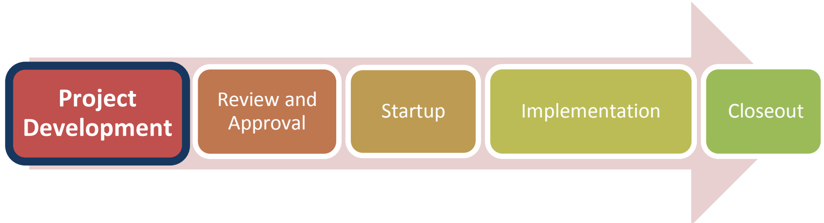
Financial Analysis

Objectives



- Partner will better understand the intent behind the Financial Analysis component of the project proposal
- Partner will better communicate with the grantee on the value of reviewing the financial potential of their project
- Financial Analyses submitted with project proposals will better articulate the financial prospects of the grantee and will be based on clear assumptions

Course Content

1. What is the Financial Analysis?

The Financial Analysis is a standalone write-up that provides information about the financial viability and sustainability of the proposed project.

2. What is it Required?

Financial Analysis is a required part of all project proposals. However, the type of analysis required for each grant type varies.

A. New EEI

Financial Analysis must include:

1) ***Assumptions Page***
2) ***Production Forecasts*** for the base year and life of the project
3) ***Profit/Loss Projections*** for the base year and life of the project
4) ***Cash Flow Projections*** for the life of the project
5) Balance Sheet for the life of the project (optional)
6) Revolving Loan Fund Projections (only for grants with revolving loan funds)

B. Graduating EDI

- No additional financial analysis is needed **<u>if</u>** the business plan completed during the EDI included financial projections that meet the requirements for a new EEI (A.2 above).
- If the EDI did not result in a business plan with the required financial analysis, then use the guidance for a new EEI (A.2 above).

C. EDI

- ***Assumptions Page***
- ***Profit/Loss Projections*** for the base year + 3 years

3. Who Is Involved?

A. <u>Partner:</u> The Partner is responsible for completing the Financial Analysis, working closely with the grantee to obtain the relevant background information, getting concurrence from the grantee on the projections, and ensuring that projections are realistic.

B. <u>Grantee:</u> The grantee is responsible for working closely with the partner to provide background information on their organization and project objectives so that the analysis accurately reflects their current operations and their yearly goals.

C. <u>ADF staff</u>: ADF program staff are responsible for reviewing the analysis to assess an applicant's viability as a grantee and to determine project performance goals.

4. What Format Should be Used?

A. BPP- Business Plan Pro

- BPP is the only standardized financial projection software that ADF uses.

- It can be used for any project to create all of the required Financial Analysis components except for the Assumptions Page.
- It simplifies the analysis process because once the background and assumptions are input, the program will formulate the financial statements and calculate the projections for you.
- When using BPP the file should be sent directly to ADF along with an Assumptions Page compiled by the partner.
- BPP is particularly useful when working with SMEs, but can be more difficult to apply to cooperatives or organizations with very simple financial records/transactions.
- In order to use and update BPP, a copy of the software is needed. Consequently it is more difficult to have the information transparent and useful for the grantees.

B. Excel

- A sample excel format is provided by ADF that consists of an Assumptions worksheet and a Financial Statement worksheet.
- Excel has the advantage that it is a more familiar software to most users and can be easily modified.
- The format is very simple and alone may not be sufficient to accurately describe and predict the grantee financial situation.
- The base format works well for most EDIs, but using it for EEIs often requires adding worksheets with further analysis.
- Grantees are likely to have access to Excel, so sharing the analysis is easier than with BPP.

C. MicroFin

- Microfinance projects require a unique financial analysis format such as MicroFin. However, this topic is addressed in a separate training course.

F*or more information see Microfinance Grants course*

D. Revolving Fund Analysis

- Grants that involve a revolving loan fund also require an analysis to ensure that it will not run out of cash over time. This involves understanding the interest charged, number of people to receive loans annually, etc.

F*or more information see Revolving Funds course*

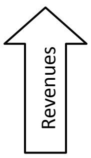
5. What Background Information is Needed?

A. Basic Assumptions

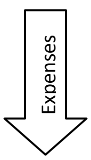
- These form the foundation of the analysis. The reliability of the projects depends on having accurate information to begin with.
- The basic assumptions will vary slightly based on the type of project (for example information on membership dues would be needed only for cooperatives/associations, not for most SMEs)
- The latest full year of operations is considered the <u>baseline year</u> (or base year). All projects are made in relation to that year because it describes the grantees position before any intervention from ADF.
- It is often useful to have data for the past 2-3 years (rather than only the baseline year) to help identify trends and better make growth estimates.
- It is critical that the baseline data be as accurate as possible or the quantitative goals for the grant will be off. Inaccurate baseline financial information may also lead to a misdiagnosis of project needs and

result in a less than ideal project design.

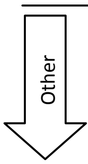
B. ***Baseline year information*** that may be needed includes:
- Sales volume for each product
- Price received for each product
- Sales revenue
- Export sales revenue
- Membership dues
- Number of members
- Number of loans given out last year (if they have a revolving loan fund)
- Interest rate charged on loans
- Income from interest charged on loans
- Other income



- Cost of goods sold for each product
- Price paid to farmers/artisans
- Number of farmer/artisan suppliers
- Write-offs for loss (because of quality or damage in transport, etc.)
- Salary expenses
- Bonuses and profit sharing paid to employees
- Number of workers
- Fees or percent of revenue given to an association or other entity involved in the sale of goods
- Outstanding Loans
- Loan repayment expenses (interest and principal)
- Other expenses (such as transportation, packaging, rent, depreciation, taxes, etc.)



- Net income (before taxes and depreciation)
- Cash on hand
- Value of assets
- Value of inventory
- Accumulated depreciation



C. ***Information for Projections*** may include:

a) Projected growth in sales volume for each product
b) Projected market prices for goods/services sold
c) Projected inflation rate
d) Projected membership increase
e) Projected yield increase
f) Other changes that will impact the financials (increase in membership fee, loss or gain of government subsidies, etc.)

D. The assumption page should include some level of justifications for projected growth rates, income levels, and profit margins. Discuss the expected changes production volumes by year, and annual changes in unit costs and unit sales prices

E. Potential Information Sources
- the grantee is the best source of information- even when written records are lacking, they often know where to find the answers
- historical financial statements or tax records of the organization
- sales records held by the grantee or if the grantee has a single client or sells through an association, sales records of the buyer
- payroll and other grantee financial records
- other industry leaders, trade groups, or industry studies
  - for example, ADF recommends using the three year average inflation rate based on current year, past year, and next year's inflation rate from the IMF website: http://www.imf.org/external/ns/cs.aspx?id=28)

6. Steps to Complete the Financial Analysis

1) Early to midway through the project development process, inform the grantee

that you will need to work with them to determine their financial situation and set project goals.

2) Gather all of the relevant information in #5.B
   - Remind the grantee that the information will not hurt their chances of getting the grant, but will be used to design a better project with attainable goals.
3) Fill in this information to construct the historical financial information and get a better picture of the grantee's financial status.
   - In BPP, there is a page to input historical information but the assumptions must be written up separately.
   - In the Excel template, the historical information is input on the same page as the projections for coming years and the assumptions are entered on a separate page in the document.
   - If you find it difficult to complete the historical information, ask the financial officer within your organization to help explain terms their relationships to one another.
4) Use your understanding of the factors that impact the grantee's bottom line, to decide what growth assumptions need to be answered to forecast the financials for the organization. Also decide how you will calculate the projections so you make sure you get all of the information you need from the grantee.
   - If you are using BPP, know the inputs you need for BPP to calculate the projections you need.
   - If you are using the Excel format, there are no formulas in the template, so you will need to determine how the information relates and create the formulas yourself in the template.
   - If you are an advanced user working with a customized Excel template, this is a good point to set up the structure for your calculations and reported information.
5) Bring the historical information, and discuss the implications of their current financial situation and talk through the projection assumptions with the grantee.
   - This should take place after initial project plans have been discussed, but before a final plan is agreed on.
   - Discuss the types of goals that are usually used to gauge ADF project success (Appendix A indicators such as net income, income to farmers, volumes sold, etc.) and what quantifiable measures the grantee would use to determine if they were being successful.
   - Confirm that the project objectives and activities address any underlying financial problems that are revealed from the review of baseline data.
   - Confirm that the project objectives and activities are likely to lead to the projected growth rates.
   - Discuss the value of setting both aggressive and conservative goals with the grantee. The aggressive goals allow the grantee to think about their potential and where they could be in a few years if everything goes as planned. The conservative goals allow the grantee to set goals of where they want to be even if conditions do not remain ideal throughout the project.
     - <u>ADF only requires the conservative projections</u>. It is not required to submit upside and downside analysis.
6) Input the projection assumptions agreed with the grantee into BPP or Excel.

7) Use the grant budget and make sure that grant activities are also accounted for in the projections:
    - Any expansion of staff, production facilities, services to members, etc. initiated under the grant that will increase the organizations cost structure need to be accounted for in the cost projections for the following years.
    - One time project costs such as a vehicle or equipment purchase should be included in projections for the year when it will be purchased.
    - Net Income and Cash on Hand should be calculated prior to including ADF income as well as with income from ADF.
8) Review the financial analysis.
    - Review the results to make sure they are realistic and correspond with grant objectives.
    - If the results do not look reasonable, investigate which assumptions are likely distorting the results and suggest a revised assumption to the grantee.
        - For example, if the assumptions result in a year 1 net income 10 times that of the baseline year and you notice membership growth alone accounts for most of the net income increase, then suggest a reduced membership growth rate may be more reasonable.
    - Look for missed factors that are affecting the projections
        - For example, if the increase in sales revenue equals the increase in net income, consider whether the cost of goods sold will also adjust because of the assumptions of increased volume or market prices that determined the growth in sales revenue.
        - Don't forget that costs can scale for different reasons- some will grow with market prices/inflation (farm gate price, marketing, etc.), others will increase with production volume (packaging costs, factory electricity use, etc.)
    - Ensure that the organization can handle the projected cost structure after ADF funds are depleted.
    - Review the results to make sure that the project plans account for reoccurring organizational costs.
        - Are cost recovery plans in place for seasonal requirements such as purchase of farm inputs? For harvest time purchases where farmers are prepaid for their crops? Etc.
9) The process for the completing the simpler EDI financial analysis should follow the same general steps, but the depth of analysis and the number of variables considered in the planning will be fewer.

7. What Results Should be Reported?

A. At minimum, the projections should include the information required to:
    - confirm that the project is likely to be viable in coming years,
    - provide baseline data for API indicators, and
    - determine annual project purpose and output level targets in the Appendix A

8. How is the Information Used?

A. Appendix A: The Appendix A targets will be pulled directly from the Financial Analysis.
    - Common indicators for EEIs include:
        - Net Income
        - Sales Revenue
        - Production Volumes
        - Number of Members or Employees
        - Wages Paid

    - Income to farmer/artisan suppliers
  - EDIs will generally include at least one quantifiable indicator from the financial analysis that demonstrates expanded capacity such as:
    - Number of Members or Employees
    - Number of farmer/artisan suppliers

B. Organizational Planning
  - The financial analysis should be used by the grantee to help with the organization's strategic decisions
  - Grantees often don't start with the capacity to fully interpret the financial analysis, but it should be a goal during the grant for them to gain this skill and better be able to plan for the financial future of their organization

9. Advice from the Experts

- It is easy to leave the financial analysis until the end of project development and exclude the grantee from the process, but in doing so the grantee gains no value from the process and has little buy-in to the project targets set in the Appendix A.
- Baseline data and projections are often over estimated. This is a disadvantage to the grantee and ADF because it results in setting goals that are too high, may lead to perceptions that the grant is failing, and undervalues the successes the grantee achieves. Projects seen to be chronically underperforming according to their yearly targets risk termination, so making reasonable projections is critical.
- Avoid extra work in the future by being conservative with projections. Overstating baselines and projections can result in having to redo the whole financial analysis later in the grant.
- Growth rates and other annual changes are rarely consistent over a number of years. Consider how the project implementation schedule will influence when growth will occur.
  - Growth in the first year is usually minimal because it takes time to do capacity building activities, order equipment, or see the impacts of improved inputs.
  - Growth for EDIs is expected to be minimal during the project because the focus is not on production increases.

Handouts

Sample Financial Analysis Excel Format

Sample Financial Analysis BPP Results

Financial Analysis Course Notes