# <u>Implementing a Forecasting Model – Practical Advice</u>
# <u>by Christiaan Vorster (Business Growth Africa)</u>

The aim of implementing a forecasting model is to enhance the financial management and decision making capabilities of any business, especially if the forecast is updated on a regular basis and a future rolling component is added during each updating period. For example, a twelve month rolling forecast implies that after each month the forecast will be updated and another month will be added to the forecasting period. Thus, at any point in time, the business will have a twelve month forecast. The update could also be quarterly or even six monthly, depending on the business's needs.

Listed below are a number of recommendations to take into account during the design of a forecasting model. However, before the design and implementation of any forecasting model, a number of financial planning principles have to be highlighted:

*The relationship between Budgeting and Forecasting*

The relationship between Budgeting and Forecasting needs to be clearly understood by all relevant parties. The definition of a budget is an expression, in financial terms, of the strategic and operational plans of an organisation for a forthcoming period of time. A budget is generally goal orientated and based on future strategies and plans.

Theoretically, some of the main purposes of a budget are:
- Resource allocation (linked to the strategic plan)
- Putting performance targets in place
- Control and measurement
- Putting everybody on the "same page"
- Focus on the end result for the budget period (setting overall defined financial goals).

A forecast is an expectation, based on all available information at a point in time, of what the near term future may in reality look like. It is based on actual expectations of the future without any influences (e.g. goals or targets).

Theoretically, some of the main purposes of a forecast are:
- Enhancement of management decision making processes, based on a reaction to near term future expectations,
- Ongoing value creation activities and continuous improvement of activities and processes
- Continuous improvement of the accuracy of forecasting and management information
- Behaviour changes from defensive (reactive) to offensive (proactive)

Forecasting is a planning discipline of facing reality; it aims to show the latest reality. It should be highlighted that Forecasting is a management tool in its own right based on foreseen reality and not a rolling budget based on updated goals or targets.

*Responsibility and Ownership of Financial Planning*

The responsibility for all financial planning, including budgeting and forecasting, lies within the operational functions of a business, where the financial function plays only a supporting role.

Operational Heads should thus be responsible and accountable for revenues, costs and capital expenditure which fall under their sphere of responsibility. Furthermore, operational heads should only be responsible for items that can be influenced by them. The finance function's role in financial planning is a support function to assist operational employees to compile their financial plans and forecasts according to set guidelines.

Listed below are 6 practical items to assist in the design and implementation of any forecasting model:

**1. Forecasting horizon**

The forecasting horizon of any business should be driven by the future visibility of the functions of the business. It is pointless to forecast beyond a certain point in time, as one of the main purposes of forecasting is to enhance near term decision making capabilities of operational employees. After a certain point in time, it will be better to extrapolate the remainder of the forecast rather than to predict an uncertain future.

Seeing that one of the longer-term goals of forecasting is the continuous improvement of forecasting accuracy, it is recommended that a phased approached to the forecasting horizon be implemented, always starting with a short-term focussed view (dependent on the business a one, two or three month horizon, with the rest of the period extrapolated). Thereafter, as forecasting accuracy increases, the focused forecasting horizon will increase.

**2. Introducing Probabilities**

Due to the difficulty to predict the future, it is preferred that forecasting should always make use of probabilities. This will enhance the overall relevance of the information gained through the forecasting process. Over time forecasting ability will improve. It is advisable to start with an option of three probabilities, each with its own % likelihood (e.g. definite, confident and possibly) for example:

| | Amount Estimated | Likelihood |
|---|---:|---:|
| Definitely | Rxxx | 95% |
| Confident | Rxxx | 80% |
| Possibly | Rxxx | 65% |
| | **Rxxx** | |

### 3. Frequency of Forecasting

Realities change every day and subsequently the forecast of a business should be updated as often as possible. It will be beneficial if a forecast can be done every month on a rolling 12 month forecasting basis. As mentioned in 1. above, the forecasting horizon will determine for how many months the forecast will be focussed, whereas the remainder will be extrapolated.

### 4. Forecasting detail

Forecasts should focus only on the key value drivers and key limiting factors and should not be drawn up in the same detail as budgets and management accounts. Accuracy and relevance of information should be weighed up against the time it takes to draw up management information.

For each "budget line" a separate detailed analysis should be performed of what level of detail should go into the forecast. Two methods can be applied to assist with this analysis:

- 80/20 principle, which implies that 80% of effects come from 20% of the causes.
- Putting a 10% selection criterion in place: If an item has less than a 10% impact, it is clustered together.

### 5. Visibility and user friendliness of reports

Usually budget and forecasts are shown in numbers and percentages. It is recommended that graphs be incorporated in the forecasting model showing the following relationships:

| | |
|---|---|
| Overall view:<br>- Actual<br>- Prior year actual<br>- Budget<br>- Actual plus forecast | Forecast Accuracy view:<br>- Prior Forecast<br>- Actual |

### Conclusion

More often than not the same assumptions, methods and models that are used during the budgeting process are used during the forecasting process, which should not be the case. Due to the different nature of budgets and forecasts, different assumptions, methods and models should be used.

As mentioned before, forecasting is a management tool and not a rolling budget, thus a separate detailed analysis should be performed to evaluate the assumptions and techniques needed for improved forecasting.

*Christiaan Vorster CA (SA) is a financial management consultant and heads up the business advisory Business Growth Africa (www.businessgrowthafrica.com). He focuses on the SME sector, specialising in business valuations, strategic planning and budgeting and forecasting. He also facilitates numerous executive courses in South Africa, Europe, Africa, and the Middle East. E-mail Christiaan at Christiaan@businessgrowthafrica.com.*