Increased Risk and Business Volatility: A Call to Action to Accelerate Improvements to Forecasting

Tom Willman, The Hackett Group

This essay is part of a series, *Controllers' Corner: Two-Minute Essays on Financial Management and Control*, which asks industry thought leaders for their opinions on critical issues facing today's finance organizations.

"In a more volatile, higher risk business environment, the probability of disruptive events that materially change the outlook of the business increases... calling for 'off cycle,' event-based re-forecasting."

Most companies will need to improve their forecasting capabilities to cope with the rise in business risk and volatility that the economy has experienced in recent years.

Q What can finance organizations do to make sure that their forecasting processes can work effectively in today's business environment?

Forecasting is by definition concerned with future events and uncertainty. The level of business risk and volatility facing any individual company can be characterized as the level of uncertainty about future events and conditions, coupled with the sensitivity of that company's performance to the variability of these events and conditions.

To respond to the structural increase in business risk and volatility that we have experienced in recent years, companies need to improve their forecasting capabilities. Companies that fail to do so will experience a decrease in forecast accuracy and a commensurate increase in the business costs associated with a higher number of forecast errors.

The optimal design of a forecasting process depends upon the business risk and volatility levels to which the company is exposed. The time horizon and frequency of forecasts need to be aligned with these volatility and risk levels. Forecasting assumptions need to be revisited periodically, based on actual economic conditions and assumptions. Value ranges and confidence levels need to be adjusted as conditions become more volatile. Forecast "drivers" need to be modeled appropriately, as does the correlation between variance in driver values and the business outcomes of the forecast. In this research piece by the Hackett Group, we analyze trends in structural business volatility and risk, and relate these trends to forecasting best practices.

Forecasting for a Volatile Environment

Forecasting is at the heart of any company's ability to manage its business in today's risky and volatile business environment. Although both the destination (i.e., future-state forecasting performance levels and service delivery model) and the transformation journey will be different for each company, there are important guiding principles and best practices in forecasting that are applicable to all companies. These main principles are at the heart of creating world-class forecasting capabilities. They are:

1. Transitioning from a year-end forecasting process to a rolling forecast
2. Transforming a financially driven to a business and market driven forecast, based on an integrated financial and operational view of the business
3. Creating a (virtual) forecasting center of excellence to drive consistency, leverage skills and foster organizational learning

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First Imperative for World-Class Forecasting: the rolling forecast done right

The Hackett Group has worked with numerous companies on the transformation of their forecasting, including the implementation of a rolling forecasting process. These companies invariably point to changes in market conditions as the reason to go down this path. Examples are financial market instability, increased exposure to global markets, and a need to dynamically reallocate resources "off cycle" in response to changing market conditions.

Although the rolling forecast is often portrayed as a "silver bullet," Hackett experience suggests that a rolling forecast process designed and implemented without appropriate consideration of the business context will yield few, if any, benefits. Changing from a fixed, year-end forecast to a rolling forecast in and of itself does not address the structural deficiencies of a traditional process. Several best practices need to be implemented for a rolling forecast process to be effective. Some of the more impactful best practices include:

1. **Aligning forecasting timeline and frequency with industry/ market dynamics** – Misaligned forecasting frequencies and time horizons defeat the purpose of the rolling forecasting process. Alignment should not be based just on levels of market risk and volatility, but also on the company's sensitivity to this volatility, and the company's response time to changes in market circumstances.

2. **Designing a top-down, enterprise wide, driver-based forecasting model and assumption management process** – A forecasting model is based on drivers and assumptions, and both are needed to build simulation scenarios. Of course, once a driver-based forecasting model has been developed, it needs to be maintained, which includes ongoing validation of the relationships between existing drivers and forecasted outcomes and the identification of new drivers.

3. **Allowing for event based, off cycle re-forecasting** – By definition, in a more volatile, higher risk business environment, the probability of disruptive events that materially change the outlook of the business increases. Such events call for "off cycle," event-based re-forecasting, and the forecast process design should allow for this. To avoid taking too much time and resources away from other operational tasks during a reforecast cycle, the reforecast may have a more limited scope than the full scale in-cycle forecast. Typically, the companies will focus on the driver(s) directly impacted by the special event.

The Second Imperative of World-Class Forecasting: From financially driven to business and market driven forecasting

The second imperative of world-class forecasting revolves around the role of the forecast in the business planning and control cycle, and the scope of the forecast. Conceptually, the forecast is simply a translation of internal and external operating conditions of the business into a projection of financial outcomes.

The business value of the forecast is a function of the scope and accuracy of the projection and the organization's ability to act on the information effectively. A forecast that is too heavily focused on finance will fall short on all counts of "business value." Companies should follow several key guidelines to transform a financially driven forecast to a business and market driven forecast.

1. **Institute a collaborative forecasting process involving all pertinent business domains** – We mentioned the importance of designing a driver-based forecast model that includes all drivers with material impact on performance. This guideline concerns good information architecture design. Equally important is the collaborative and integrated nature of the forecasting process. Typically, different business domains impact different P&L, balance sheet and cash flow statement items. For most organizations, the most important integration point is the financial forecast and the sales and operations planning (S&OP) process.

2. **Use the rolling forecast as an operational management tool** – Unless forecasting results in concrete management decisions and actions, the whole exercise is futile. The nature of the decisions and actions taken based on the forecast may vary widely. For example, the forecast may trigger the re-allocation of resources to emerging business opportunities, and away from higher risk and lower growth markets. Specific programs may be initiated to close gaps of actual versus planned performance, including increased funding. Actions may range from financial to operational to a revision of strategy, but the key is linking the outcome of the forecasting process to the business decisions. This linkage needs to be designed into the company's broader performance management process and governance model. Governance should clearly establish who is accountable for which performance areas of the forecast, and how decisions will be made to close gaps.

3. **Simplify the annual budgeting process based on the rolling forecast** – It is no secret that the annual budgeting process is a tremendous burden in most organizations. A rolling forecast process can dramatically simplify the process and alleviate this burden. However, this benefit will only be realized if the budgeting process is redesigned and integrated with the rolling forecasting process. In a mature, rolling forecast based budgeting process, the organization always has the same planning horizon, the length of which depends on the rolling forecast timeline. Once a year, the forecast is translated into an annual operating plan and budget, which should simply be a translation of the forecast into the higher level of detail required for a budget.

Third Imperative for World-Class Forecasting: Create a (virtual) forecasting center of excellence to drive consistency, leverage skills and foster organizational learning

The third and final imperative of world-class forecasting revolves around organizational design. We discussed the need for consistency of driver design and assumption management. Additionally, forecasting model design requires specific skills (e.g., statistical and econometric analysis) that can be leveraged across the entire enterprise. Considering these constraints, the optimal organizational implementation of forecasting and modeling is through an enterprise-level center of excellence (COE).

However, by itself a centralized forecasting COE is too far removed from the day-to-day operations of the business to be able to design a good driver-based model for individual business units. This is a collaborative process, requiring the direct involvement of decision support analysts who reside in the business units.

Strategic Implications

Forecasting models represent the complex relationship between external business conditions and internal operational and financial drivers and performance outcomes. As the relationships between these drivers become more complex, and the volatility of the independent variables in the forecasting model (i.e., the "drivers") increases, accurate forecasting becomes more difficult.

On the flip side, under volatile business conditions the business value of a robust forecasting capability increases dramatically, creating a compelling business case for companies to invest in improving their forecasting capability. Since business risk and volatility has indeed increased since the crisis of 2008-2009, Hackett suggests that companies critically assess the adequacy of their forecasting capability, and develop plans to remediate any gaps.

About Tom Willman

Tom Willman is the Global Practice Leader of the Enterprise Performance Management Executive Advisory Program for The Hackett Group. With more than 15 years of experience in finance, accounting and consulting in a wide range of industries, Mr. Willman focuses on helping CFOs and other finance executives transform their organizations by deploying more efficient and effective processes, service delivery models and enabling technologies. Mr. Willman may be contacted at twillman@thehackettgroup.com.

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