Developing assumptions for financial forecasts

What are assumptions and why are they important?

A question asked by all potential funders and reviewers of business plans is "Do the numbers stack up?"

The numbers referred to are the financial forecasts. The answer that the readers are looking for is that you are able to deliver a project within the money available to you. They will also want to know if your proposed enterprise is able to generate an income and derive a profit, however small, or that the income generated will be sufficient to repay a loan or an investment.

The starting point for any forecast is the assumptions. The assumptions form the logic behind the forecasts and explain why the numbers in the forecast behave the way they do. Equally important, the assumptions form the link between the business plan and the forecasts. For this reason the assumptions are considered to be a very important part of your financial forecasts.

You also need to ensure that your assumptions are well researched and robust and cannot be challenged. This is particularly important as you have to bear in mind the following:

- It is very easy to find information on the web so someone can easily double check your assumptions.
- Funders have a lot of experience reviewing business plans and probably know your sector or potential market well and will know the limits on size, resource requirements, market prices etc.
- Line managers, reviewing assumptions for an internal business plan, will also be very familiar with what can and can't be achieved.

You will need to make assumptions for several components of your financial forecast, including:

- your income
- your operations
- your profit
- your cash flow

Income assumptions

Making income assumptions can be a challenging part of the business plan as it can be difficult to predict the future. Income for social enterprises can come in a variety of ways:

- Grants.
- Sale of products.
- Fees for services. Fees could be from services delivered to individuals or organisations. They can be for discrete delivery of services, e.g. a one off workshop or fees for the delivery of a long term contract. For example, a three year support contract for employment training on behalf of a local authority.

The following is a list of methods that can be used to estimate future income.

Making income assumptions if you're already running a social enterprise
For an existing enterprise the starting point for your assumptions is what you have achieved historically. Forecasting a continuation of an existing enterprise involves deciding and supporting the incremental changes that you expect to be brought about by:

- external conditions – changes in market size, market conditions, economic conditions, competition etc.
- internal objectives – intentions to change size, improve efficiency, expansion into new markets etc.

Explain in your assumptions what your starting point is. For example, the income you generated the previous year. You also need to explain what growth you are predicting in the future and why. For instance, you may expect income to rise 10 percent year on year because the market services have improved substantially and you experienced similar growth in the previous year (see details on volume increases below). The changes you predict need to be realistic. They also need to be manageable within the resources that you have.

Changes in income through volume change
You should indicate what changes in product/service delivery you expect to achieve over the period of the forecast. This should link in with the growth explained in the business plan i.e. an increase in sales to existing customers, new customers etc.

So, you may predict that you are expecting to sell more bags of fair trade coffee by 10% year on year (increase in product volume). Or that you expect to deliver an additional 10% of employment training to individuals year on year.

Remember to vary product sales or service delivery during a year because of seasonality – take into consideration how you expect to be affected by summer holidays, school term times, Christmas breaks etc.

Changes in income because of price changes
Income will also be affected by expected, or predicted, changes in price. This could be both up and down. If there is increased competition or the economy is performing poorly you might predict that you will have to lower prices. If the economy is doing well or more people want to purchase your goods or services you might expect to increase prices. All these changes need to be explained in your assumptions (see section on pricing below).

Making income assumptions when you are starting a new social enterprise
If you are starting a new social enterprise, you can create income assumptions based on:

- previous experience with similar enterprises with another organisation
- questioning other enterprises undertaking similar work (probably best to ask an enterprise that is geographically distant enough not to feel threatened)
- looking overseas
- looking at enterprises delivering similar services in different markets
- talking to sector specialists

If it is a totally new business then you can only make an informed estimate based on research. Funders and lenders will be able to confirm how realistic estimates are based on their own experience with others in the sector or by reference to other funders/lenders with experience of this type of project.

Income predictions for long term contracts
Often local or regional authorities invite bids for long term contracts. This will mean that there is a defined expectation of what the delivery requirements are, e.g. how many unemployed people will be required to be put through employment training. There may be a stated budget available, or an indication of one, or you may be asked to come up with a figure yourself. These will then form your income assumption and this can be referenced to the contract and held as proof.

Pricing
Pricing will depend on a number of factors:

- cost of delivery
- profit mark up
- competition
- ability of customer to pay
- economic conditions

Consider also how pricing will be affected over the period of the forecast:

- will it remain the same?
- will you be able to raise prices to account for reputation or because of inflation?

Cash receivable from funding
Money received from funding will be shown as part of your income in the cash forecast. So you need to decide what type of funding you are going to go for.

List the types of funding you are considering and when you are likely to need them. For example, you may want some funding before you start trading but will need a much larger amount at a later stage.

If you are going to look for loans or overdraft facilities consider the repayment terms and the interest costs and ensure that these are included in the cost assumptions.

Expenditure assumptions

Operations
Think through very carefully how the enterprise will operate. Consider the daily routine and capture all the activities and resource requirements needed to provide the level of service that you have indicated in the assumptions above.

List the expenses and estimate the cost of each category. This can be done by looking up recruitment sites for personnel costs and supplier web sites for other types of costs. You can also ask to be provided with estimates from potential suppliers.

Separate the costs between those that are capital items and will only appear in the cash flow and those that are required for ongoing delivery of your enterprise.

You also need to make sure that the costs correspond to the income generating service delivery. Ensure support costs e.g. rent, utilities, stationery relate to the size of the intended operation. For example, don't include the electricity cost for a small house when you are going to run a large community centre that is operational 18 hours a day.

You should also include a note on the cyclical nature of costs, i.e. are they:

- monthly
- quarterly
- annual
- some other pattern?

Consider how the costs are going to change over the years in relation to changes in service delivery, inflation etc. and list these assumptions.

Capital expenditure
Consider what capital assets you are likely to need for your enterprise:

- PC's
- laptops
- printers/ scanners etc
- fixtures and fittings
- furniture
- web site
- lease
- motor vehicles
- mini bus
- vans
- machinery

Taxation
Will you need to be VAT registered? This will affect both your profit forecast and cash flow as it has an impact on fees and costs.

Remember that your cash flow will have to reflect the quarterly payment to, or refund from, HMRC for the VAT paid and collected by your enterprise.

If you are going to show that you achieve profitability during the period of the forecast you will need to account for corporation tax in the forecast, unless you are a charity. Ensure you know what the rate will be and when it will be payable. Work out or ask about what the depreciation rate should be for these items and state this.

You should also try and allocate the timing of the purchases:

- when would be appropriate to make the purchases?
- when will the items need to be replaced?

Sensitivity
You will also need to show that you have considered what would happen if you don't do as well as you think you will and what happens if you do better.

You will need to state in the assumptions what changes in volume or price or timing you have used to test the robustness of your forecasts.

Cash flow

If preparing both a profit forecast and a cash flow forecast there are a number of further considerations regarding the differences between the two. The major differences are listed below:

- timing differences
- VAT
- accounting for Capital Expenditure e.g. purchase of fixed assets
- depreciation
- loans
- investments

These are further detailed in the guide on Cash flow forecasts.

Further information

Read our guide on Financial forecasts:
www.bllondon.com/SocialEnterprise/Fundingandfinance/Financialplanning/Financialforecasts.aspx

Read our guide on Profit forecasts:
www.bllondon.com/SocialEnterprise/Fundingandfinance/Financialplanning/Profitforecasts.aspx

Read our guide on Cash flow forecasts:
www.bllondon.com/SocialEnterprise/Fundingandfinance/Financialplanning/Cashflowforecasts.aspx