



How Performance Management Can Help You to Navigate through Turbulent Times

Paper #3 – Know Where You're Going in
the Near-Term

Author: Jeremy Hope, Beyond Budgeting Roundtable

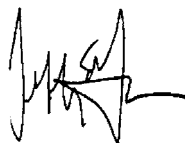
For CEOs and CFOs, the “big bad wolf” is the shock profits warning. The consequences of confessing to investors and bankers and even employees that “we didn’t see it coming” are rarely happy. Generally, the share price plummets and the CEO and CFO are shown the door. Over the past months, there have been almost countless stories of the big bad wolf blowing down companies.

If only we all had crystal balls! Imagine the potential for business – executives, leaders and managers could take the right actions to influence future outcomes favorably; decisions about capacity, capital spending and cash flows would be a snap and there would be no more shock profit warnings.

Crystal balls are fictional, of course. However, tools and methods do exist now that can help business leaders know where they’re going. The key, says Jeremy Hope, Research Director of the Beyond Budgeting Roundtable, is to stop looking in the rearview mirror of budgets and variances to manage performance and instead move to a more continuous or ‘event-driven’ planning cycle.

In this third of five articles about how you can use performance management to weather and even thrive in turbulent economic times, Hope explains how continuous planning and rolling forecasts are the keys to managing the future and keeping “in control” because they focus on performance improvement issues and relate directly to strategy.

Jeremy Hope 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.



Jeff Holker
Associate Vice President
IBM Cognos Innovation Center for Performance Management

Introduction

Imagine that you are able to forecast the short-term future (say, three to twelve months ahead) every month with little overhead burden and that, through this process, you can take the right actions to favorably influence future outcomes. Imagine that managers are able to use high quality forecasts to take actions to continuously improve performance and close the gap on peers and best practices. Imagine that forecasts can be prepared in a few days rather than weeks and enable effective decisions to be taken concerning capacity, capital spending and cash flows. How much more control would you have? How much better would your decision-making be?

The nightmare for every CEO and CFO is the shock profits warning. The admission to investors and bankers (as well as employees) that “we didn’t see it coming” is often the precursor of a fall in the share price and the replacement of the CEO and CFO. We have seen ample evidence of these problems in recent months.

The trouble is that the typical business leader presides over a performance management system that involves plans, targets and budgets that are *negotiated, annual and fixed*. These systems were designed for stable trading environments where suppliers could dictate to the market. But as most of us now know, markets are now unstable and customers rule the roost. Using the rear-view mirror of budgets and variances to manage performance when the market is changing so rapidly is a recipe for disaster. Managers need early warning of changes that impact their business particularly if they spell trouble ahead. But most organizations are poor at forecasting. Not only is there a lack of foresight but there is also an inherent fear of taking positions that go against the grain of conventional wisdom. It takes an average of 15 days to develop a forecast. Such was the detail involved at one global company that it took one business unit alone 585 people days over eight weeks to produce a forecast that was immediately out-of-date.

The problem is that the budget tries to perform too many tasks. It acts as a basis for setting targets and rewards, business planning and forecasting, cost and capital allocation, and performance measurement and control (see figure 1). In practice it takes too long (an average of four months), handles too much detail (average 1,250 lines), and adds too little value (90 percent of users are unhappy). It needs to be unravelled and each of its purposes handled in a more effective way.

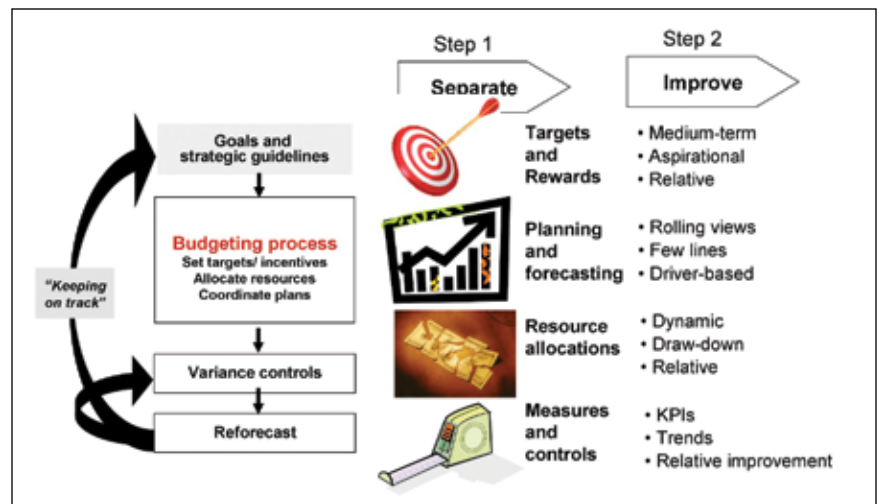


Figure 1. Break free from the budget conflicts

Forecasting is a good example. But how forecasts are prepared determines how useful they are. Most forecasts are geared to the fiscal year-end and aimed at helping managers to ‘keep on track’. They are often known as ‘3+9’, ‘6+6’ and ‘9+3’, the second number representing the months remaining until the accounting year-end. In some firms this approach amounts to four budget recompilations per year and thus adds a huge extra burden to already hard-pressed managers. These forecasts are invariably confined to asking the question “Are we on track to meeting our targets and, if not, what action do we need to take?” And the resulting action often ruptures carefully crafted strategies designed to create longer-term value. While some managers call these ‘rolling’ forecasts, they only ‘roll’ to the end of the fiscal year. The correct definition of a rolling forecast is one that continuously rolls forward usually 12-18 months ahead.

What you need to do differently

The key change is to move to a more continuous or ‘event-driven’ planning cycle. 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. Such events can be positive (e.g. introducing new products or a new business model) or negative (e.g. reacting to supply chain disruptions or changes in demand). The whole point is that these reviews are not time-dependent and thus can occur as and when needed.

This is how they work (see figure 2). 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. 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. By definition, the fiscal year-end always appears on the 12- or 18-month rolling forecast radar screen.

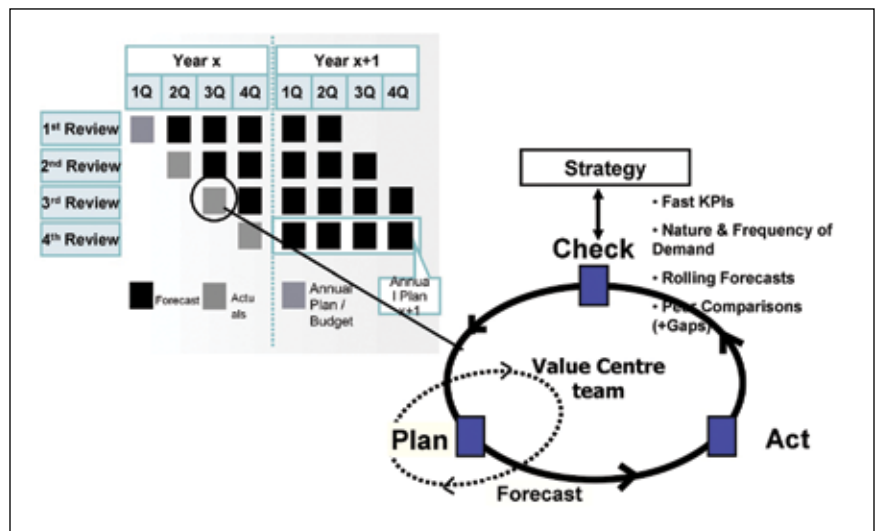


Figure 2. The rolling review and “check-plan-act” cycle.

Rolling forecasts provide a framework for the planning review. This review has three steps: check, plan, and act.

- *Check*. The cycle starts with *check* - Where are we right now? What does the near-term future look like? How are we doing against our strategy?
- *Plan*. The second 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 third step is *act* - How should we execute the plans?

You will note that nowhere in this check-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 must have the drive to make them succeed. But the key to success is that it is driven *locally* by people who want to improve their performance.

Leading companies produce insightful reports that focus on KPIs, trends, forecasts and peer performance gaps rather than on the ‘rear-view mirror’ of budget variances. In other words, they know where they’re going and whether or not to take further action. Figure 3 shows a typical report to a senior executive team. In this example, the team is looking at a twelve quarter moving performance window showing seven quarters of actuals, five quarters of forecast and a medium-term aspirational goal. This goal provides the context for the report (and it doesn’t remain static – it is updated as best-in-class performance improves). It tells the reader what success should look like and how far away the business is from achieving that result. The executive team can see (usually for the first time) a more complete view of performance including both financial metrics and non-financial KPIs. These prompt different questions from those usually asked about budget variances such as ‘Why are we not improving against our peers?’ ‘What actions have we taken and what more do we need to do?’ and ‘Why are our forecasts consistently too optimistic or pessimistic?’ They focus on performance improvement issues and relate directly to strategy. Now compare this review with the typical budget meeting where line-by-line variances are discussed. What do we learn from such a review? Not much is the answer.

	History							Forecast				GOAL		
	Q0	Q1	Q2	Q3	Q4	Q5	Q6	Q7	Q8	Q9	Q10	Q11	Q12	
KEY FINANCIALS														
Orders	290	300	312	324	290	302	314	326	339	353	367	382	397	500
Sales	280	290	300	312	324	290	302	314	326	339	353	367	382	500
Gross Profits	84	81	90	87	97	84	90	91	98	102	106	110	114	175
Gross margin	0.30	0.28	0.30	0.28	0.30	0.29	0.30	0.29	0.30	0.30	0.30	0.30	0.30	0.35
SG&A costs	50	55	57	56	58	52	51	56	59	58	60	59	61	60
Net Profit	34	26	33	31	39	32	39	35	39	44	46	51	53	115
Cash flow	44	37	44	42	51	42	49	46	51	56	58	63	66	140
COST KPIs (% sales)														
SG&A Costs (% sales)	0.18	0.19	0.19	0.18	0.18	0.18	0.17	0.18	0.18	0.17	0.17	0.16	0.16	0.12
Packaging costs (% sales)	0.06	0.06	0.05	0.05	0.05	0.05	0.05	0.05	0.05	0.05	0.04	0.04	0.04	0.03
Transportation costs (% sales)	0.04	0.04	0.04	0.04	0.04	0.04	0.04	0.04	0.04	0.04	0.04	0.04	0.03	0.03
IT costs (K per employee)	3.6	3.6	3.6	3.3	3.3	3.3	3.3	3.3	3.0	3.0	3.0	3.0	3.6	2.4
OPERATIONS KPIs														
First time through rate	86%	86%	84%	85%	84%	85%	87%	87%	88%	88%	90%	90%	92%	96%
On-time delivery	87%	87%	88%	85%	88%	89%	90%	88%	89%	90%	91%	92%	94%	98%
Customer retention	66%	67%	70%	68%	72%	74%	75%	75%	77%	80%	82%	84%	84%	95%
Inventory (number of days)	65.0	66.0	66.0	64.0	62.0	62.0	60.0	60.0	55.0	50.0	45.0	40.0	35.0	20.0
Accounts receivable days	92.0	90.0	90.0	88.0	82.0	82.0	84.0	84.0	82.0	80.0	78.0	76.0	75.0	45.0

Figure 3. Focus on KPIs, forecasts, trends and peer comparisons, not budget variances

The purpose of forecasting is to build projections of the most likely outcomes based on ‘business as usual’ and then using these forecasts to *change the future*. In other words, it is the second stage of the forecasting process that really matters. ‘What decisions do we need to take to improve the performance trajectory?’ is the focus of attention. Thus forecast accuracy is not particularly relevant except over very short time periods (one month for a monthly cycle and one quarter for a quarterly cycle is a rough guide) as every forecast is merely the basis for further decisions. That’s why comparing forecasts to actuals is a meaningless exercise except over very short periods. Instead, it is performance trends that matter with managers constantly asking if the gap between the latest projections and key aspirational goals is narrowing. So forecasting is a basis for action rather than control.

Another use of the forecasting model is scenario planning. These are usually based on driver-based models. The revenue forecast, for example, is based on a range of variables such as customer demand, price, customer acquisition and retention levels, market share, brand marketing, and capacity utilization. In other words, the idea is to simulate the business with a relational model. Many drivers are non-financial. Managers can then play the ‘what if?’ game many times over as they look at the various ways that the future might unfold and what the implications of different outcomes might be. While Southwest Airlines leaders think long range

planning is a waste of time, they believe in scenario planning. The company's executive planning committee meets periodically to create future scenarios in which the airline could find itself. For example, if it is considering opening up a new city to fly to it will look at what the competition might do, how many more planes it will need and so forth. 'Future scenario generation' as the company calls it enables Southwest to prepare for the future in a way that provides direction yet allows it to maneuver on many fronts.

American Express spent considerable time (often with much trial and error) identifying its key value drivers, and using these drivers to improve the quality of its forecasts. Value drivers must be defined at a level of detail consistent with the decision variables that are directly under the control of management. At the value center level variables such as sales growth and customer mix are particularly relevant. And at the operating process level key drivers will likely be based around cycle times, quality and cost. Examples include the speed and quality of completing a loan in a bank as this directly impacts capacity and customer satisfaction; the turnaround time of an airplane as this directly affects asset utilization and costs; the speed of finalizing an insurance claim as this directly affects costs and customer satisfaction and the number of defects for a car manufacturer as this directly affects costs, customer satisfaction and loyalty.

Most managers have an intuitive or implicit understanding of what drives actual and potential performance. At American Express, for example, there three key drivers that leaders monitor are average card member spending, card attrition rates and average assets per financial client.

Perhaps the greatest challenge is to produce a forecast that is genuinely objective (that is, with no errors). Forecast error is made up of (a) variation based on external volatility and (b) bias, that is, consistent, internal systematic error. Unless you differentiate between these two elements then you can easily make the problem worse. The problem is that many people confuse bias with variation.

Variation can't be avoided. By definition, it is beyond anyone's control. It is caused by, for example, volatile markets and unpredictable events and is almost impossible to correct. Bias is the real enemy of effective forecasting and is endemic in many forecasting processes. The most common problem is 'second guessing' that can lead to shock profit warnings as forecasts repeatedly tell senior executives what they want to hear rather than the unpleasant reality. Once a forecast becomes a target or a commitment it ceases to be an effective forecast. That's the nub of the problem. Managers avoid attention if they provide forecasts that fit prevailing expectations. This of course means that they are less likely to be objective and give their best guess regarding forecast outcomes. In other words, chronic bias is driven by the system. Whether it is intended or not, the prevailing culture is one of providing forecasts that are treated as fixed targets or commitments and if these forecasts change then explanations are necessary and can sometimes lead to a (metaphorical!) 'beating'. Needless to say few managers want to go through this ordeal (at least not more than once a year). One way to manage error and risk is to use range estimates rather than single-point numbers. And increasing the spread of 'extreme' ranges is perhaps a lesson that needs to be learned from recent experience.

Rolling forecasts, if well prepared, form the backbone of a new and much more useful information system that connects all the pieces of the organization together and gives senior management a continuous picture both of the current position and the near-term outlook. An honest view has no bias so managers should expect to see half of their forecasts to be on the high side of actual outcomes and half on the low side. The ideal forecast has 'clean' data that enables managers to improve decision-making. Forecasts must not be seen as commitments otherwise bias and distortion (dirty data) will be inevitable. That's why implementing rolling forecasts under the umbrella of fixed targets rarely works.

Six implementation guidelines

- 1. Place continuous planning and rolling forecasts at the core of value center management.** Value center teams should have the freedom and capability to take action to improve their performance at any time. Ensure that executive and support services teams know that their role is to challenge and support rather than command and control. It is the aggregate of value center forecasts that should equal the consolidated forecast for the whole organization. The role of Finance is to support this process. It may also be necessary to hold training sessions with all affected teams to build their capabilities in strategy, planning, forecasting and decision-making.
- 2. Design a standard planning review process** that follows this order: (1) CHECK where you are today and where you are heading in the near-term (use KPI dashboards, rolling forecasts; trend and trajectory analytics, and peer comparisons) (2) PLAN what you should do (frame the issue; assemble information; select alternatives; and evaluate the risks) and then ACT (make a decision; manage the implementation; measure the impact; and assess if further action is needed). Set common standards and rules. For example, create clear methods of standardizing inputs to the sales-forecasting process. If all your sales people adhere to the same rules in classifying opportunities, the forecast model will at least be based on similar data standards each time it is run. Standardizing requires implementing rules for classifying sales opportunities. First, define the stages in your sales cycle. Then, define the type of progress required to move up a stage. Finally, assign probabilities of closure based on standard rules. In general, inputs should be based on facts rather than opinions.
- 3. Design reports that show history/forecasts/goals that enable leaders to ask the right performance questions.** How information is presented determines the agenda and dialogue of most meetings. If reports are based on columns of 'actual-budget-variance' figures the meeting will focus on explaining variances and what needs to be done to get back on track. But if reports are set in a context of trends and peer-based performance gaps then far more insightful discussions will take place about what needs to be done to improve performance.

4. Avoid turning forecasts into ‘contracts’ or ‘commitments’. Ensure that forecasts are separated from target setting, performance measurement and rewards. Eliminate bias which is crucial to obtaining a good forecast. Ensure that forecasts are ‘light-touch’ and take no longer than a few days to compile. Identify (and base forecasts on) 10-20 key value/cost drivers. Many finance people believe that greater forecasting detail equals greater accuracy. But this is not rational. Given that each forecast is prone to error, then the more forecasts you combine the greater will be the error as one mistaken assumption impacts another. In other words, the distortion impact is exponential as errant assumptions have a multiplier effect. The reality is that accuracy decreases with the increased level of detail. However, if we think of forecasts in two parts – business as usual and new actions – then there should be more detail in the preparation of the new actions than in the business as usual. It is important to understand that the purpose of rolling forecasts is to provide a better framework for decision-making. While the purpose is not control (in the sense of making commitments and controlling performance against them – that’s what budgets aim to do), rolling forecasts place leaders in more control of the business in the sense of taking the right actions

5. Make the forecasting intervals and horizon appropriate to business needs (taking into account the degree of market volatility and organizational change). Never think that rolling forecasts are about four or twelve budget revisions a year! They always project past the fiscal year-end and are light-touch processes (taking days to compile) and based on a small number of key drivers. Recognize that the frequency and time horizon are entirely dependent on the business. In a fast changing market, preparing forecasts monthly looking twelve months ahead might be appropriate whereas in a capital intensive business preparing forecast quarterly looking 18-36 months ahead might be appropriate.

6. Ensure that forecasting models are consistent and aligned. While spreadsheets are fine for small local requirements, they 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. Consider using dedicated models. The I.T. industry is now offering sophisticated models to enable large organizations to prepare forecasts quickly and consolidate reports. Teams can build business rules and structures, then modify the model as their business evolves, easily accommodating changes such as added 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. Companies that successfully implement a unified forecasting process can expect revenue gains of at least ten percent according to the Gartner Group.

Continuous planning and rolling forecasts are the keys to managing the future and keeping ‘in control’. It is also a change that is uncontroversial and can be made without fanfare and directives. Most importantly, it is a key step in convincing senior executives to let go of the old annual planning and budgeting system with its time consuming revisions. It fills the gap between the coordination elements of budgeting and the more dynamic elements of real-time management. Forecasting also plays a key role in managing cash flows and investments by informing executives of available resources so they can turn the flows of investment funding on or off. Rolling forecasts also enable executives to finally kick the addiction to ‘managing the year-end’. Rather than focus all their efforts on making the target commitment, managers are now able to both see the year-end on their radar screens yet focus on managing future business outcomes. Alignment is another benefit as forecasts done speedily by different business units and functions can quickly be assembled and consolidated to enable executives to see what’s happening across the whole organization. The potential benefits are huge.

About the author

Jeremy Hope is a cofounder of the Beyond Budgeting Round Table. He has written four books on performance management including “Reinventing the CFO”, all published by Harvard Business School Press. He has helped many large organizations to improve their performance management systems and is also a keynote speaker at many conferences on performance management. You can contact him at jeremyhope@bbbt.org or call 44-1274-533012



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August 2009
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Endnotes

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- 2 Philip Bligh, Darius Vaskelis, and John Kelleher *Take the Frenzy out of Forecasting* Optimize Magazine March 2003, Issue 17 www.optimize-mag.com/issue/017/financial.htm

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