Forecasting with veracity

How to forecast accurately, and manage data effectively, during economic uncertainty

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Economic uncertainty. Forecasting accuracy.

The future is unpredictable – but your forecasts shouldn't be

The challenge for CFOs and finance professionals during economic uncertainty lies in separating the known knowns from the vast array of known unknowns and unknown unknowns to arrive at accurate forecasts. And yet one thing is certain – there are several ways Chartered Accountants (CAs) can improve their forecasts during periods of volatility.

Whether preparing one-way cash flow forecasts for a small business, or more complex three-way forecasts (combining profit and loss, cash flow and balance sheet projections), there are proven methods for developing forecasts that are robust, defensible and grounded in real-time data.

This Insight paper explores these methods, plus how to use data to its full potential. We'll look at ways that finance teams can manage expectations and educate stakeholders around forecasting, boosting business confidence and maintaining trust in finance.

How can finance teams forecast effectively during uncertainty?

Credible financial forecasts are essential for developing strategies, allocating resources, setting prices, establishing performance targets, communicating with stakeholders and more. During times of economic stress, reliable forecasts become more crucial than ever.

Here we provide seven tips for forecasting when the macroeconomy looks shaky:

1) **Be conservative:** Anticipating downside risks is important at the best of times, but it becomes crucial during tough times. Take a conservative approach when building a base case forecast, especially around cash flow and revenue generation. Also, use variance analysis so any budget variations can be understood. (For instance, to determine whether variance is due to the macroeconomic climate, new market entrants, or changes to technology etc.)
2) **Use top-down and bottom-up methods:** Apply accounting methods that are both top-down (that is, starting with macro-level market data) and bottom-up (for instance, historical performance, and marketing and sales budgets).
3) **Use internal and external sources:** Incorporate information from a range of sources including industry surveys, government data, forecasts from economists and major banks, and data from the Australian Bureau of Statistics or Stats New Zealand. The more sources you can feed into your forecasts, the more credible they will be.
4) **Look ahead but not too far ahead:** Generally, financial forecasts peer 12 months into the future but this timeframe shrinks during a downturn. Volatility and variability mean quarterly or

even monthly forecasts are required. (Long-range planning still has its place, but stakeholders need to understand its limitations during uncertain periods.)

5) **Adopt rolling forecasts and real-time reviews:** Forecasts should be continuously adjusted as conditions change and market forces shift. Adopt rolling forecasts to truly maximise opportunities. For businesses facing cash flow challenges, create a rolling 13-week forecast, updated weekly. Then provide real-time, to-the-minute demand reviews. (Note: rolling forecasts require robust accounting processes.)

6) **Use quantitative and qualitative methods:** Look beyond the numbers, and supplement quantitative forecasts with a qualitative approach. Use internal expertise and experience, and not just historical transactions, to predict performance.

7) **Competitor analysis:** Validate your assumptions by looking beyond your organisation for market indicators, shifts in consumer sentiment, and global trends. (For example, in a business-to-consumer organisation, you might note how your consumer purchase data compares to the broader consumer price index.) Also, monitor competitors – both locally and overseas – to ensure you don't lag in the marketplace.

Best-in-class forecasting tool: Scenario analysis

Scenario analysis involves mapping out different versions of the future according to certain variables and assumptions. It's one of the most effective ways to plan for the future, stress test strategies, and maximise working capital.

Ways to improve scenario analysis include:

- Using realistic drivers and careful judgement when building scenarios.
- Considering fixed and variable costs, plus sales and operational variables (such as supply chain variables).
- As a rule of thumb, preparing one base case scenario, one upside (or best case) scenario, and two downside (or worst case) scenarios. Next, supply two strategies for each scenario.

Case study:

When *not* releasing earnings guidance could be the best option

When is no earnings guidance better than some? When the market is simply too volatile. At least that's what Rohan Best FCA, Senior Finance Director, McCormick & Company found during 2H 2020, when COVID-19 disruption was at its peak.

"The reality was we missed too many forecasts during this period and so we decided not to release earnings guidance to the market," he explains.

"There was just too much uncertainty."

Company guidance on future earnings is, by very definition, only guidance and some variation is to be expected. It's when this variation becomes material that matters. (The Australian Securities Exchange (ASX) defines 'material' as variation greater than 10-15%.)

While profit guidance brings benefits (such as boosting corporate visibility and maintaining communications with stakeholders), Best says McCormick & Company benefitted more from withholding earnings guidance during COVID-19 uncertainty.

Rohan Best FCA
Senior Finance Director
McCormick & Company

"It was a courageous call, but it was well received,' he says.

Instead, McCormick & Company provided key internal stakeholders with a profit range, issued monthly rather than quarterly. This guidance considered risks and opportunities and provided forecasts in terms of high/low revenue, plus gross and operating profits.

In fact, the monthly risk analysis introduced by McCormick & Company during the volatile pandemic period proved so useful for internal stakeholders that it remains in place today. Even as the Fortune 500 company returned to quarterly opportunity/risk assessments against a full formal forecast submission; they've retained their monthly update.

"It's a very dynamic document," says Best, "which allows us to keep our finger on the pulse."

See the ASX's *Guidance Note No.8* Listing Rule 3.1 for market rules around continuous disclosure, and New Zealand's Exchange's Guidance Note Continuous Disclosure.

How to use data to its full potential

CAs are the gatekeepers of forecast data.

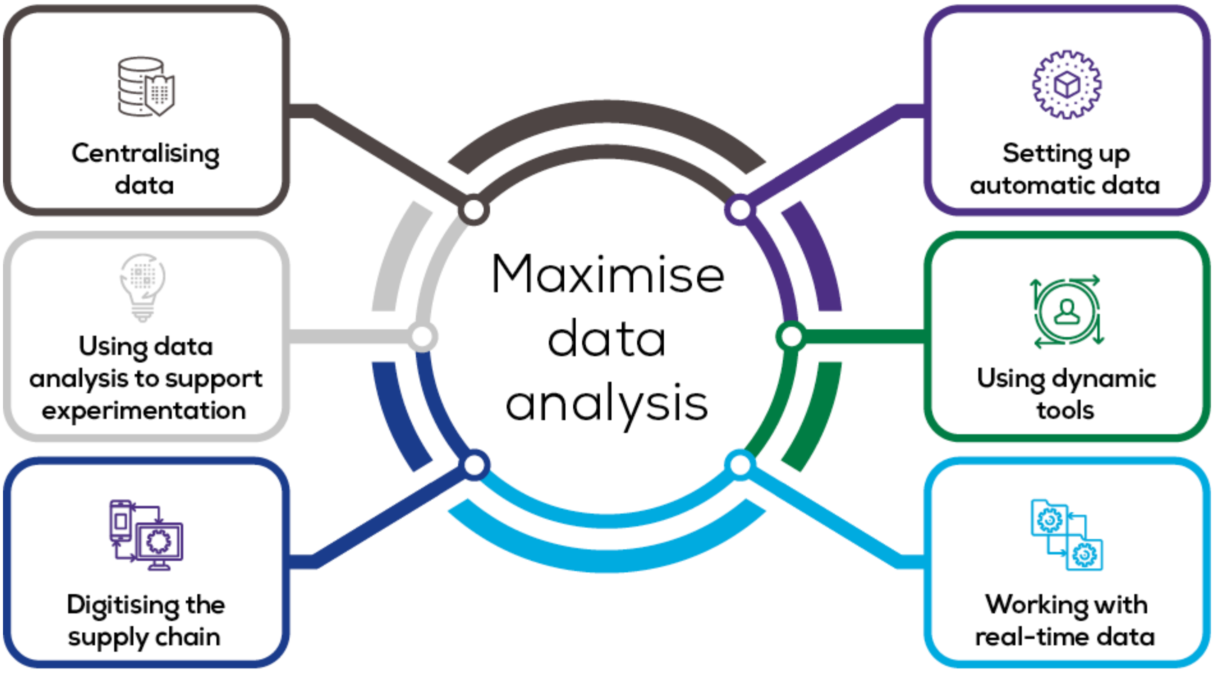
Generally, it's the finance function's responsibility to check forecasting assumptions made by other departments (for example, assumptions around key performance indicators (KPIs) and sales targets). The upshot is that as gatekeepers, CAs are perfectly positioned to use data analytics to reveal valuable insights and opportunities for the business.

Data-driven decision-making is especially crucial during times of uncertainty. By using data analysis to its full potential, CAs can help a business make rapid, assured choices that are grounded in to-the-minute information.

Practically speaking, CAs can maximise data analysis by:

- **Centralising data capture:** Ensure data is captured efficiently and effectively by creating a single data pool. This central source of truth ensures data is reliable, and provides a complete picture of the business, driving alignment and unifying strategy.
- **Setting up automatic data feeds:** Add all business accounts, credit cards and loans accounts as automatic feeds (or import statements manually is they're not available).
- **Using dynamic tools:** Extract high-quality data using targeted, tactical tools such as business intelligence (BI) solutions to extract data and create dashboards. Also, use artificial intelligence (AI) for superior data capture and collation. Note, both should be overlaid with analytics and expertise from your internal teams. Also, when using non-proprietary AI, be aware that any information entered becomes public and readily available to competitors.
- **Working with real-time data:** By removing any delay between data collection and analysis, finance professionals can achieve almost continuous business intel, which is invaluable during periods of flux.
- **Digitising the supply chain:** Bring all supply chain players and processes together under one platform to provide end-to-end visibility – saving you time, increasing visibility, and reducing risk.
- **Using data analysis to support experimentation:** Data should be used to test new products and understand demand in the face of economic volatility. Rely on data for decisions around new packaging types and product resizing.
- **Managing data risks:** CAs must ensure data is presented in a way that truly reflects how the business is performing. Good governance and data integrity management is crucial – especially in times of economic uncertainty. For example, if KPIs have been achieved for a quarter then a colleague may seek to defer an upcoming sale to the next quarter (which could potentially jeopardise the sale). Make sure you test outputs and controls, and embed good governance structures to ensure your data presents an accurate picture.

Maximise data analysis



Make forecasting part of your organisational culture

It's one thing to develop credible forecasts in the face of uncertainty; it's quite another to get the entire business on board. How can finance teams manage expectations and educate colleagues when it comes to forecasting?

1) Use forecast ranges

Step one is to get stakeholders comfortable with a degree of uncertainty in your forecasting and the best way to do this is by using forecast ranges. Range or interval forecasts offer a range of values and are more useful than singular data point predictions, especially during times of volatility, as they allow finance to express a certain amount of variance and therefore, manage stakeholder expectations. The trick is to keep the ranges within reason in order to add real insight.

Also, ensure stakeholders understand that some forecast figures come with more certainty than others. For example, any figures included in long-term contracts, or connected with highly material items (e.g. sales) can be difficult to predict with accuracy. Communicate these varying degrees of confidence to stakeholders.

2) Involve stakeholders in forecasting

To achieve buy-in, and boost the accuracy of your forecasts, finance must get internal stakeholders involved in the forecasting process. This means thinking about forecasting from other departments' points of view.

Ensure all stakeholders are focused on the right drivers or KPIs. (e.g. Are sales teams focused on profitability rather than sales volumes?) Also, ensure stakeholders feel like they're on the one, unified team. (e.g. Are teams setting realistic targets? Are they under-promising on targets in order to come in on budget?).

"Drivers are critical to any business," says Dr Aneesha Varghese Cowan CA. "And so you need to ensure KPIs are clearly understood.

"For example, instead of directing a team to 'reduce wages', you might see more success if you provide specific, achievable targets like 'reduce staff absenteeism."

In short, dial down the finance jargon. When it comes to numbers, you need to speak your stakeholders' language.

3) Go to the coalface

So much goodwill – and forecasting accuracy – can be achieved by simply attending client and supplier meetings in-person. Accompany your sales team when they go to the shopfloor or meet with suppliers. First-hand experience and open communication counts for so much when developing forecasts.

"There's no substitute for doing the hard yards and talking to a wide range of people when developing your forecasts," says Paul Anderson CA, CEO of NZSki. "The more information you can collect – from inside and outside your organisation – the more accurate your forecast will be."

Read more

CA Catalyst's playbook, Show them the money: forecasting for small and medium-sized businesses, helps CAs make forecasting part of the suite of services they offer.

Acknowledgements

This Insight paper has been developed with the Corporate Sector Advisory Committee at Chartered Accountants ANZ and informed by interviews with several Chartered Accountants across Australia and New Zealand.

Chartered Accountants ANZ wishes to acknowledge contributions from Dr Aneesha Varghese Cowan CA, Kandy Wang FCA, Rohan Best FCA and Paul Anderson CA.