Forecasting Process

A simple framework for building great forecasts

Over the years, I've written many words on the philosophy of forecasting, what makes a great forecast and why forecasting (done right) is critical to the success of any business. In this article, we're going to change the cadence a little. I'd like to offer you a simple framework for building great forecasts … clear, practical, hands-on steps you can put into action today. Note that this is a simplified version of the process we use here at Castaway. Reach out to us if you want a more comprehensive explanation.

Before we get into the detail, I'd like you to keep in mind the 3 foundation beliefs of forecasting:

1. We judge a forecast by the quality of the conversations it creates and the conversations that created it, so the forecasting process is far more important than any individual forecast
2. Forecasting is not about trying to predict a certain future. The goal instead is to be highly prepared for an uncertain future
3. A forecast should never be just a maths exercise. Great forecasts tell the story of the business, where it is heading and how it intends to get there

With those words in mind, let's get into the process. Creating a great forecast works through 5 stages:

1. Preparation
2. The story workshop
3. Build the forecast model
4. Analyse and optimise
5. Communicate

The first time through may take some time. We're investing time in designing the future of the business, something that entrepreneurs don't do nearly enough of, so the effort is worth it. The good news is the process gets quicker and easier over time as the forecasting 'muscle' gets stronger.

Step 1: Preparation

This step is critical to the outcome. Preparation involves getting clear on:

1. The Purpose of the forecast - what we're building, the audience we're building for and why we're building it (the question/s the forecast needs to answer)
2. The Business we're forecasting - the business model, historic performance and how success is defined
3. The Approach to the forecast - the level of detail, the forecast 'mood' (aggressive, realistic, conservative) and how the outcomes need to be communicated

Step 2: The story workshop

With the preparation done, it's time to bring the team together. Get advisors, business owners and (ideally) operations personnel together to design the business story that will underpin the forecast. My strongest tip … close the laptop and get away from the keyboard. This is a creative session that works best with whiteboards, sticky notes and coloured markers. Keep the agenda simple and focused.

Start the session by summarising the Purpose of the forecast (what, who & why), followed by a quick walkthrough of financial performance over the last few years. Numbers are the accountant's super-power, so tell the story as you see it. Pay close attention to signs of distress and success. These will be hot-button topics for the business … helping here is a high-value exercise.

Keep it brief, but touch on the drivers of operating cashflow and the cash conversion ratio (ie profit and working capital), focusing on changes, trends in specific areas, and the overall picture. Look also at key movements in fixed assets, investments, equity, funding and cash. Your aim is to set the scene for the next part of the workshop.

Now have the owner or manager recap (again briefly) the recent history of the business in their words. We're aiming to connect the financials with the business activities that drive them … suppliers, products, customers, competition and the industry overall. The areas they've focused on, changes that have been introduced, the things that have worked and those that haven't.

Next, shift the focus to the next 12-24 months. Where do they see the market going, what risks and opportunities do they see ahead, what changes do they want to make, what concerns them.

By this time, the group is primed for the most important part of the session, designing the story of the business. The aim is to get clear on how the team expects the business to perform over the forecast period. We find the story building process works best when approached as a series of layers. One framework we get great results from is:

1. What would happen if we do nothing different in the business (business resilience)
2. What don't we like about that outcome
3. What changes will we make to change that outcome (operations improvement)
4. What risks and opportunities do we choose to address
5. What changes will we make to manage the risks and work the opportunities (strategic improvement)

This approach builds the story as a set of solutions to a series of problems. This becomes a powerful statement of intent for the business, based on explicit assumptions and clear decisions that address specific issues.

The quality of the inputs at this stage mean the variance analysis meetings in months to come have significant meaning, because they can focus on the variance between experience and expectation rather than the simple difference between actual and forecast numbers.

Step 3: Build the forecast model

With the story agreed and written down, building a forecast is now an exercise in attaching numbers to the story. As number specialists, we accountants should find this a comfortable task. However, this is also the point where many people miss the opportunity to turn a good forecast into a great forecast model, something that creates real value for an extended time. What's the difference between good and great? Here are a few ideas:

1. Build operations drivers into the model as much as possible (units, transactions, headcount, capacity utilisation or whatever else counts in your situation)
2. Build real life business dynamics into the model, connecting different lines with % or unit-based relationships
3. Anticipate the questions that people will ask of the model and add functions that make it easy to both do the analysis and see the impact of changes

The more dynamic your model, and the better it reflects the underlying business model, the more useful it will be.

Step 4: Analyse and optimise

With the forecast in place (and ideally built as a business model), the next stage is to sanity check the numbers. Don't spend too long on this task, but make sure the time you spend is effective.

In this stage, you're assessing the forecast as a whole, the Profit & Loss, Balance Sheet and Cashflow outcomes, the KPIs and metrics and the overall business direction. Do the numbers make sense? Do they accurately reflect the story that underpins them? Do they reveal any logic holes? As you analyse, you should also be looking for areas that can be further improved, or which deserve more management attention.

By the end of this stage you have a robust forecasting model, designed to reflect the key dynamics of the business model and to tell the underlying story of the business.

Step 5: Communicate

If we accept that the higher aim of a forecast is to both reflect and motivate business change and improvement, then we also accept that communication is critical. How we tell the story is even more important than the specific numbers we have to report. Educated listeners are well aware the forecast will be wrong. What they want to know is the bigger picture behind the numbers – the assumptions, the decisions, the initiatives, the imperatives and the timelines. The story told around this framework is entirely more compelling than rows and columns of numbers.

Visual communication can be a highly effective aid here. I say 'can be' because there's an art to communicating effectively using graphs and dashboards and images. A bunch of graphs chosen because they look good and slapped on a page is not effective visual communication. Good dashboards take time and thought to design for maximum communicative impact.

Summary

There's a lot more to forecasting than meets the eye. Done well, the forecasting process is the foundation that develops the business story, drives the business plan, guides business improvement and underpins a forward-looking, strategically aware business culture. Done poorly, you have numbers on a page.

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