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Financial Forecasting

1. Definition of Financial Forecasting:

Financial forecasting is estimating a company's future financial position after examining its historical performance and evaluating the potential impact of current and evolving macroeconomic trends on the company's operations.

It involves an analysis of the company's past performances, such as sales, expenses, cash flows, and more, to deduce any possible trends and patterns. Financial forecasting also entails the consideration of any contingent events that may have a significant impact on the company's finances.

While it is impossible for firms to predict the future, financial forecasting in financial management helps them hedge against worst-case scenarios by providing predictions for such uncertain events.

2. Types of Forecasting:

While a business can undertake several types of forecasting, including sales, income, and cash flows, the three main types of forecasting are as follows:

a. **Sales Forecasting:** sales hold the key to a business's future and form the basis for internal planning, particularly expense management, production cyrcle, and capital expenditure plans. It is expected revenue from sales that requires maximization, making sales forecasting a crucial exercise.
In sales forecasting, companies predict the number of products or services and the price points they expect to sell within a specified period. Enterprises rely on time series analysis to forecast sales for an existing product but may opt for qualitative techniques when estimating revenues from a new product launch.

b. **Cash flow Forecasting:** it involves an estimation of cash inflows and cash outflows of a company and its net balance over a projected period on a weekly, monthly, or yearly basis. It factors in sales revenue and major expenses.

c. **Budget Forecasting:** a general budget provides an overall view of the business's dynamics and financial performance. It does not involve dealing with business specifics but instead is n overall estimation of certain critical financial metrics.
Budget forecasting aids companies in formulating their business strategies. It is usually informed by historical data trends, but technological advances such as big data and machine learning have transformed the way forecasting is done.

3. The Basic Methods of Financial Forecasting:

Primarily, there are two broad categories of financial forecasting methods.

a. **Qualitative Methods:** qualitative forecasting uses expert judgment and subjective opinions to predict financial performance. It is useful when numerical data is limited or unreliable and when forecasting involves unprecedented situations.

b. **Quantitative Methods:** qualitative forecasting makes use of historical numerical data and mathematical models to predict future outcomes.

4. The Techniques of Financial Forecasting:

The top financial forecasting models are:

a. **Bottom-up Financial Forecasting:** this model reviews historical company information, such as sales data, and uses it to make projections.

b. **Top-down Financial Forecasting:** this model starts with market assessment and then moves down to forecasting specific metrics for the company. It is useful for those looking at new product launches and market reach expansion.

c. **Statistical Forecasting:** it uses statistical findings to help a business benchmark its operational performance against its peers.

5. The Process of Financial Forecasting:

Financial forecasting is an iterative process requiring regular evaluation and adjustment that guides businesses in undertaking effective financial planning. It involves the following steps:

a. **Data collection:** the first step is to gather and analyze historical financial data, market trends, and other information relevant to your forecast needs to truly understand the key drivers of your business.

b. **Make assumptions:** follow up on data gathering by formulating assumptions over a specific time frame and choosing a forecasting model most suitable to your projection goals.

c. **Project Financial Metrics:** key in the assumptions made into your chosen financial model to reflect the major relationships between critical financial dependent variables, including sales growth, expenses, and cash flows. You can also undertake a scenario analysis at this stage.

d. **Monitor Performance:** compare the financial forecast to the actual financial performance on an ongoing basis to identify variances and the reasons behind these differences, and use this information to improve future forecasting accuracy.

6. Importance of Financial Forecasting:

Financial forecasting holds significance as it enables businesses to make decisions about budgeting, hiring, financing, and overall strategic planning. Indeed, financial forecasting and planning go hand-in-hand, as financial forecasts form an integral part of the budget creation process.

Financial forecasting informs internal decisions, empowering teams to set realistic performance goals. It also highlights any financing requirements, such as seeking loans for a capital project, and is relied on by banks while making lending decisions.