?
- What level of human resources will we need to dedicate to the process?
- What internal information do we have available? (Remember, a new business will not be able to produce past sales records or financial statements. It may, then, rely more heavily on qualitative forecasting methods.)

Can you see why businesses often choose to use both qualitative *and* quantitative methods for sales forecasting?

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Issues of influence

If nothing ever changed, sales forecasts would be easy to create! Businesses could just assume that they'll sell the same amount next year as they did this year. As we all know, though, change is inevitable. Factors both inside and outside the business affect predicted sales.

Internal factors are those that are at least somewhat under the business's control. They include variables such as:

- **Labor**
  Example: If a business knows there is a potential labor dispute on the horizon, it may forecast a lower sales volume. If employees go on strike, production and sales are likely to suffer.
- **Length of time to complete sales**
  Example: Making a sale and receiving payment for the sale are not always simultaneous events. A retailer's sales take place in a matter of moments—the customer brings her/his items to the cash register and purchases them. A maker of custom furniture, however, may take several weeks to complete a sale. The furniture maker may receive an order next month but not complete it until the month after. This will likely affect his/her sales forecasts.
- **Inventory**
  Example: If a business has an inventory shortage, it is likely to forecast a correspondingly lower sales volume until it can raise its level of stock.
- **Changes in promotion**
  Example: A business is planning to spend the bulk of its promotional money for the next quarter promoting a brand-new product. The business may forecast a slight dip in sales for the products it won't be promoting as heavily.
- **Changes in price**
  Example: To stay profitable, a business must make a slight increase in prices. Revenues are likely to stay the same next quarter, but sales volume may drop. This change would be reflected in the sales forecast.
- **Changes in distribution**
  Example: A small business has a new contract to sell its products through a major retailer. The addition of this new distribution channel greatly increases expected sales volume.
- **New products or product lines**
  Example: When a business introduces a new or updated product to the market, it often expects initial sales to be strong. Think of the frenzy that occurs every time a new iPhone comes out!

External factors are things the business can't control. These elements can also have a strong influence on sales forecasting. They might include the following:

- **Economic conditions**
  Example: A downturn in the economy usually puts a damper on consumer spending, and sales suffer. However, for some products, a sluggish economy is actually a good thing—consider "do-it-yourself" supplies and used vehicles.

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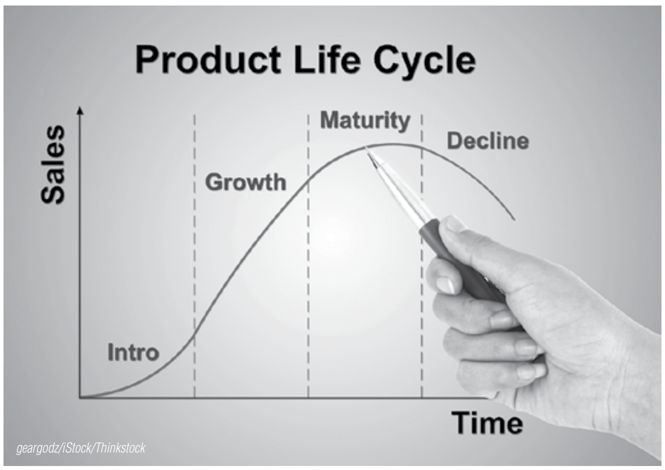
▲ Economic factors such as inflation, unemployment, and business cycles impact sales forecasts.

For new businesses, sales forecasts serve as an important part of the business plan that's used to obtain financing through loans and investments. The business's owners want banks and potential investors to view their startup as a "safe bet." A strong initial sales forecast can help portray the business in this light. But, what happens when a budding business doesn't have a lot of hard facts to back up a strong sales forecast? Is it ethical to rely entirely on qualitative input, which can be biased and less accurate? What do you think?

- **Political conditions**
  Example: A business may sell its products in foreign countries. If one of those countries is threatened by political instability or war, predicted sales volume will likely fall.
- **Product life cycle**
  Example: Every type of product goes through the ***product life cycle****. This isn't something a business can prevent from happening. Sales volume will vary based on where the product is in the life cycle. For instance, as DVD players replaced VHS players, the sales volume of VHS players slowed significantly.*



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- **Competition**
  Example: If a new competitor enters the market, sales volume may decrease, at least for a time. On the other hand, if a competitor leaves the market, a business may expect sales volume to get higher.
- **Season/Weather**
  Example: A business that rents equipment for water sports at the beach will lower its predicted sales for the off-season months.
- **Changing consumer demands and spending patterns**
  Example: Today's consumers crave convenience more than ever, and many of them are willing to pay for it. Perhaps a business is introducing a new, time-saving product (e.g., an app that pre-orders groceries from the supermarket). Based on market research, the business forecasts initial sales to be strong.
- **Population changes**
  Example: As the U.S.'s population of senior citizens continues to grow, businesses that offer products for this target market (e.g., emergency-alert devices, meal-delivery services) will likely be able to predict steady sales volumes.

Summary

A sales forecast predicts a company's future sales based on past sales performances as well as expected market conditions. Forecasting sales has many benefits for a business, including increased revenue and greater efficiency. The two main approaches to sales forecasting are qualitative and quantitative. Qualitative forecasting relies on opinion and experience, while quantitative forecasting is based on hard facts that come from both internal and external sources. Many organizations use both qualitative and quantitative sales forecasting techniques at the same time. Many internal and external factors affect a business's sales forecasts, including inventory, price changes, economic conditions, changing consumer demands, etc.

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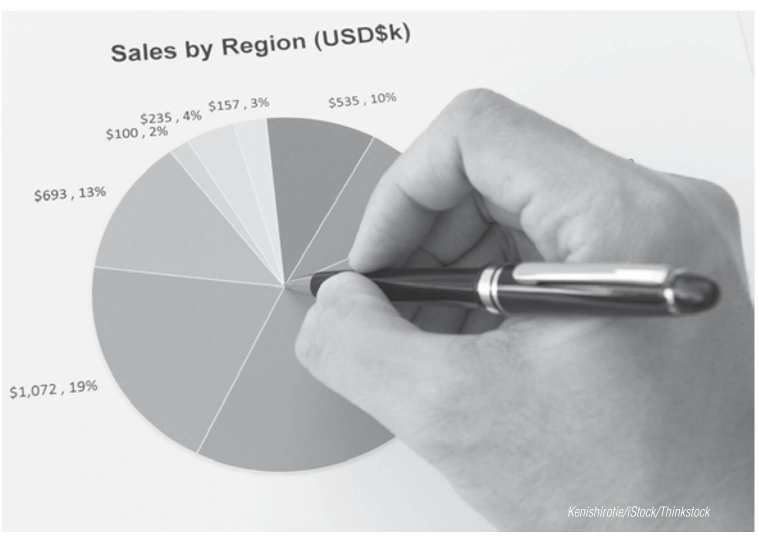
1. What is a sales forecast?
2. What are some potential benefits of sales forecasting?
3. Describe qualitative forecasting.
4. Describe quantitative forecasting.
5. List internal factors that influence a sales forecast.
6. List external factors that influence a sales forecast.

Predict and Plan

Sales forecasts are versatile business tools that can be developed and analyzed for a number of different purposes. A business may create sales forecasts for:

- **A specific product**
  Example: Kraft Foods produces thousands of individual food products. However, it may run a sales forecast specifically for its Peppercorn Ranch salad dressing.
- **An entire product line**
  Example: Kraft Foods runs a sales forecast for its entire line of salad dressings.
- **The business's total production**
  Example: Kraft Foods runs a sales forecast for all of its products and product lines. This is usually accomplished by running sales forecasts for individual products or product lines and then combining them into one.
- **A specific segment of the business's market**
  Example: Kraft Foods runs a sales forecast to predict sales among "new cooks"—a ***market segment*** *it has targeted for products that take the guesswork out of preparing meals (e.g., pre-mixed toppings, ready-to-serve cheesecake filling, etc.).*
- **A geographic area**
  Example: Kraft Foods runs a sales forecast to predict next quarter's sales in the southwestern United States.

Can you think of any more ways a company could develop its sales forecasts?



▲ Large companies often develop a separate sales forecast for each geographic region where they do business.

There's a variety of sales-forecasting software available to today's businesses. Check out http://www.forecastpro.com/ or http://www.zoho.com/crm/sales/sales-forecasting.html to learn more.

In terms of time

To contribute to ongoing business success, sales forecasts should be performed and reviewed regularly. How often to forecast is up to the individual business—forecasts can predict sales for lengths of time ranging from a week up to several years. As a general "rule of thumb," businesses should understand that the farther into the future a forecast reaches, the greater the uncertainty about its accuracy.

Short-range forecasting predicts sales for periods of less than three months. Businesses often use short-range sales forecasts to aid in day-to-day decision making regarding planning, scheduling, staffing, inventory, etc.

Intermediate-range forecasting predicts sales for periods of three months to two years. Businesses may use intermediate-range sales forecasts to plan quarterly or yearly budgets or to determine whether or not to make **capital expenditures** (purchases of equipment, land, etc.).

Long-range forecasting predicts sales for periods of more than two years. Businesses use long-range sales forecasts when making **strategic plans** to develop new products, enter new markets, build new facilities, etc.

The definitions of short-range, intermediate-range, and long-range forecasting may vary a bit from business to business. For example, one business may consider short-range forecasting to cover a time period of less than three months, while another business considers it to cover a time period of less than five months. No matter what the parameters, the general uses for each type of forecasting remain the same.

Shorter range sales forecasts are used more commonly than longer range ones because they are more reliable. Longer range forecasts are also more difficult and expensive to develop. How far into the future a business chooses to forecast its sales depends on factors such as:

- **Business objectives**
  Example: A domestic company wants to expand its operations internationally in about five years. Managers want to know if sales revenue over the next five years will be high enough to finance this expansion. This will require a long-range sales forecast.
- **Business resources**
  Example: A start-up company with limited resources may not be able to afford to develop any long-range sales forecasts.
- **Market conditions**
  Example: If market conditions are changing rapidly, developing a long-range sales forecast may be a waste of time and money. However, if market conditions are steady and have been predicted to stay that way, a longer range forecast may be more accurate (and therefore worth the extra expense).
- **The purpose of the sales forecast**
  Example: A business that needs to decide whether or not it can hire new employees next month will likely rely on a short-range forecast. On the other hand, a business that needs to decide whether or not to develop an entire new product line will likely want to look at a long-range forecast.

Sam Ashe-Edmunds talks more about the benefits of long-range forecasting in the article "Long-Term Forecasting Advantages." You can read it here—http://smallbusiness.chron.com/longterm-forecasting-advantages-67192.html.

It's a plan

To say that sales forecasts are an important business tool is quite an understatement! Sales forecasts lay the foundation for all of a business's planning activities. For new businesses, they are a vital part of the **business plan** that owners use to obtain loans and persuade potential investors to finance their startup. For established companies, sales forecasts indicate whether or not the business is a good investment by showing if it has met its predicted levels of sales. If a company consistently fails to live up to the expectations of its sales forecasts, it may be considered a bad investment.

In addition to helping obtain financing and evaluate productivity, other uses for creating and analyzing sales forecasts include:

- **Comparing sales to industry norms**—How are the business's sales stacking up to those of its competitors?
- **Creating budgets**—Knowing what to expect in sales revenue helps a business to understand what it can spend on production, marketing, etc.
- **Developing new products**—Will upcoming sales be strong enough to help fund the research and development of a new product or product line?
- **Planning promotion**—Businesses often adjust their marketing efforts according to expected sales levels.
- **Setting prices**—If expected sales are low, a business might consider lowering prices in an effort to pump up sales volume.
- **Determining sales quotas**—Projected sales volume helps a business to set realistic expectations for its sales staff.
- **Scheduling production and planning inventory levels**—To be efficient, businesses must create the right amount of product—not too little, not too much. Knowing expected sales volume can help them target the right production levels, in the right timing, with the right amount of raw materials and equipment.

▲ Retail businesses commonly use sales forecasts to determine how much inventory to carry in the coming weeks, months, and/or years.

- **Hiring workers**—When a business sets its production levels according to its latest sales forecasts, it can hire the correct number of employees to get the job done. Hiring too many employees is a waste of resources. On the flip side, hiring too few may cause lost sales due to insufficient production.

- **Monitoring costs**—No business can be successful without keeping costs under control. When a business has realistic expectations for sales, it can estimate both **operating costs** and **production costs** and create a plan for sticking to the budget.
- **Becoming aware of minor problems before they become major problems**—Sales forecasts help businesses to develop clear expectations for the future. Let's say a business has created a sales forecast for the next six months. Three months into the time period, sales have only reached about 25 percent of expectations. At this point, managers can attempt to figure out why sales are slow and make a plan to fix the problem. Without the sales forecast, there would be no **benchmark** against which to reference current results. Analyzing the sales forecast allows the business to catch sluggish sales earlier than it might have otherwise.

For more on the importance of sales forecasting to small businesses, read Tim Berry's article "Why and How Sales Forecasting is Vital to Management" at:

https://www.americanexpress.com/us/small-business/openforum/articles/why-and-how-sales-forecasting-is-vital-to-management/.

Why not?

Believe it or not, many businesses fail to develop sales forecasts! They might think that it takes too much time or that they don't have the necessary information on hand. Perhaps their owners or managers don't understand the reasons for sales forecasting or think that the results won't be accurate enough to make a difference. None of these are good reasons not to forecast! The benefits of sales forecasts far outweigh the effort it takes to develop them. Never underestimate the power of this fundamental business process.

Summary

Businesses may create sales forecasts for individual products, entire product lines, geographic areas, etc. Sales forecasts range in length from short range to long range. The length of time a business chooses to forecast its sales depends on factors such as business objectives and market conditions. There are many important business uses for sales forecasts, such as helping to obtain financing and creating budgets. Some businesses don't develop sales forecasts, but they are missing out on big benefits!

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1. List some of the types of sales forecasts a business may create.
2. What are the purposes of:
   a. Short-range sales forecasts?
   b. Intermediate-range sales forecasts?
   c. Long-range sales forecasts?
3. What are the uses of sales forecasts in business planning?
4. Why do some businesses fail to forecast sales?

Make It Pay!

Think about your place of employment. If you're not working right now, consider a local business you frequent. What qualitative and quantitative sources might the business use when creating its sales forecasts? What factors potentially influence the forecasts? How do you think this business might put its sales forecasts to use?