Intro: Welcome to the Best Practices and Actions Series. My name is Tim O'Brien, director of Global Marketing and Customer Relations for the Innovation Center, and I will be your host for this series. This series we are bringing to you is focused on customer success stories and best practices in business intelligence and performance management.

TO: Welcome, everyone. I'm pleased to have with us today Steve Player, the director of the Beyond Budgeting Round Table North America. Welcome, Steve.

SP: Thanks, Tim. Proud to be here.

TO: And, Steve is the co-author of a book titled Future Ready: How to Master Business Forecasting. He co-authored it with Steve Morlidge. And, today we're gonna talk about some of the best practices in adopting a forecasting methodology as leveraged as a strategic decision-making tool. And, firstly though, just to quickly talk about budgeting. The annual operating plan, you know, that typically "command and control," top down process that in most organizations today, and it really determines what you needed to do, how much its gonna cost. Uhh, there's some employee actions contained in there as well, as far as what they have to do. Limited flexibility, if any. And, it's typically around getting agreed-upon [inaudible] targets, action plans, resources for the year ahead, and then measuring and controlling the performance against that benchmark. And, what we found in our work with customers literally around the globe is that they're cumbersome, they're expensive, they're typically out of kilter with the competitive environment, and they no longer meet the needs of either the executives or operating managers. And, as a result, what you find a lot is that it encourage- encourages gaming of the numbers, and Steve, would you say that that's pretty accurate, that I pretty much make a good depiction of what occurred in organizations implementing an annual operating plan process?

SP: Well, most of the people that have the tradition of budgets, those com- those complaints that you've enumerated there come up quite frequently. We summarize them quickly into kinda the seven problems: They take too long, they cost too much, they're based on assumptions, they're typically out of date, even before the year begins, they lead to gamin and unethical behavior as people try to optimize their bonus performance to hit an arbitrary number. If you look at them, they cause unnecessary spending, as people will often spend up to the budget number. They might not spend over it, but they wanna make sure they spend all of it so they don't lose it for next year's allocation. So, it leads to unnecessary spending. It basically avoids transparency; instead of making thing highly illuminated, people hide the truth, and Jack Welch said it best in his book Winning, "budgeting sucks." It sucks the energy and the big ideas out of the organization, and it keeps everybody from moving forward, and becoming free. So, what's essentially finance's number one tool, in terms of how it tries to control the organization, planning, control, the traditional budget has a number of limitations that we've been able to find ways to overcome and do a better job of doing, and that's what we're excited about doing; to team with IBM and highlight and illuminate for people how you can overcome a lot of these problems many people have fallen into.

TO: And, and so is that the case, and it seems most of the organizations we work with, their only forecasting or budgeting or planning process is around the annual operating plan, or the budget, and if that's the case, how are managers, who are making decisions about the future direction, and allocating their resources appropriately, what are they using to make these decisions if this budget sounds like a static, top-down command-and-control cost-control mechanism?

SP: Well, that… I mean, what you illustrate there, Tim, is one of big problems that we see, is that there's just a huge disconnect between what it really takes to run a business in today's environment, as opposed to what this traditional tool has provided. And that became most apparent at the end of 2008 and trough most of 2009. 2009 was a watershed year for us in the Beyond Budgeting Round Table, as people really became starkly aware with the economy rolling, and uncertainty at an all-time high. They became painfully aware that that budget that was negotiated was, was really, in many cases, out of date. We did some research work for IBM, joining with the American Productivity and Quality center down in Houston, and the Business Finance Magazine. We researched and looked at the whole planning process, and two startling facts came out of that research. One, if you took a look at it, you know, how long was the budget good for? If you looked at the targets that were used in the budgeting process, we asked the basic question, how long were they valid? How long were they good for? At what point did they become obsolete? And, in 2009, the number that said they were obsolete from day one shot up from 8% in a typical year up to 28% in 2009. But, even more telling is the survey result from when we ask the question, you know, at what point do they become obsolete? And, four to six months into the year two-thirds of our respondents in even any year, much less 2009, those became obsolete four to six months into the year. So, what's the point of putting together a huge tool and a massive amount of effort if it's obsolete halfway through its useful life? And people began to realize that there's gotta be a better way of planning and controlling our organization. We get trapped in this budget, we get stuck with it, we're marching to a drummer. If you take a look at finance, it often puts finance in a bad light, because we're basically explaining variance, actual to budget, and the variance explanation is, you know, the third or fourth month in the year, we're explaining, you know, actual misses budget because the budget assumptions we used for last year were wrong. Well, after we've repeated that assumption two or three times, people begin to wonder if finance has got a problem, why can't they get that stuff right? And the reality is what we need is a more adaptive way to manage our business, to deal with the volatile world. So, we're always looking forward, in terms of what's out there. And, so, that's what we've seen people as they move to rolling forecasts and other, better ways to adapt, and manage proactively, they're literally trying to change position. I often use the analogy of, you know, finance is like a, if you're stationed on a ship, if our organization is like a ship streaming across the ocean, where would the finance department be stationed? In many cases, finance has taken up a berth on the back of the ship, looking at the wake, and we look at the wake of the ship, and we yell over our shoulders at the captain on how we're doing. And, ironically, the captain doesn't care too much about our view. Why? Because he's looking forward, at the things that are coming ahead, and what he really needs is something that says "Where am I going? Am I reaching my destination?" So, what we're trying to do with our efforts is to get rid of the annual budget and transform finance into somebody that's forward looking and someone that's there, ready to help. That survey that I talked about with APQC and Business Finance Magazine had one other huge, startling fact that I think all finance people can take to heart. We asked the question "How does your planning department spend its time?" And, what we found was 77% of the time was spent gathering data and administering the process. And so, literally only 23% of the planning department's time spent doing any kind of value-added analysis. So, if you wonder why your planning department's not more effective, its because it does very little real planning. It spends most of its time gathering data, collecting data, than managing the process. And this is particularly true of organizations that are still using spreadsheets to try to do the planning functions. Spreadsheets are a great personal productivity tool, but when you try to make them a collaborative tool across the entire enterprise, it just breaks down in massive form, and you spend all your time trying to make sure people use the right spreadsheet, trying to make sure they didn't change the template, or didn't change the form. You're gonna try and make sure it consolidates. And all you have done is taken very talented finance people and turned them into data monkeys, where their job is to try to make sure the data comes in correctly. And, the reality is we've gotta find a better way, and excitingly, we have found some good ways to do that.

TO: And Steve, I think it's worth mentioning definitionally, what a forecast is, versus a budget, and a budget sounds like it's a detailed- how you think the future should look, and a forecast is maybe what the future will most likely look, and I wonder if you could even expound on the notion that a good forecast ends up being an inaccurate forecast. Can you talk about that? A lot of people think forecast accuracy is something you should measure, and the more accurate your forecasts are, the better you're off, in your processes working. Can you talk a little bit about that?

SP: Well, Tim, that's a- that's a good point, and one of the big myths out there, we see a lot of people harping CFOs in particular about forecast accuracy. And you really never think about the definitions of forecasts, and when you talk about forecast accuracy, what's the real goal of that? What happens in traditional budgeting is we, in the middle of the previous summer, if we're a calendar year company, in the middle of the previous summer, we'll agree on some assumptions, and we'll put together a financial plan that hopefully is mathematically adds up to the objective that we're trying to work. And then we go back and forth trying to deal with that. The problem with this mathematical plan that thing that we put together called the budget is based on a lot of assumptions, most of which are usually wrong. If we tie incentive comps to reaching those assumptions, to reaching those numbers, people have an incentive to make sure they give you the lowest-ball answer they can, the minimal target. And, so what the traditional budgeting process has become is usually an argument about what's the minimal acceptable performance we can get away with. And, so everything is about setting minimal targets, as opposed to reaching optimal results. Now, if you take that forward to a forecast, what the forecast should be is what we think will happen. Look at the run rate, look at where things are, not what we think will happen. Now, in between those two there's a thing called a target. Most budgets are set out to reach certain degrees of targets. And those targets are often negotiated, they're based on what you're trying to commit to Wall Street and so forth, and so those targets, they're kinda out there, are really where you'd like to go. With the forecast, though, is you're headed. It should not be equal to the target. When you make the forecast and the target the same thing, its becomes a "trust me" target. You know, trust me that I can hit the number negotiated. And when I pay people for forecast accuracy, and I wanna insist of forecast accuracy, the reality is we live in an unpredictable world, and there's a lot of things that we don't control, and we have very limited ability to see what happens. For instance, what happens with the ability to predict the price of a barrel of oil in the future. That has a huge impact on most cost structures, yet we have virtually no control over it. The price of wheat, the price of currency exchange, the price of interest rate fluctuation. Many macrofactors are outside our control. And when we look at these things outside our control, and insist on forecast accuracy, the only way someone can give us an accurate forecast is to always forecast the minimum that's possible. The only safe haven is to go as low as possible. So, our objective in forecasting is not to hit it always accurately, by always protecting ourselves by giving the most conservative answer. Instead, our objective ought to be our best guess of what actually happens. So, that forecast and that target are different. The target is what we'd like to have happen. The forecast is what we think we'll have happen. And, when we put out a forecast, we have plans that spell out what we're trying to do. And if I split the targets from the forecasts, then I can see how my gap is. What's the difference between where I think we're gonna go and where I'd like to go. And then you can discuss more robustly your plans for closing that gap, or taking advantage, if you're overshooting, taking advantage of that excess. Uh, but if I'll split those into two pieces, I'll have a much more accurate, much more effective way of tackling it. If I focus on forecast accuracy, what I'm gonna get is a pile of minimal results, and everybody's, you know, stopping to just make sure I always hit that minimal answer. If we live in an unpredictable world, our forecast needs to reflect that unpredictability, and what we talked about in our book <u>Future Ready</u> is a series of processes that make you ready for whatever the future will be. If it's high, if it's low, you have a set of plans to react to whatever the reality comes out to be. And that's what a future-ready company's really all about.

TO: Yeah, I think what you're talking about Steve, is your want to be able to provide your management team, I guess, regardless of what level of the organization, what function they fit in, what geography, you know, you centralize the decision-making that's going on today because of the sheer velocity of business, you know, you're really arming people across the company to make decisions, and you wanna make sure it's based on the right information, of what you're talking about here, versus forecasts against the targets, is insight. Insights that evolved over time, and knowing where you think you're going to be versus where you need to be, which is that target, and that forces some insight there into the discussion around how do you allocate your resources, to either get to the target, or maybe make a decision that you're just not going to achieve that target. But, whatever it is, you've got more insight, right?

SP: Well, let me… let me paint this in analogies, one that we often use in the book. If you think, you know, if you think about your business is much more like sailing a ship. OK? When you get ready, you put together your plan, and you decide how you're gonna run the [inaudible] in the sailboat race. And you're gonna go from here to the Bar Harbor, but you've gotta, you know, move around certain objectives. When you look out there, and you're racing someone else, you can look at their boat, you can look at their past experiences, you can see what the competition- you can estimate what you think they're gonna do. And you can look at what you think you're gonna do. You have a forecast of what the wind's gonna do, what the waves are gonna do, and so forth. But the minute you begin sailing, you start to execute your plan. Oftentimes, reality's different than what you thought was gonna happen. So, the wind's blowing harder or softer, the waves are different, and so forth. The competition took a task that you didn't anticipate. And so you constantly have to, in reality, you have to always adapt your plan and be looking forward. If I follow the traditional budgeting analogy that says you must hit these points, and, you know, at 1/12 of the way through, you should be here, $2/12^{th}$s here, and $3/12^{th}$s here, and so forth, what you reality have is you have a bunch of accountants out there trying to say "Why are you not on track here? Get back on track." And the reality is you might often have to adjust your plans for a new reality. And what by moving to a rolling forecast is our target remains the same, we still wanna get to the other harbor, but the tack by which we want to get there may require adapting our plans to the new reality. The new reality about what's different about the environmental conditions, the new reality about what the competition's gonna do, the new reality about what new opportunities we might see for ourselves. So, by shifting the planning processes to instead of a fixed, locked-in look at the past, and based on that, trying to step towards the future, is instead what we'll have is a continuous look, you know, continuously looking forward. We expect that we get the finance department of the back of the boat, looking at the wake, and put them up beside the captain in the pilot-house, and constantly look forward. Now, as we look forward, we're constantly looking forward and trying to give our best plans and estimate based on our current course what's gonna happen, and then what we should do instead. It brings up a point you talked about earlier, about forecast accuracy, and let me illustrate it this way. If I'm the navigator of a ship and the captain's heading up there, and I say, "Captain, based on our best forecast, we're gonna hit those rocks ahead." What does the Captain immediately do when he gets my forecast? He does everything he can to avoid those rocks. He brings the wheel around, he changes the ship, the engines, the sails, so forth. And, if, by a miracle, he misses those rocks, did it make my forecast inaccurately? Certainly, my forecast was inaccurate in that we didn't hit the rocks, and I said we would. But it was his actions in response to my forecasts that caused us to miss the rocks. So, in many cases, the very act of forecasting should cause your management team to take additional actions to get to a better outcome. So, the objective in that situation is not forecast accuracy, but basically, understanding, and understanding what you'll do to get a better outcome. And, so, when we talk about forecasting, what we need to be sure is forecast what we think is happening environmentally, what we think we should do in terms of our action plan, and then tracking to see how well we did against that. In many cases, people use the fallacy of saying "I need to deliver an accurate forecast. I need to deliver the forecast." You can't deliver the forecast, you can only deliver the action plan. But, in many cases, even the action plan, in terms of the forecast, needs to be modified, as you see your progress. And so, this forward-looking view of the business is what we're trying to help management teams accomplish, by moving to a continuous rolling forecast, and a much more adaptive way of looking at how to go forward.

TO: And there’s some, some big questions, you know. There’s certainly a cultural and political element to all of this, to really get your organization to change its focus toward, or include a forecast if you’re adding a forecast, to have a new look at what the forecast is versus the culture that’s been instilled around what an annual operating plan or budget means. So, there’s certainly that element. There’s also some big questions you gotta ask around the level of detail you need to put into your forecast, versus your budget. Cycle-time, how often, participation, who gets involved, and a big one, Steve, is time horizons, You know, the notion of forecasting to the wall, or budgeting to the wall. Does that really meet the needs to the businesses, or is that simply just a way to work within a fiscal year. What are your thoughts around that?

SP: Well, you begin to lay out kinda what are some good specifications of what a good forecast would have. And, we have a mnemonic that we use to do that, the forecast really should be timely, actionable, reliable, aligned and cost-effective. Now, if we flip that around and go in reverse order, C for cost-effective, A for aligned, R for reliable, A for actionable, T for timely, we get the mnemonic “CARAT,” which, you can think of either the orange carrot, or the diamond carat. Uh, but we use that mnemonic to keep up with. And we think through that, you know, when you look at forecasts, in many cases, people have broken processes. They often forecast what we call “forecasting the wall.” And that’s where, I ask you how far out you forecast, you tell me it depends, and when I probe and say “what does it depend on?” he says, “Well, it depends on where we are in the year. If we’re three months into the year, we forecast nine months. If we’re six months into the year, we forecast six months. If we’re three months into- I mean, if we’re nine months into the year, we forecast three months.” What you basically, you’re forecasting to the year-end number, forecasting to the wall. And that’s literally how a lot of people do it. They forecast to say “Am I gonna hit my year-end target?” And everything is about that. Now, the problem with that is it’s kind of a diminishing visibility approach. It’s the same analogy as if you bought a car, and the first night you drive your new car, you turn the lights on, and they shown out 1500 feet, and, as you drove forward, all of a sudden you noticed a strange thing happening. The lights didn’t get any further out. You drove 1200 feet, they only shown out 1200, then it went to 1000, 800, 500. At about 2-300 feet, almost when you’re at the point of total darkness, the lights popped out again and shown you another 1500 feet. And that’s what forecasting the wall is. It’s this diminishing period of visibility until I’m almost totally blind, and then I pop out another period. And as bad as that is, obviously, if you’re sailing a boat, you wouldn’t want to have that kind of analogy coming at you, where you go almost to darkness and then you pop out again. But as bad as that is, it has even more detriments, in that even though it’s the diminishing visibility, you also have the problem that people won’t tell you the truth. Because, when you’re asked a question “Are you gonna hit your year-end number?” there’s a huge motivation for them to not tell you the truth. Instead, what they do is they basically tell you what they think you want to hear. In that situation, what they think you want to hear is “Hey, I’m gonna hit my number.” So, in many cases, what were trying to get to is a forecasting process that shows you things more clearly. Now, if we take you through that mnemonic, timely, in terms of forecasts, really has to deal with, with, you know, basically the decision you’re trying to make. IF our boat is an ocean tanker, and we’re steaming across the ocean, how far ahead do we need to see? In many cases, it’s 2-3 miles out there. Why? Because this boat's got a lot of weight and a lot of momentum. It takes a long time to stop or change direction in this boat. So , if we're a big ocean tanker, we're gonna have to have a radar to see what's out there, cause our decisions really depend on how quickly we can turn. Flip-side, though, if we were a motorboat, how fast could we turn? Well, we wouldn't need radar, cause we could turn in the next 100 meters. In that situation, we could have a system that, because we're much more adaptive, we can turn on a dime. So, when you think about how timely your forecasting process needs to be, it depends on the decision you're trying to make, and how swiftly you need to shift around. You could do a monthly forecast cycle if everything's very, very volatile. In most situations, the business might not be that volatile, you might be ok doing a quarterly forecast, or something a little, you know… if I'm tracking actuals and everything's coming in the way I thought it was going to, my direction pretty much stays the same. If seeing a lot of volatility, I might pick up that frequency so that I can understand more quickly what I think is gonna happen.

TO: OK, makes perfect sense.

SP: If I- if I take a look, my different decisions also will impact how timely things are. For instance, if we take a look at how Southwest Airlines, for instance, they have different forecast horizons for different, for different decisions. For instance, their aircraft ownership, they may only update that forecast, in terms of what they need, on an annual basis. They look at it, but they only update it, really, on a longer-term basis. Whereas something like fuel costs, they may be looking very quickly. They may be updating that weekly, because they always have a constantly changing situation there. So, you forecast horizon really has to match how things change.

TO: And, in terms of frequency, you talked a little bit about that. Change depends on whether or not you're, say, a speedboat or an ocean tanker. It also can be event-based.

SP: Obviously, if you see a cloud pop up on the horizon, that event in itself may trigger, you may need to do a new forecast. Uh, for instance, when the, uh, Gulf oil disaster happened, I think that was a trigger for everybody to take a look at what that was going to do to their oil prices, and to their business. So, there certainly can be events that in and off themselves trigger the need to take a new forecast.

TO: And, just going further on your point around forecasting and budgeting, we talked about budgeting being a fairly cumbersome process, very time consuming. You said based on your research, along with APQC published in Business Finance, for most organizations, by the time the budget is published, its out of date. Or, or out of dates within a couple of months. And that certainly isn't going to be a useful tool for people to manage their piece of the business, is it? And one statistic I think is pretty compelling is that organizations, this is, uh, a Hackett Group study in 2008, across their entire global membership. They found that organizations that had not adopted a rolling forecast, their average budget cycle is 121 days, those organizations that have adapted a rolling forecast, their budget cycle, on average, is 91 days. That's a one-month improvement. So, it obviously builds a little glide-path if you're doing an ongoing forecast within your organization, it builds a nice glide-path into the next budget cycle, doesn't it?

SP: Well, there's a glide-path, but I'll even give you a better projection than that. If you think forward, leading-edge companies are even better than that. If I've got an effective rolling forecast process, where I'm constantly looking at the same horizon, there's nothing magical about an annual budget period. In fact, we have many members of our Beyond Budgeting Round Table who have eliminated budgeting altogether. And, the reason I can eliminate that, I take an evolutionary path, its kinda scary just to stop doing that. But, if I put in a rolling forecast, and I start continuously updating and continuously managing on a constant period, every five quarters, or every six quarters forward, I'm always looking at that. I come around, what do I need an annual budget process for? Cause instead of once-a-year management, which an annual budget implies, I have continuous management. And if I have continuous management, I don't really need this annual ritual, and all the rigmarole. So, in really leading-edge companies, they'll eliminate to not 121 days, not 91 days, they eliminate it completely, because I can use that rolling forecast. If the board needs something called a budget, you can just grab the most forecast, in terms of what's out there, and let them review that, but we're educating boards really quickly that we're not stuck in the targets that may be obsolete. We're managing continuously forward. Again, that once-a-year budget picture is a snapshot of a point in time from the back of the boat. What we've gone to now, with a rolling forecast, and using that to really manage our business, is the continuous look, in terms of where we're going, and the continuous planning of where we're at, and where we're moving to, and a much more proactive role for finance in helping to steer things as they go forward.

TO: That's fantastic, and Steve, as a wrap-up of some of the things that you've said today, a lot of great information. Certainly, your book <u>Future Ready: How to Master Business Forecasting</u> expounds on a lot of the things you've been discussing with us today. Some of the fundamentals you've talked about is a target that we should- what we would like to happen, which we achieve by producing a forecast, right? Well, what we think will happen is based on a set of plans, you know, what we intend to do, which we change to achieve our target, and a forecasting purpose, really, if I can take your words, is really to make better decisions about the future. And, it's establishing by evaluating the gap from where you want to go, that is, you target, and where you think you're headed, which is a sort of forecast. And, I think that captures the essence of what you're trying to convey, along with some of the other fundamental concepts you need to take into consideration as you adopt a forecast within your organization. Steve, any final remarks you want to make to our audience?

SP: Yeah, forecasting is really proactive, forward-looking management, and that's what we're trying to help the finance teams get into position to provide, is proactive, forward-looking management, where you've got a lot of options. If you think about what a future-ready company is, a finance organization can't really change the future, but it can change how you respond to it, and the outcome that you get when you get to that future. It's like a hurricane rolling through the gulf. If we're located in Biloxi, Mississippi, and that hurricane's rolling right at us, there's not a darn thing our finance organization can do to stop it. But we sure can track it. We can see how fast it's coming, and we can have our plans in place to know how to get our people to safety, and how we can get our assets to safety. And, if we're smart, we'll know how to capitalize: If it comes through, how we'll rebuild, how we might be able to participate in that. So, really that's what finance control is, is really a hurricane center where we're really trying to have alternative visions of what could happen, and know how to optimize our business, and a future-ready company's gonna use scenario plans to be ready to whatever happens, be able to optimize it for the business. And that's just a much more powerful place to be.

TO: Well, that's great. I wanna thank you Steve Player, for joining us today in this podcast series. Uh, talking about future-ready, some of the concepts contained in this book that you've recently published, along with Steve Morlidge: Future Ready: How to Master Business Forecasting. Again, Steve Player, director of the Beyond Budgeting Round Table for North America. Steve, thank you for being with us today.

SP: Thank you, Tim. My pleasure.

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