# *Building and sensitizing financial projections*

Every business must cope with uncertainty about the future. A sensitivity analysis is a financial model that allows you to understand the effect of fluctuations in selected variables on your business' profitability.

Because sensitivity analysis answers questions such as "What if XYZ happens?" this type of analysis is also called what-if analysis.

### Terms to know

**Forecasting:** Uses historical averages to provide primary support for expected future performance.

**Use:** When the business is expecting little change in operating outcomes or objectives.

**Projections:** Estimates the expected future financial position prepared using management assumptions. It predicts what could happen in the future.

**Use:** When the business expects a change in operating outcomes (or a new venture or project) and past trends don't reasonably indicate the future.

## What to do

**1. Conduct a self-assessment. Gather information such as financial statements and consider your management objectives and projections, including cash flow.**

| Assumptions | Consider | Ask yourself |
|---|---|---|
| **Historical performance** | • Long-term revenue and expense averages<br>• Projected production units<br>• Income tax (corporate and personal)<br>• Dividends, drawings, salary deductions and living costs | • Why were revenues/expenses/dividends/salaries higher/lower last year?<br>• Is that outside of the norm?<br>• What are the expectations for this year?<br>• What assumptions am I using for those statements?<br>• Have those assumptions been called out and explained in my business plan? |
| **Key management objectives** | • Management plans and objectives for the next __ years<br>• Marketing plans<br>• Future capital expenditures<br>• Sales projections, collection policies | • What am I growing next year? What sales growth do I expect next year? Why?<br>• Am I planning to change production or expenses in the future? Are there new production techniques I want to implement?<br>• Do I plan to buy inputs or sell goods from/to different parties?<br>• Do I expect any change in the gross margin or operating expense percentage?<br>• What capital expenditures do I expect in the future? How will I finance them? |
| **Key assumptions, including industry and business risks** | • Industry background materials, such as FCC Sector Outlooks and Commodity Guides<br>• Crop insurance area averages when/if available<br>• FCC Economics for big picture items<br>• FCC lender to discuss benchmark programs<br>• Staying updated on industry news<br>• Connecting with producer groups on alternative sources | • How are environmental and economic conditions in the coming year likely to affect the operation?<br>• Are there any new competitive developments that will affect the risk drivers in the future? |

## 2. Build a farm business projection

- Project income and expenses based on the information above, including historical results, management objectives and external factors.
- Connect the projection to historical averages, including per unit of production averages. Make sure you compare the projection to the past.
- Are these projections attainable over the long term?

## 3. Consider all scenarios

- Ask yourself, "What happens if…" to identify risk factors in the projection that could lead to a drop in revenue, increase in expenses or increase in debt service requirements.
- Based on the most likely projection, anticipate how the risk factors could impact your business and adjust as needed for the identified risk factors.

## 4. Conduct a break-even analysis

- Review the numbers. What reduction in price can your business withstand?
- If an increase in expenses occurs, how much can the business tolerate before net profits are eroded?

Ensure you understand and are comfortable with the implications of rate changes, revenue decreases and expense increases. Discuss the options available if a deficiency occurs.