

Finance Function Opportunities: article 2 – Scenario Modelling – a tool for challenging times

‘The planning fallacy is that you make a plan, which is usually the best-case scenario. Then you assume that the outcome will follow your plan, even when you know better’. So commented Daniel Kahneman, an economist notable for his work on the psychology of judgment and decision-making.

This sentiment reflects the feelings of many when, as finance professionals, we look at the challenges of the current economic conditions. Can one plan help us manage our organisations?

The current economic environment for most countries offers few certainties and many challenges. Increasing costs across many of the lines of the profit and loss account are creating business conditions that many chief financial officers (CFOs) may have not directly experienced. ACCA and PwC research has shown how the pandemic has created a voice for CFOs at the strategic table¹. Yet it is one that finance teams may be unwilling to sustain in the longer-term. As organisations face the realities of today and tomorrow so CFOs will once more need to be **voice of wise counsel** to other senior executives grappling with the issues of today and the uncertainties of tomorrow.

Organisations face the risk that they fail to detect structural shifts which are masked by transitory factors. They need to be agile and reactive to the circumstances that face them. Having one view of the future cannot be effective in the management of a complex business risk landscape.

Scenario modelling offers a way for finance teams and CFOs to present a range of opportunities to their stakeholders. It takes a range of options and presents the potential outcomes. In choosing the scenarios it is important to focus on the extremes, a best case, a worst case and a median. However, **these need to be extremes**. There is little value in modelling three close scenarios. All too often at present the worst-case scenario may well be the most **realistic**. In today’s challenging environment focusing on a median case, a bad case and a worst case may be more effective in helping to identify mitigating actions and managing the strategic risks that the organisation faces. Learning from these scenarios and iterating the cases into the next range are essential; presenting three continuous scenarios when only one is consistently being achieved is not effective.

The scenarios themselves need to be **developed on an organisation wide basis**. They need to draw on the range of experiences from both operational and strategic teams across the organisation. It should not just be a finance process but one that models the whole business, for the actions that arise from them to be effective they need to be owned by the whole organisation, which necessitates a **collaborative** approach. It also requires a detailed understanding of the operating model of by those developing and evaluating the models, and the respective sensitivities that underpin performance. A robust model is not just financial, but also operational metrics and includes cash flows as well as financial statements.

The scenarios developed need to be capable of identifying and modelling the **trends and driving forces** that are influencing the operating model. Having a detailed understanding of which levers matter and how they impact the organisation will create value from the models and assist in mitigating the risks.

The model itself should not be too **complex**. In today’s rapidly changing world models can become outdated quickly. No forecast can ever be precise, nor should it be intended to be. There is a

¹ ACCA / PwC (2021) Finance Functions – Seizing the Opportunity.

crucial balance between effort and return which needs to be appreciated. A model that adds value is one that allows **rapid simulation of changing critical parameters**. It reflects the key variables, models the potential actions, key accounts and customers, and suppliers. At a time when supply chains are being challenged understanding alternative strategies, such as increasing stocks of critical components or alternative sources of supply, can be crucial in survival.

The effective model draws on a **range of trusted external and internal data sources**. There may be several views of future inflationary trends across different markets, cost drivers and revenue sources. Which has the greatest credence? Which reflect the factors impacting the business as a whole and which impact each individual area of the organisation? It also **integrates data**, often in real time, from internal operational systems such as supply chain, customer relationship management and human resourcing as well as the traditional financial ones. A value chains become increasing open in their sharing of data, so the opportunity exists to include more external sources into the model.

Whilst many teams use spreadsheets to construct their scenario models, these are not the only solution. The use of **specialised software solutions** can give a return on investment, especially where data integration is fundamental to the success of the model. Increasing these models can be offered on a self-serve basis to end users with visualisations. In so doing this can create a greater organisation wide ownership of the forecasts, at a time when many organisations are challenged, and a culture of innovative action is beneficial.

In determining the effectiveness of the solutions, focus on break even as a key determinant in understanding the narrative. From the presented narrative identify **two or three key messages** for senior stakeholders. This will help to convey the implications and develop the **actions** required.

An effective model is never complete. It needs to be **refined** and developed based upon experience, the actions taken and the changing external factors impacting the business. Key performance indicators should be determined that help understand the effectiveness of the model and to identify necessary refinements.

In this changing world modelling is an essential tool for the agile finance function who should focus on four things:

- Draw on all types and sources of data.
- Be selective in the variables that are chosen.
- Choose a range of scenarios that illustrate the extreme cases as well as the middle ground.
- Use break even as a key determinant in understanding customer and supplier behaviour.

This article was developed with the assistance of Alistair Roman, CFO, United Kingdom, Ashish Shetty, Senior Director Finance, Target, India, Cameron Jagers, PwC, Australia, and Matthew Washington, CFO, Mitre 10, New Zealand.

This topic will be expanded in a forthcoming report by ACCA, Chartered Accountants Australia and New Zealand and PwC which is due for publication in November 2022.