

THE ADVANTAGES OF ROLLING FORECASTS

In the second of a two-part series, **David Parmenter** suggests that annual planning is an anti-lean process ready for some radical surgery.

Annual planning, as businesses use it today, is one of the greatest mistakes organisations have made since 1494, the year Pacioli wrote about double-entry bookkeeping in *Summa de arithmetica, geometria, proportioni et proportionalità*. The first writers to put annual planning to the sword were Jeremy Hope and Robin Fraser in their classic book *Beyond Budgeting*. The reason the annual planning process should be replaced is because it:

- takes too long and costs too much;
- leads to dysfunctional behaviour, building silos and barriers to success;
- undermines monthly reporting (monthly budgets are poor targets);
- is not designed for a dynamic company in a rapidly changing environment; and
- is an 'anti-lean' process.

Smart organisations do not have an annual planning process anymore. Instead, they use a quarterly planning process which I call quarterly rolling planning.

The quarterly planning process

In a quarterly forecasting process, management determines the likely revenue and expenditures for the next 18 months. The focus is on what is happening in the forthcoming quarter but with an eye to the bigger picture six quarters out. The quarterly forecast thus updates the annual forecast but gives a view of the next financial year. Each quarter's forecast is never a cold start because management has reviewed the forthcoming quarter a number of times. Provided you have appropriate forecasting software, management can do their forecasts very quickly. The average time spent on the four quarterly forecasts during any given year is five weeks.

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Figure 1 (on the next page) shows how the quarterly rolling process works for a June year-end organisation. The bright green zone is the forecast for the next quarter and the most important part to get right. The light green zone is the second quarter, which is forecast monthly, and this should be reasonably right. Budget holders will be reforecasting this period next quarter.

The teal-shaded zone is only forecast in quarterly breaks, and budget holders are told not to spend too much time second-guessing these quarters. As a guide, budget holders should spend 60% of their time on the first quarter because first-quarter numbers will become targets, 20% on the second quarter and 20% on the remaining four quarters.

December update (one week duration)

In the second week of December, budget holders forecast to the end of the year, with monthly numbers, and the remaining period in quarterly breaks. On approval the January to March numbers become their funding allocation and budgets. The approval process will look at the numbers for the quarter ending March in relationship to past expenditure patterns, current revenue levels and the updated year-end forecast position. The July to June numbers are the first look at next year's annual plan.

March update and annual plan (two week duration)

In the second week of March, budget holders re-forecast to year-end and the first quarter of next year with monthly numbers, and the remaining periods in quarterly breaks. Budget holders obtain approval to spend April to June numbers. The budget holders update next year's numbers and fine-tune them for the annual plan. Budget holders know that they will not be getting an annual funding so the politics are now removed from this exercise.

For the annual plan, budget holders will be forecasting in expense categories rather than at an account code level. The annual plan documentation only shows quarterly splits of the annual plan numbers.

June update (one week duration)

Budget holders are now required to forecast the first six months of next year, July to December, monthly and the remaining period in quarterly breaks. On approval the July to September numbers become their funding allocation and they will be different to the numbers that were in the recently completed annual plan. The annual plan numbers have already been superseded by events.

September update (one week duration)

Budget holders reforecast the next six months in monthly numbers, and quarterly to March six quarters on. Budget holders obtain approval to spend October to December numbers.

“Don’t tell me what you’re doing; tell me what you’ve stopped doing” Peter Drucker



You will find that the four cycles, in a given financial year, take about five weeks, once management is fully conversant with the new forecasting system and processes.

The foundation stones of quarterly rolling planning
In the first part of this article, published in December 2014, I covered four foundation stones of quarterly rolling planning, and these were:

- forecasting at category level rather than account code level;
- separation of targets from realistic forecasts;
- a bottom-up process (using the wisdom of the crowd) that is done quarterly;
- build in a planning application – not in a spreadsheet.

I will now cover the remaining foundation stones to this important process.

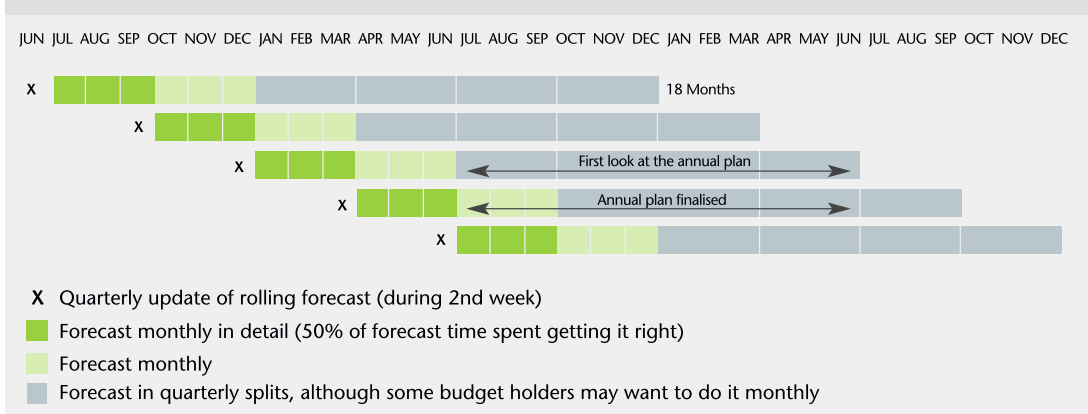
Abandoning processes that do not work

Peter Drucker frequently used the word ‘abandonment’. I think what he said about abandonment is one of the top ten gifts he gave the world. He said: ‘The first step in a growth policy is not to decide where and how to grow. It is to decide what to abandon. In order to grow, a business must have a systematic policy to get rid of the outgrown, the obsolete, and the unproductive.’

He often said that abandonment is the key to innovation. He also put it another way: ‘Don’t tell me what you’re doing; tell me what you’ve stopped doing.’ In planning, many processes are carried out, year-in and year-out, because they were done last year. When staff question, ‘Why do we do this?’ the manager will often answer, ‘There must be a reason; please do it.’ All the previous ‘givens’ associated with forecasting and planning should be challenged and all the inefficient processes thrown out, including:

- forecasting in a spreadsheet;
- forecasting in detail, at account code level and to the dollar;
- forecasting only to the end of the current year as if next year did not exist;
- giving budget holders an annual entitlement because they do not know what the coming year really holds, nor does anyone in finance;
- setting monthly targets from the annual plan because this is best done just before the quarter starts.

FIGURE 1– ROLLING FORECASTING FOR A COMPANY WITH A JUNE YEAR-END



“ Organisations are recognising the folly of giving a budget holder the right to spend an annual sum ”

A fast process (an elapsed week)

Each quarterly rolling forecasts should occur within an elapsed period of seven working days (see Figure 2), with the exception of the March forecast, for a June year-end organisation, as the March reforecast also creates the annual plan. An extra week is added for the annual plan negotiations and quality assurance, as shown in Figure 3 in my previous article in December’s FM Faculty special report, *A guide to smarter business plans*.

Quarterly rolling forecasts can be quick because:

- consolidation is instantaneous with a planning tool;
- the model is based on Pareto’s 80/20 and the ‘keep it simple’ (KIS) principle;
- budget holders can enter numbers directly into the planning tool after training;
- the quarterly repetition aids efficiency;
- because forecasting is at category level, only 12–15 categories are forecast by a budget holder; and
- repeat costs can be standardised for an entire year. For example, a London to New York roundtrip flight is £900 and overnight in New York is £200.

Jeremy Hope saw no reason why the forecast process could not be done in a day in a financial services organisation, where there is no physical supply chain and inventories to manage. For more complex businesses, he believed that these forecasts can be done in several days.

Forecast beyond year-end (eg, six quarters ahead)

Typically corporate accountants have reforecast only to year-end. Two months before year-end management appear to ignore the oncoming year. A foundation stone of a rolling process is forecasting for a rolling period that passes through the year-end barrier. There are various options as to how far forward you go, which include:

- forecasts always two years ahead – this is particularly relevant where the business is very seasonal and much activity happens in the last quarter;
- forecast six quarters ahead; and
- variations such as four or five quarters ahead.

I advocate the six quarters ahead (18-month) rolling planning regime, as it has some substantial benefits that include:

- you see the full next year half way through the current year, eg the third quarter forecast can set the goal posts for next year’s annual plan;
- the quarterly rolling update is consistent each time it is performed, as opposed to organisations who always look ahead for two financial years where the period will vary between 15 to 24 months; and
- your annual plan is never set from a cold start as you have seen the whole financial year in the previous quarter’s reforecast.

Monthly targets set, a quarter ahead, by rolling planning process

We should instead report against more recent targets derived from quarterly rolling forecasting process. This process will give us the monthly targets for the next quarter. It is important to realise that monthly targets are not set any further out than the quarter ahead. In fact information for quarters three, four, five and six are set only quarterly. In other words we patiently wait until the relevant quarter is upon us before putting the budget holders’ estimates in the reporting tool.

This change has a major impact on reporting. We no longer will be reporting against a monthly budget that was set, in some cases over 12 months before the period being reviewed.

FIGURE 2 – THE SEVEN-DAY ROLLING FORECASTING/PLANNING PROCESS

	Pre-work		1	2	3	4	5	W/E	6	7
Process ➤	Forecast pre-work	Deliver forecast workshop	Budget holders prepare and load their forecast	First look at numbers	Submissions by BHs to management board (does the forecast still go through the goal posts)				Re-run of forecast and presentation to CEO	Final alterations and finishing documents
Activities ▼										
Strategic planning		Attend				Reviewing to ensure linkage to strategic plan, and advising of any discrepancies			Attend	
Senior management team (SMT)	Set assumptions				First look at numbers	Review submissions etc full time			Hear presentation and give instructions for final changes	
Finance team	Prepare system, the presentation, overheads, personnel costs, travel standard costs, etc.	Give presentation to BHs	Help BHs with forecast (extended team)	QA	Further quality assurance				Complete preparation and present forecast presentation	Finish off documentation
Budget holders (BHs)		Attend	Prepare forecast			Present forecast and business plan where there is a major change			Present to SMT when called	Document and file all calculations

Rolling planning should be based on main events or key drivers

A quarter-by-quarter funding mechanism

Organisations are recognising the folly of giving a budget holder the right to spend an annual sum, while at the same time saying if you get it wrong there will be no more money. By forcing budget holders to second-guess their needs in this inflexible regime you enforce a defensive behaviour, a stock-piling mentality. In other words you guarantee dysfunctional behaviour from day one!

In rolling planning, the annual entitlement to spend is replaced with a quarter-by-quarter funding mechanism. In this process the management asks, 'Yes we know you need £1m for the year and we can fund it, but how much do you need in the next three months?' At first the budget holder will reply, 'I need £250,000 this quarter', to which is replied, 'Pat, how is this? Your last five quarterly expenditures have ranged between £180,000 and £225,000. Pat, you are two team members short and your recruiting is not yet underway, be realistic you will only need £225,000 tops for the next quarter'. The quarterly rolling planning process will highlight 'free funds' which can be reallocated for new projects earlier on in the financial year.

The released funds can fund new initiatives that the budget holder could not have anticipated at the time of the budget round. This will get around the common budget holder dilemma 'I cannot undertake that initiative, though we should, as I did not include it in my budget'. In the new regime the budget holder would say 'I will put it in my next quarterly update and if funds are available I am sure I will get the go ahead'.

It will come as no surprise that when a budget holder is funded only three months ahead the funding estimates are much more precise and there is little or nowhere to hide those slush funds.

Linking to current and future strategic issues and drivers

Rolling planning should be based on main events or key drivers so the finance team can quickly inform management of the impact should a major change occur to any of these drivers. In-depth interviews with your senior management team and some brainstorming about the corporate issues that worry your CEO can quickly identify the main drivers. In other words, consider the effect on your bottom line if:

- you contract in size by stopping the production of one major line or by selling a business unit;
- you grow through a major acquisition;
- you lose a major customer;
- a major change to key economic indicators occurs, such as interest rates or inflation; and
- a major overseas competitor sets up in your region.

If you have considered the major events that could concern senior management and have designed the

rolling planning to separately identify them, you will be able to quickly model the implications of such changes robustly.

Planning based around four- or five-week months

The calendar in use today can be a major hindrance in forecasting. With the weekdays and number of weekend days, in any given month, being different from the next month, forecasting and reporting can be unnecessarily compromised. Closing off the month on a weekend can make a big positive impact in all sectors. Forecasting models should be based on a '4, 4, 5 quarter'; that is, two four-week months and one five-week month are in each quarter, regardless of whether the monthly reporting has moved over to this regime. Calculating and forecasting the following items then becomes easier:

- revenues – for retail, you either have four or five complete weekends in a month (the high revenue days);
- payroll – you either have four weeks of salary or five weeks of salary; and
- power, telecommunications and property related costs – these can be automated and be much more accurate than a monthly allocation.

It is a simple step to adjust the four- and five-week month's numbers back to calendar months by looking at the number of working days in each method.

It is a better practice to migrate your accounting into four- or five-week months in any case and then your planning and reporting will be in sync.

The next steps

1. List the key driver of your business and assess how these are incorporated in your existing planning process.
2. Understand the reasons why Excel is not an appropriate application for forecasting and planning. Send me an email and I will send you the reasons why you need to migrate to a planning tool and how to sell the change to management.
3. Visit organisations in your sector, using your G/L, who are reporting on a 4,4,5 basis.
4. Develop your foundation stones for a leaner planning process and sell these to the finance team and beyond.

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