



Planning and forecasting: Use continuous planning and rolling forecasts to support adaptive management

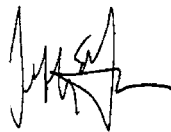
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You've probably heard it said that change is the only constant in business. If that's the case, why do so many companies lock themselves into a rigid system of annual plans, budgets, and targets that make rapid response to changing markets – and increasing competition – difficult, if not impossible?

In this series of six articles, Jeremy Hope explains how organizations are using innovative practices to create sustainable improvement in financial and operational performance. The finance teams in the companies highlighted have eliminated many of the barriers preventing the transition from business-as-usual to create – as Jeremy says – a more adaptive, lean, and ethical organization. By grabbing on to new ways of doing business and replacing (not just supplementing) outdated practices and solutions, finance can drive enhanced productivity, performance, and profitability.

Jeremy Hope, Research Director of the Beyond Budgeting Roundtable, is an advisor to the IBM Cognos® Innovation Center for Performance Management. 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.

In this fourth article in our six-part series, Jeremy explains how successful companies replace tedious annual planning cycles with regular business performance reviews and rolling forecasts to empower managers at every level to identify trends and patterns, threats and opportunities, and then make rapid, informed decisions to stay ahead of the competition.



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Introduction

The typical CFO presides over a performance management system involving plans, targets, and resources that are negotiated, annual, and fixed. Such systems were designed for stable trading environments in which manufacturing firms could invest and plan with confidence. But not only has the manufacturing sector shrunk dramatically as a proportion of economic activity (now less than 20 percent of total activity in most Western countries), the business environment is far less predictable. Companies must now simultaneously compete and cooperate with each other. Entry-level costs into the markets of the information economy are low, and new competitors can spring from anywhere at any time with new business models that take incumbents by surprise. The steady, continuous change of the industrial age is giving way to the unpredictable, discontinuous change of the information age. The future outlook is increasingly unpredictable, employees are more demanding, the pace of innovation is quickening, prices are falling, customers now rule suppliers, and shareholder loyalty can no longer be taken for granted.

To cope with these changes, CFOs need to implement systems that provide managers at every level with the capability to make fast and well-informed decisions. They need to replace annual planning cycles with more regular business reviews supported by rolling forecasts that enable managers to see trends, patterns, and “breaks in the curve” long before their competitors, and thus make better informed decisions regarding products and markets. In particular, the CFO needs to manage through continuous planning cycles, make rolling forecasts the primary management tool, and report key metrics daily and weekly.

This paper will examine how organizations can use such practices to adapt to emerging threats and opportunities.

Manage through continuous planning cycles

Adaptive organizations see planning as a continuous, inclusive process, driven by events (such as the launch of a new product or a competitive threat) and emerging knowledge, and not constrained by the current financial year. In organizations subject to continuous change, it might be appropriate to set regular (monthly or quarterly) strategic reviews or to make a review dependent on some significant event. A CFO of a Fortune 50 company explains why planning systems need to be flexible and owned by the local team. “Once the year is under way, we review performance twice a quarter. We ask questions about how we are doing, what’s changing in the marketplace, what are the new opportunities that have arisen, and so forth. We might then produce a new estimate based on the latest knowledge. Plans never work out the way you expect, so you have to adjust as you go. There are new risks and opportunities arising all the time especially in financial services. The key performance measure we look at each quarter is improvement over prior year.”

The planning cycle has four steps: check, aim, plan, and act (see figure 1).

- **Check.** It starts with *check* (where are we right now? What does the short-term future look like?)
- **Aim.** The next step is *aim*. Are we on a trajectory to meet our aspirational goals? Does our strategy need to change?
- **Plan.** The third step is *plan*. What actions do we need to take to improve our performance? What impact will these actions have on our performance?
- **Act.** The fourth step is *act*. How should we execute the plans and manage the existing business?

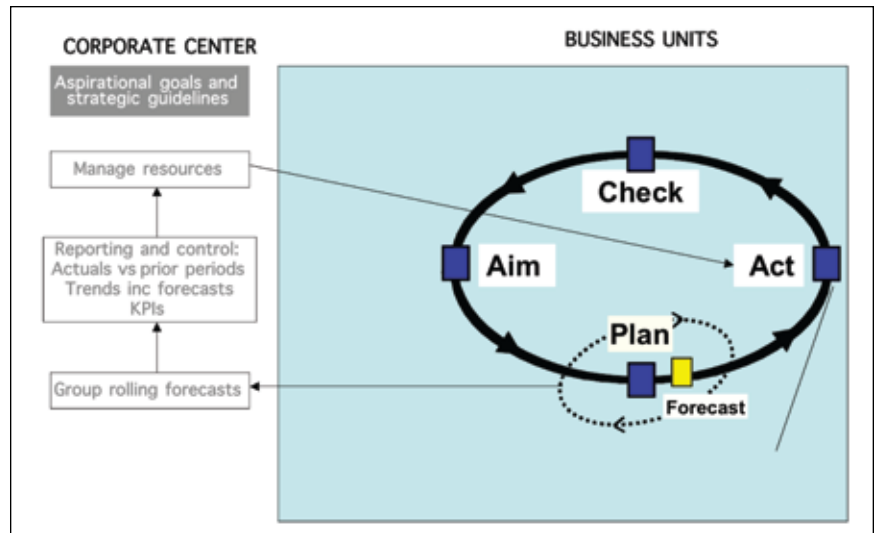


Figure 1 - The Check-Aim-Plan-Act Cycle

You will note that nowhere in this *check-aim-plan-act* cycle has the team made a commitment to a higher authority to reach a specific target. In other words, there is no fixed performance contract. All the commitment to improve is within the local team. This taps the power of intrinsic motivation. It is the team that sets the goals and plans, and it is the team that has the drive to make them succeed. This *local* check-aim-plan-act cycle is typical of many adaptive organizations. But the key to its success is that it is driven *locally* by people who want to improve their relative performance.

How does this cycle work? Imagine you have just been appointed as a branch manager at a retail bank. You have inherited a poor situation. First you *check* where you are. You are at the bottom of the league table and your cost-to-income ratio is lagging behind. Second, you *aim* for an improvement goal. You consult with your team and your regional managers and you decide to set a goal to improve your cost-to-income ratio by 30 percent over 2 years. Thirdly, you *plan* what to do. You discuss with your team the options available for achieving this goal. You then

test the options by examining their likely forecast outcomes. You would also have a dialogue with your regional manager about the range of options available and ask his advice. He would ask questions about assumptions, risk, time-scales, and may even provide some input about best practices elsewhere. Finally, you *act*. You choose those initiatives that offer the best chance of success. You then acquire (or reduce) the resources you need to put the plans into action. This cycle repeats itself endlessly as the branch continuously tries to improve its performance.

Consider using strategy tools such as the Balanced Scorecard

In organizations where strategy is a high-level, exclusive process, devolving strategic capability is not straightforward. Teams who have previously been implementers rather than thinkers and planners take some time to get their act together.

They need help. They need coaching and support from their more experienced colleagues and they need tools, models, and information to help them. Kaplan and Norton's solution to these problems was the development of the "Balanced Scorecard." In its first iteration it was primarily seen as a better *measurement system*. The original Balanced Scorecard was organized around four perspectives – financial, customer, internal, and innovation and learning. The name reflected the balance provided between short- and long-term objectives, between financial and non-financial measures, and between external and internal performance perspectives.

However, over the course of the 1990s as more firms bought into its ideas, it became obvious that rather than simply use it as a better measurement system, a number of firms (or more accurately, business units within firms) were using the Balanced Scorecard as a framework for formulating and executing their strategy. It was at this point that the most important element of the Balanced Scorecard was developed – the Strategy Map. Figure 2 shows how a finance team can help an airline focus on the right strategic objectives, measures, targets, and action plans through the design of a simple strategy map. To increase profitability (the

financial perspective) it needs to both operate with the minimum number of planes and increase its volume of customers. To achieve more customers it must ensure that flights are on time and that it offers low prices (the customer perspective). To operate with the minimum number of planes it must turn them around quickly at the gates (the operational perspective). To turn planes around quickly, it must train ground crews and align their performance evaluations with this objective (the learning perspective). Notice that targets are derived from objectives and measures, and that actions follow targets.

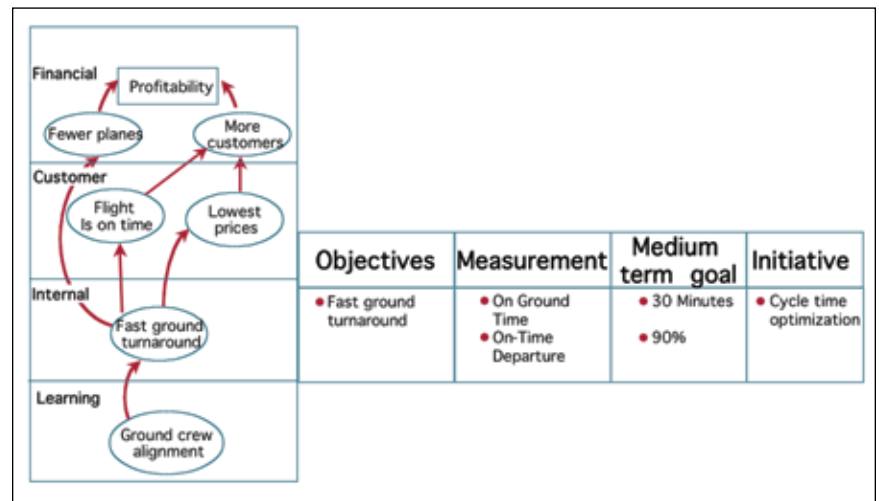


Figure 2 - A strategy map for a low-cost airline

The key change, however, is in the performance review meeting. Instead of the finance team demanding to know why financial variances have occurred, they are focused with their operating team colleagues on how to improve the business. Why are turnaround times not improving? Why are take-off times not up to par? These are the kind of questions that meetings now address.

Use rolling forecasts to improve near-term visibility

Near-term forecasting is invariably confined to asking the question, “Are we on track to meeting our targets and, if not, what action do we need to take?” Such forecasts are not aimed at supporting strategy; and what managers often find is that there’s a gap between October and January (as this year’s accounts and next year’s budgets are being finalized) when no one is looking at likely future performance. Adaptive organizations know that their operations don’t switch off on December 31 each year and start again on January 1. They deal with these problems by moving to monthly or (more commonly) quarterly *rolling forecasts*. Figure 3 shows a typical five-quarter rolling forecast. Let’s assume we are just approaching the end of Quarter One. The management team gets the rough figures for that quarter and starts to review the next four quarters ahead. Three of those quarters are already in the previous forecast, so they just need updating. A further quarter, however, needs to be added (Q1 for the next year). More time will be spent on the earlier quarters than the later ones using as much relevant knowledge and business intelligence as can be gathered.

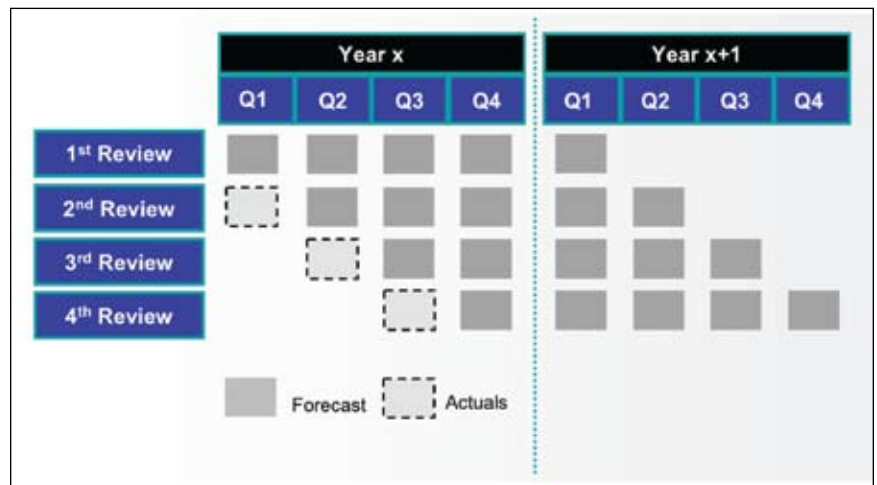


Figure 3 - A five-quarterly rolling forecast

Make forecasting a management – not a measurement – process

Forecasts must not be seen by senior managers as a tool for questioning or reassessing performance targets. Nor must they be used to demand changes or improvements. If forecasts are used to micro-manage or demand immediate action, then trust and confidence will rapidly evaporate. The only time such questions can fairly be asked is if forecasts show a significant change and such a change has not been explained beforehand. Managers should be responsible for dealing with problems and reflecting any corrective actions that they have taken in their revised forecasts. Again, if managers see that forecasts have an impact on their investment plans, they will be reluctant to present an unbiased picture. This was borne out at Danish petrochemicals company Borealis. When rolling forecasts were introduced, the initial response of managers was to include – indeed inflate – their capital expenditure commitments thinking it would influence their approval ratings, but when they realized that this had no effect (these investment decisions were taken over by a quarterly review committee), they gradually adjusted their forecasts to reflect a more realistic view of essential project expenditure.

Adaptive organizations use forecasts to support strategy reviews, rather than simply check where they are against the annual plan. Borealis has developed a fast process taking no more than one or two days per quarter. Originally designed to help with financial and tax planning, the forecasts have evolved into an integral part of the strategic and investment planning process. It is important to note that forecasts are now completely separate from any form of target-setting or performance measurement; thus managers can give their best estimates based on an open and unbiased view of the most likely future outcome. According to financial controller Thomas Boesen, “[B]ecause forecasts are separated from any form of performance evaluation, we get far more accurate forecasts than was ever the case with the budgeting system.” Forecasts are updated quarterly and look five quarters ahead. This approach has reduced dramatically the amount of time managers spend in forecasting compared with the previous budgeting process. Boesen reports that the reduction is about 95 percent.

The forecasting intervals and time taken should reflect the needs of the business. In a financial services business, for example, with no physical supply chain and inventories to manage, there is no reason why forecasts should take longer than a few days. However, in a fast-changing, capital-intensive business, where forecasts are used to make key decisions about capacity requirements often involving significant capital sums, forecasts can take longer.

Base forecasts on a few key drivers, not masses of detail

In adaptive organizations, the forecasting process is relevant and fast. It covers the important figures only. Orders, sales, margins, costs, and capital expenditure are typically the crucial data necessary (based on appropriate drivers) to produce them quickly. They should enable teams to test their strategic options within the actual performance system rather than just some off-line spreadsheet. One approach is to distinguish between “baseline” forecasting from “baseline plus” forecasting. Baseline is all the irrelevant data that you should just forecast as a whole and the uplift (baseline plus) is the data that’s relevant and where a manager’s time should be spent. Again, depending on your level in the organization, your criteria of relevance will be different.

To create the framework for a new system at a large financial services company, business units had to identify key performance drivers based on company-specific algorithms. How would \$1 in billings or one additional card member affect the bottom line? Previously, the staff had given a lot of attention to the impact of salaries and benefits on net profits. Managers had believed that all they needed to know was the cost of adding or eliminating an employee. However, they found that these numbers only had a 5 percent effect on the net figures. What they needed to identify were the volume drivers, those that influenced 80 percent of the numbers. This turned out to be only 15 lines on the profit-and-loss statement.

The team found that billings were what really drove the business: how much card members spent at restaurants, on airline tickets, and for major purchases. Two specific drivers behind this volume were the number of credit cards and the average spending per card. Knowing those two items allowed them to calculate the billings numbers. These numbers, in turn, affected quite a few other items on the profit and loss statement. From billings numbers, they could project the membership rewards, level of delayed billings, amount of interest income, measure of risk for bad debt and so forth. The trick was to create the algorithms that accurately forecast the billings.

Using driver-based forecasts together with dedicated systems and web technology enables hundreds of managers to work on forecasts together and aggregate the outcomes to the highest level thus providing more control than ever to the board. It provides many benefits including releasing people from all the non-value-adding work of detailed budgeting and clearing away all the uncontrollable spreadsheets that proliferate in large organizations. It also enables the firm to standardize on a single methodology and align key assumptions and algorithms across many business units.

Ensure that forecasting models are consistent and aligned

Most forecasting processes use simple spreadsheets. While this is fine for small local requirements, spreadsheets can cause problems when they need to be aggregated across and up the organization. It is also apparent that in large organizations, different units use different assumptions, algorithms, and software. This makes it difficult to combine and consolidate forecasts.

Software vendors are now offering sophisticated models to enable large organizations to prepare forecasts and consolidate reports quickly. Teams can build business rules and structures, then modify the model as their business evolves, easily accommodating changes such as new locations, new or discontinued product

lines, or restructured cost centers. Many have powerful modeling capabilities that enable teams to flexibly devise, compare, and assess alternative business scenarios. Such systems allow teams to build models in days rather than months. Data definitions can be imported from other sources like ERP and general ledger systems. They also enable cross-functional models to be built.

Most organizations suffer because they can't access the data they need quickly enough. Adaptive organizations use proprietary calculation engines that enable them to evaluate models and test assumptions in minutes. They avoid unproductive activities like tracking down numbers, fixing broken links, and debugging macros. They enable driver-based forecasting and the rapid recompilation of multi-dimensional models.

Adaptive organizations go to great lengths to ensure that their forecasting models— together with key assumptions and algorithms— are consistent across the group. This is essential if multiple users are working on forecasts at the same time and sharing information. One global organization discovered that there were two types of standards at work: those within a business unit and those across the company. It realized that the methods for forecasting needed to be consistent across all business units, but at the same time allowing for local needs. Spreadsheets did not give them that control.

If organizations are serious about managing strategy rather than numbers, then they need to implement a planning and forecasting model that supports that process. Indeed, surveys show that most organizations want to do this. But how these models are implemented is crucial. If they become entangled in the web of targets and measures, then you can say goodbye to quality data and the process will be a waste of time and money. That's why planning and forecasting systems must not be seen in isolation from other components in the performance management system. They must be part of a coherent system that supports the right behavior



About the author

Jeremy Hope is research director with the Beyond Budgeting Roundtable, a members-based consortium of organizations dedicated to finding better ways to manage performance. He has co-authored three books – *Transforming the Bottom Line* (1995) and *Competing in the Third Wave* (1997) with Tony Hope and *Beyond Budgeting* (2003) with Robin Fraser – all published by Harvard Business School Press. His latest book *Reinventing the CFO* will also be published by Harvard Business School Press in late 2005. He is also an advisor to the IBM Cognos Innovation Center for Performance Management.

About the BBRT

The Beyond Budgeting Roundtable is an independent international research collaborative that supports a global network of BBRT regions and members that share knowledge for mutual benefit, and searches for ways to build lean, adaptive, and ethical organizations. The BBRT is dedicated to helping organizations improve bottom-line performance by introducing simple adaptive control principles and continuous planning techniques.

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