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Outmaneuvering Uncertainty with Financial Planning and Analysis

A Rapid Response guide for Chief Financial Officers

OUTMANEUVER UNCERTAINTY

NOW NEXT

IT'S TIME TO RETHINK FINANCIAL PLANNING AND ANALYSIS.

As the business and human impacts of the global pandemic continue, the time for creating a new approach to managing complexity is now. Shaping the mindset for a rapidly evolving planning environment is next.

In this environment, a new approach to planning is called for. An integrated, end-to-end plan to simulate operating scenarios within a financial model plan can connect all elements of the business. These include workforce, sales and revenue, costs such as indirect costs, selling, general and administrative (SG&A) expenses and cost of goods sold, and working capital.

Forming a sustainable planning process

Many companies have found that annual plans, budgets and forecasts formulated pre-COVID-19 have quickly become irrelevant.

In a six-week period from early March to mid-April, 295 companies withdrew their annual guidance.[1]

To adjust to new realities, planning should shift to **real time, using scenario modeling techniques** and rapid simulation to adjust controllable and non-controllable variables. These scenarios should leverage internal and external data to **create what- if hypotheses** that can be shared with executive leadership to determine a most likely path forward, using experience and intuition as the final determining factor.

The four key stages in getting the planning process right:

01 Plan across multiple time horizons

02 Identify the drivers of the financial forecast

03 Model rapid changes to external factors

04 Create agile planning processes and solutions

01 Plan across multiple time horizons

Forecasting time horizons will vary depending upon the industry sector, geography and other key factors.

Many companies look forward three to six months in making key decisions on elements such as sales, workforce, cash flow, distribution and supply chain. Businesses should be able to solve short-term challenges while delivering a robust plan for investors that addresses the next 12 months and beyond.

Plans for now (immediate to 90 days), next (three to 12 months) and beyond are interdependent and interlocked. Plans that focus exclusively on the short term may not reflect longer-term trends and may fall short of a longer-term recovery. And the "next 12 months" forecast should factor in alternative scenarios for the initial three months, as economic disruption begins to subside.

02 Identify the drivers of the financial forecast

To identify the new drivers of the financial forecast, CFOs should first look at what has changed due to the crisis.

At a macro level, most drivers of a business will remain consistent, although the pandemic may have created new drivers—specific to the product or service offered but affecting business performance—in some industries. For example, layoffs may drive the number of loan defaults and late credit card payments in the financial services industry.

Finance teams should identify where the greatest financial divergences from the original financial forecast have occurred. This can help them understand where value can be gained (or has been lost) and why actual outcomes diverged from plan.

Many companies now face new and largely uncontrollable variables. These include government restrictions, supply chain disruptions, and changing consumer behavior. With the right structure and solutions, these and other variables can be updated on a highly granular basis—monthly, weekly, or even daily—guiding immediate actions but also providing a foundation for more stable systems and planning mechanisms going forward.

03 Model rapid changes to external factors

Fast, accurate scenario modeling to support financial planning requires four key elements:

- **The right data**
- **True correlations**
- **AI/Machine learning algorithms**
- **What-if scenario modeling**

The right data

To perform rapid scenario modeling, the company needs **good quality data** that finance trusts, based on common standards. It also needs **cloud-based tools** that allow for rapid modeling of multiple options and/or factors, replacing spreadsheets and workbooks shared via email.

While this level of complexity defies human analysis, **internal and external data and data science** can help establish actual drivers, provide an understanding of the impact of uncontrollable variables on different scenarios, and create what if models to identify possible paths forward. These models may not be perfect, but they could be superior to models based strictly on intuition.

True correlations

The company needs a clear understanding of the correlations and interconnections among key categories such as sales, cost of goods sold, working capital, workforce and other cost categories. Identifying the **correct correlation is critical to the success of any modeling exercise**.

If the data is linearly correlated, a non-linear modeling technique should not be used. Powerful tools including **visualization as well as machine learning** (ML) techniques such as principal component analysis are increasingly used to identify correlation in data. Such techniques can allow modelers to identify the right model family to use and may help to identify drivers that traditional modeling may miss.

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AI/Machine learning algorithms

ML algorithms can build nowcasting or **very short-term prediction models** to understand the causal relationships between internal factors and macroeconomic indicators. This can help guide the company through the crisis while pointing the way to changes that may need to be made in the future such as in the way the firm attracts and retains customers, manages costs or goes to market.

In addition to using more granular and more frequently updated data, the company should conduct **mixed-time horizon forecasts**. Many ML algorithms can perform sophisticated and dynamic approximation to solve for finite horizon data, leading to greater overall accuracy. Meanwhile, ML and AI software learns over time, helping prediction models become more precise.

What-if scenario modeling

What-if scenarios can be created to understand the **impact of change in any of the underlying factors** or macroeconomic situations. The scenarios are designed keeping relevant impact factors in mind and uses previous market conditions—adverse and benign—in the industry to simulate downturn/upturn.

04 Create agile planning processes and solutions

Any changes in assumption made for one scenario plan component should be reflected in the enterprise-wide integrated plan.

→ Companies should consider establishing a planning task force that brings together cross-functional expertise to focus on identifying changes in the key drivers that affect the company's financial statements and the company's industry and customer base.

→ The task force should have access to timely, relevant data, sophisticated analytics, and visualization tools to enable exploration and understanding of the rapidly changing situation. The team's insights can be used to update scenario modeling and related financial forecasts.

Case study

A large media company's new CFO together with the finance, planning and accounting team leveraged SAP Analytics Cloud to complete new interactive scenario-based discussion of the long-term plan with the board of directors.

The base case plan and key planning organic and inorganic mergers and acquisition growth scenarios were set up so that input variables (macroeconomic indicators, cash flow and allocations) could be adjusted in real time, based on feedback from the board. This allowed the board to immediately visualize impact upon a set of output KPIs including revenue and expense growth rates, EBITDA and margins, adjusted earnings per share, share price, market capitalization, price/earnings ratio and leverage ratios.

This new scenario-based process accelerated the alignment among the board, the C-suite and the business unit presidents on the long-term strategic plan and prioritized investment decisions.

Planning for certain uncertainty

While economic conditions may improve in the wake of the pandemic, some things are likely to change permanently, even as economic conditions improve.

It is likely that many aspects of doing business—from managing customer and supplier relationships to maintaining adequate levels of liquidity to predicting levels of demand—will be very different from the way they were pre-crisis.

Old ways of financial planning, forecasting and analysis may disappear as well. Leading companies can create opportunities by using the scenario-planning process as a guide to outmaneuver this certain uncertainty in a COVID-19 world.

References

1. The Wall Street Journal, "How Coronavirus Spread Through Corporate America", April 10, 2020.

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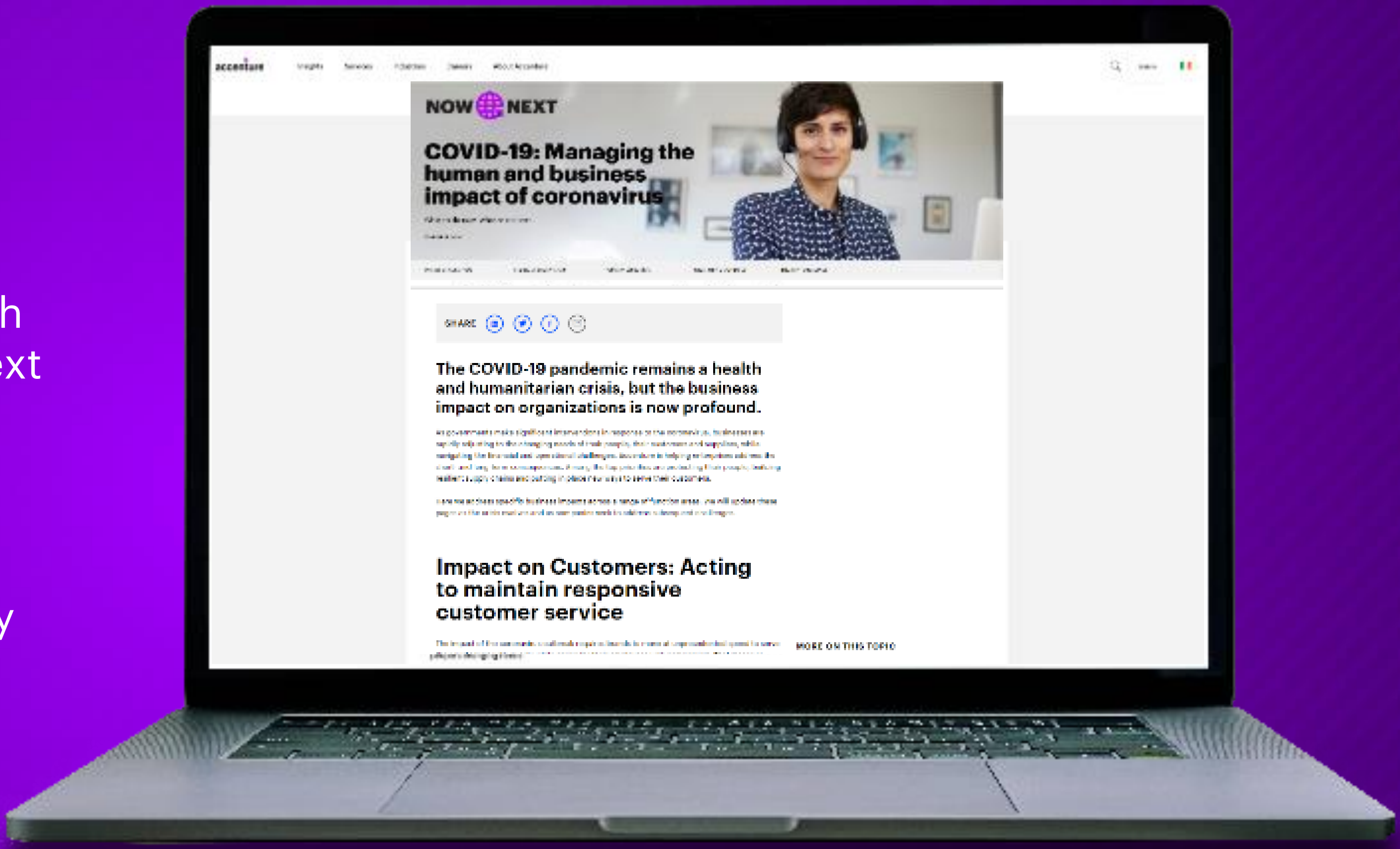
To help our clients navigate both the human and business impact of COVID-19, we've created a hub of all of our latest thinking on a variety of topics.

Each topic highlights specific actions which can be taken now, and what to consider next as industries move towards a new normal.

From leadership essentials to ensuring productivity for your employees and customer service groups to building supply chain resilience and much more, our hub will be constantly updated. Check back regularly for more insights.



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