Managing the Unthinkable
Scenario-Based
Enterprise Performance Management (EPM)

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Introduction
The Case for Scenario-Based EPM

Since 2008, the global business community has been operating under extraordinary circumstances. After years of crises, extreme volatility and unforeseen events, the extraordinary has become the ordinary and the previously unthinkable has become reality. Companies that once prepared detailed, long-range plans—with budgets based on a stable view of the future—now operate in an environment that presents new and unforeseen challenges every day, week and month.

Is the business and economic environment really more volatile and unpredictable than it was in previous years? Accenture believes that a combination of long-range trends and specific events is, in fact, resulting in greater volatility, uncertainty and risk.

Material trends that are reshaping the world include:

- The rise of new economies such as China, India and Brazil, with attendant wealth creation and rising consumer demand;
- Demand for commodities creating boom and bust cycles in everything from oil to corn to copper;
- Demographic change, with rapid population growth in some countries and an aging, shrinking population in others;
- Environmental concerns including climate change, water scarcity and resource depletion;
- Global interdependence, with companies sourcing talent and resources from multiple countries while opening up new markets for their own products and services; and
- Technological innovation, as inexpensive cloud computing, telecommunications and social media increase global interconnectedness while accelerating the pace of change.

Against the backdrop of these macro trends, a series of events over the last dozen years or so has illustrated how the world has become smaller and more closely connected.

Increasingly, managers are realizing that the past is not a good predictor of the future. They and their boards, as well as the investors and other stakeholders to whom they are ultimately accountable, are questioning the logic of basing strategies, plans and budgets on a single, static view of the future, derived from an extrapolation of past performance.

Executives also recognize that things have changed. Finance organizations, in particular, are under more pressure than ever to find better ways to support the core business by managing uncertainty, volatility and risk.

Not surprisingly, scenario planning—a capability that helps manage uncertainty by providing alternative views of the future
against which strategies, tactics and budgets can be tested—has become increasingly important in such an environment. As the complexity of the environment grows, so are the advantages of scenarios over other commonly used uncertainty management techniques like sensitivity analysis. This latter technique analyzes changes one variable at a time, which is useful for simple situations, while scenarios consider combinations of uncertainties and their significant interactions. Not surprisingly, by late 2009, two-thirds of companies were using scenario planning, compared to just 35 percent in early 2008 and less than 20 percent in 1979. In addition, three out of four firms that do use scenario planning indicated that they had started using it more extensively in response to the increased uncertainty and volatility of the business environment.

Due to global supply chains, a 24/7 news cycle, international financial dependencies and other elements, today's uncertainties and events have immediate impact as well as long-term consequences.

As a result, while scenario planning was once used primarily by capital-intensive industries with long planning horizons—such as aerospace, chemicals and energy—more industries are now using it. As a broader range of companies adopt this capability, however, the mere ability to use scenario planning no longer provides a competitive advantage. Rather, companies should consider moving to what Accenture calls Scenario-Based Enterprise Performance Management (EPM), in which scenarios are incorporated into processes for managing the business on an ongoing basis. Scenario-Based EPM can assist, not just in strategic planning, but in business planning, forecasting, reporting and analysis, providing the foundation for risk mitigation strategies, integration of early warning measures into performance management and, perhaps most valuable of all, for managing the unexpected nature of day to day business.

Scenario-Based EPM can help firms transform their planning and reporting process from a reactive, accounting-based activity—a rear-view mirror—into a value-centric capability focused on shaping and managing optimal outcomes. This capability can help pre-empt the competition, by enabling companies to seize opportunities quicker and to make faster, more confident decisions in the face of uncertainty, volatility and complexity.

Terrorist attacks, the threat of global pandemics such as SARS and H1N1, massive economic upheavals following the subprime mortgage meltdown of 2008, the Eurozone crisis – even natural disasters such as the Asian tsunami, the Japanese earthquake and tsunami, and Hurricane Katrina – all seem to indicate a world in which anything can happen, and frequently does.
1. Moving to Scenario-Based EPM

Incorporating a scenario capability into an organization’s EPM processes requires seven steps:

1. Identify the key factors that can have a material impact on the organization. For example, consumer products companies may look at GDP growth and consumer spending, airlines at oil prices, global manufacturing companies at exchange rates and freight costs, and financial services companies at consumer credit quality, interest rates and asset prices.

2. Define relevant scenarios (typically three to four) that describe a range of future operating environments. For example, what if oil prices average $75 a barrel, $110 a barrel or $140 a barrel?

3. Agree on a baseline scenario that will be used to develop/review strategy, set targets and develop operational plans and budgets.

4. Develop strategic plans, targets, action plans and budgets using the baseline scenario.

5. Develop alternative views of targets, plans and budgets under each scenario. Identify the major impacts and changes under each scenario. For example:
   a. What will be the positive/negative impact on key financial metrics such as sales, margins and earnings under each scenario?
   b. How will investments/projects be re-prioritized under each scenario?
   c. What will be the impact on product mix, pricing and promotional spending under each scenario?

6. Identify relevant triggers and corresponding tolerance ranges for each scenario that should be monitored on an ongoing basis in order to provide management with advance warning of material changes in the operating environment.

7. Whenever established triggers/tolerances are exceeded – meaning a new scenario becomes effective – adjust tactics using the previously developed plans and generate a new forecast reflecting the change in scenario and the changes in tactics.

The seven steps provide the basis for the entire Scenario-Based EPM capability, starting with strategic planning and supporting other key EPM elements ranging from target setting to forecasting and action planning. (Figure 1)
II. Integrating Scenarios into Core EPM Processes

Strategic planning

The commercial application of scenario planning has its origins in strategic planning. Close to 85 percent of companies that use scenarios today, extensively use them in the strategic planning process. Pioneers such as Royal Dutch Shell started to envision alternative scenarios as a guide to long term planning more than 40 years ago. Today, Shell’s scenarios for the energy industry look out to 2050, a longer time horizon than most organizations require.

Even in today’s uncertain world the value of using scenarios in strategic planning remains high. Consider the implications of answers to the following questions on long-term strategy around market participation and positioning, research and development, and capital investment:

• For consumer products companies: How fast will the emerging middle classes in Eastern Europe, South-East Asia and South America grow and will their consumption patterns mirror those of the middle class in North America and Western Europe?

• For oil and automotive companies: Will the trend to more fuel-efficient power generation and transportation accelerate?

• For infrastructure and construction companies: Will nascent signs of political and economic stability in parts of sub-Saharan Africa translate into meaningful business opportunities?

Using scenarios to provide insight into the choices and trade-offs to be made in strategic planning can increase flexibility and provide access to a broader range of growth options. For example, at Alliant Credit Union, which serves United Airlines employees, the company’s top executives meet with the board and spend a full day testing Alliant’s strategy to see how the business would fare under each scenario. The process helps the management team and the board address risks the company might face and possible steps to deal with such risks.4
Typically, organizations set targets on an annual basis to guide the annual planning and budgeting process. The targets are usually set based upon two or three inputs: past performance, strategic plan objectives and external market expectations (for public companies). With a Scenario-Based EPM capability, a fourth input will be used: scenarios. For example, a large global transportation company built its targets for 2011 using a baseline assumption for oil prices of $79 per barrel, a not unrealistic assumption based upon oil price trends during the second half of 2010. However, as part of the planning process they developed alternative sets of targets under both a $110 per barrel scenario and a $140 per barrel scenario. The business modeled the impact on volumes, revenues, operating expenses and earnings under each scenario. The value became clear as oil prices moved up rapidly from the $79 baseline to average more than $110 per barrel during the first quarter of 2011.

The target setting process in a Scenario-Based EPM environment often involves a shift from setting absolute targets (e.g., sales of $8 billion and earnings of $1.2 billion) to the use of relative targets, whereby targets are set in relation to relevant external benchmarks. For example, a company may be targeting to exceed industry growth by three percent. As the expected rate of industry growth would change depending on a scenario, so would the targets.

Our research indicates that more than 80 percent of companies set targets in relation to their historical performance. However, historical performance has often been a suboptimal baseline for targeting future performance, even in a more stable environment. Now, there is an even more compelling argument for organizations to adopt an approach that recognizes uncertainty and volatility while still providing a sound foundation for making resource allocation decisions.
Tactical planning, budgeting and resource allocation

More than four out of five companies that use scenarios extensively, use them in their budgeting and resource allocation processes.\(^5\) As with target setting, moving to Scenario-Based EPM for tactical planning, budgeting and resource allocation processes requires new approaches and a different orientation. Once targets have been set, each organization develops a set of tactics and resource allocation plans that seek to meet the targets. The budget is simply a financial representation of the tactics and resource allocation plans and serves to validate the adequacy of plans.

Moving to a Scenario-Based EPM approach adds one more step. Once the baseline plans are complete, each organization then identifies the changes to the tactical, resource allocation and financial plans that would take place under each scenario. For example, a pharmaceutical company could show how the impact of a delay in regulatory approval of a new drug would impact marketing plans and sales plans. A retailer may adjust its merchandise assortments and promotional spending if the economy tips into recession. There should be a resource allocation plan or “budget” for each scenario that explains the impact on the organization’s ability to meet the targets that have been set. For example, a fast-growing European software company uses scenario plans to recast budgets under each defined scenario, assessing the financial implications for revenues, margins, cash flows and capital expenditures.

The resource allocation plan is based on defined corrective actions, that is, how to close gaps to reach targets for each scenario. If, for any given scenario, there is a gap between target performance and expected performance based on the prepared budget, an action plan to close the gap should be prepared and agreed upon. One major change of moving to Scenario-Based EPM is to recognize that the level of detail for resource allocation plans and budgets should not be too granular. In conditions of high volatility and uncertainty, the more detailed the budget, the more likely it is to be wrong, so effort should go not to more detail but to developing different views of different scenarios.

All projects and initiatives should be reviewed on a continuous basis to ensure the original business rationale still holds true. In situations in which there is a high level of uncertainty, the focus should be on channeling the understanding gained from the scenarios into decision making. Where uncertainty is greatest the objective should be to retain flexibility to react to changing conditions. This may mean entering into shorter term contracts so as not to make long term commitments when the near term is uncertain, using hedging strategies to mitigate risk, utilizing temporary labor instead of hiring full time staff and other tactics that reduce risk or increase flexibility.
Evaluating the business case for investment

The case for investment—entering new markets, building new plants, making acquisitions, launching new products, adopting new technology should be evaluated under a range of different scenarios to identify the circumstances under which specific projects might no longer be attractive. For example, a consumer products company that is looking to enter new markets may look at the likely market demand for its products under a range of different scenarios based upon forecasts of GDP growth and consumer spending levels. It is important to understand — before making an investment — the key assumptions upon which the investment is based, and to define clear “abandonment criteria” which identify the scenarios under which an investment or project no longer makes sense.

Abandonment criteria should be tracked closely and should be monitored, along with the investments themselves, for continued validity. In the immediate aftermath of the near-collapse of the financial markets in late-2008, a leading global airline rapidly determined that future traffic volumes would decline significantly. This meant that the assumptions upon which the airline had based its capital investment plans for new aircraft were no longer valid. They quickly adjusted their plans by delaying delivery dates of committed orders and reducing the number of options they held to buy additional aircraft.

The transition to Scenario-Based EPM and the use of abandonment criteria may in fact create new opportunities. The management team should identify and monitor a pipeline of projects that may become not only feasible but attractive if a new scenario becomes effective. Resources from a project that no longer makes sense can be rapidly diverted to new opportunities. One leading financial services company reviews its portfolio of projects on a monthly basis and does not hesitate to shut down projects that no longer make sense, reallocating resources to those that become more attractive. Such agility allows organizations to react to changing market conditions with speed and confidence.
Monitoring and performance measurement

While 78 percent of companies using scenario planning claim that they monitor leading indicators for key internal and external factors affecting their business, less than two-thirds of those companies have established tolerance thresholds for these indicators and connected them to scenarios in order to detect when the current baseline is no longer valid and an alternative scenario has become material.

In Scenario-Based EPM, monitoring of indicators designated as scenario triggers takes place on an ongoing basis. Monitoring frequency can vary depending on the volatility of different indicators and the business environment in general. What should stay the same is a structured, consistent approach. At Eli Lilly, the global pharmaceutical firm, they track leading indicators on an ongoing basis and review scenarios every six months, while a “watchers network” follows other developments.

As the following figure illustrates, the range of triggers and the decisions they affect are broad. For example, in consumer-based industries, issues involving pricing, margins, product and service portfolios are common, while for commodity-based industries, focus on capacity and supply management is more prevalent. (Figure 2)
### Decisions Impacted

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<thead>
<tr>
<th>Triggers</th>
<th>Banking</th>
<th>Communications</th>
<th>Consumer Goods &amp; Services (CG&amp;S)</th>
<th>Retail</th>
<th>Defense</th>
<th>Energy</th>
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<td>Complimentary products</td>
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In general, forecasts should be developed using a “best prediction” principle based on the most reliable information available at the time of preparation. Many companies, however, base their forecasts on the ambitions and expectations of the board of directors and top management, which masks the need to develop rational action plans that help the organization achieve agreed-upon performance targets.

To avoid this problem, forecasts prepared under Scenario-Based EPM should explain both the predicted impact of a specific scenario on business performance and the expected result of executing agreed-upon corrective actions to close gaps in reaching both short- and long-term targets. If there is a remaining gap, additional potential corrective actions will need to be defined to help close the gap.

Figure 3 shows how actions are defined to close a gap to target according to the most likely defined scenario. Changes in assumptions due to a predicted alternative scenario will impact the resource allocation or budget.

For the most likely scenario:
Allocate resources in line with prioritizations (short and long term targets)
Report status on corrective actions to close gap to target

Source: Accenture
Scenario-base EPM can help proactively address threats and identify opportunities to generate superior returns ahead of the business plan by capturing new opportunities. The Danish toymaker Lego, for instance, uses a monthly meeting of senior managers, known as the operations board, to pool knowledge of what is happening in major markets and act upon it. However, in order to successfully transition to scenario-based forecasting and realize its benefits, organizations must have the ability to execute event-driven dynamic planning, as shown in Figure 4.

Such planning originates in the Observe-Orient-Decide-Act loop used in military strategy and reflects the reality that circumstances can change quickly. This decision-making approach has proven successful in helping adapt to the realities of an engagement more quickly and decisively than the enemy. In business, an organization’s ability to identify change and respond quickly is an important element in improving performance and pre-empting competition.

The most effective way to identify and respond to events is by monitoring a set of triggers chosen for their volatility and their material impact on the business, as seen in Figure 4. Dynamic planning requires very tight integration of forecasting with monitoring and action planning, which many companies find challenging to achieve. However, given the dynamic nature of scenario planning, information captured by monitoring value drivers can improve decision making during the forecasting process.

Figure 4. Approach to event-driven planning

One must continually observe, orient, decide, and act in order to achieve and maintain freedom of action and maximize the chances for survival and prosperity.

By systemically monitoring a series of performance related triggers, organizations are able to sense changes and respond dynamically by reallocating resources.

In Scenario-Based EPM, the key is to have pre-defined action plans ready for each scenario. The organization can then act immediately to implement such an action plan if it is clear that a particular scenario is unfolding. Scenario changes can require changes in pricing, promotion, production scheduling, inventory management and other operational components. For example, in the post 9/11 world, airlines dramatically reduced capacity while also lowering prices to encourage customers to fly. The lessons learned served them well during the more recent economic crisis and planes have been flying with far higher load factors than in previous downturns.

Clearly, companies that have established scenario triggers and associated thresholds are in a much better position to maximize the benefits from early detection of scenario changes and execution of their pre-determined action plans. Not surprisingly, for close to 90 percent\(^\text{10}\) of companies that have established tolerance thresholds for scenario triggers, contingency planning is an integral part of scenario planning. This is in contrast to the less than half of companies that use scenario planning, but do not monitor scenario triggers against pre-set tolerances.

One of the exemplars of this capability is the global shipping company UPS that used scenario planning to understand the impact of an avian flu outbreak. A team of 20 employees explored scenarios that might unfold and how they would affect UPS and the general population. As a result of this initiative, UPS developed an in-depth contingency plan that could help respond to a severe pandemic.\(^\text{11}\)
III. Applying Scenario-Based EPM to Enhance Decision Making

Moving to Scenario-Based EPM allows for scenarios to be applied to a broad range of tactical and operational decisions as part of the planning process, as well as enhancing the ability to respond with speed and confidence to internal or external events. For example:

- How do material short term changes in key external variables such as commodity prices, interest and exchange rates, consumer spending, and employment levels impact an organization’s ability to meet quarterly and annual performance targets?

- What internal actions should be taken in response to fluctuations in customer demand or actions of competitors (e.g., new product launch, pricing changes)?

- How would the organization respond to unexpected external events such as a major natural disaster, political or regulatory actions, or occurrence of a pandemic? As part of the overall EPM processes, scenarios can be used to help answer a broad range of questions.

- How will a targeted merger or acquisition likely impact the behavior of customers and competitors?

- What is the impact of adopting different organizational models (e.g., centralized/decentralized; sell direct to customers/sell through third parties) on the ability to effectively reach and then serve customers?

- How will alternative sourcing choices (e.g., insource/outsourcing; onshore/offshore) impact operating costs?

- What are the likely advantages and disadvantages of moving our enterprise systems to a cloud-based platform versus retaining them in-house?

- What is the most effective way to enter a new market: acquire an established player in the market, partner with a local market participant, or establish a company-owned operation?

- What is the range of likely impacts on our brand, our customers and our other products, of our competitors withdrawing a product from the market?

- What is the likely effect on sales of either lowering product prices or offering targeted discounts or promotions?

Scenario-Based EPM is a powerful capability for institutionalizing a decision-making culture that explicitly addresses uncertainty. This not only increases the confidence in making effective decisions but also allows managers to react with speed in taking advantage of new opportunities or effectively mitigating risk in today’s uncertain and volatile world.
IV. Putting Scenario-Based EPM to Work

A key benefit of Scenario-Based EPM is the organizational ability to generate more proactive, dynamic and faster market responses. To realize these benefits, companies need to put the right process, people and technology in place.

Process
Before embarking on the journey towards Scenario-Based EPM, companies need to ensure that their current EPM processes are nimble and flexible. Key pre-requisites for implementing Scenario-Based EPM include 1) EPM processes built around key drivers of business value, which are incorporated into driver-based models and exception-based reporting; and 2) a focus on the most volatile and material aspects of the business, minimizing attention paid to immaterial and non-controllable factors. Without these elements in place, Scenario-Based EPM can become an academically interesting exercise requiring significant organizational effort, but bringing little practical benefit.

People
Moving to Scenario-Based EPM represents a significant change not only in processes, but also in mindset for many organizations, requiring leadership commitment in three key areas:

• Program sponsorship by a member of the executive team;
• Organizational discipline in implementing and then executing Scenario-Based EPM; and
• Developing a new mindset and capability that integrates scenarios into all steps of the EPM processes.

Of course, getting the right people working on building this capability is a crucial factor for success. The people selected should be aware of the external environment, thoroughly trained, and should understand the current operating model. They should bring cross-functional expertise together with a combination of analytic and creative minds, as well as excellent communication and facilitation skills. Such people should be able to tolerate a relatively high degree of ambiguity and uncertainty, and be empowered to make decisions based on such uncertainty.

Technology
Technology is a major enabler of Scenario-Based EPM. For example, only 40 percent of firms using spreadsheets as their main planning tool perform “what if” analyses, compared to about 85 percent of firms that use a more advanced technology platform and report a high degree of satisfaction with their planning tool. The impact of technology is also pronounced in companies’ ability to build ad hoc scenarios in response to material “unthinkable” events. Only 35 percent of companies that use spreadsheets as their main planning tool are able to build such scenarios, as opposed to almost 70 percent of those with more advanced planning tools.

There has been a rapid evolution in technology capabilities over the last few years that is making scenario planning easier and is enabling Scenario-Based EPM. Three major trends—the growth in types and volume of data; the emergence of analytics as a major differentiator and value creator for organizations; and the growing power of cloud computing—have significant implications for Scenario-Based EPM. The ability to apply advanced analytic tools such as probabilistic analysis for scenario development and consensus methods for monitoring scenario triggers to rich sets of both unstructured and structured data can only enhance an organization’s ability to develop and act upon scenario plans. Cloud computing offers the promise of providing access to advanced collaborative and analytic technologies at a price point that allows small and mid-sized organizations to effectively implement Scenario-Based EPM.
We believe that companies can obtain significant benefits by developing a Scenario-Based EPM capability. A primary benefit is that Scenario-Based EPM leads to better formulation of strategic plans, tactical plans, budgets and forecasts by helping companies think more broadly. Management teams look at a wider range of possible outcomes, identifying new opportunities as well as potential problems. The dialogue and debate that is inherent in effective scenario planning often leads to new insights about the interaction of external and internal factors in the business environment and their impact on plans and actions.

Companies adopting Scenario-Based EPM, we believe, will also be able to make decisions and take action quicker in response to market events. Our research shows that companies with such ability outperform their competitors on a consistent basis. In fact, a new, large-scale Accenture study, entitled Fast Forward to Growth, suggests that successful companies in high-growth markets adopt new approaches to assessing potential market opportunity. They take a more dynamic view that incorporates foresight and flexibility into strategic planning, and they examine global opportunities from multiple perspectives, as do the companies we have cited. These skills allow successful companies to enter disparate markets and identify business opportunities that might otherwise have remained unexplored.

Additionally, many organizations are now faced not only with contemplating previously unthinkable scenarios, but also sharing their response strategies with stakeholders. For example, the U.S. Federal Reserve Bank, as well as other regulators, asked banks in late-2011 to publish the results of a “hypothetical global market shock” related to economic...
Companies that have thought through various scenarios have greater confidence in their decision making, and communicate more effectively with investors, boards of directors, regulators and other stakeholders, thereby helping achieve higher management credibility and faster and more consistent growth of their business value.

Another benefit derived from Scenario-Based EPM is in the enhanced ability to make decisions in the face of uncertainty and ambiguity. Sometimes, the power structure within companies inhibits the free flow of debate. The ability to review multiple scenarios allows companies to break out of this trap by providing an environment for open discussion.

At a time of intense market uncertainty, we can expect broader use of Scenario-Based EPM as a valuable tool for determining how businesses will respond in a wide range of potentially difficult situations. We also believe, however, that Scenario-Based EPM will become the basis, not just for avoiding risk, but for identifying and seizing growth opportunities in both developed and emerging markets.
Notes


4 Kate O’Sullivan, "Alternate Realities: Responding to today’s volatile environment, some companies are taking scenario planning to a new level." CFO.com, July 8, 2010. Accessed March 1, 2012.


7 Constance Gustke, "All the Options," The Conference Board Review, January/February 2009.


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Accenture is a global management consulting, technology services and outsourcing company, with more than 244,000 people serving clients in more than 120 countries. Combining unparalleled experience, comprehensive capabilities across all industries and business functions, and extensive research on the world’s most successful companies, Accenture collaborates with clients to help them become high-performance businesses and governments. The company generated net revenues of US$25.5 billion for the fiscal year ended Aug. 31, 2011. Its home page is www.accenture.com.

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