Why you need financial forecasting for your small business!

Forecasting is extremely important for any business, but unfortunately, many small businesses do not conduct this process. Business owners are often too busy solving problems and searching for the next sale and miss to be forward thinking. But in order to identify new opportunities and stay ahead of the competition, small businesses need to incorporate forecasting into the management process. Once they have put together projections, they can use them as a guiding principle for strategy and decision making.

What is Forecasting?

Forecasting is a planning process that helps management better confront uncertainties about the future. It relies on past and present data to identify trends and estimates future outcomes. Forecasting projects the company's financial future and can be used to determine expected future revenue and expenses.

Forecasts are used in a variety of ways within a business. Management might use a forecast to make decisions on hiring or required inventory levels. Forecasts can also be used in the development of a budget or creating a pathway for the company's short-term and long-term strategic vision.

There are generally three types of forecasting:

Top-down forecasting – Top-down forecasting starts with the big picture and moves toward the specifics. The method estimates future performance by starting with high-level data and works toward specifics on revenue. This is probably the most useful type of forecast for small businesses. The owner or management first determine goals for the next year or forecasting period and then calculate what steps they need to take and what resources they need to use to reach them. For example, if a business wants to increase revenue for the next year more than its historic rate of growth, they may need to hire a new salesperson and they need to determine first if they have funds to do that.

Bottom up forecasting – Bottom up looks at specific customers and products and broadens to estimate revenue. It starts with lower-level data and expands out.

Hybrid – Some companies use a mixture of the two that combines broader market data and lower-level information. The objective is to accentuate the advantages of both systems while minimizing their disadvantages.

Helps determine long-term vision

With forecasting you can create a long-term vision for the company. This is the overall vision for the organization and can sometimes include the development of a mission statement. A long-term vision can be anywhere between five and 10 years in the future and are very broad. They try to get an overall picture of what the company wants to be down the road.

Establish a pathway for achieving goals

You need a roadmap to know where you are going. The forecasts are the map to help you establish the short and long-term goals and develop a pathway on how to reach those goals. You need to understand the historical data about your company and the overall market trends. Once the forecasts are developed, you will be able to achieve attainable goals. Often these are what are called SMART goals, which stand for specific, measurable, attainable, relevant and timely. You want goals that are very specific and advance actionable ways to achieve those goals.

Provide investors with necessary information

Investors want to understand a business' current financial health but also want to understand where a business is headed. Do you think it will take 18 months before you reach profitability? If so, you need a forecast that makes that prediction. You need solid data on how you made the prediction – market trends, past performance, etc. An investor wants to limit their risk when making an investment and a forecast will show them where a business is headed.

Helps identify risky and opportunities

You want to limit your risk and increase new opportunities. That's how you succeed in business. Forecasting can help you flesh out unforeseen risk and identify new opportunities. You will be able to better understand your customers and will learn ways to attract new ones with proper forecasting. You can develop sales plans to go out and market to those new customers, but you have to make sure your forecasting is accurate and does not make unreasonable assumptions.

Plan and predict cash flow

For most small businesses, cash flow is a challenge. You have more than enough cash flow one month and not enough cash flow the next. Forecasting allows you to predict and anticipate your cash flow. You might look at several years of data and realize that fall is a time where you seem to have a cash flow problem. You can investigate, so you understand why the issue is occurring, and find ways to limit the impact when it occurs in the future.

Ability to inform employees

Any good organization must openly communicate with employees. Forecasting is a tool that helps management effectively communicate valuable information about the company. Employees need to understand the plan for being successful and in what way the company plans to achieve the objectives. That gives everyone within the organization a shared vision for the future. Everybody is steering the boat in the same direction.

Tools that can help

Multiple software tools exist to help you with the forecasting process, but it’s often best to involve a financial professional. They can help you identify the tools that will work best for you, so you get to best maximize the use of technology. Ideally, you want to make it a collaborative process between management and financial professionals.