



Managing through change: The power of rolling forecasts

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Business never stands still. E-business has broken down natural competitive barriers, creating new challenges and offering new opportunities. And as competition heats up, so does demand for resources. Many CFOs and CIOs are just plain jittery over such trends. And they wonder if their in-place planning, budgeting, and forecasting tools will really help them succeed...or even survive.

Steve Player offers good news: Many organizations are finding success by adopting a rolling forecast to supplement existing approaches or – in some cases – to replace less-effective alternatives to help their companies become more agile and more adaptive.

In this paper, Steve reviews the purposes of traditional planning, budgeting, and forecasting, as well as common associated problems. He highlights improvements achieved through rolling forecasts and enumerates rolling forecast “dos” and “don’ts.”

“Managing through change: The power of rolling forecasts” is the first in a new series of papers written for the IBM Cognos Innovation Center for Performance Management by Steve Player. Steve is North American Program Director of the Beyond Budgeting Round Table, CEO of the Player Group, and an Innovation Center Advisor. He is co-author/editor of four books on Activity-Based Management, has been featured in major business publications, and regularly publishes case studies documenting successful implementation of “beyond budgeting” principles.



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Traditional budgeting – Objectives and common problems

Budgets have been described as “a financial blueprint of management’s expected plan of action.”¹ As such, they serve at least six key functions.

- Setting targets
- Aligning incentives
- Developing action plans
- Allocating resources
- Coordinating across all functions
- Monitoring and controlling finances

Many see these budget functions as keys to successful management. Yet numerous studies have identified criticisms and complaints. One well-documented issue is that traditional budgeting often creates a fixed performance contract that limits an organization’s ability to be responsive in today’s ever-changing environment (see *Exhibit 1*). The annual budget or plan often has all the elements of a fixed contract, including contract period (typically one year), fixed targets with pre-determined rewards, allocated resources, and a monthly control process to track progress to pre-defined targets. The entire process is agreed to through lengthy negotiation before ultimate sign-off by managers and directors.

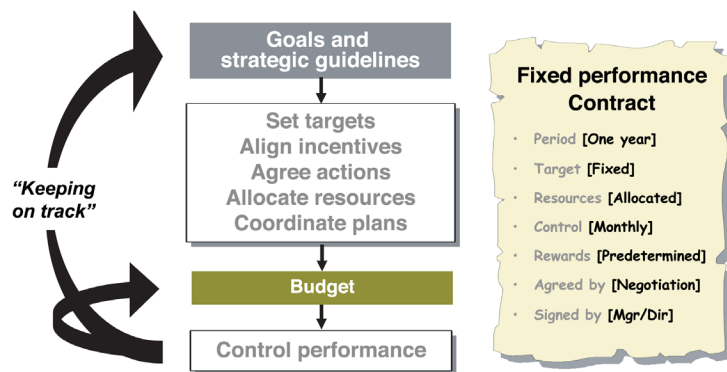


Exhibit 1. What is the budgeting process?

Many believe that this negotiation process is driven by a manager's desire to reach incentive targets. Operating managers typically want to negotiate targets that can be easily reached. Senior managers try to stretch the targets and the budgeting games begin.

The ills of traditional budgeting in large corporations are detailed in a chapter of the recent book *Winning* by Jack Welch, former Chief Executive of General Electric. Jack begins Chapter 12 "Budgeting: Reinventing the Ritual" by saying:

Not to beat around the bush, but the budgeting process at most companies has to be the most ineffective practice in management. It sucks the energy, time, fun, and big dreams out of an organization. It hides opportunity and stunts growth. It brings out the most unproductive behaviors in an organization, from sandbagging to settling for mediocrity. In fact when companies win, in most cases it is despite their budgets, not because of them.²

While there are many criticisms of traditional budgeting, the following seven are sources of pain for most organizations. Most find that budgeting:

- Costs too much
- Takes too long (budgets are out-of-date when published)
- Does not add value in managing the business
- Requires a crystal ball to predict the future
- Slows response time, limiting discussion of innovative ideas to narrow budget preparation window
- Leads to gaming where managers try to negotiate low targets to reach maximum bonuses
- Sub-optimizes results³

The Beyond Budgeting Round Table has defined a new management model that overcomes many of the problems in traditional budgeting. It can be compared to the approach to achieving the key functions noted above (see *Exhibit 2*).

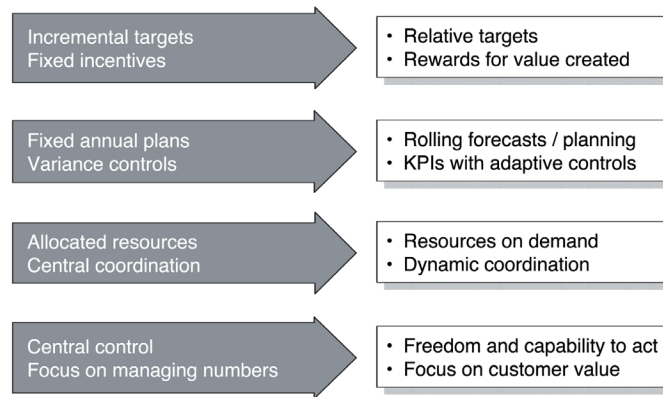


Exhibit 2. The new framework for continuous planning and adaptive control

With this model as context, the remainder of this paper will focus on rolling forecasts.

Traditional forecasting

Many organizations seek to mitigate some of the budgeting problems noted above by implementing a form of forecasting that allows managers to update budgeted numbers with actual results from past periods. The forecasts are used to predict what may happen in the future, often seeking to confirm whether pre-determined annual targets will be met.

While financial managers think of forecasting in terms of periodic forecasts, operating managers constantly adjust plans, including sales estimates, which are converted to operating plans for production and inventory control levels. Most of these efforts are conducted in discrete systems supporting diverse functional areas. A great deal of effort is required to integrate and reconcile these differing views of the future.

Financial forecasts are performed on a preset schedule, typically quarterly or monthly. Often, they only forecast to the end of the financial period (a process described as “forecasting to the wall” below).

Publicly held companies usually time the forecasting process to support discussions with investment analysts. According to David Axson, author of *Best Practices in Planning and Management Reporting*,⁴ the average company takes 14 days to develop a financial forecast. Axson explains that process cycle times are prolonged due to:

- Difficulty in getting timely information
- High level of required detail taking significant time to forecast each item
- Data in disconnected spreadsheets, making integration a time-consuming process

Many companies use a purely financial process that is disconnected from its specific business drivers – a mere accumulation of financial trends. Such companies often determine their monthly forecasts by subtracting actual results-to-date from their annual targets, dividing the gap by the months remaining, and then viewing the monthly result to see if it is even possible to attain. All their forecasting work focuses on achieving the pre-defined annual targets, even if their underlying assumptions are incorrect.

The level of detail used often mirrors the annual plan. Some planners forecast at the same level of detail used for actuals reporting, which can require tremendous efforts in calculating and explaining variances. In some cases, apparent variances are merely due to timing differences – for example, March sales are lower in a particular year since Easter falls in April. The downside of excessive detail is that the time spent calculating variances reduces the time available to review significant items.

Such an approach often turns traditional forecasting into a version of traditional budgeting – with its attendant problems. Let’s examine why:

For many organizations, forecasting is a mechanical process that adjusts future run rates upward or downward as necessary so that predetermined annual targets are still met, but ignoring the fact that targets were set based on various assumptions. What happens when the annual targets are held, but their underlying basis proves incorrect? The quality guru, W. Edwards Deming, noted that, “[I]f you pay people to hit targets, they often will, even if it destroys your company.”

Pitfalls to avoid

This assortment of “Dos and Don’ts” should help you successfully implement rolling forecasts by identifying some pitfalls to avoid (don’ts) as well as ways to leverage success (dos).

Pitfall 1 - Forecasting to the wall

The most common pitfall occurs when a company forecasts to the end-of-period, as is illustrated by *Exhibit 3*.

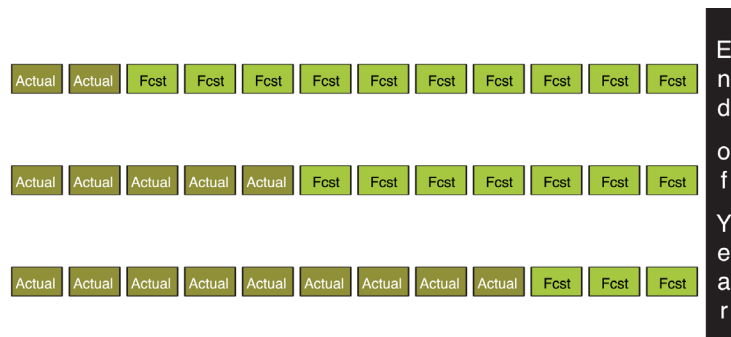


Exhibit 3. Forecasting to the wall

When this approach is taken, the purpose of forecasting shifts dramatically. Instead of being a discussion about organizational direction and the risks and potential opportunities in getting there, the conversation quickly turns to one of performance evaluation and a revalidation of whether managers still agree to earnings commitments. The conversation cannot be about the future if the future magically ends when the period ends.

Some organizations try to make the shift by extending their forecast period into subsequent periods. This effort is also ineffective if all management review questions continue to focus on the period end. Rather than coordinating activities for the future, this process is about performance evaluation. In essence, senior management is asking whether each operating manager can be trusted to deliver her/his share of the earnings target. This tends to garner cautious responses, particularly for those lagging in performance who want to project confidence in their ability to catch up, while those running ahead project high future costs to avoid having their targets raised at mid-year.

Top management then faces a maddening game of trying to find the organization's true position. This makes calls for forecast accuracy seem like a reasonable response.

What is really needed is an unbiased forecast with a narrowing degree of uncertainty, which would imply that any occurrences over-forecast would balance out those under-forecast. As Hope points out, "... [T]he only certainty about a forecast is that it will be wrong. The question is by how much. Narrowing that variation comes from learning, experience, decent information systems, and ultimately, judgment."⁵

To overcome forecasting to the wall, organizations should use a rolling forecast with a consistent period in each forecast. The objective is visibility across the business cycle.

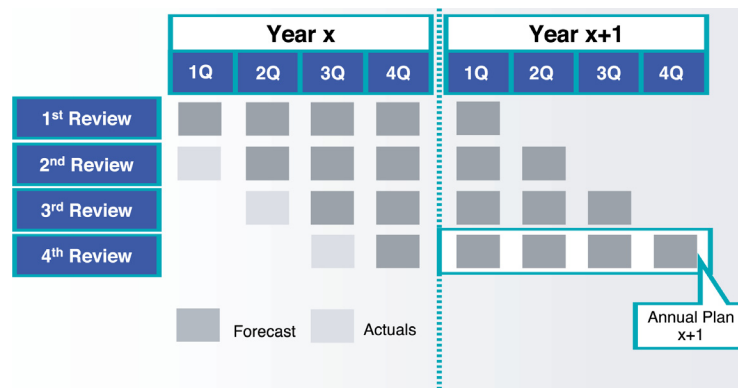


Exhibit 4. Use Consistent Period Rolling Forecasts

The process goal is coordination of the different parts of the organization using the latest available estimates of what may likely occur. Action plans to correct negative trends or to exploit positive developments can be included with discussion of their likelihood of success. These plans can be made dynamic based on the movement of leading indicators.

Pitfall 2 - Confusing forecast with targets

The second key pitfall occurs when managers confuse forecasts with targets. Simply stated, targets are where a company wants to go. They are typically medium-term aspirations or goals that often get converted into quantified annual targets. Forecasts, on the other hand, highlight a company’s strategic direction.

The problem occurs when the two points are different. Many organizations use the forecast to “close the gap.” Managers who are behind on an actual basis can show their organizations catching up in the forecasts. The problem with this approach is that it blends both current trends with expected results of future action plans. It obscures the details of what needs to happen and limits discussion of the risks of achieving these action plans.

This pitfall can be avoided by projecting the current trend line of actual results and overlaying explicit discussion of the corrective action plans management anticipates using to close any gaps (*Exhibit 5*). This provides a better view of the risks of achieving initiatives. Organizations that merely provide a single forecast line blend both trends and action plans which require senior management to “trust them” to reach their goals.

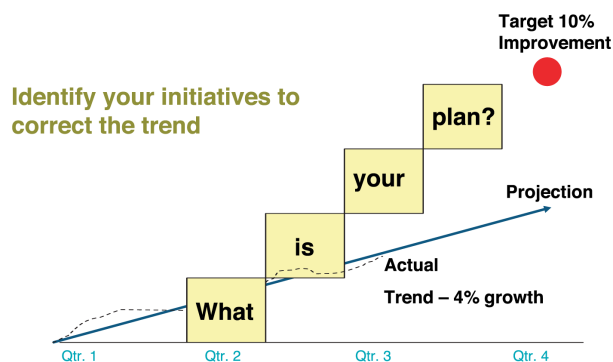


Exhibit 5. Separating Forecast Trends from Targets

Pitfall 3 - Insisting on forecast accuracy in an unpredictable world

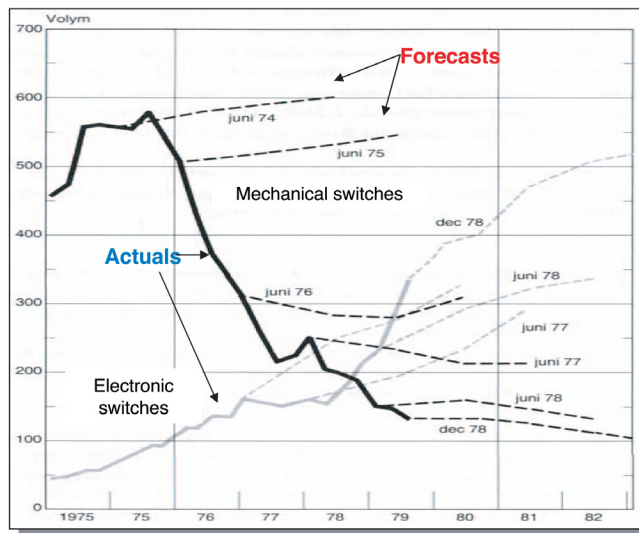
Many believe forecasting is about both predicting and controlling the future. Some organizations have a goal of forecast accuracy even to the point of providing incentives to achieve forecast accuracy. While motivated by attempts to control the world, such efforts seem highly irrational in today’s volatile and chaotic business environment.

To accurately predict the future, any business would need to forecast the price and availability of key business inputs such as labor, transportation (which is likely influenced by oil prices), and interest rates or other capital costs. Strategic planning also requires forecasting the success of planned improvement actions, the response of current and future customers, as well as the countering actions of current and future competitors.

This is just the beginning of the list.

Ironically, while there is a need to plan and control, the only thing certain about most forecasts is that they are likely to be wrong. More than 30 years ago, after spending 20 years as a professional economist, Dr. Jan Wallander (who eventually became CEO of the Swedish bank, Handelsbanken) reached the following conclusion:

Although it was useful to understand the interactions between various events, the degrees of possibilities made it virtually impossible to accurately predict a specific outcome. His conclusions are illustrated by the histogram in *Exhibit 6*.



Source: Jan Wallander, Budgeten - ett onödigt ont, 1994, p24

Exhibit 6. Histogram to Evaluate Ability to Predict Results.

The solid lines track actual results, while each broken line shows sales forecasts. Any business using forecasting could develop a similar chart to track its forecast accuracy.

The expense side becomes a little more predictable as many organizations use the annual budget process to authorize expenditures. This outflow is often authorized regardless of whether the full amounts of related revenues have been realized. While this chart reflects annual projections, the same approach can be used with quarterly or monthly forecasts.

However, a major problem with forecasting, when used in a predict-and-control environment, is the natural tendency to make sure forecast numbers are achieved. Companies typically forecast a conservative net income that minimizes revenue expectations while it maximizes future expenses, so long as the net total is acceptable. While considered prudent from a financial management point of view, this approach results in constant minimizations of opportunities and timid approaches to growth.

Budgeting expert Jeremy Hope notes, “The purpose of forecasting is to inform decision makers to help shape outcomes, not to predict the future. In reality, forecasting is necessary only because organizations cannot react instantly to changing events.”⁶

The focus should be on understanding how to react more quickly and understanding both causes and effects. The winds will change, how quickly can you trim your sails?

Pitfall 4 - Forecasting with spreadsheets

For most organizations, forecasting is performed using spreadsheets. Well known as a powerful personal productivity tool, the spreadsheet is ill-suited for integrated cross-company communication and collaboration. While it is possible to do a single pass with spreadsheets, multiple iterations with changing budget assumptions are a nightmare to control. Security of key financial data is difficult. Consolidation of results is cumbersome. The risk of error is high, with user reviews often the only control mechanisms.

All of these issues lead to excessive time required to gather the data and validate that what has been received is the most current and accurate information. A recent benchmarking survey⁷ by the American Productivity and Quality Center, a recognized resource for process and performance improvement, notes that companies that rely heavily on spreadsheets typically take 30 days longer to complete their budgets than those who use integrated systems. Companies that have moved to continuous planning all have fast, open information systems. In contrast, using spreadsheets to budget is neither fast nor open.

Reductions in the cost of technology are allowing companies to move away from reliance on spreadsheets. Enterprise-class solutions such as IBM Cognos TM1 can be implemented quickly, provide real-time, read write budgeting, forecasting, planning and analytics, flexible modeling, and scalability. Such tools support dynamic business workflow and provide views of complex data across multiple dimensions and drill-downs into specific data. Any organization still using spreadsheets to budget should examine such tools that can greatly simplify the budgeting process.

In conjunction with the use of a proven technology, many organizations have found key levers to improve the success in using rolling forecasts. These new solutions include:

- Using today's tools to visualize results
- Focusing on critical drivers and avoiding excessive detail
- Matching your forecast with your ability to see
- Using different time horizons for different decisions, but integrating systems
- Moving to advanced planning approaches

Improvement levers

Improvement lever 1 - Use today's tools to visualize results

Most financial departments continue to present results using tables of data that compare the current period to the budget or to the prior period. This is usually done for the current period and for the year-to-date amount. Differences (or variances) are then calculated, usually in both dollars and percentages, with an explanation included for items over a certain amount.

The problem with this approach is that it focuses on snapshots in time. Normal variations in operations make trends difficult to identify (e.g., Easter falls in March one year and April the next), and companies focus on the past, rather than a combination of past and future. Management can get better analysis more quickly by taking advantage of today's tools to visualize results.

As illustrated by *Exhibit 7*, today's reporting tools provide graphical options for viewing and understanding information. This creates a dynamic view, easily shared across the enterprise, enabling financial managers and executives to perform analysis more quickly.

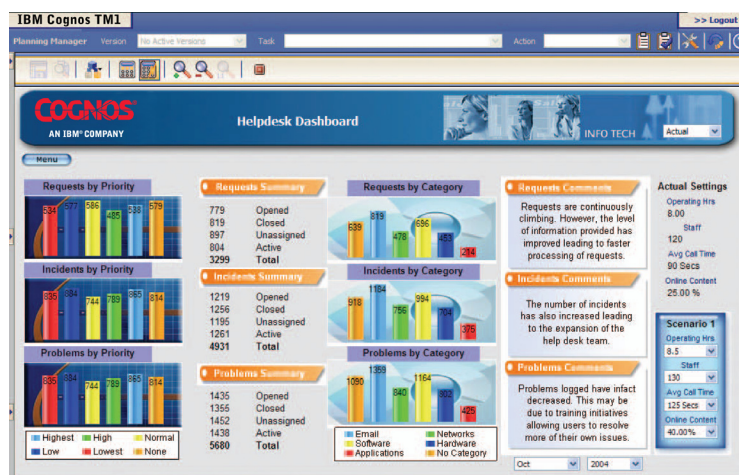


Exhibit 7. Visualizing Results

Improvement lever 2 – Focus on critical drivers, avoid excessive details

Some organizations spend a tremendous amount of time preparing their annual budgets. Consequently, they doubt their ability to move to rolling forecasts, seeing the effort as performing the same amount of work four times per year. These organizations are confusing accounting detail with useful management information. The two are not the same.

Budget managers often want plans to match each line of accounting detail (budgeting at the chart of accounts level). How else can managers understand what causes budget variations? These approaches miss the major point. What is the purpose of planning?

The more detail an organization pumps into its plans, the more variances it needs to calculate and explain. Since each analyst has a fixed amount of time to work (whether you consider that 40 hours per week or 168 per week), there is a direct trade-off between the amount of time spent gathering data and calculating forecast variances and the amount of time spent on useful analysis. The more line items a business has, the less time it spends on analysis.

Leading companies focus on the critical drivers that determine whether they will be successful. This requires managers to determine which factors actually drive their business. While today's information age provides an overwhelming number of signals, adopting a driver-based approach to forecasting allows managers to focus. It also requires a disciplined strategic approach to get management to agree on what will be key to their success.

Improvement lever 3 – Match your forecasts with your ability to see

Some organizations try to adopt the best practices of others by directly copying their approaches. They assume the only type of rolling forecast is a five-quarter rolling forecast. While five quarters seems to be the most common time-frame for a rolling forecast, it is not the only one, nor is it necessarily the best for all situations.

One of the key benefits of adopting rolling forecasts is that management can focus on understanding the degrees to which they control the future, as well as the external events that force them to react. By tracking those external factors and understanding the company's speed of reaction, managers gain a deeper understanding of how to make their organization more successful.

Leading organizations match their forecasts with their ability to see. At a large competitive exchange carrier, this translated into requesting that the field prepare rolling six-month forecasts. The planning director at that organization noted, "When we asked the field how far out they could see, they told us six months was

the maximum. But the forecast we were asking for went out twelve months. We realized any data past six months was just mathematical extrapolation. We decided we would rather ‘do the math’ at corporate to better understand and control the assumptions in the forecast.”

Similarly, at a large credit card company, the move to continuous planning was driven by a desire to speed the organization’s ability to optimize their investments and speed new cardmember growth (*Exhibit 8*).

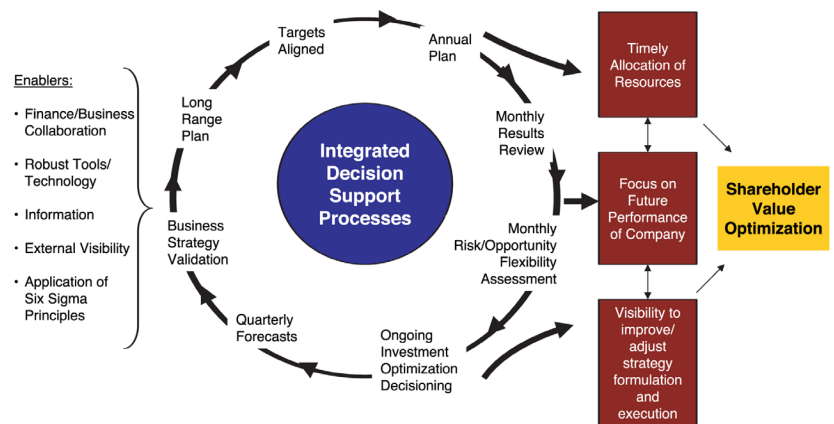


Exhibit 8. Continuous Planning Example

By adopting a 15-month rolling forecast, the credit card provider was able to improve the visibility of investments in marketing initiatives, customer support systems, and capital expenditures used to drive future improvements. The ongoing investment optimization decisions greatly accelerated the organization’s ability to respond to rapidly changing markets. In the first full year of operation, using rolling forecasts to frequently review investments is credited with increasing the growth in new card-holders by eight percent, which directly improved the credit card company’s bottom line.

Improvement lever 4 - Use different time horizons for different decisions, but integrate the systems

Another key to success with rolling forecasts is realizing that different decisions require different time horizons. Operational functions are engaged in short-term sales and operations planning to make sure current orders can be fulfilled in a timely manner. Financial forecasts are used to understand cash flow needs for the near term and for identifying longer term capital requirements. Organizations with specialized fixed facilities, such as semiconductor manufacturers, need at least a five-year horizon to determine build-outs of fabrication facilities. Extraction industries such as coal, petroleum, and other mining companies often need 30-to-50-year plans.

Leading companies use different processes to meet such divergent needs, but they do so by using integrated systems. Updates to one system feed into others. This integration is one of the latest advances in how leading edge planning systems enable companies to manage adaptively.

Improvement lever 5 - Move to advanced planning approaches

Moving to rolling forecasts allows organizations to utilize advanced planning approaches. This is primarily driven by available information and available time to move to more advanced states of performance.

A key example is scenario planning (*Exhibit 9*). Using this approach, management identifies possible future outcomes as well as the events that might trigger them. The impact of these events is mapped, as well as the counter-measures that could be taken.

In an example from the same credit card company, the potential effects of a second Gulf War are estimated. Management then identifies what counter-measures they can take to respond to the negatives. The business can plan different scenarios and create management “playbooks” that allow the organization to rapidly respond to developing events.

Frequent scenario planning allows finance to forecast the potential impact of a range of uncontrollable events to the annual plan...

...and to create management “playbooks” to mitigate risks and take advantage of emerging opportunities

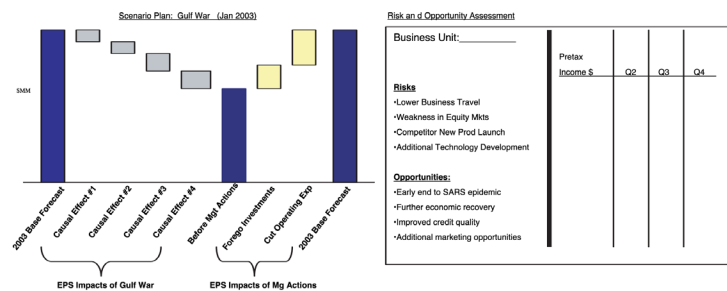


Exhibit 9. Move to Scenario Planning

A summary of risks and opportunities helps managers focus on both positive contingencies as well as negative trends. This approach shifts planning into looking at what is possible, rather than merely reacting to what has occurred.

Numerous companies have adopted rolling forecasts. Some of the more advanced firms have even used them to replace annual budgeting processes. In essence, they are continuously planning and have eliminated the need for an annual budget event.

Dos and Don'ts for Rolling Forecasting

Rolling forecasts need not be as oppressive and unpleasant as the annual budgeting and forecasting cycle. In fact, if implemented well, a rolling forecast with a performance management platform that streamlines the process can run like the proverbial well-oiled machine.

Getting started

Because it is strategic, the rolling forecast should not be implemented with tactical tools. Spreadsheets may seem up to the task, but they aren't. To get the most out of rolling forecasting, look at options that incorporate your overall budgeting, forecasting, planning and strategic management needs. In many cases, the solution is a performance management application that automates data input, provides real-time data access, offers a variety of front-end user interface options, and grows with your business.

Once you've integrated your disparate information systems to yield "a single version of the truth" – that is, your performance management application can serve up the complex, detailed data you need, you are ready to move forward with rolling forecasts.

Here are some Dos and Don'ts, provided by a specialty pharmaceutical company employing innovative strategies for its products through its internal and financial management. These tips come directly from the CFO and senior director for planning and decision support.

- **Do** involve the senior management team early.
- **Do** start with the basics: revenue and P&Ls, and major markets or divisions.
- **Do** incorporate driver-based forecasts to facilitate top-down KPI and goal setting. Once you add the driver-based information, the rest of the details are pretty easy to work out mathematically.

- **Do** increase participation. Rolling forecasting enables more parties to participate in the process and also facilitates participation.
- **Do** link accountability to those in control.
- **Do** train the parties using the system. Training puts you in front of users, enabling you to enhance buy in. Training also serves as a forum to discuss user needs and to agree upon common definitions.
- **Do** make sure there are IT systems in place that can support your implementation and processes. Where possible, you want to pre-populate the forecast to reduce both the time for manual entry and the possibility of errors creeping into the forecast.
- **Do** continually improve your processes to ensure that both user needs and company needs are being met.
- **Don't** underestimate the significance of the change. Many of your team members, colleagues, and executives have decades of experience with the annual process. These patterns, as well as your own business processes, are ingrained in the ways people work. Studies have shown that when corporate processes are changed, one-third of the people will embrace the changes, one third will resist the changes, and one-third will leave the organization. You need to understand that this is a significant change in mind-set. Focus on the value of the activity – greatly reduced effort in the budgeting process.
- **Don't** ask for excessive detail, especially at the initial roll-out. You don't need actuals – you need information for forecasting.

Summary

Rolling forecasting is a strategic opportunity, not an onerous task. Implemented correctly, rolling forecasting can be the single most valuable tool to “trimming those sails,” that is, identifying where changes need to be made in order to maximize profitability and minimize losses.

By implementing rolling forecast methodology and technology, companies can gain greater visibility into the business (alert executives earlier), better anticipate changing business environments, improve focus (deal with key business drivers vs. data input), reduce focus on current year, and avoid spikes in quarterly and annual efforts.



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Endnotes

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- 2 Jack Welch (with Suzy Welch), *Winning*, Chapter 12 “Budgeting: Reinventing the Ritual” (pp. 189-204). HarperCollins, 2005
- 3 For a more detailed discussion of these issues, see “*Becoming Lean, Adaptive, and Ethical: How to Move Beyond Budgeting*,” by Robin Fraser, Jeremy Hope, and Steve Player in *Business Performance Management Magazine*, November, 2003, and “*Beyond Budgeting: How Managers Can Break Free from the Annual Performance Trap*,” by Robin Fraser and Jeremy Hope, Harvard Business School Press, 2003.
- 4 David A. J. Axson, “*Best Practices in Planning and Management Reporting*,” John Wiley & Sons, 2003, page 191. For a full discussion of the best practices in forecasting see Chapter 8, “Forecasting: Pass the Crystal Ball,” pages 189-206.
- 5 Jeremy Hope, “*Use a Rolling Forecast to Spot Trends*,” Working Knowledge – Harvard Business School, March 13, 2006

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