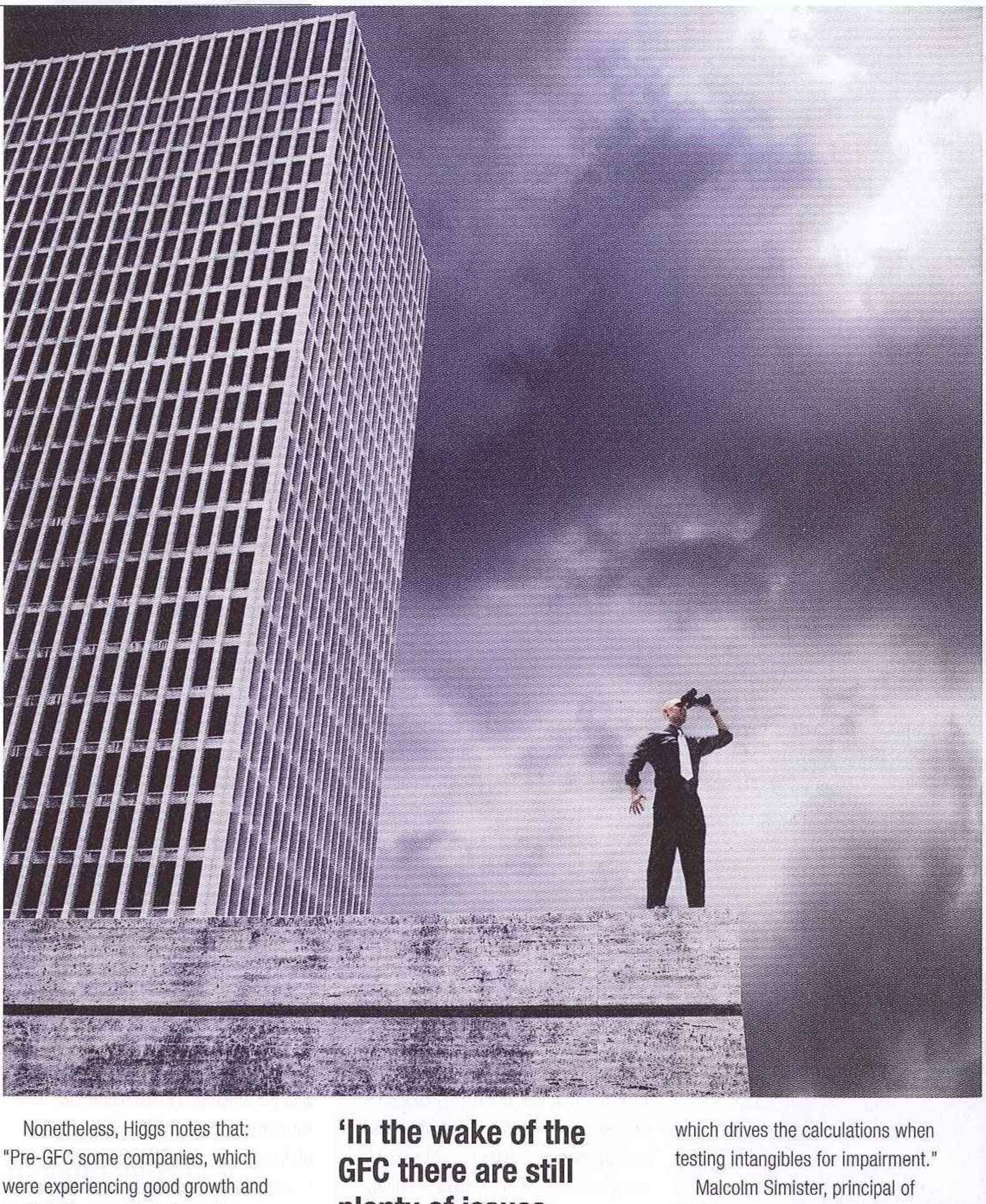
Dossier

Focus on forecasting: AFTER THE GFC, FINANCIAL FORECASTS ARE BEING SCRUTINISED LIKE NEVER BEFORE, AND IT'S IMPORTANT TO STRIKE THE RIGHT BALANCE, NICOLA FIELD REVEALS.

The tomorrow people



IN THE IMMEDIATE AFTERMATH OF the global financial crisis (GFC), many stakeholders were left reeling. Questions were asked – and still are, about the validity of forecasts that showed a disconnect with reality. It's put a fresh focus on the quality of forecasting.

Forecasting goes beyond a basic accounting exercise of rolling forward profits. Since 1 January 2005, all Australian reporting entities have been required to prepare their financial reports in accordance with International Financial Reporting Standards (IFRS), and it's the IFRS requirements regarding asset impairment that have prompted fresh scrutiny of forecasts.

Brad Higgs, head of WHK Horwath's Corporate Finance practice in Sydney, says: "Prior to the global financial crisis a lot of businesses didn't focus on impairment testing. But with the arrival of the GFC, some businesses began projecting negative growth, and in an environment of increased risk, the whole issue of impairment testing became a focus for auditors, banks and other investors."

Intense scrutiny post-GFC

Anecdotally, Australia has a reputation for producing high-quality forecasts – the result of accounting and auditing standards backed by the watchful eye of regulators such as ASIC.

Nonetheless, Higgs notes that: "Pre-GFC some companies, which were experiencing good growth and profitability, would get through an impairment review with little analysis, adopting a tick-a-box approach. These days auditors want a clear picture of the future performance of the business in light of the value of their intangibles. This puts an onus on directors and the board to participate in quality forecasting

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which drives the calculations when testing intangibles for impairment."

Malcolm Simister, principal of Melbourne-based consulting firm Finacc Solutions, goes further. "There is likely to be more scrutiny of forecasts post-GFC. Directors have a responsibility to ensure the market is properly informed and as forecasts assist in this duty, it is important that forecasts are reasonably reliable," he says.

Irrespective of external requirements, forecasting plays an integral role within organisations. "Internally, forecasts are a valuable management tool, showing where action needs to be taken to fix problems or to profit from certain circumstances," Simister explains.

Get to know the business

Producing quality forecasts can be an extensive undertaking. Both Higgs and Simister say that an important first step is investing time getting to know a business – finding out what drives it and what its variables are, before work can begin on projecting numbers.

According to Higgs, WHK Horwath adopts a 'ground up' approach. "We work our way up from the organisation's business and strategic plan to gain a thorough understanding of the entity, rather than just rolling last year's profit numbers forward and applying some high-level growth rate," he says.

"We also look at key drivers over past years to form a view or recognise a potential trend. External research may be necessary, including benchmarking, competitor analysis and industry sector reports."

Malcolm Simister also recommends a 'big picture' approach, cautioning against the trap of focusing on "the minutiae". He recommends gaining an understanding of an organisation's customers and what drives them, as well as considering issues beyond the business itself, including government legislation, the activities of competitors and even technological change.

Indeed a wide range of external factors can be critical to the quality of forecasting information.

"We generate sensitivity analysis models to demonstrate how external variables can change over time and how this will affect the business, its profits, cash flow and balance sheet," Higgs explains. "This allows stakeholders to understand the health of a business and its ability to meet debt and equity requirements if there are changes to certain variables. Naturally it's critical in determining if intangible assets need to be impaired."

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Prepare for curve balls

The process of gathering all the necessary information may not always be straightforward.

"Certain staff within an organisation may be familiar with a wide range of areas that need to be incorporated in a forecast, but these may not be the same people that are preparing the forecasts," Simister points out.

"It's critical to be in touch with those people who know the business, its market and industry segment well enough to come up with numbers that make sense."

In the post-GFC world, it's almost certain that forecasts will increasingly come under the spotlight, yet ironically this additional scrutiny comes at a time of greater uncertainty.

"In the wake of the GFC there are still plenty of issues that can appear from left field," Simister notes.

The prospect of curve balls makes it wise to assume every figure will be questioned. "It's good practice to prepare every forecast as though it's to be subject to an audit," Higgs suggests. "Every assumption must be backed up – even if it's by a management assertion. Aim for forecasts that would stand up to the same level of scrutiny as a prospectus."

A new conservatism

One of the lingering legacies of the economic crisis is likely to be a more conservative approach in forecasting. Finding the right balance is a must.

"An overly pessimistic approach can have adverse consequences as banks and shareholders abandon the business. Equally, overly optimistic forecasts can result in a loss of credibility if a business misses its targets. The key is to prepare realistic forecasts that are based on meaningful information and data, and which have a good probability of being achieved."

The investment of time and resources it can take to deliver quality forecasting information is worth the pay-off. Quality forecasts may improve the way businesses can take advantage of opportunities, as well as allow better decision-making by debt and equity stakeholders. And, ultimately, that paves the way for improved partnerships. ■

MORE ON THE WEB

Malcolm Simister, a former CFO with more than 30 years' experience, is principal of Finacc Solutions, a consultancy specialising in business performance management and process re-engineering. He will be presenting practical workshops on "Preparing accurate rolling forecasts" and "Setting sophisticated targets without budgets" for CPA Australia in VIC on 14 April, QLD on 20 April and NSW on 11 May. Find out more at **www.cpaaustralia.com.au/intouch**. He can also be viewed at **www.youtube.com/CPAaustralia**

Professional conduct

The latest outcomes from CPA Australia's disciplinary tribunals.

New South Wales

● On 15 December 2009 a Disciplinary Committee found Stuart Ariff guilty of breaches of Clause 27(1)(g) of the Constitution in respect of a decision of the Professional Conduct Tribunal of the Institute of Chartered Accountants in Australia of 12 February 2008, which found Ariff breached its By-Laws 40(e) and 40(j) when, in Wambo Coal Pty Ltd v Ariff & 1 Or, the NSW District Court made adverse findings against Ariff and criticised his conduct as a liquidator. The Committee also found he had breached Article 39(a)(ii)F of the Constitution in respect of orders made in the NSW Supreme Court on 18 August 2009 in proceedings brought by ASIC, in which Ariff conceded 83 counts of misconduct, was banned for life as a registered liquidator and ordered to pay compensation approximating A$4.9 million.

In relation to the first breach, the Disciplinary Committee handed down a penalty of a severe reprimand and a fine of A$20,000; for the second breach, the penalty was forfeiture of membership, that Ariff may not re-apply for membership for 20 years, a fine of A$50,000 and costs of A$1153.

● On 3 March 2010 the One Person Tribunal found Sergio Laureti had breached Clause 27(1)(a) of the (former) Constitution and Section 290 of the Code of Ethics for Professional Accountants in that for the financial year ended 30 June 2007, he audited his own self-managed superannuation fund. The Tribunal imposed a severe reprimand and costs of A$625. ■