

Week 7 discussion 1

Analyze the process of forecasting financial statements and make at least one recommendation for improving the accuracy of forecasts. Provide specific examples to support your response.

Forecasting financial statements is a process that involves multiple steps to arrive at forecasted balance sheets, income statements, expense and budget statements used by management and department heads for decision making. One-year forecasts are likely to be more accurate than five-year forecasts because more actual information is likely to be known by each department. However, having long-term financial forecast assists upper management in planning future building, equipment and personnel needs. Long-term forecasts are subject to revisions when actual information becomes known. Individual line items are forecast and then totals are brought together.

Source: Financial Statement Forecasting Process | eHow.com http://www.ehow.com/how-does_5008574_financial-statement-forecasting-process.html#ixzz1duS710iN

The purpose of forecasting financial statements is twofold. Firstly, the forecasted financial statements & analysis assist the business in determining whether or not a proposed venture or planned expansion is feasible. Secondly, the forecasted financial statements assist potential investors in determining whether or not they should invest into the business.

Generally speaking, investors (banks, government organizations, individuals, etc) request the business to develop three years of forecasted financial statements & analysis including a forecasted cash flow statement, a forecasted income statement, a forecasted balance sheet, a forecasted break-even analysis, a forecasted sensitivity analysis, and forecasted ratios for years 1, 2, and 3 into the future.

Source: <http://businessplanhut.com/forecasting-financial-statements-and-examples>

The forecast accuracy is limited by the validity of the assumptions used in creating them. Often a series of statements is developed by making different assumptions about sales and about the relationship between sales and the balance sheet accounts. This is called a sensitivity analysis. The resulting set of statements suggests the most likely outcomes for the firm and a range of financing needs. After building a proforma balance sheet based on expected sales, a manager can then use sensitivity analyses to answer questions such as how the company's financial needs will change if sales are 10 percent below their expected level, etc.

Source: Roger Clarke and Grant McQueen (2001) FORECASTING FINANCIAL STATEMENTS: PROFORMA ANALYSIS