Financial Forecasting

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WHAT'S COVERED

In this lesson, you will learn about the facets of strategic planning. Specifically, this lesson will cover:

1. Financial Forecasts

One of the most important actions a company takes is the development of its strategic plan. It defines the direction it will take and generates decisions that have to be made about available resources. All of the available alternatives need to be evaluated.

The biggest part of this is the **financial forecast**. This is done using accounting and sales data and evaluating what the externalities and the market might be. The financial forecast should be the best estimate of what will happen to the company financially over the next year.

STEP BY STEP

1. Sales Forecast
2. Modeling
3. Estimating AFN

Every financial forecast starts with the most difficult aspect, which is predicting revenue and coming up with a sales forecast. After this, future costs can be estimated, starting by using earlier accounting data.

Once the sales forecast is determined, the next step is **financial modeling**. The modeling consists of building a representation of what the impact of financial decisions will be. It is a mathematical model that represents a very simple version of the performance of a business, portfolio, or project. It uses information from accounting and financial systems.

DID YOU KNOW

In small and medium-sized businesses, spreadsheet software can be used.

The main goal of building this financial forecast is to project the additional funds needed (AFN). Since the strategy of most companies is focused on growth in sales, a business needs to figure out how much in additional resources will be required to support that new sales level, and how it will finance the acquisition of those resources.

AFN is a way of calculating just how much new funding will be needed. A firm can then realistically look at whether or not they are going to be able to generate the additional funding required to reach the new goals. Figuring out the amount of external funding needed is a key part of calculating AFN and involve some detailed mathematical formulas. However, the AFN simplified formula can be expressed in the following way:

FORMULA TO KNOW

Additional Funds Needed

$$AFN = \text{increase in assets} - \text{spontaneous increase in liabilities} - \text{any change in}$$

AFN equals the projected increase in assets minus the spontaneous increase in the liabilities that occur, minus any increase in retained earnings that does not pay back the shareholders.

TERMS TO KNOW

Financial Forecast

Best estimate of what the financial performance of a company will be over the next year using the firm's historic financial and accounting data.

Financial Modeling

The task of building an abstract representation (a model) of a financial decision-making situation.

2. Capacity Planning

The second important concept that a business must address is the issue of **capacity**. Capacity is the maximum level of output that can be produced by a firm. Capacity planning ensures that a firm will keep from growing too fast in sales and makes sure it is using financial resources in the most efficient way possible.

Capacity is central to planning, and it is the process of determining the production capacity level needed by an organization to meet its new sales forecast. In finance and economics, you often hear the term capacity utilization. This refers to the extent to which a business actually uses its installed productive capacity and it talks about the relationship between the actual output that gets produced with the equipment fixed resources and any potential output that could be produced.

A problem that is frequently seen in large corporations is that companies suffer from chronic excess capacity. Business production is not often as efficient as it should be.

TERM TO KNOW

Capacity

Maximum level of output that can be produced by the firm.

SUMMARY

In this lesson, we learned that by using historical internal accounting data and a sales forecast, while also looking at external market in economic indicators, a **financial forecast** is the best estimate of what will happen to a company in financial terms over the next period. Financial forecasting is held by financial modeling which can be as simple as using spreadsheet software. Assumptions can play a key role in the financial forecast. One necessary result of financial forecasting is the calculation of the AFN, or additional funds needed. This helps a firm realistically examine what additional funding will be needed to generate the assets to support the projected sales level.

A second issue that must be examined is **capacity planning**. This is the process of determining the production capacity needed by the firm to meet its new sales goals. Capacity utilization is the extent to which a company is using its capacity to create production efficiency.

Best of luck in your learning!

TERMS TO KNOW

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FORMULAS TO KNOW

Additional Funds Needed
$\text{AFN} = \text{increase in assets} - \text{spontaneous increase in liabilities} - \text{any change in } \textit{retained earnings}$

