

A GPS for Your BUSINESS

By David A.J. Axson

New Approaches to Forecasting for Today's Turbulent World

Imagine you had sat down at your desk in October 2007 to develop a forecast for the price of oil as an input to your 2008 planning process. After a few iterations, you draw a graph that shows a steep climb from \$45 a barrel to \$145 by the middle of 2008, followed by an even steeper decline to \$35 by the end of the year. What do you think the reaction of your boss would have been if you had presented him with such a scenario as a basis for building your 2008 plan? Today the reality of business is stranger than fiction and it is causing many managers to question traditional planning and forecasting techniques.

In a world characterised by increased volatility, uncertainty and risk, the traditional approaches of five-year strategies, detailed annual budgets, quarterly forecasts and monthly reports are becoming obsolete.

Even the best companies acknowledge the challenges. In October 2008, Apple CFO Peter Oppenheimer commented that, "visibility is low and forecasting is challenging." In a world characterised by increased volatility, uncertainty and risk, the traditional approaches of five-year strategies, detailed annual budgets, quarterly forecasts and monthly reports are becoming obsolete. Forecasting, in particular, has become very difficult, yet done right, it is one of the most valuable decision support tools available to managers. So how are the best adapting their forecast processes?

More Wrong Than Right

First, they understand that that the objective of forecasting is not to be right. Predicting the future is by definition an exercise in being wrong more than being right – after all, how many forecasts accurately predicted the global economic meltdown during the latter half of 2008?

The real value of forecasting, as Peter Schwartz wrote in his 1991 book, *The Art of the Long View*, is "not an accurate picture of tomorrow, but better decisions about the future."

Think of the forecast as the business equivalent of the GPS system in your car: It provides you with immediate feedback when you vary from your planned course; provides you insight as to the corrective actions you need to take; and updates the forecast of when you can expect to arrive at your destination based upon your rate of progress. The more sophisticated GPS systems will also provide you with advanced warning of hazards ahead and offer suggestions as to alternative routes. Effective forecasts are the GPS of your business.

However, for many organisations, forecasting remains a time-consuming, very detailed extrapolation of past performance into the future. The failure of this approach has been clear to see over the last two years. So how can managers

Think of the forecast as the business equivalent of the GPS system in your car: It provides you with immediate feedback when you vary from your planned course; provides you insight as to the corrective actions you need to take; and updates the forecast of when you can expect to arrive at your destination based upon your rate of progress.

develop useful, credible forecasts in today's turbulent world? It is not as hard as you may think. Here are some simple techniques that can rapidly improve the quality and accuracy of your forecasts:

1. Recognize that your predictive ability declines the further out you look by:

- Expressing forecasts as ranges that reflect your confidence level. The broader the range, the less confidence you have in the numbers and the less reliance that managers should place on those numbers for making critical decisions.
- Matching the level of detail in the forecast to your predictive ability. Develop less detail the further out you are looking.
- Adjusting the time horizon of the forecast. If you can only develop an accurate view for the next 90 days, don't try to develop a six-quarter rolling forecast.

2. Business as usual does not exist anymore. The past is not a good predictor of the future.

- Avoid simply forecasting the future by just looking at the past. Gary Kelly, CEO of Southwest Airlines, offered the following advice: "What I have to guard against is using previous downturns as a road map and assuming that, 'Oh, yeah, things are going to happen just like they did in, say, 1991.'"
- Use tools such as scenario forecasting to assess how your business will perform under a range of different views of the future.

For example, how will your business look if oil averages \$40, \$100 or \$175 a barrel over the next three years?

3. Add additional insight to your forecasts by:

- Identifying the real drivers of changes in the forecast. Explaining a change in terms of volume, rate or mix does not identify the underlying cause. A sales volume variance could be caused by competitors undercutting your prices or by a production problem that caused a decline in inventory levels leading to "stock-outs." The action to be taken is different depending upon the driver.
- Communicating upside and downside items of which you are aware, but on which you have insufficient data to forecast the exact magnitude or timing. For example, you are aware of a potentially favourable settlement of a lawsuit but have little insight as to the timing or value of the settlement.

4. Let the real-time flow of business drive the forecast by:

- Decoupling the forecast from the accounting calendar. Don't wait for the quarter to end and the books to close; forecast when you need to, that is, when the market tells you things have materially changed from your previous view.
- Changing your forecast frequency in response to changes in the market. Fast-food chain McDonald's has instructed its UK managers to look at key data tracking customer buying patterns, competitor traffic and local employment data every two weeks instead of just once or twice a year in response to the current economic uncertainty.

Applying these commonsense techniques can dramatically improve the value of your forecasts by providing managers with a much deeper understanding of the impact of volatility on future results and equipping them to make faster, more confident decisions – the key to success in turbulent times.

David A.J. Axson is a noted author and business consultant. John Wiley will publish his next book, *The Management Mythbuster*, later in 2009. For further information, visit David's website at www.davidaxson.com

