



# **FINANCIAL** **FORECASTING**

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# What is Financial Forecasting?

- It is a Part of Planning process.
- They are inferences as to what the future may be.
- Extends over a time horizon.
- Based on:
  - v. Economic assumptions (interest rate, inflation rate, growth rate and so on).
  - vi. Sales forecast.
  - vii. Pro forma statements of Income account and Balance sheet.
  - viii. Asset requirements.
  - ix. Financing plan.
  - x. Cash Budget

# The Need

- Financial Manager prepares Pro forma or projected financial statements to:
  - b. Assess the firm's forecasted performance is in line with Targets and expectations of investors.
  - d. Examine the effect of proposed operating changes.
  - f. Anticipate the financing needs of the firm.
  - h. Estimate the future free cash flows.

# **Techniques of Financial projections**

2. Proforma Financial Statements.
4. Cash Budgets.
6. Operating Budgets.
8. Sales Budget

# **Proforma Financial Statements**

- A comprehensive look at the likely future financial performance.
- Pro forma Income Statement. (Represents the operational plan for the whole organization.)
- Pro forma Balance sheet. (Reflects the cumulative impact of anticipated future decisions).

# Preparation of Pro Forma Income Statements

## **Percent of Sales Method**

- Assumes that future relationship between various elements of cost to sales will be similar to their historical relationships.
- These cost ratios are generally based on the average of previous two or three years.
- For example, Cost of Goods sold may be expressed as a percentage of Sales.

## 2. Budgeted Expense Method.

- Estimate the value of each item on the basis of expected developments in the future period for which the pro forma P&L a/c is being prepared.
- Calls for greater effort on the part of Management, since they have to define the likely happenings.

# 3. Combination method

- Neither the Percent of sales method nor the Budgeted expense method should be used in isolation.
- A combination of both methods work best.
- Items which have stable relationship to sales can be forecasted using the Percent of sales method.
- For items where the future is likely to be very different from the past, budgeted expense method can be used.



# Proforma Income

## Statement

	Actual figures for Quarter 31-3-2006	Assumptions	Proforma for the qr ended 30-6-2006
1.No.of units sold	14000	Sales decline 30% due to low demand.	9800
2.Net Sales	140000 100%	No change in Product mix.	98000 100%
3.Cost of Goods sold:			
4.Labour	22960	20% of Cost of good	16366
5. Materials	25256	22% of COG	18002.6
6.Distribution cost	4592	4% of COG	3273.2
7. Overhead	<u>61992</u>		<u>44188.2</u>
8. Total	114800	<u>54% of COG</u>	<u>81830</u>
9. Ratio of CGS to Sales.	82.0%	Increase by 1.5%	<b>83.5%</b>
10. Gross Profit	25200		16170
11. GP Margin	18%		16.5%

## Contd.

	Actuals	Assumption	Proforma
12. Expenses:			
13. Selling Expenses	8250	A drop of Rs.	7500
14. Admin. Expense	4450	750 .	3600
15. Others	Nil	A drop of Rs. 850	Nil
16.Total	12700		11100
17. Operating Profit	12500		5070
18. Interest	2500		2000
19. Depreciation	2000	Rs.2000 only	2000
20.PBT	7000		1070
21. Tax @ 30%	2100		321
22.Net Income	4900		749
23.Dividends	900		0
24.Retained earnings.	4000	No dividends Carried to B/s.	749
25. Cash flow after dividends.	6000	Retained earning + Depreciation	2749

# Pro forma Balance sheet

- Projections for Balance sheet can be made asunder:
  2. Employ Percent of Sales method to project items on the asset side, except “Investments” and “Misc Exp & Losses”.
  3. Expected values for Investment and Misc exp can be estimated using specific information.
  4. Use Percent of sales method to project values of current liabilities and Provisions. (Also referred to as ‘spontaneous liabilities’)
  5. Projected values of R & S can be obtained by adding projected retained earnings from P&L proforma statement.

# B/S Contd..

1. Projected value for Equity and preferential capital can be set tentatively equal to their previous values.
3. Projected values for loan funds will be tentatively equal to their previous level less repayments or retirements.
5. Compare the total of asset side with that of liabilities side and determine the balancing figure. (If assets exceed liabilities, the balancing figure represents external funding requirement. If liabilities exceeds Assets, the balancing item represents 'surplus available funds' )

# PROFORMA BALANCE SHEET.

	Actual	Assumptions	Proforma for June	Change
LIABILITIES:				
B.CAPITAL	6500	Issue of shares	7000	+500
C.R& S.(C+D)	4500	Rs.500	5250	+750
D.RESERVES	500		500	0
E.P&L Balance	4000	P&L account.	4750	+750
F.Total share holders funds.	11000		12250	+1250
G.Total Debt				
H.Total Liabilities (E+F)	<u>7500</u> 18500		<u>7500</u> <u>19750</u>	<u>0</u> +1250

# Proforma Balance sheet contd..

	Actuals	Assumptions	Proforma	Change
<u>ASSETS:</u>				
<u>H. GROSS BLOCK (I+j)</u>	<u>24000</u>		23000	-1000
<u>III.LAND</u>				
<u>j. Plant &amp; Machinery</u>	<u>3000</u>	No change	3000	0
<u>K. LESS DEPRECN.</u>	<u>21000</u>	Sale of 1000	20000	-1000
<u>L. NET BLOCK (J-K)</u>	<u>10000</u>	Depreciation of 9500	9500	-500
<u>M. CURRENT ASSETS</u>	<u>11000</u>		10500	-500
<u>(N+O)</u>	<u>14500</u>		16000	+1500
<u>N. INVENTORIES</u>				
<u>I.CASH.</u>	<u>10500</u>	Increase by 2000	12500	+2000
<u>Less:</u>	<u>4000</u>	Maintain CB of 3500	3500	-500
<u>P. CURRENT LIAILITIES.</u>				
<u>Q. Provisions</u>	<u>5000</u>	Decrease by 1000	4000	-1000
<u>R. Net current assets</u>				
<u>(M-P-Q)</u>	<u>2000</u>		<u>2000</u>	0
<u>o.Total assets (L+R)</u>	<u>7500</u>		<u>10000</u>	+2500
<u>p.Additional funds</u>				
<u>required.</u>	<u>18500</u>		<u>20500</u>	+2000

# **Other Proforma statements**

- Cash Budget
- Operating Budget
- Sales Budget
- Production Budget
- Sales and Distribution expenses budget
- Administrative overheads budget.

# Sales forecasting

- Long duration sales forecasts- for Investment planning
- Sales forecast for one year-for preparation of pro forma statements
- Sales forecasts for shorter durations (1 to 6 months) – for cash budgeting and working capital planning.



# **Techniques of sales forecasting**

## **1. Subjective Methods:**

- Jury of Executive opinion
- Sales Force estimates

## **2. Objective methods:**

- Trend Analysis by Extrapolation (Long term trend, Cyclical variations, Seasonal variations, and erratic movement)
- Regression Analysis (Relationship between dependent variable Sales, and independent variables like Income, etc).

# **Growth and External Financing Requirement**

- When ratios remain constant, it is assumed that the increased growth will require an equal increase in assets.
- Such increase in assets will be funded by external financing

**External funding Requirement (EFR) is calculated as follows:**

$$\text{EFR} = \text{A/S} (\Delta\text{S}) - \text{L/S} (\Delta\text{S}) - m \text{SI} (1-d)$$

**Where, EFR= external funds requirement**

**A/S = Current Assets and Fixed Assets as proportion of Sales**

**L/S= CL and Provisions (spontaneous liabilities) as a proportion of Sales.**

**$\Delta\text{S}$ = Expected increase in sales.**

**M = Net profit Margin**

**SI = Projected sales for next year**

**d = dividend payout ratio**



**THANK YOU**