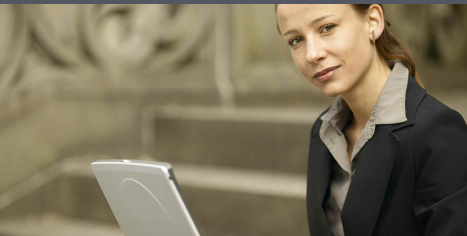


BUDGETING, FORECASTING, and FINANCIAL PLANNING



PROCEEDINGS DOCUMENT:
HOW TO SUCCESSFULLY
IMPLEMENT
A ROLLING FORECAST

JUNE 4 – 5, AMSTERDAM:
3RD SENIOR EXECUTIVE
SUMMIT

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INTRODUCTION

The business world is changing significantly. Volatility in global markets has increased dramatically over recent years, new markets and competitors seem to appear out of nowhere accompanied by new opportunities and new risks. High-profile bankruptcies have created an unprecedented focus on regulation and oversight by investors and government agencies. To deal with such situations, management dare not rely on ten- or twenty-year-old solutions and technologies.

Consequently, forecasting has become a vital management process. It is a mistake to attempt running a business on a budget developed months in the past (and most likely out-of-date the moment it was published). To seize opportunities, satisfy investors, and identify risks as they appear, insight into potential developments is requisite—which demands a contemporary, effective approach to forecasting. Many companies, however, still follow a detailed fiscal-year forecasting approach which limits their ability to make effective decisions beyond the year's end. In fact, many companies do not actually forecast, but merely replan instead.

The Critical Question: How do you shift from a static forecasting model to one that uses a rolling time horizon to support strategy through an improved management process?

That question was the primary focus of a workshop that Cognos, an IBM company, facilitated among 65 senior finance executives attending the 2008 “Budgeting, Forecasting, and Financial Planning Senior Executive Summit” held in Amsterdam. Delegates from across Europe represented industries such as pharmaceuticals, telecommunications, consumer goods, and banking. They came to learn—from their peers and from Cognos experts—how to successfully implement a rolling forecast to enhance organizational performance.

The participants worked in topic-focused peer groups, addressing

- Key business process steps
- Cultural change requirements
- Principles for developing sophisticated rolling forecast models

The workshop included a discussion of best business practices and a detailed review of modeling approaches led by Cognos executives Christoph Papenfuss, Director, EMEA Innovation Center and Innovation Center Manager, Stephen Brook.

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THE SITUATION

Many companies still manage their business using an annual budget, a course of action wholly inadequate in today's constantly changing marketplace. The impact of a global economy—with local conditions creating ripples felt in corporate headquarters—along with the impact of 24/7 business operations, have driven the change. Regardless of industry, the pain is felt most sharply in the office of the CFO and across the finance department. While operating decisions on business strategy, product positioning, hours of operations, and product-line enhancements may be made outside of finance, such decisions should be made considering the critical data finance provides. At the same time, finance needs to consider the impacts of operating decisions on the overall business model. Clearly, a solid forecasting approach is required.

Forecasting is, in essence, determining what the future will *possibly* look like and how a company can react to alternative scenarios. Planning and budgeting, on the other hand, detail what the future *should* look like. Because there are substantial differences between processes, companies need to keep the distinctions clear.

Moving from static annual financial activities to a more dynamic environment, companies are increasingly adopting the rolling forecast or something close to it. Most often, rolling forecasts are updated much more frequently (they're sometimes even event-driven), facilitating more rapid reaction, realignment, and readiness throughout the organization. They also tend to look beyond the arbitrary fiscal year end—since business does not stop on December 31st, after all.

In addition, modern forecasting approaches are lighter and more flexible, thanks to sophisticated modeling techniques that are quite different from traditional accounting-driven approaches. Successful forecasting practices encourage managers to produce a future projection rather than just tweaking numbers to meet budget goals. All in all, companies that have forsaken static approaches have gained much by doing so: For example, they've seen increased forecast accuracy, decreased cycle times, and deeper visibility into business processes and outcomes.

Most companies use spreadsheets for financial analysis, management, and reporting. Among the many difficulties are problems of version control, lack of security, inability to collaborate, and chaos created by hundreds of linked spreadsheets. Furthermore, as organizations drive accountability down to line-of-business managers, they are requiring many non-finance personnel—who may be less comfortable with spreadsheets than finance people—to participate in the budgeting and forecasting process. All of these factors drive organizations to move from stand-alone spreadsheets to discrete performance management applications.



THE WORKSHOP

The 65 delegates were split up into six working groups. Each group was given a challenge that related to specific rolling forecast-related questions. The challenges were:

1. Current problems
2. Barriers to a new approach
3. Modeling for success
4. Measuring the process
5. Rolling the forecast
6. Finance and the business

The following is a summary of workshop findings. For each one of the challenge categories, we have included further considerations not discussed during the workshop. We hope they prove valuable.

1. CURRENT PROBLEMS

Assignment Information

The forecasting processes in many companies do not provide a platform to support today's business requirements. Issues:

- Identify typical static forecasting process characteristics.
- Where are the process challenges?
- People.
- Process.
- Technology.
- What are risks associated with this process?
- Why are companies maintaining the status quo?



Summary of Findings

Companies struggle with forecasting processes for various reasons. Workshop delegates identified a number of issues:

- Forecasts tend to be highly detailed processes that mirror the budget. Not only are the processes detailed, they also tend to be driven by accounting and are very time-consuming
- Since the traditional forecasting process devours time, information obtained is typically out of date. Forecasts are updated too infrequently.
- Because they do not look beyond the fiscal year's end, traditional forecasts provide limited visibility, which makes little sense: Business does not stop on December 31st! Using a forecast to make decisions reaching beyond the current fiscal year is therefore a near-impossibility.
- The forecast is merely a re-budgeting or re-planning exercise and not a forecast in the true sense. People do not try to describe what the future might look like, but rather focus on re-crafting their budgets. This creates an information gap: Is the company on the right track or isn't it?
- The processes also involve too many people.
- Many times, "gaming" is inherent in the system, since managers are compensated on meeting their budgets. As a result, variances might be pushed out towards the end of a fiscal year and the focus is on meeting budget targets instead of identifying business opportunities.
- Lack of transparency.

Other considerations

An estimated 60 percent of all companies use a traditional year-end forecasting process. But the processes are too highly detailed, very time consuming, and seem to add little value to the organization. Furthermore, most people tend to dislike budgeting and forecasting intensely.

There are additional factors that make such processes difficult:

- Forecasts and budgets are managed using hundreds—even thousands—of unsecured spreadsheets. Spreadsheets are error-prone and introduce significant risk: Formulas can be changed, data can be lost, model logic is largely untested, and so on. Forecasts tend to be very much finance-oriented. Business-area managers are asked to provide an outlook based on G/L accounts and time periods. But business managers don't typically think in accounting terms; instead, they think about business drivers.
- The purpose of a forecast is not clear-cut—forecasts tend to be treated as updates to budgets and plans. However, a forecast should detail what the future will look like, while a plan describes the future in general terms. This situation leads to a limited view of likely scenarios, which in turn diminishes the value of the forecast process.



2. BARRIERS TO A NEW APPROACH

Assignment Information

Most companies would agree that rolling forecasts are a necessary and useful management tool, yet very few have actually implemented the process. Issues:

- Identify barriers that may inhibit companies from implementing a rolling forecast.
- How can these barriers be removed?
- How can we sell the required change to the CFO, to the business at large?

Summary of Findings

The group identified issues common to current forecasting systems and processes. Some of the challenges are quite severe and one wonders why companies still stick to them. Curiously enough, more than 60 percent of companies still rely on static forecasts.

Thought-leaders, management consultants, and academics have been promoting the concept of improved forecasting for years. Rolling forecasts seem to make great sense, and companies have reaped tremendous benefits from them. Yet so many are still struggling to move beyond static approaches. Why is that so? What is the impediment? The delegates identified a number of factors:

- There might be a lack of understanding of why things need to change. For example, senior management might not see or feel that effort is required to maintain the current forecasting processes. They obtain the information that they want, but do not understand what is needed to get it. Business areas unfamiliar with finance might not see the need for and value of change.
- With this in mind, developing a positive investment rationale can be difficult. How can we measure the cost of the current process and the benefits of the current situation? Top management support is clearly required.
- Managers are still very focused on meeting budget targets. Creating a “forecasting culture” can be very difficult, since people are not trained to provide an objective outlook instead of an adjusted plan.
- There is a fear of systems. The current processes (often spreadsheet-based) are already difficult enough to manage. Managing an agile forecast with a spreadsheet system is almost unthinkable for some organizations. Financial analysts push back at the thought of having to make significant changes and to juggle spreadsheets more frequently. To remove this barrier, a strong alliance between finance and IT is required, along with the appropriate coaching for business area owners, select finance staff, and other stakeholders.
- Removing barriers requires clear communication across the business—including senior management, the finance-IT alliance, business area owners, and beyond. All in all, communication represents a substantial change-management challenge.
- Decision makers are afraid of failure. Changing the forecasting culture and process can represent complexities that have caused many companies to fail.



- The mindset of the organization has to change. Instead of re-assessing budgets a few times a year, they are suddenly being asked to produce an unbiased glimpse of the future—on a more frequent basis. Implementing change can be seen as both difficult and risky.
- To implement a rolling forecast, companies may have to review and change their current budget-based incentive system. However, incentive systems are extremely difficult to change. Will the move to a new forecasting system be effective without forcing painful change?

A clear, concise roadmap can help eliminate these barriers. It can also help with change management, since the roadmap would lay out objectives, milestones, risks, and opportunities. In addition, organizations will have to accept that mistakes can happen, but that valuable lessons will be learned along the way.

Other Considerations

Removing the barriers and beginning to implement a better process—such as rolling forecasts—is difficult. But it is very do-able, and the potential rewards are great. Here are some other ideas for removing barriers:

- Start measuring the efficiency and effectiveness of the current processes. The process-measurement group (Group 4) compiled some measures that can be used to perform this kind of an assessment. Measurement of the current situation should happen over a longer period of time, and historical data should be used. This will help reveal specific issues and identify anticipated benefits.
- Automating processes through modern technology will free up resources for more important tasks, and will help allay fears of work overload, broken spreadsheets, and so on.



3. MODELLING FOR SUCCESS

Assignment Information

Very often static forecasting processes are accounting-driven, detail-oriented and time-consuming. However, a rolling forecast requires a streamlined, flexible process to enable frequent and timely updates. Issues:

- What are the characteristics of an ideal rolling forecasting model?
- What type of pre-loaded data, inputs, drivers, and calculations should the model include?
- How does this relate to the accountability of participating business units and individuals?
- Are there differences between industries (e.g. utilities vs. software) and forecasting processes (e.g. sales vs. expenses)?

Summary of Findings

Rolling forecasts require a different set of models to provide the platform for a more agile process. Delegates identified the following ideal model characteristics to support a modern forecasting process. Models should be:

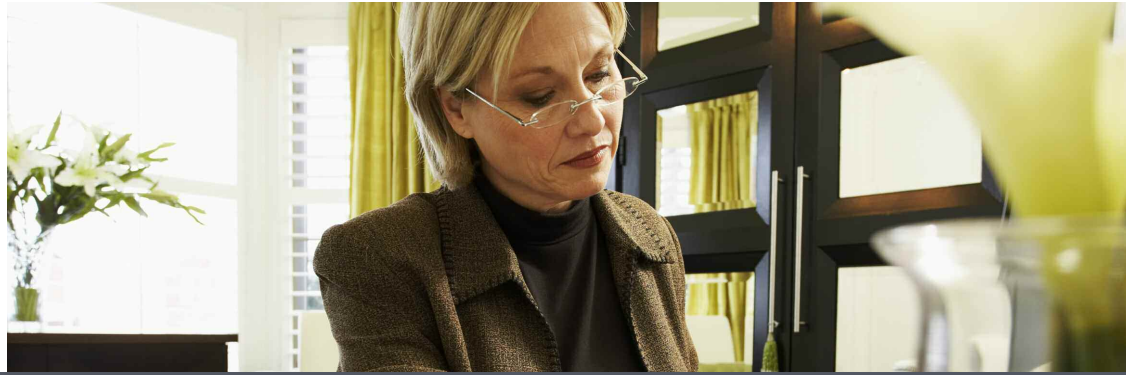
- Higher level than budget: Instead of using many or all line items as in a budget, move towards higher-level groupings to significantly reduce the number of line items, which will then accelerate the process.
- Focused on main value drivers: Models should focus on primary stimulators of value and incorporate driver-based approaches that automate the calculation of line items.
- Run by knowledgeable employees: Staff need to understand both their business and the models themselves.

To facilitate a solid process, the following data inputs were deemed important:

- Current-year actuals (year-to-date)
- Prior-period actuals (as appropriate)
- Previous forecast
- Current budget
- General economic indicators
- Explanations for potential variances in actuals to budget to last forecast

Models should further be structured to drive and ensure accountability. This requires involvement and sign-off by the responsible employees; review could be similar to that of the budget process

The delegates also commented that forecast accuracy should be part of variable compensation to ensure that the models are being utilized correctly.



Last but not least, the delegates explored whether the modeling approach could differ by industry. Issues:

- Does the company provide external guidance? If it does, scrutiny of processes must be greatly increased, which would also affect the required level of accuracy.
- The impact of uncontrollable external factors on results varies by industry. This will drive the detailed design of the models. Specific key drivers need to be incorporated and emphasized accordingly.

Other considerations

Modern forecasting processes really do require models other than detailed, accounting-driven templates. When developing such models, world-class organizations also consider the following:

- Forecasting describes what the future will most likely look like, but there is no “silver bullet” that ensures accuracy. Many companies therefore consider the use of well-documented scenarios. Instead of just providing one forecast, a business manager could be asked to consider alternatives—whether the economy was doing well or poorly, and so on. Thinking in scenarios will help an organization develop a more comprehensive picture of the future, which provides a better response base for both risk and opportunity.
- Incorporating leading indicators (e.g. product quality suggests that customers will purchase more) in the models can help identify trends and double-check forecast values.
- Providing the right solutions to perform detailed analysis of business data will provide insights. World-class organizations provide the right data along with the right analysis tools.



4. MEASURING THE PROCESS

Assignment Information

The forecast process is vital to a successful finance department. Yet very few companies measure process effectiveness and efficiency. This is surprising, since one tends to get what one measures. Issues:

- Why is the forecast process getting so much attention these days?
- Which KPIs can help measure the efficiency and effectiveness of a forecast process.
- How can the data be used to drive change?
- How and when should the KPIs be reviewed?

Summary of Findings

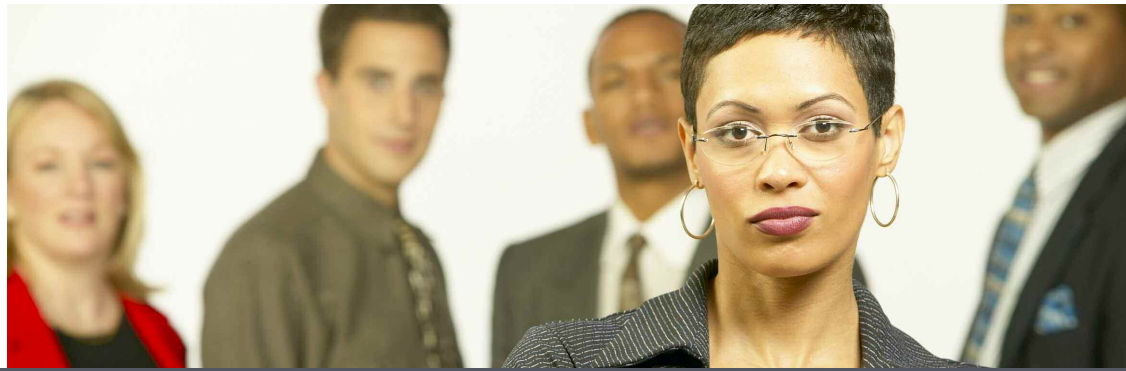
The team had mixed views on whether and how to use metrics to measure process effectiveness. For example, only three out of eight delegates monitor forecast accuracy within their organization. The delegates identified the following issues concerning measures of their forecast process effectiveness and efficiency:

- The forecast process should be placed in the context of expectations of the capital markets and the volatility of the market.
- Forecast vs. forecast and actual vs. forecast variances are common outputs from the forecasting process. There was some discussion on the usefulness of these metrics. It was noted that the main value of the forecast vs. forecast variance lies in its forward-looking nature.
- Effectiveness: sticking to the essentials.
- Follow up and seek senior management attention.
- Organizations shouldn't review the KPIs they use to monitor effectiveness and efficiency too often. It should be done perhaps quarterly, depending on the organization's reporting cycle.

Other Considerations

In addition to the issues noted above, other metrics that can be easily used to gauge the efficiency of a forecast process are:

- Cycle time: The Hackett presentation suggested that longer cycle times not only consume greater resources, but do not actually produce the desired effect—that is, they yield worse rather than better forecast accuracy compared to shorter forecasting cycles.
- Satisfaction levels: Organizations looking to assess the current state of their forecasting can survey key business stakeholders to understand how satisfied they are with the process.
- Staff Leverage Ratio: David Axson defines the Staff Leverage Ratio (SLR) as the ratio of productive, high-value work undertaken by professional staff versus lower-value data manipulation and reporting activities. He suggests that the average SLR for most US companies is around 0.2 to 0.3.



5. ROLLING THE FORECAST

Assignment Information

When talking about a rolling forecast, many assume a default 12-month time horizon. But this seems arbitrary. Further, many companies forecast all processes on the same predetermined update schedule. Issues:

- What are the drivers of an appropriate time horizon?
- Will this time horizon apply to all processes and business units?
- Do these guidelines also apply to update frequency?
- Are there some general rules that we can identify?

Summary of Findings

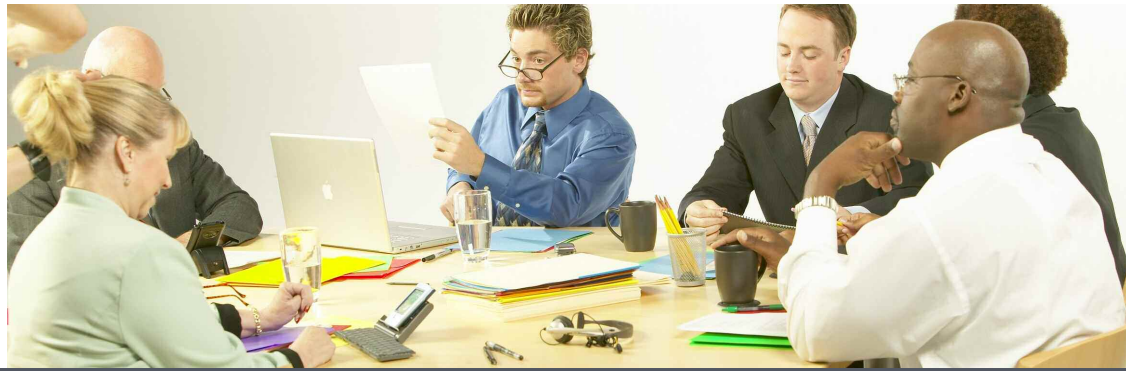
Establishing the appropriate timescale and update frequency for a forecast can be a rather arbitrary decision, frequently based on previous custom and practice. It is sometimes also guided by the ease with which process can actually be supported by the technology solution being used.

The group examined factors driving the most appropriate time horizon for the forecasting process:

- It depends upon sector dynamics.
- It could relate to the length of supplier and customer contracts.
- Business cycle: Perhaps an appropriate forecast horizon might be just longer than a complete cycle, which will vary by industry.
- Availability of good data: Pragmatically, there is no point in forecasting further out if there is no solid basis for the forecast.
- Incremental value-add of the last time period: The acid test is whether forecasting the last time period (furthest out) is adding value to your decision-making process.

Another discussion concerned the consistency of forecasting across various business process or organization units: For example, should every unit forecast according to the same calendar or at the same depth of detail?

- The time horizon should usually be the same for the whole organization.
- Any difference may be justified for companies that are sales- and production-driven.
- The required level of forecast accuracy could differ across units (possibly a function of the sector dynamics).



Similarly, the team discussed whether forecast update frequency should be uniform across all organization units. The following drivers were identified:

- The volatility and materiality of forecast items could drive update frequency (that is, those items that are either less volatile or immaterial may be actively forecast less frequently).
- System availability: On a practical level, the frequency of forecasting might be driven by technology constraints.
- General rules.
- Opportunity to look into the future.
- Culture-driven.

Other Considerations

The process of thinking through time horizon and update frequency can re-focus the organization on the most relevant areas of risk. Consider the analogy of the company as a boat: If the company operates in a dynamic consumer goods sector, it will need to be nimble like a speedboat, making very frequent adjustments to its course. A company operating in a sector involving very long term investments may be more like an oil tanker. It may not be necessary to react so quickly, but changes of course must be planned carefully as they can have effects for considerable time afterwards.

The metrics of volatility and materiality can also be used to decide the optimum effort to invest in the forecasting process. If an organization has a number of smaller or less volatile business units, there may be no point in re-forecasting their performance as frequently as for larger units. For smaller units, it may be more appropriate simply to monitor the current performance against plan.



6. FINANCE AND THE BUSINESS

Assignment Information

Because forecasting processes can be labor-intensive and time-consuming, finance team morale can suffer. Highly qualified finance professionals would rather perform value-adding analysis than merely drive the number-crunching machine. Issues:

- What should be the role of finance in an ideal forecasting process?
- What are the pros and cons of a decentralized forecasting process?
- How should finance govern the forecasting process?

Summary of Findings

This group quickly achieved consensus on how they saw the role of the finance organization. They agreed that:

- Finance should be responsible for the process and its facilitation, but ...
- Finance should not generate the data, because the business itself owns the numbers.
- Finance should challenge the numbers produced by the business.
- Finance can add value through analysis of the numbers.
- Finance should aspire to partner with the business.

Most businesses have a somewhat decentralized forecasting process—one which involves input from a range of staff outside corporate headquarters. The group explored the issues and choices around the use of decentralized forecasting.

Advantages:

- Ownership and accountability, since the lines of business contribute forecast data.
- Alignment.
- Business consensus.
- Same assumptions.
- Business knowledge—those with real operational knowledge run the forecast.



Disadvantages:

- The time required to complete the process.
- Managing the process.
- Communication/coordination of the parties involved in the process.

The group agreed that finance should facilitate the forecasting process. But how should finance go about governing it, and what approach should they use? These factors emerged:

- Finance should define the metrics to be used, and develop standards for them.
- Finance and the business should work in partnership
- Finance and the business should be open with each other to avoid behavior such as layering additional “buffer” or “padding” into forecasts.
- Finance should ensure that the purpose and requirements of the forecast are clear.
- The organization should recognize that finance playing a coordinating role does mean that finance owns the forecast.
- Output should be relevant.

Other Considerations

The issues identified are useful in helping a company understand the extent to which it might wish to de-centralize the forecasting process. In large companies, there is a degree of tension, because attempting to reach the people who really understand the business will mean that greater numbers of staff participate in the process. Many companies find that such large-scale forecasting cannot work with traditional spreadsheet-based approaches. Coordinating communication and workflow in large organizations is best performed using a specialized planning or forecasting solution.

In addition to the responsibility for facilitation and governance of the forecasting process, there is also an opportunity for finance to take on the task of “coaching” the business. For example, finance can help the business with some of the topics discussed above, such as understanding the right performance metrics to use, how to derive relevant drivers of business performance, how operational factors drive financial results, and so on.