

from fast close to
fast forward →

HOW AN OPERATIONAL
PERSPECTIVE CAN
REVOLUTIONIZE BUDGETING
AND FORECASTING

BY RICHARD BARRETT

*r*umor has it that the board of one of the world's largest technology companies announced to the analyst community that it would hit its quarterly earnings projections at the end of the month. During the month, though, the production staff sunbathed outside the company's main plant because there weren't enough orders in the pipeline. Needless to say, this huge company collapsed and is now owned by the banks rather than the shareholders.

The story may be no more than another urban legend, often repeated but never substantiated. Yet it's worth sharing just one more time, as it dramatically illustrates one of the key challenges for finance both now and in the future: How, in today's increasingly turbulent economy, does an enterprise keep its performance on track and get an accurate prediction of future earnings?

Some external factors, such as inflation and interest rates, have been more stable in recent years, which ought to lead to greater certainty in planning and budgeting. Other factors, such as the rapid downturn in the global economy, have made forecasting demand increasingly difficult. At the same time, the level of competitive activity is stepping up so that companies often find themselves facing new competition from unexpected quarters. All this, together with lower economic growth, has led to pressure on prices that can wipe out earnings at a stroke and has made managing financial performance in any business more challenging—even more so in the technology market. Here, where product lifecycles are getting ever shorter, it is vital to track their evolution closely during the early stages of their introduction and adoption, as their ultimate profitability is critical to future earnings.

THE DEMISE OF THE FASCINATION FOR “FAST CLOSE”

Faced with such uncertainty, businesses want to be able to accurately forecast future earnings, anxious not to become another casualty on the list of companies whose stock price has been marked down by analysts unimpressed with the surprise of poor results. In recent years, finance has tried to improve the reliability of forecasts with the “fast close,” the relentless pursuit of reporting earlier. But it’s doubtful whether the “fast close” has delivered the anticipated benefits. For most companies, the improvements have been modest. In fact, the Fast Close Survey for 2002, conducted by BearingPoint (formerly KPMG Consulting), showed that, during the last five years, companies have only cut the time taken to submit their subcorporate-level reports from 19.7 to 17.2 working days. Such incremental improvement is unlikely to have transformed the way these companies run their businesses, so has it been worth all the time, effort, and cost?

With the benefit of hindsight, the answer is probably “no.” While having access to past financial results a few days earlier may give the board or management a false sense of security and control, it’s unlikely to help companies deliver better forecasts for Wall Street or benefit the line managers involved in running the business. Knowing that they overspent the previous month’s budget 17 days into the following month rather than 19 days is unlikely to be a revelation. In fact, if finance were able to deliver the ultimate “fast close” and provide them with their variance reports on the very stroke of midnight on the last working day of every month, chances are the line managers would remain uninspired. What line managers need is not infor-

mation about the past—they need information about the future that will help them manage the business better during the coming month and the months after that.

The BearingPoint report notes that companies aren’t hitting their previous targets for “fast close,” and this may reflect a growing realization that it isn’t the answer to better forecasting. Writing history quicker doesn’t help predict the future. The only way to better predict future earnings is by making the organization more sensitive to both internal and external changes that impact financial performance, and this is why better forecasting is replacing “fast close” on many corporate agendas.

THE BARRIER TO MORE FREQUENT RE-FORECASTING

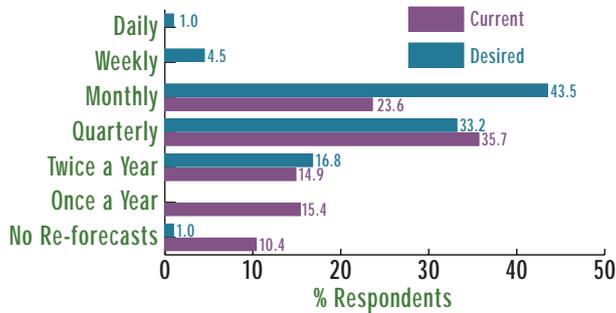
But how can companies achieve better forecasting? They are increasingly aware that the traditional annual round of planning and budgeting is failing to deliver value. It consumes too much time and effort and is out of date even before its completion. Rather than do away with budgets altogether, though, many are seeking to supplement budgets with rolling forecasts—regular monthly or quarterly re-forecasts looking 15 months or more into the future.

Although there has been extensive research and discussion on the topic of budgeting, re-forecasting has received little analysis anywhere in the world. A July 2002 survey of the U.K.’s Top 1,000 companies, jointly sponsored by *Real Finance* magazine and Armstrong Laing Group (see www.predictiveplanning.com), revealed that only 25% of companies re-forecast each month, most managing only one or two rounds of re-forecasting each year. Yet nearly 80% of respondents wanted to re-forecast more frequently, with 5% hoping to move to weekly or, in some cases, daily re-forecasts (see Figure 1).

With this type of interest and momentum, what’s holding them back? The answer is that most organizations feel more frequent re-forecasting is beyond them. Sixty-three percent of the respondents recognized that moving to more frequent re-forecasts was problematic either because of the time it would take line managers to re-forecast their line items or the time it would take finance to manage a round of re-forecasts and produce a new profit-and-loss statement.

To overcome this apparent barrier and enable more frequent re-forecasts, many organizations will undoubtedly diagnose the problem as poor systems and invest in new budgeting software. This tendency is reflected in the predictions of the global IT analysts who estimate that the market for budgeting software will quadruple over the next five years. But before businesses invest in new

Figure 1: *Current and Desired Trends in Re-forecasting*



Web-based planning and budgeting systems, they would be well advised to take stock of what they are really trying to achieve and review their planning and budgeting process. Otherwise they may find that their investment in new software simply speeds up the time it takes to complete a round of budgeting or re-forecasting but fails to give any better visibility into future performance.

THE OPERATIONAL PERSPECTIVE IS VITAL

Again, although the real purpose of budgeting is to align the resources of an organization with its strategy, the practice is still dominated by finance and too focused on costs and control. A better way of improving the budgeting process is to get back to basics and reconsider it from the operational perspective of resource planning.

As previously mentioned, line managers don't manage their responsibility centers by constantly looking at their costs or by looking at the past. Typically, they focus on a handful of key performance indicators that drive their costs. For instance, the manager of a call center will model the projected number of inbound and outbound calls, call durations, and the availability and utilization of their staff, as these are the key drivers of their costs. Much of this information will be available to them in real time through their telephone and customer relationship management (CRM) systems, and they will be monitoring it routinely throughout the working day. They don't have to wait for monthly variance reports to tell them they missed their revenue target or overspent the budget. Halfway through the month, they were probably all too aware that the number of calls being presented was below target and that their sales conversion ratio was below par. As a result, they knew far in advance that they were heading for a poor month.

This key nonfinancial data is what's important to these line managers when they begin preparing their budgets and re-forecasts. Typically they will model all the nonfinancial data that drives their costs in a spreadsheet and

simply cut and paste their line-item costs into a central budgeting application. The net result is that all the budgeting application contains is "dead" cost data. You can add it up, you can do variance analysis against it, but it tells you very little about what is actually driving cost in the enterprise or what demands the company faces in the future.

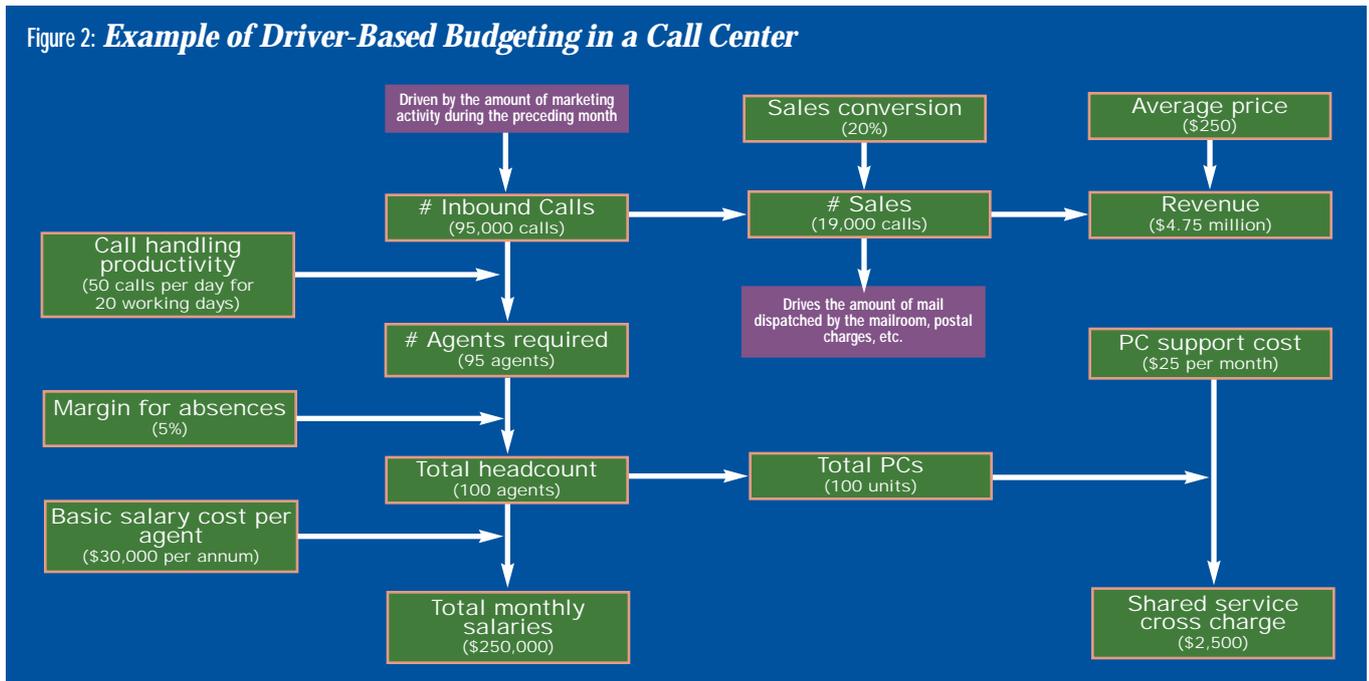
Increasingly, the new generations of planning and budgeting applications are going beyond simply consolidating and reporting on costs. Many allow nonfinancial data that drive costs to be incorporated alongside line-item costs, enabling users to write rules to calculate resource requirements both within and between responsibility centers as well as between time periods.

Nonlife insurance providers that typically manage their business using actuarial and other nonfinancial ratios offer numerous examples of how this might work in practice. For instance, assume a healthcare insurer plans to generate 125,000 new customers in the coming year.

- ◆ Using existing claims frequency ratios, they can predict the number of claims to expect from these customers during each policy year. For example, if 10% are anticipated to make a claim, the insurer will have an additional 12,500 claims to process.
- ◆ If a claims assessor working 250 days per year can process 50 claims in a working day, the insurer will need to budget for exactly one additional claims assessor (12,500/(50x250)).
- ◆ If a claims assessor typically costs \$50,000 in salary, needs a pension plan, a computer, and induction training, and costs \$5,000 to recruit, the company can model their impact on the budget for the claims department as and when the rising level of claims predicts the additional resource is required.
- ◆ The same thinking can be applied to other areas of the business, such as the call center and the mailroom, using nonfinancial data to model the anticipated level of demand, the resource required to cope with that level of demand, and the cost of that resource in a continuous iterative process.

While it may seem radical to bring nonfinancial data into a budgeting system, it's no more than incorporating the disparate spreadsheets that line managers typically use offline into a central application to produce a truly "dynamic" budget. This isn't new thinking. An August 2002 report prepared by CFO Research Services, titled "CFOs: Driving Finance Transformation for the 21st Century," shows that 14% of senior finance executives in large U.S. companies already incorporate operational dri-

Figure 2: *Example of Driver-Based Budgeting in a Call Center*



ver data into their budgeting and forecasting process (although I suspect it is still held on spreadsheets rather than in the budgeting application), and 52% say they plan to have it within the next three years.

It is *not* an onerous task to build a dynamic budget where a web of nonfinancial data, such as sales volumes and consumption rates, is used to model resource requirements and costs and where rules link the outputs of one department with the demands of another. Most line managers already know what drives cost in their department and already have the formulas hidden away in their offline spreadsheets. Building a dynamic budget is therefore frequently little more than integrating all these disparate spreadsheets into a single application. The net result can be called driver-based budgeting or predictive budgeting (the terms being interchangeable), and while it may take some extra time and effort to set up the first time around, the long-term benefits are immense.

THE DAWN OF THE SINGLE-CLICK RE-FORECAST

As I mentioned earlier, many of the new generations of planning and budgeting applications allow users to incorporate nonfinancial line items alongside financial line items so that they appear exactly as they would in a spreadsheet. Once you've done this, re-forecasting becomes almost instantaneous. Front-line managers simply update their key nonfinancial inputs, such as a resource consumption rate like the call-handling capacity of a telemarketing agent, and with a single click of a mouse button the results ripple through the model,

impacting the resource requirements and costs in their own responsibility center as well those of their colleagues, right through to the profit-and-loss account and the cashflow statement. Suddenly, rolling re-forecasts are attainable with little or no extra effort. At the same time, should a major event occur, such as the loss of a chief revenue source, you can easily build multiple scenarios to assess the impact on financial performance. Because these scenarios go well beyond financial modeling and are firmly based on the key operational metrics, they can simply be picked up and implemented across the business, effectively aligning resources and costs with the new revenue forecast.

ALIGNING RESOURCES ACROSS THE OPERATION

For the most part, traditional budgeting is silo based, with line managers planning their resource requirements with limited interaction with their colleagues upstream or downstream in the business process. But predictive budgeting involves linking driver volumes between responsibility centers and time periods so that managers are encouraged to collaborate. Only by doing this can they ensure that they plan for sufficient resources to be able to deal with the demands being put on their department from other areas of the business but don't overresource and create expensive excess capacity. Because traditional budgeting applications don't incorporate the operational perspective and only show costs and variances, they are incapable of showing up areas of excess capacity in a business. For instance, using only traditional budgeting

information, a call center manager might get a pat on the back for a 10% positive variance on his staff costs at the end of the month. But if the volume of calls handled during the month was 20% below projections, he might get reproached for running with excess capacity and overspending on the actual level of resource required. Only by incorporating nonfinancial driver data alongside the costs to provide such analysis can excess capacity be highlighted. If the call center manager's company had deployed one of the newer generations of budgeting applications, things might have turned out differently. Alerts could have been programmed so that as soon as call volumes dipped and excess capacity looked set to appear, e-mails would appear on managers' screens, spurring them into action so that they could adjust staffing plans and realign the actual capacity with the reduced level of demand.

GREATER ACCOUNTABILITY IN SHARED SERVICES

The simple example in Figure 2 talks about aligning resources between two operational areas, but one of the biggest challenges is aligning the resources and costs in the shared services function with the needs of the business. In many businesses, the cost of IT and the other support functions such as HR, training, and finance can be as much as, if not greater than, the cost of the frontline functions. Keeping these costs under control is a constant source of frustration and concern for many CEOs, but reexamining the way shared services functions plan and budget may help bring them into line with the needs of the business.

Currently, many heads of shared services functions plan resources and costs in isolation from the operations areas. Then once the budgets are consolidated and authorized, the costs of the shared services functions are allocated back to the business units, a process that is frequently accompanied by politics and backbiting as division heads try to offload cross charges that they consider excessive or unjustified. The only way to remove such unproductive internal bickering is to ensure that the costing methodology for shared services goes well beyond simple apportionment and that it's visible and understood by everyone involved.

Predictive budgeting can provide an answer as nonfinancial driver data can be incorporated into the budget and used to calculate the cost of shared services and to drive the cross charges to each business unit. For instance, one of the services provided by an IT shared service function might be called "PC Support," and the logical driver for this service would be the number of

desktops in each responsibility center. Budgeting applications that allow the integration of such key nonfinancial driver data alongside the more traditional cost line items will allow users to model shared services costs at the time of planning and budgeting so that these costs are visible to internal customers and they understand how their consumption of the shared services drives their cross charges. Building shared services into a predictive budget also helps to align the resources and costs of the shared services function with the needs of the frontline operation so that the impact of a 5% downturn in sales units quickly ripples through to show excess capacity in both the operational areas and the shared services functions.

JUST A NORMAL WORKDAY

Health insurance provider Fortis Health, based in Milwaukee, is in the process of building a predictive budget that uses nonfinancial data to link business drivers and departments in their budget in the way described above. Fortis Health will routinely update their predictive budget with nonfinancial driver data to generate rolling re-forecasts that give an operational as well as a financial perspective. "Flexibility to re-forecast and quickly revise plans is important in today's business climate, especially in the complex health insurance industry," says Cathy Jorgensen, director of performance management at Fortis Health.

In today's turbulent markets, strategy doesn't start in January and end in December. It needs to be constantly reviewed so that an organization is responsive to both opportunities and threats as they present themselves and can be nimble in formulating and implementing new plans. When an enterprise gets to this stage, it could be said to be in a state of perpetual planning and forecasting, and Fortis Health intends to use their predictive budget to replace their annual budgeting process.

Once a company invests the time to build a predictive budget, perpetual revision and re-forecasting will no longer be tiresome and time-consuming for line managers or finance—it will just be part of their normal working day. ■

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