

***Using Financial Forecasts to Support
Effective Strategic Decisions***

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“Planning is bringing the future to the present so that you can do something about it now.”

-Alan Lakein

INTRODUCTION

Financial forecasting can be a highly effective strategic planning tool by evaluating any or all of the following:

1. Future outcomes based upon the “flexing” of various variables within a range of reasonable possibilities.
2. The addition of new services or programs, or conversely, the discontinuance of existing services or programs.
3. Major capital outlays, such as new facilities or facilities expansion.¹
4. Envisioned capital replacement needs.
5. The financial impact of adverse economic conditions or events (referred to in this paper as stress-test modeling).

A robust forecasting tool should be able to accurately project future outcomes under any or any combination of the above-noted conditions. For example, the addition of new programs may require new facilities or the expansion of existing facilities. And, in this example it would probably be prudent to also do some stress test modeling that asks the question, “If we go ahead and commit significant capital for a new building, what happens if economic conditions erode and assumed service volumes (and/or donations) fall short by 20% and our endowment contracts by 15%?”

¹ Often, creditors of debt-financed major capital projects will require a long-range financial forecast as part of the loan application process. Guidance on preparing a forecast for these purposes is contained in ADVISORY NOTES topic *Effective Debt Financing Strategies*.

FIRST THINGS FIRST: START WITH A BASELINE

Before one delves into evaluating multiple forecast scenarios, **it is crucial to establish a baseline forecast that assumes a linear progression of future events and trends, even if such outcomes are improbable**. The baseline forecast is crucial because:

1. It enables the organization to better understand where it is headed on a “business as usual” trajectory.
2. It provides a context from which to understand and evaluate other scenarios’ (and strategic plans’) outcomes. For example, if a baseline scenario produces an operating margin of 2.3% in Year 5 and the impact of a new program (with, for example, a new facility) produces a 3.5% Year 5 operating margin, we have a context from which to better evaluate the new program.

AVOIDING INFORMATION OVERLOAD

The power of a robust forecasting tool can also be its biggest liability, for if decision-makers become enamored in evaluating excessive modeling outcomes, it can lead to analysis paralysis. The best way to manage the number of modeling scenarios is to keep decision-makers focused on the core variables that will have the most significant impact on modeled outcomes. To achieve this goal, I include in my forecast reports a *Quick Calculator* tool, as illustrated in the following example.

EXAMPLE: FIVE YEAR FORECAST FOR A COMMUNITY HEALTH CLINIC

Assume a community health clinic provides medical care to underprivileged citizens. Its two major sources of program service revenue are from Medicare and Medicaid, and most of its expenses relate to compensating its employees. In building a forecast template, all detailed revenue and expense line items will be modeled, but only a few have the potential to significantly impact operating results. In order to keep decision-makers focused on the most important variables I use a *Quick Calculator*, as shown in Table 1. Note that the tool has been designed to illustrate the affect on operating results of a 1% change in several of the model’s line items. Furthermore, the example assumes that the Health Center has a variable rate mortgage with an expected average FY11 loan balance of \$4.5 million.

TABLE 1 – QUICK CALCULATOR OF FY11 OUTCOME SENSITIVITY OF HOMETOWN COMM. HEALTH CTR.

CORE VARIABLE	AFFECT OF 1% CHANGE
Medicare rates	\$20,000
Medicaid rates	\$30,000
Medicare volumes	\$ 5,000
Medicaid volumes*	\$ -3,000
Salaries, wages, and payroll taxes	\$55,000
Employee benefits	\$10,000
Interest on variable rate mortgage	\$45,000
Supplies	\$ 3,000
Professional fees and other costs	\$ 2,000

The negative sensitivity amount indicates an inverse relationship between changes in volumes and changes in outcomes, as further discussed below.

It is important to note that the 1% change can be an increase or decrease. That is, if Medicare reimbursement rates were cut by 1%, the organization could expect a \$20,000 reduction in revenue. On the other hand if Medicare reimbursement rates were increased by 1%, the organization would realize \$20,000 of additional revenue.

In this example, the quick calculator shows:

- Compensation costs (salaries, wages, payroll taxes, and benefits) have the largest outcome sensitivity (and are the most controllable).
- A spike in the mortgage interest rate would have a significant impact on operating results.
- Pruning supply costs will have very little impact on operating results.
- In terms of Medicare and Medicaid reimbursements, the specter of cuts in reimbursement—coupled with pressure to award some level of compensation increases—could have profound negative impacts on future operating results. Also, note that the -\$3,000 amount for Medicaid volumes suggests that the organization is losing money on Medicaid patients. That is, there is an inverse relationship between changes in Medicaid volumes and financial outcomes.

EXAMPLE CONTINUED – USING THE QUICK CALCULATOR TO EFFECTIVELY GUIDE THE DECISION-MAKING PROCESS

The data from the quick calculator should keep decision-makers focused on the key planning dynamics. In this example it may lead to any or all of the following actions:

- Evaluate staffing levels and structures in order to see if positions could be eliminated or restructured
- Implement a one-year salary and wage freeze or review benefits
- Consider the expansion of development staff in order to raise more gifts and secure more grants
- Consider fixing at least a portion of the long-term debt.

REPORTING FORECAST RESULTS

Forecast results are typically generated from the model in a data-intensive report containing several line items and a column for each projected year. These detailed reports are valuable to the finance staff, but other decision-makers should be provided with highly summarized reports that focus only on comparative operating results. This summary format, coupled with the Quick Calculator Tool, serve to keep decision-makers focused in the task at-hand. Continuing with the example, Table 2 provides a sample summary report for the Health Center.

TABLE 2 – PROJECTED OPERATING RESULTS FOR THE HOMETOWN COMMUNITY HEALTH CENTER

Scenario Number	Scenario Name*	<<<<<<<<<<< Projected NET Operating Income for: >>>>>>>>>>				
		FY11	FY12	FY13	FY14	FY15
1	Baseline	\$100,000	\$ 85,000	\$ 65,000	\$ 50,000	\$ 25,000
2	Change EE Benefits	\$105,000	\$ 95,000	\$ 82,000	\$ 65,000	\$ 52,000
3	Pay Freeze in FY11	\$155,000	\$140,000	\$120,000	\$105,000	\$ 80,000
4	Fundraising Strategy	\$ 75,000	\$ 85,000	\$ 95,000	\$115,000	\$150,000
5	Stress Test	\$ 85,000	\$ 42,000	\$ 0	\$ -25,000	\$ -65,000

*Scenario names appear as a summary description and would be accompanied by a detailed description of key modeling assumptions. Following is a general description of each scenario:

1. Baseline: Assumes a business-as-usual linear trend.
2. Change in EE Benefits: Under this scenario, employee benefits are modified in order to reduce costs.
3. Pay Freeze in FY11: In order to reduce the magnitude of erosion in future year’s margins, a one-year pay freeze is implemented in FY11.
4. Fundraising Strategy: This reflects an expansion of fundraising resources. Note that in early years, operating margins decline due to up-front investment in fundraising personnel and the natural lag in these employees’ ability to generate gifts. But, also note the expected long-term payoff of this strategy.
5. Stress Test: This scenario includes substantial negative trends and events, such as: a) A rise in interest rates, b) Medicare and/or Medicaid reimbursement rate cuts, and c) Escalating employee benefits costs

OTHER KEY POINTS

Following are some other key points to keep in mind.

1. Don't Ignore Projected Cash Flows: An effective financial forecast should take projected operating results and then factor in: a) expected cash outflows for principal payments on long-term debt; b) expected cash outflows for capital expenditures; and c) add back amounts for depreciation and amortization expenses. The sum of these adjustments will yield projected net cash flows. **Be wary of negative operating results but positive cash flows, as these outcomes may reflect the under-funding of depreciation and a growing deferred maintenance challenge.** Exhibit 1 illustrates this concept:

EXHIBIT 1 – EXAMPLE OF MODELED N.O.L BUT POSITIVE CASH FLOWS*

	FY11	FY12	FY13	FY14	FY15
Net Oper. Income	\$ -50,000	\$ -60,000	\$ -65,000	\$ -75,000	\$ -85,000
Capital-Related Cash Expenditures:					
Principal Pmts. on LTD	\$ -50,000	\$ -55,000	\$ -62,000	\$ -70,000	\$ -80,000
Capital Expenditures	\$ -75,000	\$ -70,000	\$ -65,000	\$ -65,000	\$ -60,000
Add Depr. & Amort.	\$240,000	\$250,000	\$235,000	\$220,000	\$210,000
Net Cash Flow	\$ 65,000	\$ 65,000	\$ 43,000	\$ 15,000	\$ -15,000

In this example, projected new capital expenditures fall far short of annual depreciation and amortization. These data suggest that depreciation is not being adequately funded and that a deferred maintenance problem may be growing. These projected outcomes should become the basis for the organization to further analyze and better understand this dynamic.

****This illustration does not relate to the Hometown Community Health Center Example above.***

2. Consider Projecting the Balance Sheet: A disciplined approach to projecting cash flows creates an opportunity to project future balance sheets. This can be a complex process, so at first build simple but informative tool. Ultimately a projected balance sheet can very effectively augment projected results from an operating statement, as the balance sheet reflects the financial health of the organization.
3. Financial Forecasting is a Never-Ending Work-in-Process: Financial forecasts should be performed **at least** annually, and each time one is compiled the modeling assumptions should be revisited. When a busy analyst must update the forecast after a hiatus of several months to a year, he/she may be tempted to simply replicate many of the prior iteration's assumptions and quickly crank out the results. Be on-guard for this mindset and be sure to carefully revisit all modeling assumptions. Financial forecasting can deliver substantial strategic value, and

analysts who approach the next iteration wishing to simply “do it the same way as last time” run the risk of compromising the strategic planning process.

OTHER RESOURCES

A simple web search will provide additional resources on this topic. One that I recommend is “Avoid Forecasting Pitfalls”, which can be accessed at:

<http://office.microsoft.com/en-us/excel/HA011589961033.aspx>

CONCLUSION

A robust financial forecasting model is a very effective tool for shaping and enhancing strategic planning. Building a forecast model from scratch can be a daunting experience, and at the outset its utility may only be marginal. However with added experience, its quality will improve and within a few seasonal iterations it should evolve to become a key component of your organization’s strategic planning.

ABOUT THE AUTHOR

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