Exploratory Note 9
Pro Forma Development

INTRODUCTION

For many entrepreneurs, the development of pro forma financial statements is an absolute must—especially when external capital is required. This final exploratory note of the evening is designed to flesh out some of the nuances of pro forma development while also introducing the importance of both scenario and sensitivity analysis.

PRO FORMA FINANCIAL STATEMENTS – SUBJECTIVITY

Oftentimes, financial statements are backwards-looking. An income statement, for instance, tells us how a firm did over a period of time in the past (perhaps over the course of a day, week, month, quarter, or year) while a balance sheet identifies a firm's assets and liabilities at a particular point in time (perhaps as of the last day of the week, month, quarter, or year). Pro formas are quite a bit different. Who can tell us about them?

Are pro forma financial statements always objective? If not, how can biases affect the numbers? Should they always be strictly objective?

In an entrepreneurial setting, why might pro formas differ across circumstances? Consider, for instance, pro formas developed for a bank, for a prospective shareholder, or for internal purposes.

PRO FORMA FINANCIAL STATEMENTS – THE INCOME STATEMENT

Starting with the income statement, how does an entrepreneur make future projections? The top line, revenue, is often an appropriate place to start. How to project revenues into the future?

Are revenues less important for some firms than others? Why?

Do entrepreneurs have a tendency to overestimate revenues? Why is this a problem?

As is the case with seemingly everyone, entrepreneurs have trouble accurately projecting costs. What are different costs which may arise in entrepreneurial settings that need to be taken into consideration?

PRO FORMA FINANCIAL STATEMENTS – BALANCE SHEET AND STATEMENT OF CASH FLOW

Moving on to the balance sheet and statement of cash flows, pass-through projections from the pro forma income statements will be helpful for development, but accuracy will depend on reasonable projections when it comes to the non-income statement entries.

Why is accounts receivable particularly important? Consider timing.

Why is accounts payable particularly important? Again, consider timing.

Why is the cash provided by (or used by) financing activities so important?

SCENARIO AND SENSITIVITY ANALYSIS

Oftentimes, practitioners use scenario analysis—perhaps, considering worst, base, and best cases—to assist in building adequate pro forma financial statements. Consider below:

	BASE	WORST	BEST
Units	6,000	5,500	6,500
Price/unit	$ 80.00	$ 75.00	$ 85.00
Variable cost/unit	$ 60.00	$ 62.00	$ 58.00
Fixed Cost	$ 50,000	$ 55,000	$ 45,000
Sales	$ 480,000	$ 412,500	$ 552,500
Variable Cost	360,000	341,000	377,000
Fixed Cost	50,000	55,000	45,000
Depreciation	40,000	40,000	40,000
EBIT	30,000	(23,500)	90,500
Taxes	10,200	(7,990)	30,770
Net Income	19,800	(15,510)	59,730
+ Deprec	40,000	40,000	40,000
TOTAL CF	59,800	24,490	99,730
NPV	15,566	(111,719)	159,504
IRR	15.1%	-14.4%	40.9%

Of course, scenario analysis is less than perfect. Can we, for instance, really gauge probabilities when it comes to the likelihood if a scenario occurring? Are inputs always so perfectly correlated (all bad inputs occurring at once, all good inputs occurring at once, etc.)?

This leads us to sensitivity analysis which holds everything constant except one variable—thereby helping to determine which variables are particularly critical.

CONCLUSIONS

Pro forma financial statements are rarely going to be accurate since they deal with future states. That said, thoughtful preparation can make a big difference for would be entrepreneurs as it can highlight potential issues well in advance—permitting more time to flesh out new business, to attract more outside capital, or to be creative.