

Adaptive Budgeting and Forecasting in a Rapidly Changing World

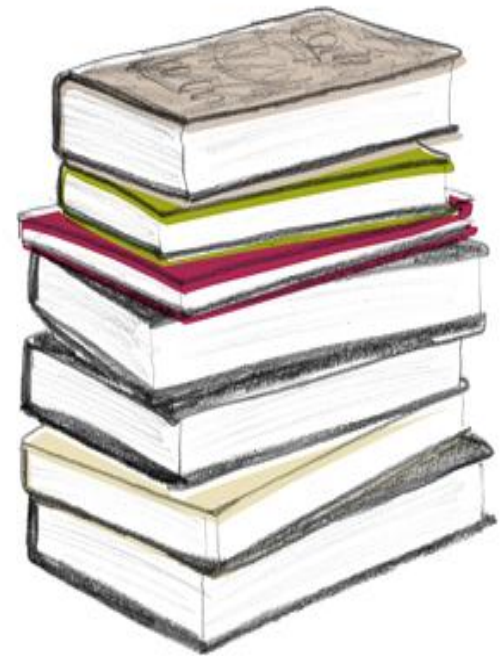
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Meeting Objectives

- Discuss the traditional budgeting process and common pitfalls of that process
- Describe leading practices related to budgeting and forecasting
- Discuss specific recommendations to help make the budgeting and forecasting process more effective



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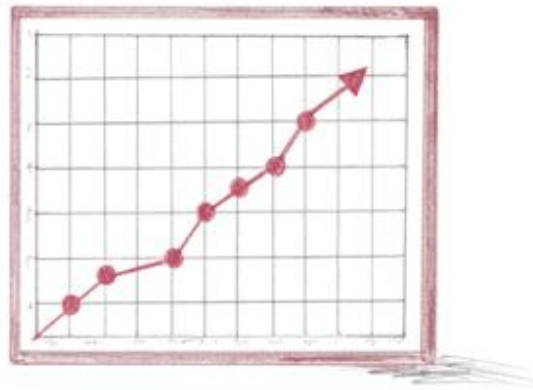
Introduction

- In his book, "Winning," Jack Welch shares his opinion regarding the budgeting process:

"The budgeting process at most companies has to be the most ineffective practice in management. It sucks the energy, time, fun, and big dreams out of an organization. It hides opportunity and stunts growth. It brings out the most unproductive behaviors in an organization, from sandbagging to settling for mediocrity. In fact, when companies win, in most cases, it is despite their budgets, not because of them. "



TRADITIONAL BUDGETING



Traditional Budgeting

- Performed on an annual basis
- Results in financial targets set at the beginning of the year
- Typically based upon historical financial performance
- Static in nature
- Focuses on current earnings
- Often is heavily top-down influenced
- Can be as simplistic as adding an arbitrary percentage to last year's financial results
- Used as justification for spending levels



Traditional Budgeting Pitfalls

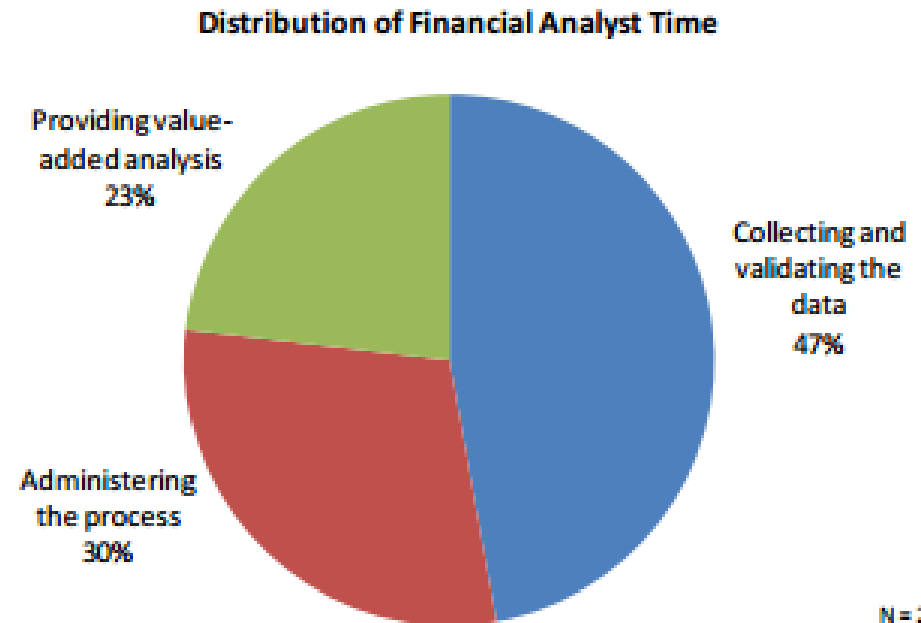
- Creates a "fixed performance contract" which can limit a company's ability/drive to react to a continually changing environment
- Managers may perceive a threat empowerment and entrepreneurialism
- Inefficient process from negotiations to the ultimate sign-off
- Often creates focus on short-term performance goals while ignoring long-term strategic initiatives
- Leads to managers gaming the process to achieve bonuses
- Top-down pressure risks alienating business owners, threatens buy-in and thus accountability

LEADING PRACTICES



Leading Practices Utilize Technology

- Simplify the process and eliminate busy work
 - *On average, 77% of analysts' time is spent collecting, validating and administering the budgeting process instead of on value-added analytics, which leads to data that is outdated by the time it is ready to be analyzed*



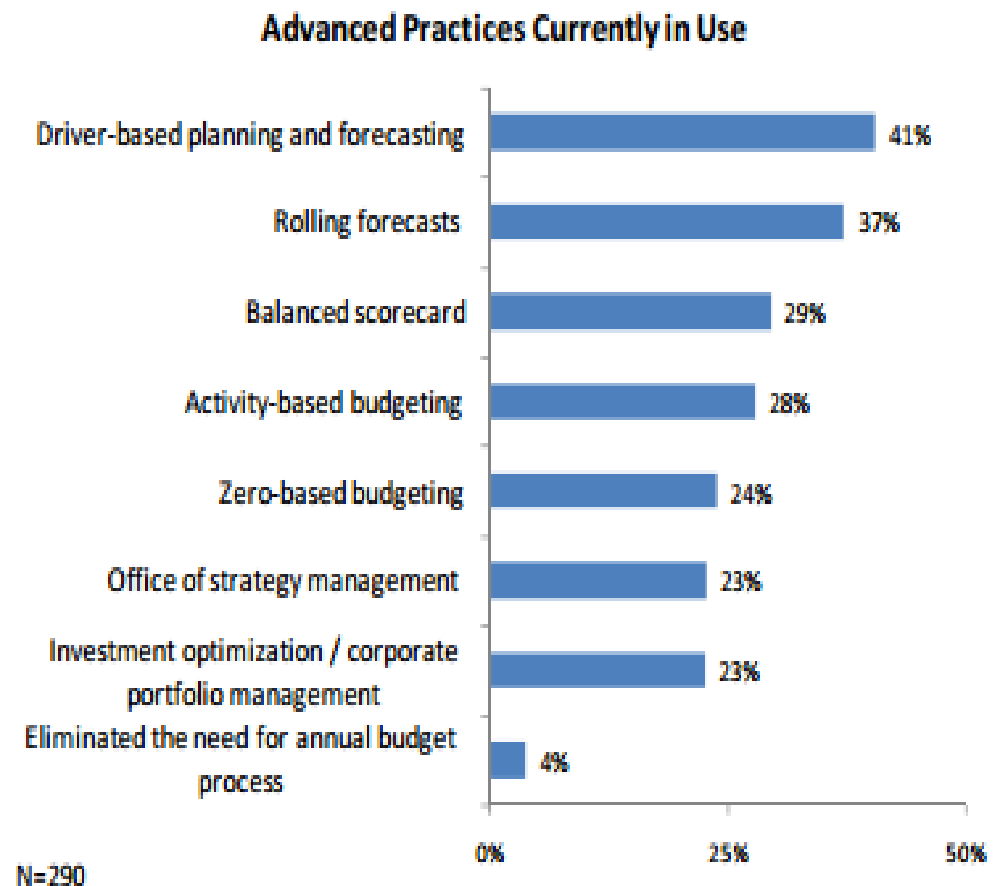
Leading Practices

Utilize Technology Continued

- Many ERP systems have budget functionality
- Commercial applications, such as Hyperion and IBM's Cognos, and other technologies can reduce planning iterations as well as time to collect quality data
 - *Companies that utilize commercial applications are 59% more likely than spreadsheet users to come within 5% of their planned targets*

Leading Practices

- This graph illustrates the top practices currently in use for budgeting and forecasting
- The following slides discuss the top 3 advanced practices currently in use: driver-based planning and forecasting, rolling forecasts, and balanced scorecards

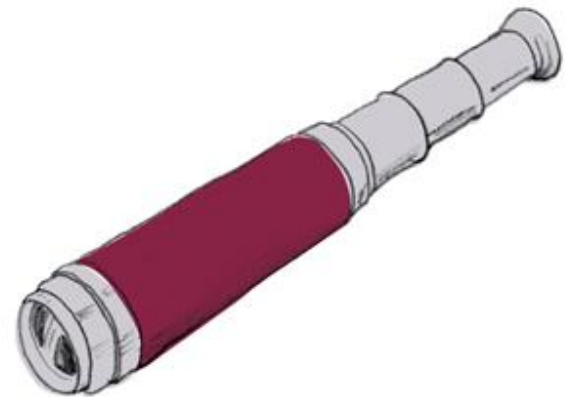


DRIVER-BASED PLANNING



Driver-Based Planning

- Driver-based planning is planning using assumptions about business activities which are modeled to drive financial data such as revenue projections and capital requirements
- Focuses on the leading indicators that drive business instead of forecasts of outputs and results such as Cost of Goods Sold or Sales Dollars



Driver-Based Planning Continued

- 3 examples of types of drivers used in Driver-Based Planning
 - Profit-Based Drivers
 - Working Capital Drivers
 - Risk Drivers



Driver-Based Planning Continued

➤ Profit-Based Drivers

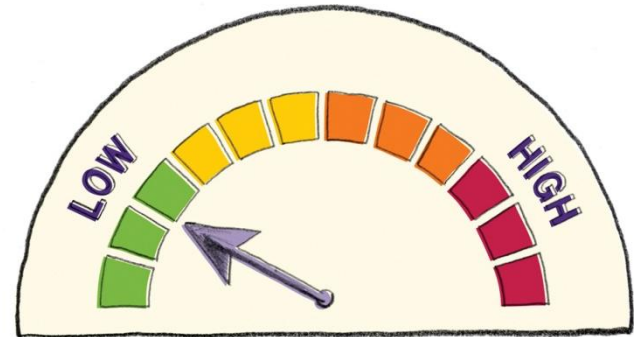
- Customer Demand
- Changes in Distribution Methods
- Production Volume



- Can provide insight into financial performance in advance of traditional forecasting, which can allow management to make informed decisions regarding the effects of changes in performance drivers throughout the forecasting period
- Implement a monthly re-forecasting initiative to examine changes in the marketplace; consider need for SWAT analysis or other formal external environment analysis

Driver-Based Planning Continued

- Working Capital Drivers
 - Labor Cost
 - Purchase Price Changes
 - Cost of Capital
- Risk Drivers
 - Regulatory Changes
 - Foreign Exchange Rate fluctuations
 - Inflation



ROLLING FORECASTS

Exhibit 4 Five-Quarter Rolling Forecast

	Year X				Year X+1			
	1Q	2Q	3Q	4Q	1Q	2Q	3Q	4Q
1st Review	Forecast	Forecast	Forecast	Forecast	Forecast	Actuals	Actuals	Actuals
2nd Review	Actuals	Forecast	Forecast	Forecast	Forecast	Forecast	Actuals	Actuals
3rd Review	Actuals	Actuals	Forecast	Forecast	Forecast	Forecast	Forecast	Actuals
4th Review	Actuals	Actuals	Actuals	Forecast	Forecast	Forecast	Forecast	Forecast

■ Forecast ■ Actuals

Source: Beyond Budgeting Round Table.

Annual Plan X+1

Rolling Forecasts

- Quarterly projection for 5 quarters or more
- When a period ends, a new period is added to the cycle and the 2nd period becomes the 1st period
- Recent surveys of CFOs show many are moving away from a formal yearly budget process to a less formal rolling forecast model
 - *According to a study performed by APQC, out of 349 companies surveyed, 54.4% reported using rolling forecasts*
- Rolling forecast models more easily allow management to adapt to a changing economic environment throughout the business cycle

Rolling Forecasts Continued

- Continuous business outlook
- Depending on management's preference, may augment or eventually replace the traditional budgets
- Management can perform “What if Analyses” to gain more insight by combining multi-variable scenarios
- Best in class companies perform monthly updates to the rolling forecast

Rolling Forecasts Continued

- Benefits of a rolling forecast
 - Lower processing costs and shorter cycle times for the budgeting process
 - *According to a recent APQC survey, organizations using rolling forecasts saved between 5 and 25 days annually in their budgeting process*
 - Incorporates best information available at any point in time, not just at the beginning of the year



Rolling Forecasts Continued

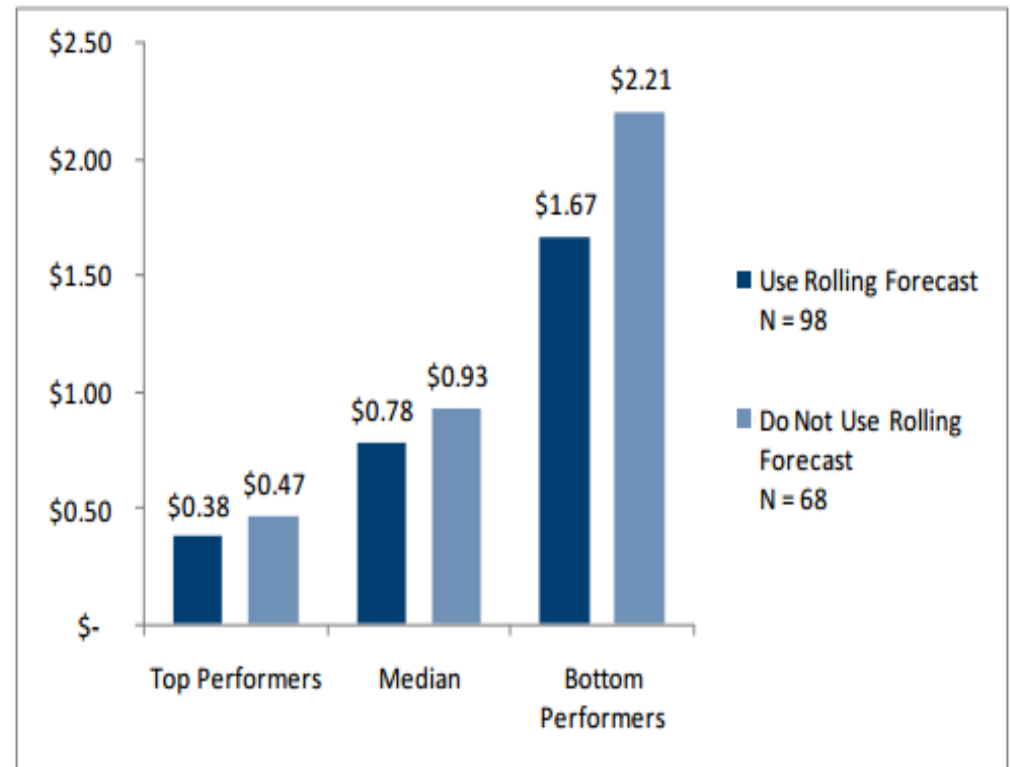
Example of a Rolling Forecast Model

Period	Jan Feb Mar	Apr May Jun	Jul Aug Sep	Oct Nov Dec	Jan Feb Mar	Apr May Jun	Jul Aug Sep
Numeric Forecast Period	1	2	3	4	5	6	7
Current Year/Next Year	CY	CY	CY	CY	CY	CY	CY
Budget	1	2	3	4			
Traditional Forecast(Replaces Budget)		R2	R3	R4			
Rolling Forecast-Beginning of First Period	1	2	3	4	5		
Rolling Forecast-End of First Period		1	2	3	4	5	
Rolling Forecast-End of Second Period			1	2	3	4	5
----Continuing							
Rolling forecast and beyond							

Rolling Forecasts Continued

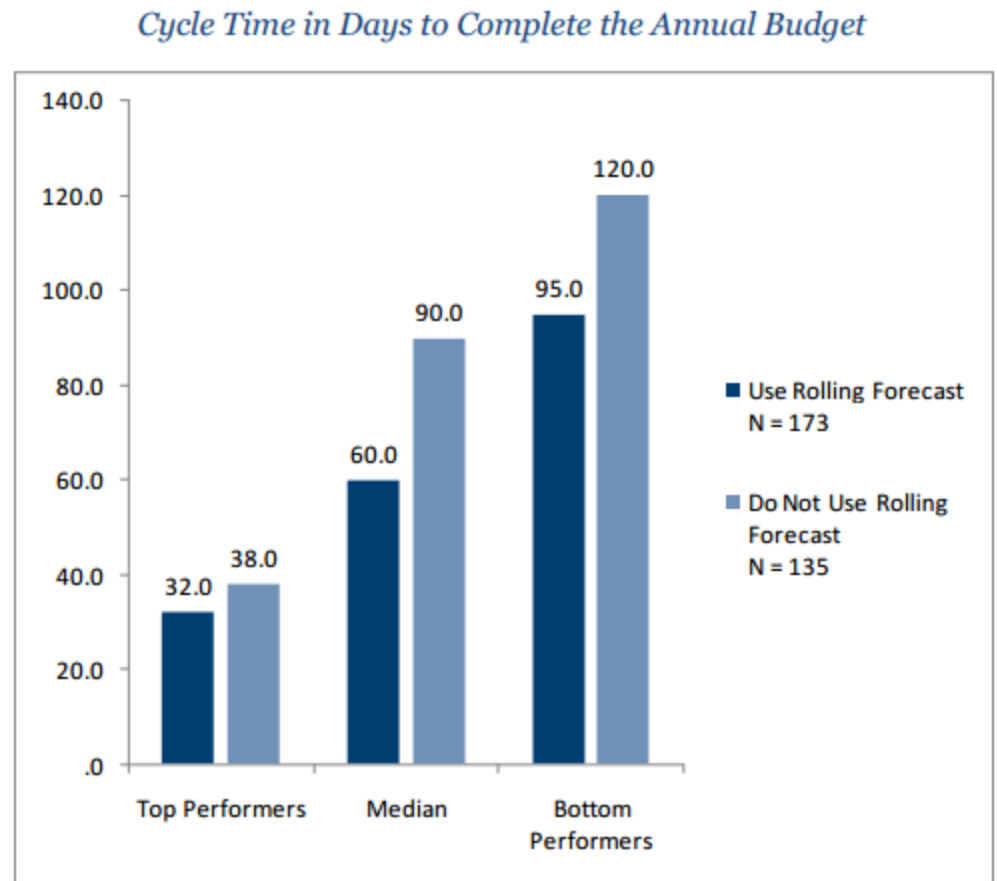
- Companies that implemented rolling forecasts experienced less cost related to the budgeting process
- The cost variance between companies that used rolling forecasts and those that didn't increases as you move down the scale of performance

Total Cost of Budgeting per \$1,000 Revenue

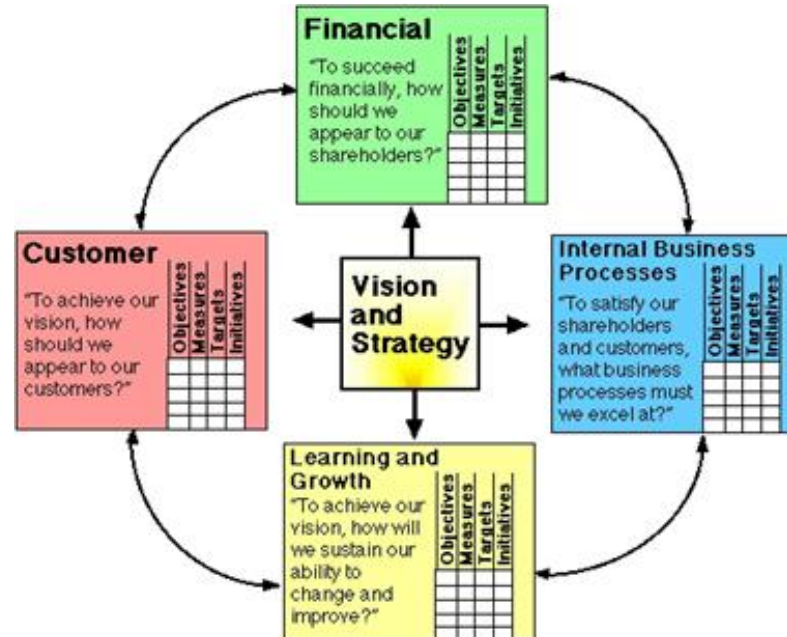


Rolling Forecasts Continued

- Across all three types of performers, companies that implemented rolling forecasts experienced a significant decrease in the amount of time required to complete the budgeting process



BALANCED SCORECARDS



Balanced Scorecards

- Summarizes a company's performance from multiple perspectives in a single diagram
- Facilitates the budgeting process by examining a company's four key perspectives (can be adapted)
 - Financial
 - Customer
 - Business Process
 - Innovation and Learning

Balanced Scorecards

Continued

- This process seeks to create goals within each perspective to be incorporated into an overall budgeting plan
- Effective scorecards establish goals that not only focus on short term financial results but also link to longer-term strategic goals, all of which should translate into better financial performance
 - Example: Increase customer base by 10% over 5 years
 - Example: Develop “XYZ” product by 2014

Balanced Scorecards Continued

- The 4 main categories which normally appear on the balanced scorecard are:
- Financial perspective
 - Customer perspective
 - Business process perspective
 - Innovation and learning perspective

Financial Perspective			
Key Performance Indicators	Measures and Targets	Action Items	Accountability
Revenues	Increase Revenues by 10% by Q3		
Direct Cost	Reduce Direct Cost by 5% by Q2		
Net Income	Increase Net Income by 5% by Q4		
Customer Perspective			
Key Performance Indicators	Measures and Targets	Action Items	Accountability
Customer Loyalty	Limit customer turnover to 5% annually		
New Products	Develop "XYZ" Product by Q4		
New Customer Acquisition	Acquire X new customers per quarter		
Business Process Perspective			
Key Performance Indicators	Measures and Targets	Action Items	Accountability
Improvement in Technology	Integrate Budgeting Software with ERP by Q4		
Inventory Management	Maintain at least X inventory turns per year		
Improve Core Competencies	Develop Z competency by Q2 to support new business opportunities		
Innovation and Learning Perspective			
Key Performance Indicators	Measures and Targets	Action Items	Accountability
Product Diversification	TBD		
Continuous Improvement	TBD		
New Product Development	TBD		

RECOMMENDATIONS



Recommendations

- Leverage current technology instead of placing too much reliance on spreadsheets
- Eliminate budgeting activities which have become stale and non-value added
- Create a flexible driver-based budget which can adapt to the rapidly changing environment
- Focus on leading indicators which give the organization time to re-adjust



Recommendations Continued

- Rather than relying on historical assumptions, implement a continuous, forward-looking planning approach
- Consider financial (profitability, working capital and cash flow), operational and risk-related KPIs which link to strategic goals
- Align financial incentives with performance drivers to help facilitate adoption of the budget
- Aim to increase the visibility of forecasts and to provide broader organizational input and access
- Create a culture of inclusion, buy-in and accountability

Thank you...

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