INCOME FORECASTING TECHNIQUES

One of the most important steps in the construction of a written plan for your proposed business is the development of meaningful financial projections. No business enterprise should be undertaken without a clear plan of profit potential and an understanding of the sales volume needed to achieve this profit. Experienced entrepreneurs recognize such projections as necessary for the success of any new business, and potential investment and lending sources will insist upon reviewing your financial projections before any serious discussion can take place. To be of maximum value in the planning process, your projections should accurately reflect the potential of your business and must not be influenced by wishful thinking.

Maintaining a high level of objectivity while researching the potential for a new business can be difficult. The difficulty results from the fact that many prospective business owners select the type of business to enter for a variety of quite personal reasons. They may choose a type of operation because the very nature of the work involved appeals to them. Others may work for someone else in a similar business and now would like to be their own boss. Some may have spent time acquiring the necessary technical skills or may have simply observed that a particular enterprise appears enjoyable or profitable. When combining any of these personal reasons for entering business with the complex task of analyzing the market, it is not uncommon for a prospective business owner to start up an operation with unrealistic expectations of the potential returns.

It is suggested that in your planning efforts you use the desired income approach to help determine the feasibility of your idea. This approach recognizes that, for the investment of time and effort and the assumption of risk, you are entitled to a fair monetary return. If this business were not started, your money could be invested to earn a return elsewhere and your time and effort could be devoted to working for someone else. The desired income approach allows you to select the minimum desired return and build on this to determine the level of sales required to achieve this return. If this sales level cannot be reasonably supported by market analysis, you would probably be better off working for someone else or investigating a different business opportunity.

To begin, you must first ascertain the minimum acceptable level of profit. To do this, it is necessary to explore the uses of profit. Profit can be used to support personal living needs, to pay back borrowed funds, or to reinvest in the company. Since we are attempting to determine the minimum level of profit, we will not be concerned with reinvestment which involves a use of profit over this minimum.

To determine personal living requirements, you must consider the minimum amount you will need to withdraw from the proposed business. If there is substantial personal income available from other sources, the amount required from the proposed business may be reduced. If there is no other source for personal income, then the proposed business should be recognized as the sole source for providing a living. Obviously, this desired draw will vary by individual needs and must be arrived at by thoughtful personal planning.

If it is necessary to borrow funds to begin the proposed enterprise, it must be realized that these borrowed dollars will have to be repaid from earnings of the business. This is of special importance to prospective lenders. It is the reason why a presentation of a projected income statement is required when seeking outside financing for a business. To determine the level of profit necessary to repay a loan, you need to determine the dollar amount to be borrowed, the term of the loan and the percentage of interest likely to be charged.

The loan amount usually is the total amount of money needed to begin the business less the amount supplied by you in the form of equity. The term of the loan is based on the use of the proceeds and the percent of interest reflects the general risk involved. It is advisable to speak with lenders and those offering business advice to help determine realistic terms and current interest rates for your situation.

For our example, we will use $30,000 as the amount of the loan requested and a term of five years at 15 percent annual interest rate.

The calculation of the annual payment is as follows:

$30,000 over five years at 15 percent
$30,000 / .023790* = $713.70/month
$713.70 x 12 months = $8,564.40/year

*(.023790 comes from loan amortization tables which are available at local bookstores or in most finance textbooks.)

This $8,564.40 represents the total interest and principal repaid on the loan the first year of operation. If we round this figure to $8,600 and estimate personal living expenses to be withdrawn from this business at $15,000, we have a total of $23,600 which must be generated to sustain our personal needs and keep current with the lender.

The next step is to determine the level of sales necessary to earn the $23,600. From industry statistics, we can ascertain average performance data for various types of business operations. One of the most commonly used sources for this information is ***Annual Statement Studies***, published by The Risk Management Association, www.RMAHQ.com. Other sources can be found in the library and include Dun and Bradstreet, Industry Norms and Key Business Ratios™, the Almanac of Business and Industrial Financial Ratios (Prentice Hall) and local and national trade associations. Be sure to determine that the industry standard being applied includes the owner's draw as a part of profit. If it does not, this withdrawal amount will have been deducted as a salary expense in the operating statement and will have to be added to the stated profit to get an accurate indication of the total percent of sales available as profit to the business owner. For our example we will assume the industry sources show that, for the type of business under consideration, the average profit, including the owner's draw or salary, is 11 percent of sales.

To determine required annual sales volume:

$23,600 is 11 percent of X
X = minimum required annual sales
.11 X = $23,600
X = $214,500

We have now determined that, if our proposed business is assumed to be average, we will need to sell $214,500 of our products or services to cover expenses, keep our loan current through the first year and withdraw the desired $15,000. This in no way implies that we will sell $214,500, of products or services, but this dollar amount serves as a goal that must be met. We now have available a minimum target sales figure to test and verify through the techniques of market analysis. For some, it will be readily apparent that the required sales target is not realistic. For others, careful market research will be necessary before any conclusion can be drawn.

The desired income approach of determining required sales can help us answer the question of whether we would start a particular business, begin the business as we have it conceptualized or whether the idea we have is likely not to grant the desired return. It gives a benchmark that must be met. It provides a realistic financial goal that must be achieved. If our research shows that this goal is attainable and that estimated sales are likely to meet or surpass this level, we can enter business with that much more confidence. If our market investigation does not thoroughly support the minimum required sales level, we can rethink our position. We can consider changes to our business plan which will make the concept more realistic or we can search for another, potentially more profitable business opportunity. The desired income approach allows us to start up a business operation with knowledge of what must be achieved and the level of return we can expect for our efforts.

To verify whether your target minimum sales are attainable, it is necessary to thoroughly investigate your potential market. Market research is an imprecise science, but basic research can be performed by most prospective entrepreneurs. Stated simply, market research is the orderly and objective gathering of facts about your market. It involves finding out how things are, not how you think they are or would like them to be. Much raw data already exists, but before this data will be of use to you, it is necessary to develop some basic definitions regarding your proposed business.

The first of these definitions involves describing in detail the business you wish to establish and the industry it will operate within. Concerns here relate to the image you wish to project and the products and services to be offered. Your business image is the single most important factor in achieving target sales. Be careful to design an image that addresses a perceived market need, and do not select an image that appeals solely to you. Industry influences are also important and involve an assessment of firms currently operating within your industry and major historical trends. In addition, you should examine and define significant outside influences on your business such as government regulation, energy concerns, inflation and other economic factors. Many of these forces will be beyond your control, but they must be recognized and planned for.

A full and complete analysis of your production capabilities should be developed. Your ability to satisfy market demand will be directly limited by your ability to produce, finance, sell and service. It is of little value to determine from the market that potential revenues can meet or exceed your target minimum sales volume if your production cannot match this needed output. Similarly, sales revenues are limited by the availability of working capital and by your ability to negotiate sufficient sales transactions. Indeed, you may determine that a substantial market potential exists, but you will need to consider the restricting impact of these internal factors.

Next, you will need to define the actual market segment you wish to enter. Attempt to describe in detail the target customer most likely to be interested in your product or service. There is a definable portion of the population to whom the output of your business will be of special interest. This is your target customer and the focus of your market analysis. Target customers can be defined in terms of some demographic descriptor. Examples could include income level, home ownership, sex, marital status, age, occupation, education or any of a host of market-related characteristics. You will need to spend considerable time researching and defining a target customer profile, but this process is critical to further market analysis.

Once you have arrived at a definite category of customer, you can begin investigating where your potential customers are and in what numbers. Basic demographic data outlining population size, density, distribution and other vital statistics is readily available from a variety of sources. A list of such sources would include the following: U.S. Bureau of Census, Chambers of Commerce, colleges and universities, James J. Hill Reference Library (St. Paul, Minnesota), and your local library, which contains sources for locating trade journals, directories and local and national trade associations. You will also need to develop a trade area based on geographic considerations. Defining your trade area involves making a determination of how far you can reasonably and profitably take your product or service out into the marketplace or how far you can expect to draw customers to your place of business. This trade area is related to the type of business you are investigating and can range from a segment of a community to international dimensions. Within this trade area you will need to examine the population data you have researched to determine how many target customers are available. Of course, not all these potential customers will do business with you. The market deals with people and their constantly changing likes and dislikes which are affected by hundreds of influences.

Competition within and adjacent to your trade area should be thoroughly examined. Attempt to describe who your competitors are and compare strengths and weaknesses with the business you want to operate. Become familiar with your competitors' pricing policies and overall method of operation. You will be competing head-on for the limited number of opportunities within your selected trade area and you must have as much knowledge of your competition as possible. Do not neglect to analyze future competition. Market dynamics are not static and freely allow others to enter your market and to change and improve on products or services you will be offering.

Keep in mind throughout all of your research efforts that verification of your target minimum sales is your goal. Ask basic questions about your business. How much does the average customer spend in a typical sales transaction? How many sales transactions are required to meet your target minimum sales? Does your knowledge of the market indicate that there is a sufficient customer base to generate the needed sales revenue? As mentioned previously, market research is an inexact process, but, with a desired income as your target and an orderly approach to gathering data, you can become aware of the magnitude of market opportunities. This knowledge will then assist you in making rational and intelligent decisions regarding your proposed business.