HOW TO GET IT APPROXIMATELY RIGHT, NOT PRECISELY WRONG

We all know that there is a good chance of our annual plan being wrong as soon as the ink is dried. **David Parmenter** suggests a way forward.

In the past accountants have tried in vain to budget at an ever more detailed level to somehow see into the future. It was and is now still a pointless exercise. We need to acknowledge that it will be wrong so let's get it wrong quicker! Albeit as close as possible to the future actuals.

In planning, many processes are carried out, year-in and year-out, because they were done last year. All the previous 'givens' associated with forecasting should be challenged and all the inefficient processes abandoned as Peter Drucker preached.

Just as a house is built on a solid foundation, forecasting financial numbers should be built on best practice 'foundation stones'.

Forecasting at a category level rather than at account code level

Forecasting at a detailed level does not lead to a better prediction of the future. A forecast is rarely right. Looking at detail does not help you see the future better. In fact, I would argue that it screens you from the obvious.

Staying in a helicopter to count the trees in a forest

Imagine that you have been asked to count the trees in a state forest that consists of 100 square miles of trees. You have two choices: the detailed way and the 'helicopter' way. For the detailed way, you could set up 10 teams of seven people.

Each team is assigned 10 square miles and is given satellite navigation equipment, a different colour of spray paint, safety gear, camping equipment and provisions for three weeks or so. The teams update their count each night on a spreadsheet. At the end, the counts are consolidated, and some data is left out because the counters in some teams forgot to load all their spreadsheets into the workbook.

' A forecast should concentrate on the key drivers and large numbers rather than a myriad of numbers gathered at account code level '

The final count, therefore, is wrong, although no one knows that. For the helicopter way, satellite imaging is used to select five sample areas that are 1/1,000 of the forest. The staff is assigned to five bigger teams, and each counts their area in a day. The count of the five areas is averaged and then multiplied by 1,000.

The answer is wrong. But it was wrong quickly and is still a good approximation.

For forecasting, the helicopter way is usually the better option unless you are forecasting payroll, which each manager can forecast by staff member, in less than 20 minutes.

A forecast should concentrate on the key drivers and large numbers rather than a myriad of numbers gathered at account code level. Think about it. Do you need a target or budget at account code level to control costs? If we have good trend analysis captured in a reporting tool we can easily identify costs that are out of control. Therefore, you can apply the 10% rule and dispense with forecasting at account code level unless an account code is over 10% of total expenditure, see Figure 1, below left – How a forecasting model consolidates account codes.

Separating targets and realistic forecasts

Generating realistic forecasts rather than forecasts that the board or senior management wants to achieve is vital. The board might want a 20% growth in net profit, yet management might see that only 10% is achievable with existing products, customers and capacity constraints. If the forecasting team reports what the board wants to hear, they are simply hiding the truth. Figure 2 (on the next page) shows what happens if the team reports what the board wants.

In this example, only in the final quarter does the real situation become clear: a year-end performance below expectations. The annual plan, which was prepared in

FIGURE 1: FORECASTING MODEL

Forecasting at account code level		Forecasting at category level	
Stationery	4,556		
Uniforms	3,325		
Cleaning	1,245		
Miscellaneous	7,654	Consumables	22,000
Consumables	2,365		
Tea and coffee	2,134		
Kitchen utensils	145		
	£21,424		£22,000

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March for the new year that starts in July, is forced to match the stretch target and subsequent forecasts in June, September and December to keep up this charade. In reality, the truth was always a shortfall, as the dark line in Figure 2 shows.

In this scenario the board when setting a stretch target accepts that the organisation might not be able to achieve it with existing resources. The bonuses would not be pegged against the lowered threshold. The early communication of the performance gap enables the board to think strategically about how we are to close the gap.

How to forecast revenue – a number you will never get right
With over 200 products and 2,000 customers, how do you reasonably obtain an accurate sales forecast? The answer is to follow these guidelines by:
• applying Pareto's 80/20 rule (see the definition in the box below) to the sales forecasting process; and
• using the wisdom of the crowd.

Applying Pareto's 80/20 rule to sales forecasting
Sales need to be forecast by major customers and major products. The rest of the customers and rest of the products should be put into meaningful groups and modelled based on the historic relationship to the major

customers' buying patterns (see 'Pareto and the sales forecasting process', below left).

Using the wisdom of the crowd
James Surowiecki wrote that 'a large group of people are often smarter than the smartest people in them' in his book *Wisdom of the Crowds.* Involving a 'crowd' in planning and forecasting can have a major positive impact on the process because:
• a great deal of trend information is being noted by those at the workplace, such as unsold products that are piling up, products that are being returned and customer comments;
• groups are less motivated to forecast what management wants to see;
• a small group of forecasters can only process a tiny fraction of the information available whereas a crowd can take in an almost unlimited 'harvest of data'; and
• experts tend to have a bias of optimism, especially if they are looking at sales from inside the company rather than from the customer perspective.

The theory of 'the wisdom of the crowd', has been well documented by a number of writers and proved by a number of organisations. At Best Buy, a leading US electronics retailer, the forecasts are now prepared by asking selected 'sages' in the business to provide an anonymous forecast directly into a system. They are provided with some basic trend information with the incentive of the recognition and a prize if their forecast is the nearest to the actual figure.

The forecast used in the business is now an average of all the forecasts and the reported forecast accuracy to actual is on occasion so close that it appears incredible.

PARETO AND THE SALES FORECASTING PROCESS

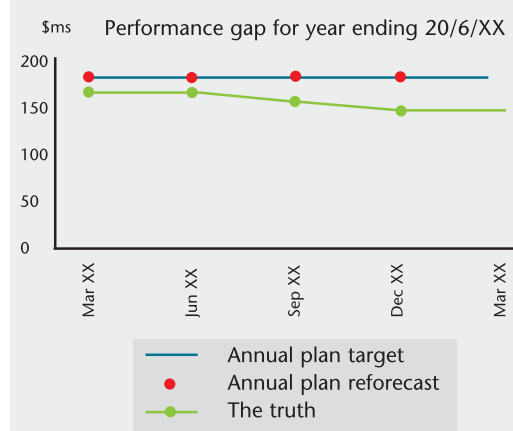|	
Major customers	You can forecast revenue more accurately by delving into your main customers' future demand patterns by asking them 'Who should we speak to in order to get a better understanding of your likely demand for our products in the next three months and subsequent five quarters?' Forecast the major products line-by-line. You would not identify a product if the revenue was less than 5% of total sales in the year. Using analytics then forecast the minor product purchases in relevant groupings.
The other customers	Forecast all non major customers by first looking at their demand for the major products and then by minor products using analytics to forecast their demand.
Products with recall risk	Identify in the forecast all products with a significant recall risk so you can quickly identify these and the impact should a recall occur.
Branches	Important to forecast through the major customers to the organisation. One branch may be assigned the responsibility to link to the customer and complete the forecast for all relevant branches.

* Pareto's 80/20 rule is the principle, named after Italian economist Vilfredo Pareto, which asserts that for many events, 80% of the effects come from 20% of the causes.

FIGURE 2: HIDING THE PERFORMANCE GAP

$ms — Performance gap for year ending 20/6/XX

(x-axis: Mar XX, Jun XX, Sep XX, Dec XX, Mar XX; y-axis: 0, 50, 100, 150, 200)

Legend:
— Annual plan target
● Annual plan reforecast
— The truth

Take the politics out of planning

The annual plan should not create an entitlement to spend, it should merely be an indication, the funding being based on a quarterly rolling basis, a quarter ahead each time. This takes the politics out of planning.

Asking budget holders what they want and then, after many arguments, giving them an 'annual entitlement' to funding is the worse form of management we have ever presided over.

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 stockpiling mentality. In other words you guarantee dysfunctional behaviour from day one!

In fact, the annual planning process has a lot in common with the handling of a nine-year-old's birthday cake.

The cake is never offered to the kids with the question 'How much do you want?' There is not enough time in the party for that debate. The clever care giver says to the kids 'Here is the first slice, if you finish that slice, and want more, I will give you a second slice.'

Instead, what we do in the annual planning process is divide the cake up and portion all of it to the budget holders. Like the nine-year-olds, budget holders will not share any surplus to requirements. Why not, like the clever parent, give the manager what they need for the first three months, and then say 'what do you need for the next three months?' and so on. Each time we can apportion the amount that is appropriate for the conditions at that time. This is called rolling planning.

Abandon large forecasting spreadsheets

Spreadsheets have no place in forecasting, budgeting and reporting routines because of their susceptibility to error. A spreadsheet is a great tool for creating static graphs for a report or designing and testing a reporting template; what it is not, and should never have been, is a building block for your organisation's reporting, forecasting or planning systems.

'Often, the main hurdle is the finance team's reluctance to divorce itself from the spreadsheets'

Rule of 100

If you can build a forecasting, reporting or planning model in a spreadsheet application and can keep it within 100 rows, you can do so without much risk. Pass this threshold and you expose yourself, your finance team and the organisation.

Forecasting requires a robust tool, not a spreadsheet that was built by an innovative accountant and that, now, no one can understand. I always ask in workshops, 'Who has a massive spreadsheet written by someone else which you pray about before you use it?' You can see the pain in the instant response.

Most people know that the person who built the spreadsheet certainly was not trained in operational systems design. The workbook will be a collage of evolving logic that only the originator has a chance of understanding.

Often, the main hurdle is the finance team's reluctance to divorce itself from the spreadsheets. It has been a long and troublesome marriage, that has limited the finance team's potential.

Acquire a planning tool

Acquiring a planning tool is a major step forward, and one that needs to be pursued, not only for your organisation's future, but also for the future careers of the finance team. Soon, a career prerequisite is likely to be planning tool experience, and, conversely, being a spreadsheet guru is likely to be career limiting.

Search the internet for all the reasons why a spreadsheet is inappropriate for planning and forecasting. Use the following search strings: 'spreadsheet errors'; 'implementing a planning tool'; and visit my website for further assistance on this important journey. In all my workshops, around the world, I have never come across a finance team that have reverted back from a planning tool to a spreadsheet willingly.

Embrace lean and complete your plan in two weeks

An annual plan should be completed from start to finish, including negotiations and quality assurance, in a two-week timeframe. You will then be ready to migrate to quarterly rolling planning. Unlike wine, planning does not improve, with the more time and effort you put into it. Planning can be quick if you follow the guideline set out in 'Guide to faster planning' on this page.

Management consultant Jeremy Hope called it a fast light touch and he 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, Hope believed that these forecasts can be done in several days.

A two-week annual plan is possible. I first heard about it in a major government department in the 1990s when I was benchmarking finance functions. Quite unbelievable. The programme they followed is set out in Figure 3 (below).

The next steps
• List now what you need to abandon in your annual planning process.
• Dispense with forecasting at account code level unless an account code is over 10% of total annual expenditure.
• Use wisdom of the crowd for your revenue forecasting.
• Migrate your forecasting to a planning tool.

GUIDE TO FASTER PLANNING

Reliability	Consolidation is instantaneous with a planning tool.
Pareto's 80/20	The planning model is based on Pareto's 80/20 and the 'keep it simple' principle. Budget holders can enter numbers directly into the planning tool after training as the model is based around Pareto's 80/20 principle, focusing on the major items, events, drivers etc. Because forecasting is at category level, only 12-15 categories are forecast by a budget holder. Only need monthly data for the first two quarters.
Quarterly repetition improves forecasting	Clever organisations are doing quarterly rolling planning so the quarterly repetition aids efficiency.

FIGURE 3: THE TIMETABLE FOR A 10-DAY PLAN

	10 day annual planning process (part of the fourth quarter's QRP performed in the last month of the third quarter)										
	Pre-work			**1**	**2**	**3**	**4**	**5**	**6**	**7**	**8**	**9**	**10**
Process	Budget prework	Meeting with divisional heads (DHs)	Present budget workshop	Budget holders prepare and load their forecast			First look at numbers	Rework some budgets	Submissions by BHs to budget committee			Completion of final draft budget for board approval	Final alterations and finishing documents
Activities by team													
Strategic planning		Attend						Reviewing to ensure linkage to plan, and advising of any discrepancies				Attend	
Senior management team (SMT)	Set assumptions	One-to-one with the finance team						First look at numbers		Review submissions, all day long			Hear presentation and give instructions for final changes	
Finance team	Prepare system, overheads, costs etc.	One-to-one with DHs	Give presentation to BHs	Help BHs with budget plans (extended team)			Quality assurance	Help BHs	Further quality assurance			Complete preparation and deliver annual plan presentation	Complete documentation
Budget holders (BHs)			Attend		Prepare budget		Alter numbers after feedback	Rework numbers if needed	Present plan to SMT when called			Attend	Document and file all calculations