3 Factors for Building an Accurate Financial Forecasting Process

A Guide for Improving Profitability and Cash Flow

Are you satisfied with the predictive value of your forecasting process?

“Forecasting” is a common term used to define different predictions for different departments within an enterprise. Sales concerns itself with the sales forecast. Supply Chain thinks about widgets, parts, and volumes. Finance worries about revenue and gross margin.

However you define it, your approach to forecasting likely takes into account a range of quantitative and qualitative factors. But it should involve more than coming up with a number. For ultimate success, you’ll need to develop a proactive process that supports accuracy throughout your enterprise and helps you make informed decisions about your business.

This is no simple task, but it’s an important one. If you can create an effective forecasting process, you’ll have one of the most powerful business tools for improving profitability and cash flow at your disposal.

Our goal for this piece is to help you understand three key factors of accurate forecasts:

1 Type 2 Methodology 3 Process

By understanding these factors, you can create clarity and collaboration at the onset of your forecasting improvement journey. This will help create a culture of accountability and make employees feel invested in the outcome.

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FORECAST TYPE

Before you build a forecasting process, you'll need to understand what type or types of forecast you need. There are four main types of forecast, and each has a different focus and accuracy. When you think of each, it's important to know responsibilities, nuances, and the time horizon.

1. Sales Forecast

A Sales Forecast is a prediction of company sales, mainly $ bookings or customer orders. Most sales organizations provide a 3- to 6-month sales forecast based on the sales pipeline and expected close rates.

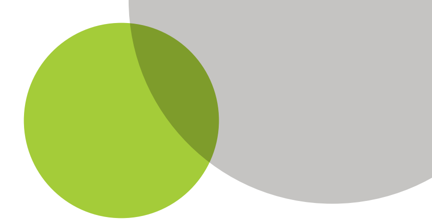
Many companies use combinations of qualitative and quantitative methods in their sales forecasting process.

Here are popular qualitative methods of sales forecasting, each of which has pros and cons:

- Executive Method – An executive within the organization develops the forecast.
- Delphi Method – A team of experts (e.g., department heads and/or consultants) develops and reviews forecasts.
- Salesforce Method – Individual estimates from each member of the sales team, often rolled up by region or parent SKU, are consolidated into a single forecast.
- Ask the Customer – An organization goes straight to its customers to gauge their intentions for buying a company's products or services.
- Test Marketing Method – This method uses smaller, more controlled markets to determine demand for new products or services.

Best Practice

When we work with clients on improving their forecasts, we typically suggest choosing two or three methods, both quantitative and qualitative.



Here are some quantitative methods of sales forecasting, which also have their own pros and cons:

- Moving Averages/Weighted Moving Averages – This uses a company previous year's sales to calculate current sales averages.
- Exponential Smoothing – Sales forecast for next period = (L) (actual sales of this year) + (1-L) (this year's sales FCST); where (L) is a smoothing constant ranging from $0<L<1$
- Decomposition – This breaks down a company's sales data from previous periods into components like trend, cycle, seasonality, other events, and then recombines those components to produce a sales forecast.
- Naïve/Ratio Method – Sales forecast for next year = Actual Sales of this year X (Actual Sales TY/ Actual Sales LY)
- Regression Analysis – Identifies causal relationship between company sales (dependent variable, y) and independent variable (x), which influences sales. Company sales are usually influenced by multiple variables including price, population, promotional expenditure.

Best Practice

Finding the optimal mix of methodologies takes time and largely depends on a company's resources and time. It also takes ongoing, active coordination between teams within an organization. Many companies find an outside perspective is helpful in developing and guiding the sales forecasting process.

If you're interested in learning more, then check out our blog post: ***"3 Tips for a Better Bottom Line: Sales Forecast Methods & More."*** *It includes some of the information we presented above, but dives into a little more detail.*

2. Profit and Loss (P&L) Forecast

P&L forecasts are typically prepared by the company finance team and look at top-line revenue, margin, costs, operating expense, and profitability. A P&L forecast is synonymous with a revenue and margin forecast and/or financial forecast. The time horizon for this type of forecast is usually 6–12 months.

Active collaboration and comprehensive input from multiple teams is important when creating a P&L forecast. During forecast creation, companies should look at the organization holistically and align values and expectations with revenue targets.

The key is to work together to find a reasonable medium for all parties. A publicly traded company, for example, may want to start the forecasting process with discussions among C-levels to determine what investors are expecting from a revenue standpoint. Executives can then work in tandem with several cross-functional subgroups to best find ways to achieve those goals. As specialists in their areas, department leaders are a valuable resource in driving initiatives that will produce the desired revenue, and they are the best resources to weigh in on the feasibility of your targets.

Best Practice

Collaborating on a profit and loss forecast can prevent common morale and accountability problems by giving responsible parties input into their revenue targets.

For more information on P&L forecasts, you can read our blog ***"Trouble Forecasting Revenue? Try a Collaborative Approach."*** *It takes a look at common issues with this type of forecast and how to address them.*

3. Demand Forecast

Demand forecasts are used for materials planning by supply chain organizations to procure parts, negotiate costs, volumes and shipments with the supply chain partners. The typical time horizon is 12–18 months.

Particularly in today's globalized marketplace, companies that can predict the ebbs and flows of demand are at a distinct advantage. What sells? What doesn't? How do specific products impact your bottom line? These are all questions that can be answered through good demand forecasting models, which allow companies to:

- **Gain Insights at a SKU Level.** Your demand forecast model can reveal key insights about your sales right down to the SKU level. Analyzing trends and predicting demand at this minute level of detail enables you to make more surgical decisions about your product offerings. Consider a business that sells coffee among other things. Their product line is made up of varying product types, each of which comes with its own set of variables, ranging from different suppliers, to different brewing processes, to different pricing and so on. Breaking down its forecast by SKU number would give it a clear idea on each product's potential impact on profitability.
- **Achieve Greater Accuracy for Related Costs.** You can use your demand forecast to make more precise top-line revenue predictions. This will, in effect, help you more accurately budget and forecast related costs such as COGS, SG&A expenses, and other elements that are calculated as a percentage of revenue.

Best Practice

Finance leaders should on rely on demand forecasting models to analyze and predict sales trends over time, gauge their inventory position, and eliminate barriers to profitability.

- **Plan for High-Selling or Low-Selling Products.** In reviewing your sales trends, your demand forecast model surfaces both high-selling and underperforming/obsolete products. Knowing your top sellers ahead of time not only allows you to stock your inventory accordingly, but helps reduce risk. If you haven't sold a given product in five years, chances are, you won't sell it in the coming year. So it's simply not cost-efficient for your business to have it on hand.

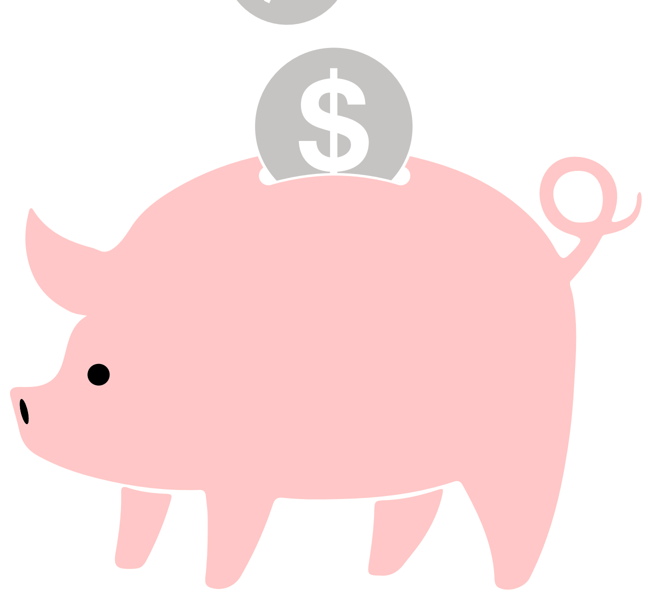
Sales are the lifeblood of any business, but a demand forecasting model keeps tabs on what feeds those sales. If you'd like to learn more about demand forecasts, we have a helpful blog titled ***"Demand Forecasting Strategies Every Finance Leader Should Know."***

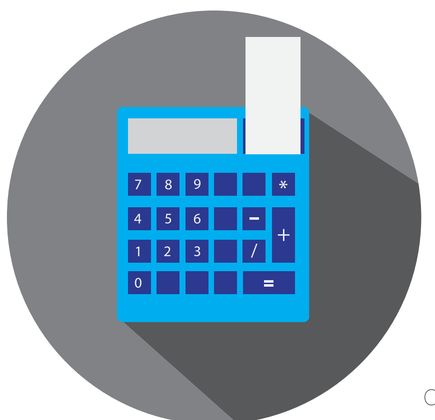
4. Cash Flow Forecast

A cash flow forecast looks at weekly, monthly, quarterly, and annual cash flow to manage and align cash assets with operational requirements. Time periods will depend on how tight cash constraints are.

Cash flow forecasting is about predicting the inflows and outflows of money for a corporation. This is critical because your operations can only be sustained through three actions:

1. Ensuring liquidity for short- and long-term operations,
2. Fulfilling covenants to remain on good terms with lenders, and
3. Paying your liabilities (e.g., payroll, interest, dividends).





So the goal is to determine your company's ability to pay for the outflows with the inflows. This determination is critical across all business segments, and along with it come significant implications for your organization including:

- Legal Aspects: Is there enough cash on hand for payroll? And enough cash to pay interest on outstanding loans and assure covenants are fulfilled? If your company lacks the liquidity to cover these aspects, there can be serious legal ramifications.
- Performance within Terms: Does the company need to postpone payment of invoices, especially at year end? Is there enough liquidity to ensure vendor goodwill, which in and of itself is an intangible asset that could impact the cost of doing business and as such company's cash flows?

Because planning and managing corporation's cash touches on just about every business area, it's the backbone of any successful company. And while rooted in a seemingly simple concept, cash flow forecasts are comprised of weighty considerations and complexities, often making it difficult for finance teams to maintain optimal cash forecasting processes. To learn more about cash flow forecasting, we invite you to read our blog, ***"3 Steps to Better Cash Flow Forecasting,"*** *which takes a more detailed look at the process.*

Best Practice

At the heart of cash flow forecasting is an understanding of the state of your business, specifically liquidity versus solvency and its impact on operations.

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FORECAST METHODOLOGY

The choice of forecasting method is a good representation of the way a company is organized and operates. We noted specific qualitative and quantitative methods in the sales forecasting section. But if we look at enterprise forecasting more holistically, there are three typical forecast methodologies:

1. **Top-Down Method:** In this methodology, management develops and agrees on a forecast based on their expectations. Then all sales organizations are assigned their prospective share of targets. This can be effective if management is realistic and open to dialog, but it can also engender inaccuracy if sales organizations feel pressured to inflate their numbers.
2. **Bottom-Up Method:** Companies collect information at the detailed level from the sales organization, whose forecasts give management opportunity to assess and adopt the forecast. Again, this is effective in honest and collaborative environments. Conversely, it can create inaccuracies if sales professionals feel incentivized to sand-bag their forecasts to increase their commissions.
3. **Hybrid Method:** In this combination of Top-Down and Bottom-Up, executives set revenue goals, and sales and product management functions develop bottom-up forecasts. Gaps, as well as actions, are identified to offset differences between bottom-up forecast and management targets, and management agrees on a consensus forecast.

Best Practice

Understanding forecasting methodologies is only half the story. Knowing how to apply them is what will help you maintain a healthy bottom line.

Methodologies offer structure for an enterprise's approach to forecasting, and as we noted, they typically offer insight into organizational structure and operations. Whether a chosen methodology will be successful will come down to application, and the process an organization uses to ensure predictability.

FORECAST PROCESS

Building a forecasting process around efficiency and collaboration will go a long way to towards ensuring that the process is sustainable. The best forecast process is a cross-functional exercise where different elements come together to improve the accuracy, value and efficiency of financial planning, forecasting, and budgeting.

Forecasts need to reflect reality to be successful. Top performing organizations rely on a combination of people, technologies, and processes in creating accurate forecasting processes.

Think of forecasting as a team sport. Far too many organizations separate their financial planning team from their strategic planning and operating teams. Combining cross-functional team resources would help them see the broader picture, communicate short- and long-term goals, and optimize the forecasting model to changing business conditions.

Key elements of a best practice forecast process are:

1. **People:** Key stakeholders must be involved in a collaborative effort that targets accuracy and accountability. In the same manner as the Federal Reserve Bank, your company's financial forecast should be an independent view that represents the most likely case of the business as accurately as possible. It is crucial to have an independent group or someone who is invested in forecast accuracy, because you don't want the forecast to be skewed based on someone's wishes or expectations (e.g., a private equity parent company).

Best Practice

Research shows companies that are adept in these processes outperform their competition. For a deeper look at collaborative approaches to forecasting, read our **free guide on cross-functional collaboration**.

2. **Data:** Internal and external data sets should be aggregated from different functions. How do you collect your data? If you are using skewed numbers, or omitting information, you'll negatively impact the forecast. The accuracy of the forecast is directly impacted by the accuracy and accessibility of:
    a. **Sales Data:** Sales pipeline and bookings data by account and territory
    b. **Financial Data:** Revenue and expense information by product and department
    c. **Product Data:** Product volumes, models, average sales price, configurations, use cases
    d. **Accounting Data:** Days receivable and days payable
    e. **Product Management & Marketing Data:** Product mix, product roadmap, market size, market growth, competition and marketing programs
    f. **Supply Chain Data:** Inventory, unit cost, lead times, shipment information

3. **Systems & Tools:** The systems and tools used to collect, aggregate data, and process the information to and from key stakeholders are dependent on business size and complexity. While most small/mid-sized companies rely on Microsoft Excel, as organizational and business complexity grow, companies should transition from Excel-based processes to Cloud-based Enterprise Performance Management "EPM" solutions such as Anaplan, Host Analytics, or Adaptive Insights to reduce personnel costs, human errors, manage complexity, and scale with the business.

CONCLUSION

Understanding the three major components of success – **Type**, **Methodology**, and **Process** – sets the foundation for your organization to create meaningful forecasts. Forecasting is a highly involved, time-consuming effort — and the need for accuracy can place an enormous burden of responsibility on your organization. The real-world success of your Financial forecasts comes down to putting Type, Methodology, and Process into action.

When we work with clients on this process, we use a framework called Integrated Business Planning, which integrates the three factors and develops a cohesive plan to increase forecasting accuracy, performance, and profitability. At **8020 Consulting**, we believe that an Integrated Business Planning model is an imperative part of business and a competitive edge in the age of data.

An Integrated Business Plan enables:

- **Informed Decision-Making.** Executives connect with their employees and can really see what is going on; divisions are not just reporting outcomes. The left hand knows what the right hand is doing.
- **What-If Scenario Planning.** A realistic financial forecast allows companies to identify the possibilities and to change course with a better plan to meet possible outcomes.
- **Proactive Business Management.** When you know what to expect in the next six to nine months, you can make corrections to stay on track.

If you're interested in improving the predictability of your forecasting, **8020 Consulting** can help. We're experienced in helping organizations fine-tune their forecasting methodologies and processes. We can also identify and implement the best-fit tools and systems to help you realize your full profit potential.

Whether you're interested in working with us to develop and Integrated Business Planning model or improve your forecasting — or even if you just want to learn more about forecasting — we hope this guide has been helpful for you. Thanks for reading.

Click here to contact **8020 Consulting** about improving your forecasting process.
Or call us anytime at 855.367.8020.