WHAT IS THE POINT OF PLANNING, BUDGETING AND FORECASTING?

THE ANSWER MAY SURPRISE YOU, ESPECIALLY IF YOUR COMPANY IS UNDERPERFORMING.

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The Planning, Budgeting and Forecasting (PBF) process is a Finance department function that is time consuming, often misunderstood, and generally disliked. For companies that are growing and healthy, the process can serve as the foundation for long-range strategic, operational, and financial planning. However, in an underperforming company or turnaround it is especially critical to improving profitability and may be the basis of the success or failure of the company. So, why is it needed and what is it supposed to accomplish? The answer varies depending on whom you are talking to, and to which aspect of PBF you are referring.

What is PBF?

The PBF process is actually three unique sets of activities that are often grouped together:

PLANNING

Planning provides the overall venue and process for stating the direction and financial objectives of an organization. Most companies put together an annual plan that is part of the larger strategic plan of the company. This is where the senior executives lay out their vision for “what is possible.” In a deeply distressed company, where survival is in question, timeframes may be compressed. However, it is critical to maintain a long-term view in these situations so that short term tactics do not overpower long term goals.

The overall planning picture is commonly composed of two or three main components:

- **Strategic Plans**: Set overall long-range goals and objectives. These are often are both qualitative and quantitative in nature.
- **Long-Range Plans**: Typically, these set financial targets over a three to 10 year horizon, and they comprise the quantified financial plan for the strategic plan above. A shorter time horizon (i.e. three to five years) may be more appropriate where a company is in a state of extreme change.
- **Annual Plans**: This is the first year of the long-range plan and provides the high level targets to guide the budget.

BUDGETING

Budgeting supplies the execution path for the plans with a detailed, operational and short-term view. Planning provides "what is possible;" budgets outline "what is expected" from the business, based on the approved annual plan. Budgets are absolutely critical in monitoring historical progress and adjusting activities or implementing new activities to meet turnaround or profitability goals.

The budgeting process is broadly focused on the following major components:

- Sales/Gross Margin Budgets
- Capital Expenditure Budgets
- Headcount Budgets
- Operating Expense Budgets

FORECASTING

Forecasts typically use actual performance data to project the remainder of the current year's performance. Rolling forecasts are the same concept but reset expectations for some predefined future period, usually 12 to 18 months. However, shorter 13-week timeframes **with a focus on liquidity** rather than Generally Accepted Accounting Principles (GAAP) are needed in a distressed company environment. Forecasts focus on what is happening from a revenue and income statement perspective.

There are three general forecasting methodologies:

- **Top-Down Forecasting**: Primarily focused on current demand and operational conditions translated into revenue predictions.
- **Bottom-Up Forecasting**: Rely on business managers to enter current and specific line item details per the revenue budget.
- **Hybrid**: A combination of the above two methodologies, e.g., a top-down focus coupled with a bottom-up proportional allocation.

BRINGING IT ALL TOGETHER

The PBF processes are in fact related but they are also distinctly different. Recognizing this is part of understanding the overall purpose behind the general process and what types of improvement opportunities exist. In fact, there are significant points of view and multiple studies that outline all the various issues with the overall PBF process; however, few have tried to answer the fundamental question: what is the main purpose of the overall PBF process? Here is an example that helps to answer the question:

A few years ago, Huron Consulting Group met with a client reviewing its P&L and associated cash flow forecast. The company was historically profitable with strong cash flow. We thoroughly examined the income statement and all the forecasting logic as well as ties to performance improvement activities and were quite pleased with the forecasted profit and P&L-based cash flow implications (e.g. EBITDA). The forecast showed a nice trend of profitability and implied cash flow looked strong. Things started well.

We then reviewed the balance sheet. Like most organizations, the forecasted balance sheet was relatively simplistic and not substantially integrated with the income statement. Our analysis of the balance sheet quickly revealed major problems. The "forecasted" accounts receivable balances were lower than they had historically been. Conversely, accounts payable balances were higher than they had ever been. Inventory levels were too low. These working capital components just didn't make sense when compared to history and the forecasted income statement.

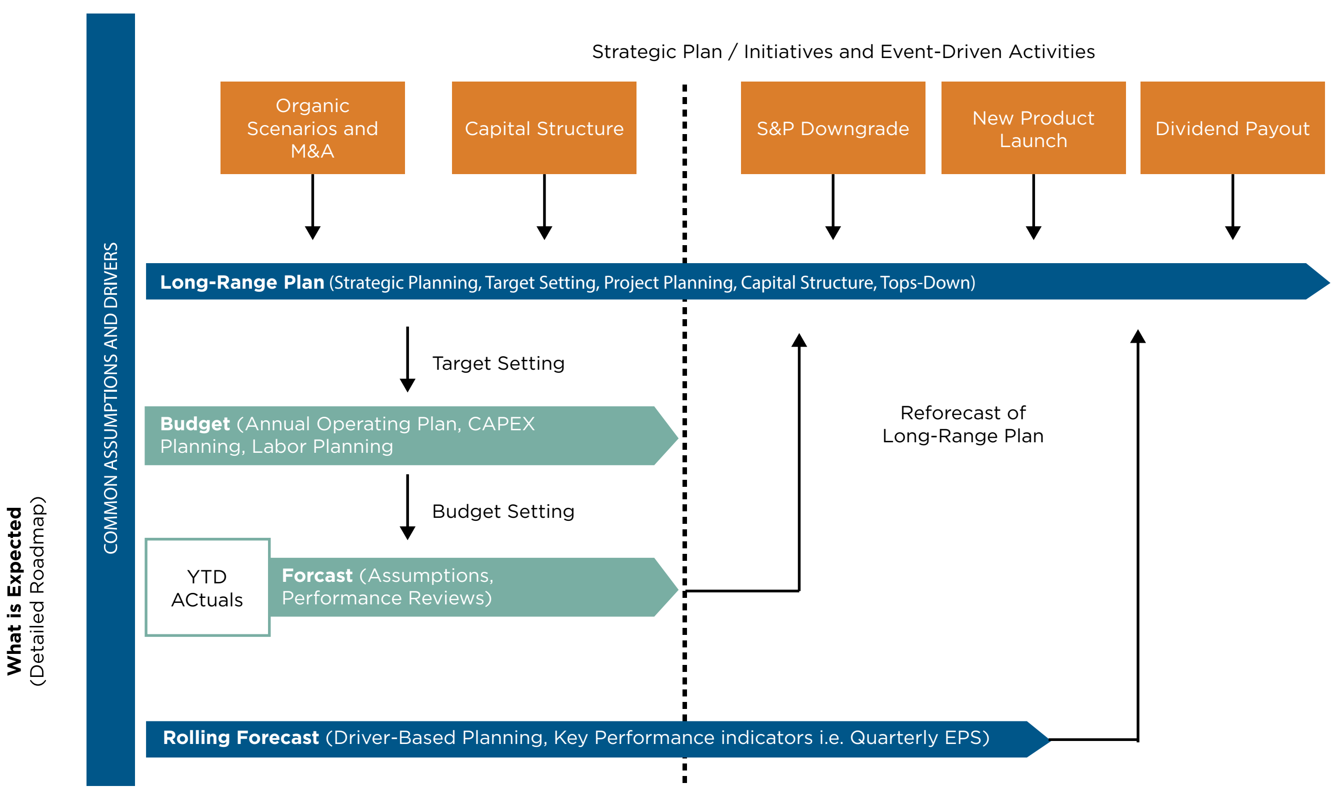
This analysis of the balance sheet in a larger context led us to discover discrepancies in the current forecast assumptions and logic. Even though we had a sound P&L forecast, it did not properly provide insight to the cash needs and/or forecast. This lack of a dynamic relationship between the two financial statements becomes an even greater issue when trying to run scenarios. The above example was point in time; imagine running multiple versions of the P&L numbers and trying to ensure everything continues to make sense! Many clients struggle here but this type of analysis is fundamental to providing better financial direction. It also is essential in highly dynamic situations involving underperformance or distress.

This example illustrates a common gap in the PBF process. How were the overall financial implications being associated to the changes in the forecasted revenues? For lack of a better term, let's use financial planning to describe this often overlooked, major PBF component. Proper financial planning demonstrates the effects of the operational plan components on cash flow and overall financial position. These effects are important in all companies, but critical in a turnaround where cash acts as a lifeline for the future survival.

Key characteristics of a financial plan include:

- Ability to easily produce a complete set of fully-integrated, relationship-based financial statements that provide the comprehensive picture of financial objectives.
- Ability to test the sensitivity of various condition assumptions across the full financials.
- Ability to quickly and accurately gauge the working capital impacts of the operating activities.

The following diagram shows how financial planning fits into the overall PBF process:



The three process components defined:

- **Strategic Planning:** A component of the "Planning" use case in the original PBF breakdown. The strategic planning process quantifies the "vision" of the company and helps management determine "what is possible." Information is at a very high level, is driver and scenario-focused, incorporates full financial statement impacts, and produces the long-range plan. Analysis is most powerful here when external drivers are included at the higher levels (i.e. long-range or strategic plan levels) and the lower levels (i.e. budgets or operational plans) are integrated to shape the outputs.
- **Financial Planning**: Has a role in building the "budget" and the "forecast" and in general terms, is the "top-down" version of the budget. The output from the financial plan is the input to the operational plan. Scenario analysis, stress testing, working capital analysis and re-forecasting of the full financial statements are the key use cases.
- **Operational Planning**: The "B" in PBF and focuses on "what is expected" while highlighting the accountability in the detailed cost structure. The operational plan is also the basis for the allocation of the "top-down" financial plans and is at the lowest level of detail.

Why is there generally so little focus on improved financial planning and/or having a financial planning process integrated with the overall PBF process? The simple answer is that financial planning is difficult and requires unique insight into how the enterprise generates cash flow. Adding to the complexity, most packaged software applications help to gain efficiencies in the PBF components but do not address the financial planning attributes. Depending on the level of complexity and scope of the business, maintaining the required financial relationships within an Excel-centric environment can be cumbersome with a high risk of error.

The "ideal" PBF system incorporates financial planning and will:

- Ensure that the strategic and/or long-range plans focus on integrated scenario analysis. The ability to "stress test" plans and run multiple financial and operational what-if cases will provide unique insight to "what is possible" as well as better forecast 'what is expected'.
- Effectively balance "top-down" and "bottom-up" points of view and forecasting methodologies. Top-down projections apply a more centralized view and can include many influencing factors including market data, economic indicators and general product and customer trends. Bottom-up projections are accumulated from many contributors and are more "inward" focused.
- Produce more than a great income statement. The financial impacts of the operational plans are best analyzed with integrated balance sheet and cash flow statements.

So, again, what is the point of the process?

An optimized PBF process should provide an effective system of checks and balances on possible and expected performance from top to bottom and from immediate to long-term. It serves as both scorecard and action plan for management, allowing management to implement operational change. It should also let management know in advance how much capital they will need and when they will need it.

Contact Huron Consulting Group today to see how we can empower your organization.

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