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Forecasts and Projections: Understanding the Differences

Too often, accounting and business literature treats forecasts and projections as interchangeable terms, as different names for the same activities. Yet forecasts and projections differ both in scope and in the circumstances in which each is appropriate.

Since forecasts and projections are common in valuations, understanding those differences is important. One other note on differences. Forecasts and projections used in litigation do not necessarily comply with the rules governing their use in financial statements.

What's Appropriate?

In general, a forecast is more detailed and more objective than a projection. Forecasts generally also require more effort and expense to prepare. While projections may be used internally and, in limited cases, with outside third parties, only a forecast is appropriate for general use outside the entity preparing it.

If the outside third party that will rely on the prospective financial information being prepared negotiates directly with the company regarding the nature and scope of that information, then a projection may be appropriate.

For instance, a lender can require certain steps be performed in compiling a projection. Since the lender is negotiating directly with the entity responsible for the prospective information, a projection is appropriate.

Potential investors reading a prospectus prepared by the company, on the other hand, have no say in the effort expended or the assumptions made in developing the prospective information the prospectus contains. A forecast, therefore, should be performed in that case.

Questions and Answers

In deciding whether a projection or forecast is appropriate, three issues must be examined. First, how will the prospective information be used? Second, why is the entity preparing the prospective information? Finally, how certain is the entity of any assertions it makes in this information?

Answering the first question generally determines not just how the information will be used, but also who will use it.

If a company is compiling prospective information for internal planning purposes or to borrow money, it will either use the information internally, or negotiate with the parties that will use it. Therefore, a projection is appropriate, although a forecast is still a viable option.

If, on the other hand, the company is preparing a prospectus or other materials for general use outside the company, only a forecast is appropriate.

Second, an entity should examine why it is developing prospective information. For example, is the company planning to develop information that will illustrate what it expects to happen, or information that shows what it would like to happen?

Consider budgets and sales goals. A budget, at least one used for planning purposes, seeks to extrapolate results as accurately as possible. Such a budget would be a forecast. Sales goals, on the other hand, are often designed to motivate personnel to reach goals that the company recognizes as optimistic. This information must be considered a projection.

Third, what assertions does the company make in its prospective information, and how willing is it to stand behind them? This is often the most difficult question to answer when separating projections from forecasts.

For prospective information to qualify as a forecast, the company must be willing to state that the information represents the expected results of its future operations to the best of the company's knowledge and belief.

For example, in a projection, every hypothetical assumption need not rest on a reasonably objective basis. These assumptions need only be consistent with the purpose of the projection.

A company can, therefore, assume an increase in market penetration from 10 percent to 15 percent in its internal sales projection since the purpose of that projection is to motivate its personnel to reach that goal.

In a forecast, however, there must be a reasonably objective basis for each material assumption. Using the above example, if the company had recently acquired a rival with significant sales in the same market, then assuming an increase could be reasonable, provided other available information does not argue against that result.

All assumptions a company uses in making a forecast or projection must be clearly identified and spelled out in the statement of assumptions. Users of these statements, therefore, should closely review the statement of assumptions when deciding how much faith to place in a forecast or projection.

Consistency Required

Not only must each assumption in a forecast be reasonable on its own, it also should be consistent with the entity's plans and expectations, and consistent with other assumptions within the forecast.

For example, if the company projects a 50 percent increase in sales, but also projects cost savings by closing a plant that would be necessary to produce the

volume of goods necessary to support the sales increase, one could question whether those assumptions are consistent.

Forecasts and projections are different. They meet different needs, are appropriate in different circumstances and are meant for different users. Valuation professionals need to understand when each is appropriate.



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