Making a pro forma income statement

It would be nice if companies could borrow a page from the hit superhero movie and travel to alternative dimensions. You know, you might see what would happen if they merged with fast-growing R' Us Widgets or were acquired by Global Conglomerate, Inc. But, unfortunately, even Embark can't provide this type of insight. However, we can give you the next best thing – a detailed explanation of pro forma statements and how to create them. Granted, pro formas are not quite up to the Sorcerer's Highest Levels of Omnipotence, but they certainly come in handy when it's time to look at what if you have a scenario or two. Want to know what the financial results from a potential business combination for the year might look like? But it's pro forma. Or maybe you want to look back and see where you can be today if this combination took place last year. That's what makes pro formas so powerful and up to that point why we're going to spend the next few minutes discussing their apps and how to create them. What is Pro Forma financial statements? As we have already said, the pro forma statement is a look at the scenario what if. It is a tool that business owners, policymakers, stakeholders, investors, creditors and others use to study hypothetical conditions. They can look to the future or backwards by disclosing financial information that standard financial statements simply cannot provide. Also, while there is certainly the right and wrong way to format a pro forma, just ask AICPA, FASB and SEC the term pro forma can mean a profit and loss account, cash flow statement or balance sheet. In other words, these are basically the same finances you're already used to, just using hypothetical data. Just as you'll see when we discuss how to create a pro formas in just a little bit, they don't require you to recreate the financial reporting wheel, at least in terms of format. One caveat that we have to make before we go any further, however, stems from the word we have already used – hypothetical. Yes, pro formas are extremely helpful in looking at different iterations of events based on different assumptions. They really are second to none in this particular department. But according to the good people at Merriam-Webster, hypothetical means commitment or is based on a suggested idea or theory. Otherwise, pro formas use information that may differ significantly from actual data. So, while they are very helpful in looking at events from different sides, never take them as gospel, just well-informed guesses. When you use Pro Forma financial statements Now that we understand what pro forma is and why they are so extremely insightful, let's bring you closer to the different ways companies use them. Business Planning & Financial Modeling It's worth it for business leaders to look at side-by-side comparisons different assumptions in order to guide their strategies. For example, if management tries to decide between two separate proposals or business, business plans, Use the pro forma instructions for each scenario to see which ones can best serve their goals and visions. In fact, creating pro forma statements for each of these scenarios is a useful exercise in itself, enabling policymakers: Defining different assumptions that drive each scenario create sales forecasts and budgets for each Gather Results in P&A forecasts; L Use data to generate cash flow forecasts Compare resulting pro forma balance sheets Compare resulting pro forma balance sheets Compare the performance of each scenario against industry indicators using financial indicator analysis In a sense, pro forma financial statements allow management to test a/b different strategies without affecting the real world. Gauge the Impact of Financial Decisions Yes that the subheading is a sip, but there's a reason for that - it covers an awful lot. One of the most common uses of pro forma claims is to predict the impact of a material event, perhaps a business combination or debt refinancing. As in the previous section, a company can use a pro forma profit and loss account, balance sheet, and cash flow statement to forecast how a significant event might affect its financial position. In this case, think of pro forma statements, such as dipping your finger into the water before diving into the pool. If the water is too cold – that is, pro forma projections are not beneficial – it's probably not a great idea to dip in. But if the water is to your liking, then you can take advantage of a nice bath. Financial reporting Naturally, pro formas are not only useful for internal purposes. Companies use them in external reports to shareholders, creditors and potential investors. Listed companies must include pro forma statements with any SEC filings, registration statements, or proxy statements. This only makes sense because shareholders need to know the impact of material changes – in relation to the company's financial statements – that have either already taken place or are to take place. Some of these changes may include: Impact of changes to newly adopted accounting standards Updated estimate of economic life and net residual value of an asset Combining business units with acquisitions, disposition, investments or combined interests of two or more existing business lines Correcting errors made in previously filed reports It is important to note that the Securities and Exchange Commission, AICPA and FASB have detailed guidance on the form, content and necessity of pro forma financing in special circumstances. Therefore, regardless of what causes the need for pro forma statements, you need to be sure to follow any mandatory guidelines. For example, SOX regulations state that a company must a set of generally accepted accounting statements (GAAP) combined with any pro formas to avoid giving the public a false impression of the company's actual financial status. Creating Your Pro Forma Statements We Will the steps necessary to create a basic pro forma projection using the profit and loss account, cash flow statement and balance sheet. However, context is everything when using pro formas. Of course, the formatting is not as strict and especially for internal purposes as it would be for the SEC filing. So what exactly are we trying to say, you ask? Take the following walks with a grain of salt as you provide them as a look at the process. If you are trying to attract investment capital or a buyer for your business, you will want to use something more detailed and tailored for this purpose. Fortunately, you already get to know a team of experts that can only do for you. Blink, blink. Pro Forma Profit and Loss Account Let's start with profit and loss account. We'll use the sales forecast percentage to make things simple. Start with the profit and loss account for the last fiscal year and determine which items will be adjusted for the projection. As a side note, for more detailed information on pro forma adjustments, as well as some useful best practices and examples, we encourage you to read our Ultimate Guide to Pro Forma Statements. For these transitions, however, we assume that you have already looked at various events and scenarios that may prompt for pro forma adjustments. Anyhoo, back to our regular programming. Now that you have a profit and loss account in hand and adjustments ready to roll, it's time to start calculating the pro forma. They should look extremely familiar because it's the same process you use when creating common income statements. In fact, the same applies to the cash flow statement and balance sheet as well. Gross profit: Take all expected revenue adjustments – i.e. price changes, new product lines & customers, promotional offers – and inflate them by the expected amount. Do the same with the cost of goods sold (COGS) to achieve a pro forma gross profit. Total operating costs: Review each line item and determine what costs you'll reduce in the next year. Make these cuts and then inflate your expenses by the projected rate for total pro forma operating costs. Net income before tax: Net gross profit and total operating expenses Taxes: Multiplie the estimated tax rate by net income Net income after tax: Deduct the tax bill from net income before tax to achieve pro forma profit after tax. Please note that because we used a sales-based forecast, other variables, such as operating costs, depreciation and interest costs, were not affected by our pro forma adjustments. This doesn't have to happen in real-world apps. Pro Forma Balance Sheet Given the relationship between the profit and loss account and the balance sheet, you will want to create a pro formas for each in conjunction with each other. Create a pro forma balance sheet in the following steps: change of retained earnings pro forma from pro forma profit and loss account to the balance sheet Identify adjustments to current assets and liabilities, which will vary depending on the sales deviations used in the projection Use ordinary suspects – assets, total liabilities, equity of the owner – to replenish the balance sheet. Remember that what distinguishes these pro forma statements from standard finances is adjustments, not calculations or even format. As we have already said, some regulators and scenarios will require specific information, but from a fundamental point of view, the framework for each of them is essentially the same as what you already use when preparing your finances. Pro Forma Cash Flow Statement Finally, with the pro forma profit and loss account and balance sheet competing, we can knock out the cash flow statement as well. Start with cash on hand, then add all your cash receipts, such as sales, loans and cash injections, interest income, and more. Exchange all outgoing cash payments, such as sales, salaries, deliveries, etc. Sum up your operating costs as well as any other expenses, including cash withdrawals to owners, interest costs, income taxes, etc. Calculate the total amount of cash payments, net cash change, and final cash position. Once again, this is the same process you use for a normal cash flow statement. Putting them at all Now that you've done the weight of heavy lifting, you want to double check that you have correctly combined the data between the pro formas. Make sure: Add net income from the pro forma profit and loss account to the accompanying balance sheet and cash flow statement. Add depreciation back to capital expenditures in the cash flow statement, which then provides PP&E to the balance sheet. Financial activities affect the balance sheet and cash. The profit and loss account should include interest on financing. The closing balance of the balance sheet is the sum of the closing cash of the previous period and the cash of the current period from operations, financial activities and investments. Other Pro Forma scenarios As we have said before, pro forma statements are crucial for the company to look at the potential impact of the proposed transaction or investment capital. In the case of a business combination, for example, you can use a pro forma statement to combine the financial statements of both companies to calculate net acquisition costs, as you can see as follows: Alternatively, if you want to demonstrate the impact of different amounts of capital investment, you can create multiple pro formas so a potential investor can see different effects on, as an example, a pro forma balance sheet. Our goal is, pro formas are not a one-trick pony. They have many applications for many scenarios, ranging from simple sales growth forecasts to more complex M&A; A or investment purposes. From what you use them for, just make sure you are organized, detailed and accurate throughout. Otherwise, you limit the information that pro formas in the first place. And if all this seems a little much, Embark is always around to throw up and save the day. Day.