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WHY FINANCIAL PLANNING & ANALYSIS IS KEY TO NAVIGATING VOLATILE ECONOMIC OUTLOOK

Companies need to be prepared and plan ahead.

Few, if any, companies have a long track record of consistent growth and profitability without careful financial planning, reporting and money management. This is true even when the economic outlook is stable and can be forecast with some certainty but becomes more important when the outlook is volatile and uncertain. The “wait and see” approach risks not be able to react appropriately and in a timely manner.

RESPONSIBILITIES OF A CFO

A company’s senior financial officer – whether it be a CFO or otherwise, may have many responsibilities but three of them are key: (a) accounting overview and financial reporting, (b) financial planning & analysis, and (c) treasury management.

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Regular financial reporting from the financial team to key stakeholders is a vital component of management information. However, it is a look-back on past performance. For example, quarterly reports mean that the management team is not analyzing their financial performance until more than 90 days after that quarter began. This means that decisions that should have been made during a quarter, based on financial performance, are being made months later. Monthly financial reports, on the other hand, give a 30+ day lookback period, so the lag between receiving data, and making decisions based on that data, are shorter.

FINANCIAL MODELING

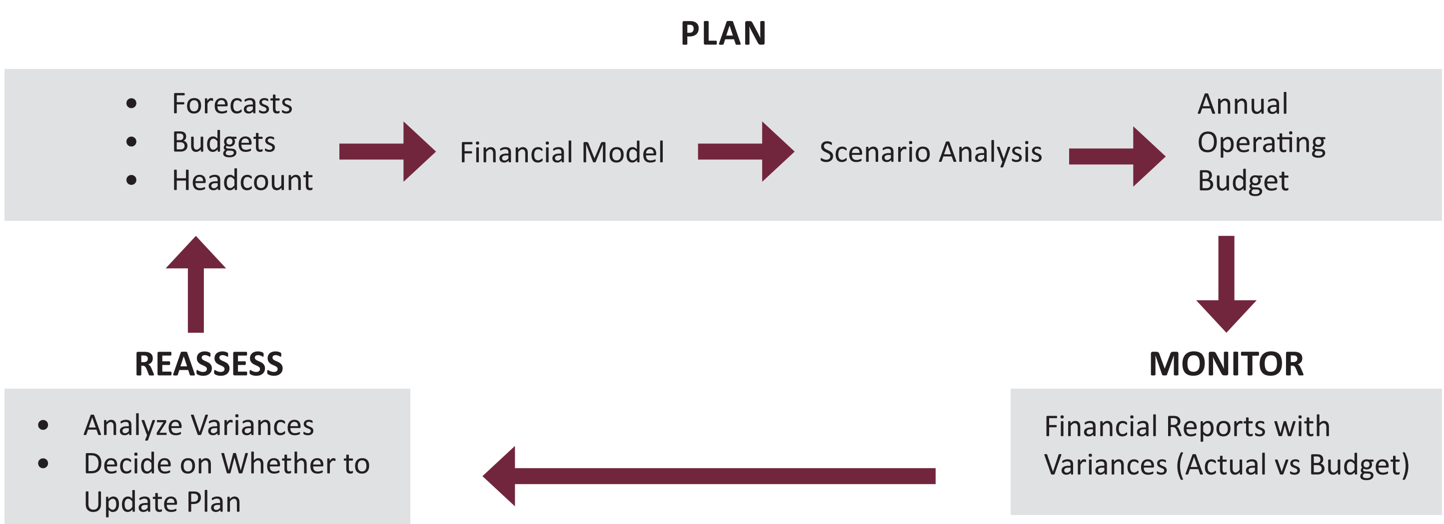
Important as they are, financial reports that are solely based on past results are still a look-back. What about a look-forward? This is where financial planning and analysis (FP&A) plays a vital role. FP&A is the budgeting, forecasting and modelling function that supports an organization's financial health and business strategy.

Every company should have an annual operating budget (AOB). The AOB estimates revenue, costs of goods sold and expenses for at least one year. We recommend that the AOB is an Excel-based financial model. The key to a workable AOB is ensuring all assumptions are parameterized so that as those assumptions change, the corresponding financials are re-calculated.

For example, what drives revenue? Is there a relationship between sales & marketing expenditure and sales? If so, that relationship should be modeled and built into revenue projections. Is there a relationship between inventory management and sales? That should also be modeled. Typically, a significant portion of all the company's expenses are the cost of personnel. Does the company have forward plans to staff according to expected needs? If so, that should be built into the expenses budget. As these parameters are being built into the model, their values should become a variable that can be changed easily. If built correctly, changes in the assumptions will result in an automatic re-calculation of the corresponding financial values. But the P&L should not be the only company financials that are modeled – the balance sheet, and most importantly cash flow, should also be modeled. In fact, the best financial models have the P&L, balance sheet and cashflow forecast linked. For example, planned purchases should be linked to inventory, accounts payable and cash. Depending on how a company receives money from its customers, an increase in projected revenue should be linked to accounts receivable and cash.

SCENARIO ANALYSIS

Once a parameterized financial model is built, it allows management to run a number of what-if scenarios. The assumptions that model the business drivers can be altered and their effects can be visualized. Once multiple scenarios have been analyzed, the Annual Operating Budget should be finalized.



FINANCIAL MONITORING

As each month progresses, financial reports intended for management, boards of directors, shareholders and lenders should include actual reported values and variances, by row, against the AOB. Understanding and articulating these variances is key to the decision-making process going forward, and plans may change accordingly. But should the AOB be changed to reflect new plans? We recommend a quarterly re-assessment of the budget and using the same scenario analysis, amending the AOB accordingly.

CONCLUSION

Planning and being prepared is an important function during all cycles of a business's development- early-stage, mid-stage and mature. But when the economic outlook becomes uncertain and volatile, then the cycle of planning, monitoring, re-assessing, re-planning etc. becomes a vital function necessary for the financial health of a business.

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At KROST, our M&A and Capital Markets department performs non-transactional services such as readiness reviews, business valuations, evaluating sales, acquisition or financing options, looking at strategic alternatives and providing fractional CFO services.

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