The Power of Rolling Forecasts

Information Management

Cognos software

Executive Summary

The impact of 24/7 business operations has created an environment of constant and rapid change. Risk, volatility and uncertainty are constant. Organizations not only have to anticipate and react to traditional competitor activity, but also factor in growing competition from places such as China, Russia or India. Further, any economic turbulence has far-reaching and almost immediate impact. Just consider that in the space of one week the U.S. investment banking industry, a pillar of the economy, fell completely, having a domino effect around the globe.

There is no question that this exposure to change is felt most sharply in the office of the CFO and the finance department. While decisions on business strategy, product positioning, hours of operations and product line improvements may be made outside the finance department, those decisions are made based on key data and analysis provided by the finance team through performance reporting and forecasting. Forward thinking finance teams recognize that traditional static forecasts are not up to the job and are rapidly adopting more dynamic, rolling and driver based approaches.

Clearly a reliable and flexible approach to anticipating and forecasting future performance is required to ensure businesses can prepare for the unexpected. The question is, what is the alternative and how should it be introduced? In 2009, the IBM Cognos Innovation Center for Performance Management conducted a number of executive workshops across Europe to discuss these topics.

The salient points of discussions at these evente are summarized in the following document. Leading the workshops were Christoph Papenfuss, Director, IBM Cognos Innovation Centre and Stephen Brook, IBM Cognos Innovation Center.

A) Where Do Organisations Stand Today

The workshop leaders asked delegates for a view on whether future business activity is less or more predictable than ten years ago. All delegates believed it was much less so. Yet, when asked if their planning and forecasting processes had changed significantly in the same period, the majority said that no real changes have been made. The majority of attendees still leverage a traditional year-end budget process and quarterly forecast process.

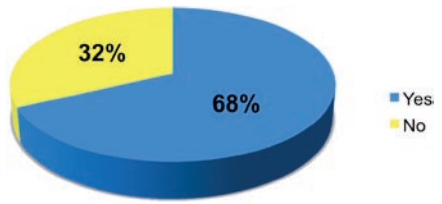
The challenge is that by the time the budget is approved and in action, some of the numbers which were inputted three months ago by business managers are already out-of-date. Certainly, 12 months later, even the best laid plans and most informed forecasts are no longer relevant. This is the way in which budgets were built 70 years ago, but this is not good enough for today. As the challenges facing businesses evolve, so too must the approach to optimizing performance in this environment. Changing the forecasting model is key to this, and the finance department has responsibility to drive this forward.

One thing which the workshop leaders wanted to make clear was the main focus of the event – forecasting. This is about identifying what the future will most likely look like. Based on this outlook, business managers can make the right decisions on how to react. On the other hand, plans and budgets detail what the future SHOULD look like. There is a distinct difference between these two processes and companies should keep them separate.

A Snapshot Analysis of Delegates

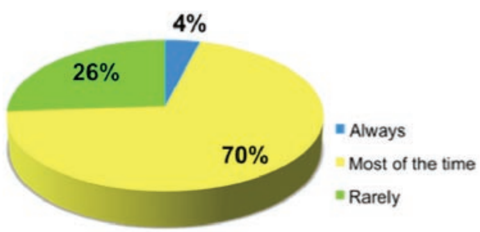
Ahead of the workshops, the IBM Cognos Innovation Center for Performance Management sent a survey to all attendees. The breakdown is detailed below.

1/ Do business managers see planning as a high value activity?



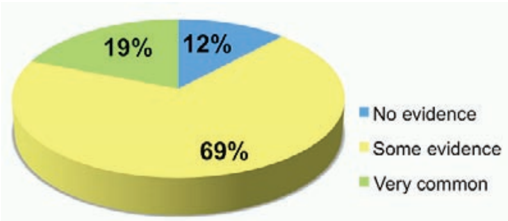
The survey shows that nearly a third of business managers don't see planning as a high value activity. This is a serious problem. While the finance team is responsible for managing the forecasting process that drives business decision-making, the business itself provides and owns the numbers. The less a business manager is engaged in the process, the less time he / she is going to dedicate to providing an accurate future outlook. Inaccurate numbers render the business-critical process meaningless. The problem is that it is seen as an accounting process, rather than a business process, which helps them. It should be seen as a chance to take a step back and consider the opportunities and threats affecting their business. The fact that many managers aren't doing this is worrying.

2/ Do business managers have confidence in the outputs?



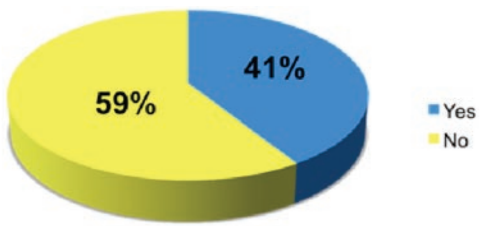
As forecasts are meant to underlie future decisions and guide performance, it is worrying that over a quarter don't trust them. Papenfuss also points out that little comfort can be drawn from the fact that 70% said that that it is right 'most of the time'. His view is that the forecast is right 'most of the time' due to luck. Mr Papenfuss argues that if the market had been volatile, or if a competitor made an unexpected move, these forecasts would not have helped predict this possible outcome. Only 4% believed outputs were always as expected. Therefore, less than one in 25 organizations have full confidence in their predicted numbers.

3/ Are managers motivated to negotiate plans or sandbag budgets?



In too many organizations, forecasts are not just used to guide decision-making, but also to set a benchmark for distributing bonuses. However, this leads to business managers 'playing the system' to ensure they get their financial reward at the end of the year. When business managers submit their predictions for sales, they often underplay, or 'sandbag' the expected numbers to ensure that they are easy to exceed. However, this inaccuracy leads to an unrealistic picture of the future business, which could give rise to potentially damaging decisions being made. Just consider if a sales team believes it will hit 100 sales of a product in a quarter, yet forecasts that it will hit 80. Based on this information, the manufacturing plant will only buy enough raw materials for 80 products, and possibly lose out on the opportunity for 25% more sales.

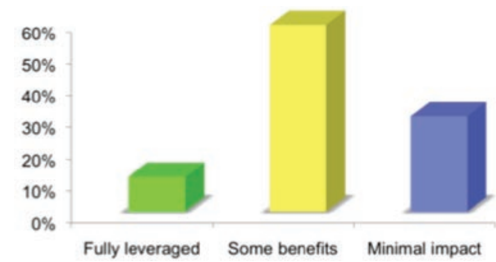
4/ Do plans identify the impact of all major initiatives on key measures?



The workshop leaders argue that every organization needs to be able to draw a direct line from every new project or initiative, to the balance sheet or profit and loss account, current and future. However, this survey highlights that two out of five organizations ignore projects that could substantially impact future numbers.

For example, when attendees were asked if they made predictions on or tracked whether technology investment would impact the business, the majority admitted they did not forecast this. These omissions lead to an incomplete view of future performance.

5/ To what extent have the full benefits of technology been realised?



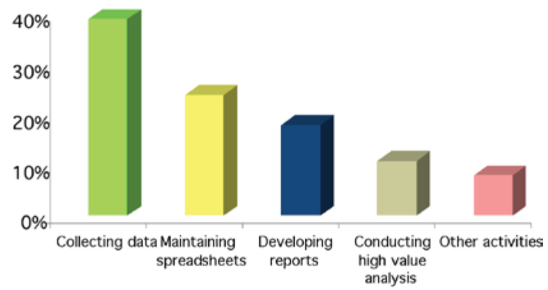
While many respondents had taken steps to improve the process through introducing new systems, for most only some benefits had actually been realized.

Technology has significantly and positively impacted our personal and working lives in the last decade – just consider BlackBerrys, mobile phones, social

networking sites and SatNavs. The continued reliance on old tools is an anomaly in an increasingly technically savvy world.

According to attendees, the overwhelming challenge in moving away from spreadsheets is a cultural one. Too many employees are reluctant to move away from antiquated spreadsheets towards the modern technology. So many have used spreadsheets their whole working life and they believe will be difficult to use another solution.

6/ Where do analysts spend their time



The responses of the survey show that analysts spend the majority of their time on low value-add tasks. Mr. Papenfuss and Mr Brook argue that the picture should be reversed. Analysts need to spend more time on conducting high value analysis and other activities such as meeting with their business partners. The results of the survey are attributed to the extensive use of spreadsheets. Modern performance management technology on the other hand provides the means of automating many of the low value tasks.

Instead of manually preparing spreadsheets and loading them with actuals, the rolling time horizons, performance management solutions provide the ability to centrally maintain models, to automate data loads and to leverage standard mechanisms for the monthly handling of complex data.

C) A New World, A New Approach

A new approach to forecasting is clearly needed, but the question asked here is what should that be?

Before deciding on a new approach, the workshop leaders asked the group to consider what forecasting should achieve:

> *'Forecasting is the process of periodically updating the current view of future performance to reflect new or changing information. It is based on the process of analysing current and historical data to determine future trends.'*

To break this down, Mr. Papenfuss believes that a forecast should be the preparation and consolidation of interim forecasts. This would typically include external market factors such as market size and share, sales, capital spending, production and operating expenses and other key business measures

He believes that the current method of static forecasts no longer achieves this in today's business environments. When competitors were less active, customers more predictable and markets less volatile, forecasting new numbers every 12 months was enough to reflect new or changing information. However, this is not frequent enough to manage today's business challenges.

D) Challenges In Moving Away From 12-month Forecasts

What is clear is that most finance directors at the workshop understood that annual forecasting is not good enough. Yet very few have implemented an alternative. Ahead of considering what these might be, the workshop leaders looked at why so many organizations were still relying on static forecasts.

Some of the reasons are listed below:

Forecasting is a time-consuming process

Many of the delegates said they found the forecasting and planning process time-consuming, expensive and detail-intensive.

A survey of attendees showed that it took an average of three to four months to build the detailed forecast for the 12 months of the next financial year. This clearly makes regular forecasting a logistical challenge.

Cultural challenges

Many companies treat the forecast as a plan update. A submitted forecast becomes a new target. This can lead to dangerous gaming behavior. Forecasters no longer provide an objective outlook but rather a number that they feel comfortable with. A sales manager, for example, would submit a sales number that is achievable as opposed to a realistic market assessment. This in turn can lead to issues if sales come in much higher: product & resource shortages will create issues.

Technology

People have used spreadsheets their whole professional life and are reluctant to move away from the tools which they see as being 'good enough' and, most importantly, familiar.

Until the arrival of powerful Performance Management software, the lack of adequate technology has been one barrier to best practice forecasting. Today, technology is integrated, flexible, easy-to-use such as IBM Cognos 8 are well placed to support the best practice process of forecasting. These platforms enable companies to significantly speed up their processes and to automate process steps. This results in analysts and business managers being able to spend more time on high-value work rather than simple data collection and spreadsheet maintenance.

The conclusion is that it is not the potential of technology, but the operating business process that is limiting the value of forecasting.

E) Rolling Forecasts

It is clear a solid forecasting approach is required to support decision-making.

In response to this need, many companies are increasingly adopting rolling forecasts.

Companies that have moved away from the static approach often see an increase in forecast accuracy, faster cycle times, less administration for the finance team, better business engagement and more informed decision-making.

The workshop leaders spelt out some of the key benefits which organizations experience when adopting rolling forecasts.

Ensures a consistent time horizon of the future: The workshop leaders used a driving analogy to illustrate this point. When driving, you need to have a consistent view of what is ahead of you on the road so you have sufficient time to react to unexpected obstacles or danger. Looking ahead to business performance is the same. If an annual forecast for business performance ends on December 31, by the middle of December the finance team does not have a view of what to expect for January 1. Business does not stop on arbitrary dates, and forecasts should reflect this.

Provides a baseline for future plan periods: A rolling forecast is continuously updated, so when it comes to putting together the annual plan and budget, the finance team will already have a base line "business as usual" view of time ahead. This takes a lot of the initial pain and figure-gathering out of the process.

Captures the longer-term impact of changes: A project rarely fits neatly into an accounting year or period, but obviously you have to spend money before you can get results on a project. A traditional forecast places an artificial deadline on when the results should be realized. For example, money is often spent on a technology implementation in one financial year, while the return is not seen until the following one. As a result, long-term and potentially beneficial projects can be pulled at times of cost-cutting. This is especially relevant in economically difficult times.

Realistic view of the future: When asked how long it would take to develop a new forecast after a triggering event, such as a competitor product launch, 42% said that it took 7 days or longer. However, the delegates agreed that businesses should be able to build a new forecast based on events or external impacts much more quickly. For example, if a competitor launches a new product. Or if banks raise or slash interest rates, impacting consumer spend and / or the business' own ability to repay loans. These are events that may alter the business' future performance and which should be understood quickly. Rolling forecasts, in contrast with the static annual ones, can be updated regularly at points that are sensible for business decision-making.

Relieves the finance team of a huge administrative burden: Forecasting processes can be labor-intensive and time-consuming, the morale of the finance team can suffer. Best practice forecasting is not just about producing them more frequently, but also removing unnecessary details from the process. There is no point in including predicted rent or salary costs in a weekly forecast, as these line items will not change from week-to-week and just bog down the report. All these factors reduce the amount of time spent on administration, and increase the amount of time focused on strategic activity. There is also a need for supporting the process with better technology, as spreadsheets will not be able to cope with a more rigorous and regular forecasting process.

F) Understanding The Limitations Of Rolling Forecasts

While many organizations have benefited from a rolling forecast, it is not right for all. There may be some industries for which a 12-month static forecast is sufficient, however these are getting few and far between.

Importantly, for those considering a move to a rolling forecast, it is critical to understand that there is not a 'one-size-fits-all' approach. The right way to approach the change depends 100% upon your business and its decision-making requirements. Every company has to make decisions that work for their specific business.

Mr. Papenfuss warns caution for those who do want to move to a rolling forecast, and lists a number of areas to bear in mind:

Understand the rhythm of your business: While the rolling forecast allows you to project a constantly adjusted view of the business, the time horizon must match the natural rhythm of your business. For example, pharmaceutical organisations have a rolling forecast of 17 years for a specific drug's profits, as the patent on a product lasts that length of time. But other businesses should not use that time horizon as a guide. Just consider investment banks and retail banks. While a 90-day forecast is sufficient for a retail bank, this would not be enough for the fast-moving world of investment banks.

Understand your predictive ability: Everyone would like to have a crystal ball to predict what is coming but this is not possible. There is no point in trying to predict the sales team's expenses for 12 months. Firstly, this is almost impossible so the numbers are likely to be wrong. Secondly, it is unlikely there is any need to know these numbers 12 months beforehand. The level of detail predicted should be driven by decision-making needs. Only predict the numbers you need to make the next decision. Organisations should not try to overstretch themselves and forecast numbers for the sake of it.

Avoid creating confusion with annual performance targets: In too many organisations, bonuses depend on hitting the forecast numbers. The workshop leader believes that this idea is very dangerous. Firstly, this could lead to sandbagging. Secondly, if competitors grow more than your organisation, even though you hit your forecast numbers, it is not good performance relative to the market. Yet you will end up awarding staff for a performance that is below market average. The converse is also true. It may be that there are difficult market conditions, and you don't hit your target numbers. However, if you grow more than your competition, staff should be rewarded. The message is that forecast numbers should be kept separate from awarding bonuses.

G) Designing A Rolling Forecast

As was previously mentioned, there is no one size fits all rolling forecast. Individually, there are a number of areas which organisations must consider when designing one to best suit their organisations.

Purpose

Before even considering the different elements of a forecast, the purpose(s) must be clearly defined. Only then will the business managers be able to provide the right information. The purpose should outline the business decisions or plans that the forecast is designed to support. This helps forecasts 100% focused on supporting the decision-making which matters.

Content

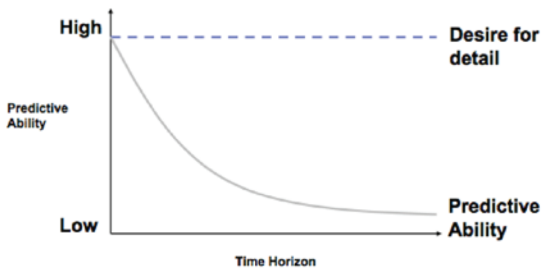
It is critical to define the exact variables that are to be forecast. Firstly, the workshop leaders believe that many organisations spend too long on forecast line items which are not relevant to decision-making. For example, they ask sales teams to forecast rent or electricity bills. As business managers have little involvement in these areas, it leads to them being less engaged with the process. Instead, finance teams need to identify the exact drivers and information requirements to best support the development of a meaningful forecast. Therefore, they need to be asking for forecast submissions in the language business people will understand. For example, how many customers do you think you will retain or how many trade shows will you need to attend in this next quarter? This engages the business managers more. It's a question of forecasting line items which matters, rather than those finance departments have simply fallen into the habit of forecasting. Workshop leaders also encourage businesses to consider new measures to forecast, such as customer delight or customer lifetime value. These are the things that will really have an impact on performance.

Time horizon: It is critical for the finance team to define the period for the forecast. This will vary from organisation to organisation, and from line item to line item within the same organisation. For example, the forecast can even be a matter of weeks, such as retail sales over the Christmas period, to many years, such as population growth in a specific area.

It can also be focused on a fixed end date; a rolling end date (e.g. four quarters) or vary based upon another variable, such as the selling season.

Level of detail

As before, it is critical to match the desire for detail with predictive ability to help set reasonable limits. The further ahead an organisation tries to look, the more likely it is to be wrong, as this graph shows.



The challenge is to get the balance between what is required to be predicted and what is realistic. It should be a perfect balance of the following:

- When does a decision need to be made?
- What is the minimum amount of information needed to make the decision?
- What are the consequences of getting it wrong?

Scenarios

The basic scenario is to forecast the most likely future outcome based on information currently available about internal and external influencers. But there is no silver bullet for making a totally accurate forecast. As a result, best practice organizations use scenario planning. Instead of just providing one forecast, a business manager could be asked to think of multiple scenarios that may affect performance. This could include how he thinks the business will do if the economy does very badly or very well. Or, a scenario could take into account a specific event, such as the merger of two competitors or a major terrorist attack. Thinking in scenarios will enable an organization to develop a more comprehensive picture of the future, which can then create a better basis for reacting to risk and opportunities.

Frequency

A rolling forecast is more than forecasting once a year, but how often should it actually take place? Again, this depends on the business. The workshop leaders point to three different factors which should influence the decision:

- External needs – reporting to shareholders, investors and the market
- Management decision-making needs – the key driver for forecasts
- Operational needs (related to resourcing the business)

The workshop leaders do stress that organisations should not allow their commitments to external reporting to dominate their forward-looking forecasts too much. Ultimately they should be used for business decision-making, to get bogged down with external

requirements. For example, companies such as Google or Coca Cola don't even provide external indicators about future performance. According to Eric Schmidt, CEO of Google:

> *"There is a cost to not providing guidance and I understand that. The reason that we don't is our business is so dynamic we'd have to give very broad ranges and I don't think that would be constructive."*

Too much focus on future reporting for external demands will take away time spent on reporting for management, and guiding decision-making.

Participation

In many organizations, finance is responsible for compiling and preparing the forecast. While business managers might provide limited input, the burden is on the finance team. Companies have reported that this approach creates two potential issues:

- Limited buy-in from the business.
- Finance tied up in data collection rather than analysis

Companies are moving towards a high-participation model. Business managers create the forecast and finance provides valuable insights. This approach speeds up the process. Working as a team will help ensure the content of the forecast is more relevant, while ensuring engagement with the business managers. This will go a long way to ensuring they not only see the forecasting process as an important business activity

H) Change And Driving The Difference

Making the decision that rolling forecasts are for your organisation and choosing the right technology platform to support it is one thing. However, changing a long-standing process is quite another. It will need to be carefully planned and, critically, it should have senior level buy-in to increase acceptance.

The workshop leaders believe that the challenge is to highlight the key benefits to senior management and business managers. A key point to bear in mind is that senior managers have to see return in investment. While business managers need to see the value the change will bring to their business processes.

From past experience, there are three things that they recommend:

1/ Building commitment through involvement: Don't just show and tell business executives about the advantages of the new approach to forecasting - involve them in the change process. If senior executives can see the potential benefits in action, then they are more likely to support the project.

2/ Check the health of your forecast: Best practice companies measure and monitor specific performance indicators to assess the health of their forecasting processes. This helps identify issues. The key measures are: Forecast Accuracy (Actuals vs prior Forecast), Process Cycle Time (time from start to end of the process) and Senior Management Confidence. Measurement should be frequent and the results should be communicated. Companies find that these measures help drive change.

3/ Maximizing the finance team resources: The finance team should be focusing on three things – transaction support, risk management and decision-making. The key is to highlight to business leaders that the final two add most value to the business and performance, yet, the majority of the finance team's time is taken up by transaction support. Rolling forecasts will change this. Another thing to stress is that a move to rolling forecasts will help with staff retention within the finance team. Bright finance executives do not want to spend their time on administration and transaction support, and will leave if they are forced to.

4/ Gain momentum quickly: Too many projects create a lot of excitement at launch time, but don't deliver for months. This is a sure fry way for a project to lose momentum. A good rule of thumb is to ensure that meaningful, tangible results are delivered every three months. Then, your marketing effort should publicize these successes widely to ensure high visibility.

Conclusion

All attendees agreed that it is more of a challenge to drive performance management in today's increasingly volatile, complex, competitive and global markets. In this environment, forecasting has become a tremendously important management process. To seize the right opportunities, to satisfy investors and to identify risks as they appear it is crucial to gain insight into potential future developments. Management can no longer rely on traditional management tools that worked fifty, or even ten, years ago.

In reaction, more and more organizations have already moved, or are planning to move from static forecasting model to one that utilizes a rolling time horizon. The workshop attendees were in agreement this would better support decision-making.

However, this cannot happen overnight as it requires process, cultural and technology changes. To drive change management, careful planning, leadership, marketing skills, business support and best practice technology are all needed. However, with the right technology and dedication, the successful introduction of rolling forecasts is achievable and thousands of organizations across the world are already reaping the benefits.

For additional resources, please consult:

i) Best Practices in Planning and Performance Management, by David Axson

ii) The IBM Cognos Innovation Center for Performance Management: cicpm@us.ibm.com

About IBM Cognos BI and Performance Management

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IBM Canada
3755 Riverside Drive
Ottawa, ON, Canada K1G 4K9

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