International Journal of Management and International Business Studies.
ISSN 2277-3177 Volume 4, Number 3 (2014), pp. 371-374

http://www.ripublication.com

Financial Forecasting

C. Vijendra

Research Scholar, Kakatiya University, Warangal.

1. Need for Forecasting

Financial forecasting is a planning process by which the company's management positions its firm's future activities related to the expected economic, technical, competitive and social environment. Business plans always have strategies and actions for achieving desired short-term, intermediate, and long –term results. These are qualified in financial terms, in the form of projected Financial Statements (pro forma statements) and a variety of operational budgets.

Basically there are three main techniques if financial projections. They are Pro forma financial statements, cash budgets and operating budgets. Pro forma statements are projected financial statements embodying asset of assumptions about a company's future performance and funding requirements. Cash budgets are detailed projections of the specific incidence of cash moving in and out of the business. Operating budgets are detailed projections of departmental revenue and/or expense patterns, and they are subsidiary to both pro forma statements and cash flow statements.

By developing pro forma statements, a comprehensive look at the likely future financial performance of a company can be obtained. These statements comprising of P&L statement and a balance sheet are extended into the future. The pro forma operating statement (P&L) represents an "Operational Plan" for the business as a whole, while the pro forma balance sheet reflects the anticipated cumulative impact of assumed future decisions on the financial condition of the business at a selected point of time. Both statements are prepared by taking the most readily available estimates of future activity and projecting, account by account, the assumed results and conditions .A third statement, a pro forma funds flow statement, adds further insight by displaying the various funds movements expected during the forecast period.

2. Performa Financial Statement

The preparation of pro forma statements is explained with an illustration of an hypothetical manufacturing company called Wilsh Corporation. The company sells two kinds of winter care products. These have a seasonal pattern with a low point of sale during May. The most recent results are available for the first quarter of the year 1. These statements give the initial set of data to project the future statements. the pro forma projection is to be made for the second quarter of the year 1, and the objective is to determine both the level of profit and the amount of additional funds required at the end of the second quarter.

3. Pro Forma Income Statement

The operating system is usually prepared first because the amount of after-tax profit must be reflected in the balance sheet as a change in retained earnings. The starting point in the preparation of pro forma operating statement ,as shown on the first line of the table 1 is a projection of the unit and rupee volume of sales .These can be estimated in a variety of ways like trend-line projection to detailed departmental sales forecasts by Individual Products.

In table 1, the actual operating statement for the first quarter ended March 31, is shown as base for the analysis. Company statistics from past years shown that during the second quarter a decrease of 29 to 31 percent from first quarter is normal. By taking the mid- point of 30 percent as mid-point the sales figure is obtained by decreasing the first quarter unit sales by 30 percent. After calculating a 30 percent decrease in unit volume further assumption is that both prices and product mix will remain unchanged. The assumption can be relaxed to have more insights or to test the impact of "What if so and so is changed by some percentage "type of questions.

Next is the estimation of cost of goods sold. For this, Percent of sales method is used .An assumption is made that the future relationship is between various elements of costs to sales will be similar to their historical relationship. The actual first-quarter operating statement provides details on the main components (labor, materials, overheads and distribution) in cost of goods sold. As the second quarter is the company's seasonal low point, it is assumed that some inefficiencies are likely to raise the overall cost of goods sold as operations slowdown. Cost of goods sold and gross margin can be calculated directly without the detailed cost breakdown. Selling expense is shown as Rs.8, 250. Given that the second quarter has lower sales activity, a small decrease of Rs.750 can be assumed. A reduction fully proportional to the 20 percent drop in volume would not be possible as some of the expenses are fixed in nature. Similar is the case with the general and administrative expenses .This method of estimating the value of various items on the basis of expected developments in the future is called the budgeted expense method.

As a result of the assumptions, the second quarter operating profit falls by over 5,000 and the profit after-tax drops to less than one by five times is former level. This is Mostly due to the 30 percent drop in sales volume and the associated profit contribution loss. Interest is charged according to the provisions of the outstanding debt, and this information can be obtained from the company's annual reports. The operating statement will be completed after we calculate the tax rates(assumed here at the rate of 30%). It can be observed that there is a signified decrease in the amount of net profit because of the slowdown in operations. One more assumption needs to be made about the dividends to arrive at the retained earnings for the per the period, to be reflected in the pro forma balance sheet. In Wilsh Corp's case it is assumed that no dividends will be declared because of low earnings.

	Actual quarter ended March 31,Year 1	**Pro forma Quarter ended June 30,year 1**	**Assumptions**
Units sold	15,000	10,500	Second quarter has seasonally low sales, past data show 30% decline from first quarter.
Net sales	1,40,000 100.0%	98,000 100.0%	No change in Product mix and price.
Cost of goods sold labor	25,960	16,366	20% of cost of goods sold as before.
Materials Distribution Over head	25,256 4,592 61,992	18,002.6 3,273.2 44,188.2	22%of cost of goods sold as before. 4%of cost of goods sold as before. 54% of cost of goods sold as before.
Total Gross profit Gross Profit Margin Expenses: Selling expenses Gen &Admn Total. Operating Profit Interest Depreciation PBT Tax@30% Net income Dividends Retained Earnings Cash Flow after dividends	1,14,800 25,200 18.0% 8,250 4,450 12,700 12,500 2,500 2,000 7,000 2,100 4,900 900 4,000 6,000	81,830 16,170 16.5% 7,500 3,600 11,100 5,070 2,000 2,000 1,070 321 749 -0- 749 2,749	
			Increase by 1.5 percentage point simulates operating inefficiencies.

			Assuming a drop of Rs.750 due to lower activity Assuming a drop of Rs.850 Based on outstanding dept No Payment of Dividends Carried to balance sheet Retained earnings +Depreciation

Note: The above figures are assumed figures.

4. Cash Budget

Cash budgets are very specific planning tools that are prepared every month or even every week. The financial manger who uses the cash budget after observing the changing levels of cash flows, decides the minimum amount of cash that should be kept to allow timely payments of obligation.

5. Operational Budget

The proforma statement and cash budget provide an overall view of the company's future performance. In big organizations normally specific operating budgets are prepared for different divisions (sales, production, etc) in the organization hierarchy.

6. Sales Budget

Sales forecast provides the basis around which the firms planning process is centered. Important area of decision making such as production and inventory scheduling, investment in machinery and other fixed assets, manpower the sale forecast. A sales forecast for the coming year would reflect:

1. Any past trend in sales that is expected to be continued in the coming year.
2. The influence of any events which might naturally effect that trend.

7. Conclusion

Financial planning plays a very important role in any business. The owner/management need to have the financial planning. By doing financial planning regularly say for every 3 months helps the management to know where the company is going. It helps the management to plan standards and actual in order to asses adverse and favorable conditions. Therefore, a sound financial planning is the need of the hour for any business to prosper.

References

[1] The ICFAI University, April 2005, Financial Accounting, ICFAI Publication, Hyderabad.

[2] S.P. Jain & K.L. Narang, 1994, Advance Accountancy, Kalyani Publication, New Delhi