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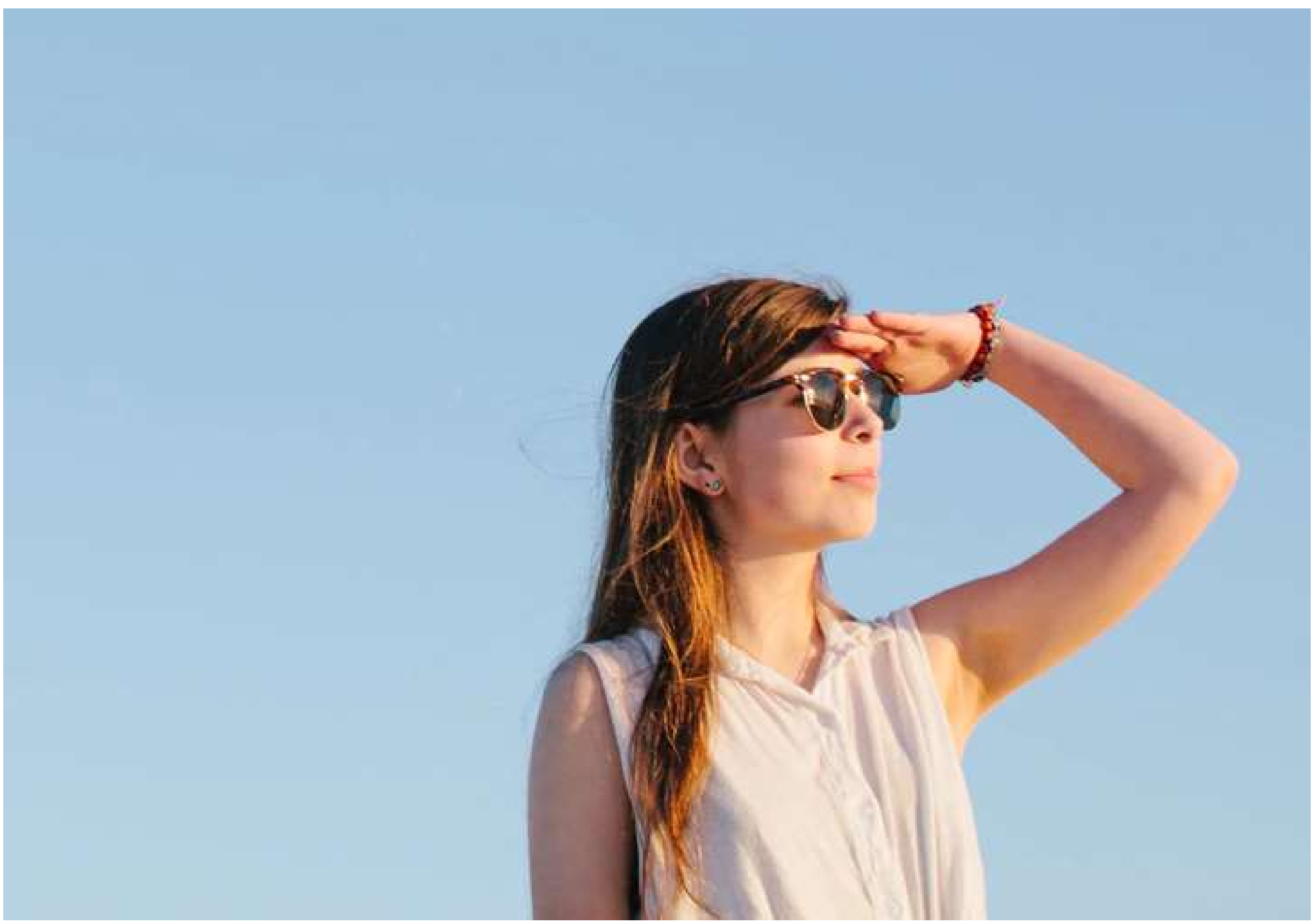
FORECASTING

Top-Down vs. Bottom-Up: Which Financial Forecasting Model Works for You?

By April Maguire July 29, 2015



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the current market size available for your business and factor in relevant sales trends. Then you can estimate how much of the market will buy your products or services. In the context of these trends, you then examine your company's strengths and weaknesses and, ideally, how to amplify your strengths and remedy your weaknesses.

On the other hand, a **bottom-up analysis** is grounded in the product or service itself, from which a projection is made based on what you need to get your offering to the market (i.e. things like how many employees you have, how many factories you can open or how many clients you have). Also known as an operating expense plan, bottom-up forecasts examine factors such as production capacity, department-specific expenses, and addressable market in order to create a more accurate sales projection.

In simple terms, top-down models start with the entire market and work down, while bottom-up forecasts begin with the individual business and expand out. Understanding the pros and cons of both types of financial forecasting is the best way to determine which methodology is ideal for your specific needs.

Pros of Top-Down Forecasting

The following are advantages associated with calculating profit potential using a top-down methodology.

Reduced Variability

One of the benefits of top-down financial forecasting is that it avoids statistical outliers—the data-swings—common to lower-level facts and figures. Because of this, a top-down approach offers companies a broader picture of revenue potential and can help them identify sales patterns. This could allow companies to create more accurate models for strategizing and allocating resources. Because this view tends to provide a more optimistic outlook, businesses may have an easier time using a top-down forecast to spark investor interest.

Faster Results

With top-down forecasting, companies don't need up-to-the-minute point of sale (POS) data to forecast results. Businesses that assess available market revenue from the top down—especially new ones—may find it easier to generate projections. As an added benefit, a top-down view evaluates whether a market is increasing or decreasing, so startups can easily gain insight into long-term profit potential.

Pros of Bottom-Up Forecasting

Here are some reasons to consider using bottom-up forecasting to calculate profit potential.

bottom-up forecasting employs actual sales data, the resulting forecast may be more accurate, which enables you to make better strategic decisions moving forward.

Better Item-Level Forecasting

With top-down forecasting, profits from various products and regions are averaged together rather than considered on an item-by-item basis. As a result, businesses may struggle when deciding how best to manufacture and distribute specific products. If you want to decide how best to allocate your resources to specific items, a bottom-up financial forecast may be the way to go.

Greater Employee Involvement

One of the benefits of a bottom-up approach is that it offers more opportunities for employees and managers to participate in the budgeting process. With a bottom-up plan, owners examine operating expenses and assess spending by department. This includes production and hiring costs, marketing and distribution. By looking at these figures, small business owners can provide department heads and advisors with the details needed to make better spending decisions. As an added bonus, managers are more likely to adhere to the budget if they helped create it.

Financial Forecasting by Business Type

While it's clear that both top-down and bottom-up forecasting techniques have their advantages, the best model may ultimately depend on the nature of your specific business. Firms that experience little deviation in profits from one month to the next may benefit from a top-down financial model. Additionally, top-down models can be effective for startups that do not have any accumulated sales data. Finally, the more optimistic view provided by the top-down model is often effective for new businesses looking for outside funding.

On the other hand, bottom-up forecasting may be ideal if you have a seasonal business model that experiences great variation throughout the year. While startups may want to use the top-down view to forecast revenue for investors, the bottom-up model is crucial for helping startups make smart budgeting and hiring decisions.

Accurate financial forecasting can be a challenge. By taking the time to assess your business' financials, however, you can develop a far more comprehensive view of your company.

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