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How to Keep the Board Informed and in Control in Times of Change

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Information Management

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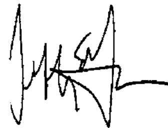
As regulations tighten on corporate reporting, CEOs and CFOs worry about staying in control. But most remain exposed and vulnerable because their information systems cannot tell them where they are today, let alone where they are going.

What is the solution? Jeremy Hope takes a look at how some organizations are regaining control using more advanced information systems, including include key performance indicators, rolling forecasts and trend reporting.

"How to Keep the Board Informed and in Control in Times of Change" is the eighth in a series of papers written for the IBM Cognos Innovation Center for Performance Management by Jeremy Hope, Research Director of the Beyond Budgeting Round Table. Jeremy is an advisor to the Innovation Center. He is also a tireless champion for innovation in performance management theory and practice, believing that business-as-usual is NOT a route to success.



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Ask any group of CEOs what keeps them awake at night, and they will tell you it's a fear of the unexpected. Their recurring nightmare? The shock profits warning. Few know what their performance looks like today, let alone what it will look like through the next quarter or year. These fears are not just imaginary. They are real and becoming more acute each year, as discontinuous change becomes the norm and the pressure for performance improvement intensifies. Most companies operate with inflexible planning and reporting processes, poor forecasting systems, and a plethora of performance contracts, which can drive unethical behavior at every level. With too much complexity and confusion and not enough clarity, simplicity, accountability, transparency and trust, companies suffer from higher costs, ineffective decision-making, and poor governance.

When author Ken McGee asked a group of Fortune 1,000 executives, "Is there information that would help you run your company far better if you had it in real time, and, if so, what is it?" the answer was a unanimous "yes," followed by two or three key indicators. Dave Doman of AT&T asked for real-time customer transaction information, such as contract renewals and cancellations. Rick Wagoner at General Motors wanted real-time progress reports on new vehicle development. Dick Notebaert at Qwest wanted customer satisfaction numbers.[1] But none of these executives or others interviewed by McGee could get what they wanted. Their information systems were not up to the task.

In earlier times, management information and control were more straightforward. The board would approve a budget and control monthly performance against it. It would require managers to take necessary action to meet budget agreements. But this rear-view-mirror control system is well past its sell-by date. Most companies must wait well into the following month—the average is nine days—before receiving management accounts and other reports. Flying blind for six weeks at a time is not a comfortable position when unpredictable events—such as an environmental problem, the loss of a major customer, a product launch by a key competitor or a terrorist incident—can wreak havoc on a company's performance outlook.

So how can a board improve its control systems and respond more rapidly to unpredictable events? A number of organizations have completely overhauled their management information systems to manage more confidently short-term future outcomes, up to 12 months ahead.

Know where you are today

Does information—such as supply-chain, production and product problems; competitor actions; order shortfalls; and customer problems and opportunities—move through your organization in a matter of minutes instead of days? Are problems shared immediately with people who can take the right action to resolve them? If you could answer these questions in the affirmative, you would have real control of your business, and the benefits to the bottom line would be incalculable.

Sadly, few businesses have these advantages. Most organizations operate with inflexible information systems that struggle to deal with basic bookkeeping and are not designed to help managers sense and respond at high speed. Finance functions typically spend the first couple of weeks of each month joining their disparate systems and re-keying information into spreadsheets before showing leaders a complete picture. When this happens, management reporting is driven by the calendar rather than by management need. In a fast-changing market or in the first few months of a new product launch, the speed with which information moves in companies can mean the difference between making right and wrong decisions, which can have a major impact on the bottom line.

The problem? Too much detail and complexity. Too many

- general ledger systems (an average of 10)
- enterprise resource planning (ERP)systems (an average of 2.8)
- reports (by a factor of two)
- measures (by a factor of five)
- budget lines, journals and inter-company reconciliations

And with an average error rate between one and 30 percent, the quality of data leaves much be desired.

Many large organizations use "flash" reports to overcome process problems and provide managers with reasonably fast information for decision making. In many cases, numbers are generated on spreadsheets and are disconnected from the main general ledger system. Such a process adds time and cost to the reporting cycle and should not be necessary if the close process is running more smoothly.

By contrast, here is what best-practice companies do.

1. Operate with a single, fully integrated financial application system. Doing so enables all transaction accounting systems – such as accounts payable, fixed assets, accounts receivable and customer billing – to feed directly into the general ledger. According to the Hackett Group, best-practice companies close their books within three days and produce 44 percent fewer manual journal entries and 60 percent fewer general ledger reports that other firms.[2] Best-practice companies also rely on a single chart of accounts, use half the bank accounts of typical companies and have fewer budget iterations.[3]

2. Use an enterprise-wide performance management system. While ERP systems focus on managing transactions, leading organizations now use a new platform known variously as corporate performance management (CPM), business performance management (BPM) or enterprise performance management (EPM). CPM integrates planning, scorecarding and business intelligence (or decision support), including financial reporting and consolidation. It uses a common database and can display data on a scorecard or dashboard interface. CPM is to performance data what ERP is to transactional data: a broad embrace of all relevant information, fully integrated, which provides a single view tailored to the needs of finance and operations executives.

3. Provide online reporting. Leading organizations conduct self-service reporting, which allows individual managers to analyze information and provide insights unavailable before. But managers need help designing reports. The litmus test of any report is whether it is *actionable*. Providing information that no one uses is pointless.

A good example of self-service reporting occurs at Svenska Handelsbanken, which can produce a profit and loss account in four *minutes*. Sweden's second-largest bank runs a shadow accounting system behind the real one and operates on the principle of "approximately right," as every internal transaction carries a standard cost. Branches can access and print profit statements online and deconstruct them by customer, enabling branch teams to evaluate customer relationships and focus on improving profitability rather than just selling products.

Know where you are going

Imagine being able to forecast the short-term future (say, three to twelve months ahead) every month with little overhead burden and high levels of accuracy? Through such a process, you could

- take the right actions to influence future outcomes favorably
- use your new forecasting capabilities – free from bias – to evaluate strategic options and make higher quality decisions
- provide your CEO with adequate warning of profits outcomes and avoid surprises
- test strategic options to see how they would play out in real cash-flow forecasts

While fast, high quality, rolling forecasts offer the prospect of an exceptional control system, few organizations have implemented them. In fact, large companies are subject to increasing levels of turbulence and consequently fail more frequently. When asked, fully two-thirds of corporate strategists admit to being surprised by as many as three high-impact events over the previous five years, and 97 percent report having had no early warning systems.[4] Had they operated with effective forecasting systems and been more adaptive, in all likelihood, more companies would have performed better and lasted longer.

Leading CFOs are ahead of the game. They know their role is to keep the board in control while enabling front-line teams to adapt to a changing competitive landscape. The solution is the rolling forecast, and the key to a successful re-forecasting process lies in how it is implemented and managed. Revenue gains of at least 10 percent are the prize for successful implementation and management, according to the Gartner Group.[5]

Two basic approaches to short-term forecasting exist. The first, which is geared to the fiscal year-end, aims to help managers keep on track and meet their targets. Most re-forecasting efforts fall into this category. They are often known as "3+9," "6+6" and "9+3"—with the second number representing the months remaining until the fiscal year-end. In some companies, this approach amounts to four budget recompilations per year, which adds a huge extra burden to already hard-pressed finance staff. Forecasts are invariably confined to asking the question "Are we on track to meeting our targets and, if not, what action do we need to take?" The resulting action often ruptures carefully crafted strategies meant to create longer-term value.

As a consequence of this gap-closing mentality, forecasts can come to be associated closely with targets. It is not unusual, even among senior managers, to hear that forecasts are not "stretching" enough. Forecasts come to be perceived as a commitment, rather than a realistic assessment of what we think will happen, given certain assumptions. Such thinking leads to spurious forecasts, poor decision making and lack of control.

The second approach to short-term forecasting involves improving decision-making, rather than meeting the number. Most managers know that their operations don't switch off on December 31 and start again on January 1, so they use monthly, or more commonly quarterly, rolling forecasts, or a combination of both.

How does this approach work? Let's assume we are approaching the end of quarter one. The management team receives the rough figures for the quarter and starts to review the upcoming four quarters. Three of the quarters are already in the previous forecast and only require updating. The additional quarter (Q1 for the next year), however, must be added. The management team will spend more time on the earlier quarters than the later ones, using as much relevant knowledge and business intelligence as can be gathered. By definition, the fiscal year-end is always on the 12- or 18-month rolling-forecast radar screen. But the quality of these forecasts can vary widely, depending on the degree of ownership accepted by key managers.

Rolling forecasts differ from budgets in a number of ways. They are based on just a few key drivers, rather than significant detail, and should take only a few days, not months, to prepare. At the short-term tactical level, rolling forecasts should clearly show where the business is going. They should not be used for resource allocation decisions, though they would support the capacity-planning process. Rolling forecasts work best when they support monthly or quarterly performance reviews. Instead of the annual planning and budgeting cycle, planning becomes continuous, and rolling forecasts act as a feeder mechanism. Unlike budgets, rolling forecasts must not be prepared under the umbrella of fixed targets, or spurious data is almost guaranteed. Rolling forecasts usually range from a two- to three-month outlook to a 12- to 18-month outlook.

Effective near-term forecasting is the key to managing the future and maintaining control. Such a change is uncontroversial, and management can make it without fanfare and directives. Most importantly, it is a key step in convincing the CFO to let go of an old annual planning and budgeting system, with its time-consuming revisions. It fills the gap between the coordination elements of budgeting and the more dynamic elements of fast-response devolved management. Forecasting also plays a key role in managing cash flows and investments by informing executives of available resources, which allows them to turn the flows of investment funding on and off. Rolling forecasts also enable executives to kick the addiction to managing the year-end. Rather than focus all efforts on making the target commitment, managers can see the year-end on their radar screens and also focus on managing future business outcomes. Alignment is another benefit, as forecasts done speedily by different business units and functions can be assembled quickly and consolidated to help executives see what is happening throughout the organization. In all, the potential benefits are huge.

So what's the problem? Actually, there are several interrelated problems. For example, when managers fixate on the year-end target, they have little time or incentive to look further ahead. As a result, they are often caught by nasty surprises as managers "game" the numbers to meet targets and achieve bonuses. Another problem is that the forecasting process invariably resides in the planning and budgeting system, and forecasts are seen as commitments or contracted outcomes that managers must meet. Such thinking inevitably leads to unreliable results, as managers do their utmost to avoid promising too much; most take the opposite approach and under-promise so they can deliver pleasant surprises. Doing so might make individual managers feel better but does nothing to help the decision-making process because the company orders too few parts through the supply chain or plans for too little capacity. Some managers (particularly salespeople) want to provide good news, so they overestimate demand and growth and underestimate the volatility of markets and the unpredictable actions of competitors and customers. Thus we can place forecasters into three groups: serial pessimists, serial optimists and objective realists.

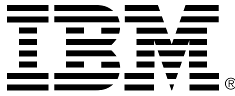
Of course, what we all want is the third type—the objective realists, who take an unbiased view of the future and adjust for volatility and account for risk and uncertainty in a rational way. If, for example, the acceptable variation between forecast and actual outturns is 10 percent, objective realists will be within that range either above or below the trend line. In an unbiased forecast, the difference between forecasts and actuals is as likely to be wrong on the high side as on the low side.

What causes forecast error? Two factors: 1) variation around an average level of error and 2) bias—that is, consistent, systematic error. Unless you differentiate between these two elements, you easily can worsen the problem, but many people confuse bias with variation.

Variation is unavoidable. By definition, it is beyond control. It may be caused by volatile markets and unpredictable events and is almost impossible to correct. Bias, the real enemy of effective forecasting, is endemic in many forecasting processes. Commonly, it is manifested as second-guessing, which can lead to shock profit warnings, as forecasts repeatedly tell senior executives what they want to hear, rather than the unpleasant reality. Once a forecast becomes a target or commitment, it ceases to be effective. Managers avoid attention if they provide forecasts that fit prevailing expectations, which means that they are less likely to be objective and give their best guess regarding forecast outcomes. In other words, the system drives chronic bias. Whether intended or not, the prevailing culture produces forecasts as fixed targets, and when forecasts change, explanations are necessary and can lead to a metaphoric "beating." Few managers invite such an ordeal.

To remove bias, you must remove the drivers—that is, change the system. If senior executives can agree to acceptable variance parameters, they can monitor actuals against forecast to see whether these differences are within set limits. The greater the expected volatility, the wider the control limits and vice-versa. In this way (and with appropriate software tools), managers can test for bias continuously and investigate any that appears. Such a powerful control system can remove bias from the process and provide managers with a realistic and actionable view of the short-term future. Managers need only four data points (e.g., days, weeks, months of data) to analyze a time series for bias, but every report must be explained within its own context to remove extraneous factors.

Some organizations operate forecasts on multiple cycles, offering near-term control and a medium-term view. U.K. manufacturing company Tomkins has done this well and uses rolling forecasts in two ways. One is a monthly flash forecast that looks to the end of that month and two months ahead. The other is a quarterly process that looks six quarters ahead. The forecasting process is now *the key management tool* for managing the business at every level.



Reliable forecasts serve as the essential platform to help managers go beyond budgeting and operate in a more dynamic way. Because the vast majority of forecasts are based not on scientific evidence but on judgment, the only way to improve judgment is to learn from best practices and experience. No clear guidelines exist for the interactive learning experience.

Control systems do not prevent information "black spots" for the board, as collusion between two or more people is hard to detect. But they do enable the CEO to sleep more comfortably knowing that the best systems are in place.

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Endnotes

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