CHAPTER 1: INTRODUCTION

1.1. The fifth variance (part 1)

One day in November 2007, a worried Jack Jones, operations director for a transport company, is preparing for a meeting the following day with the group's financial director. At this meeting, Jack has to explain the overspending on his fuel account which looks like this:

Fuel budget – 10 months to end of October, 2007	R 5,000,000
Fuel actual – 10 months to end of October, 2007	R 8,000,000
Negative variance	-R 3,000,000

There are many reasons for the variance. Jack's explanations are as follows:

1. Price

"At budget time we thought the fuel price would remain steady at R4.00 per litre, but it quickly went up and is now R6.00 per litre."

2. Volume

"At budget time we didn't know we would get the Lowveld Steel contract. We were awarded it in February, so we've had to use a lot of additional fuel"

3. Mix

"Company policy has always been to use diesel driven vehicles in our fleet, but for the Lowveld contract our technical people advised us to buy petrol driven vehicles. Petrol is about 50% more expensive than diesel."

4. Timing/calendar/smoothing

"Our new depot in Richards Bay has just become operational and we needed to fill their 20,000 litre tank. I budgeted for this to happen in November; in fact it came on stream in October."

5. Waste, loss and inefficiency

"Two vehicles collided with each other in our yard and caught alight. The insurance company alleges negligence and refuses to settle. Also, an underground pipe in our main depot sprang a leak and we lost 10,000 litres of petrol. Finally, a ring of employees were fraudulently falsifying petrol purchases at a filling station on the Durban route".

The fifth variance (part 2)

The group financial director listened to Jack's nervous explanations and sighed to himself. He wondered how many meetings like this he'd have to attend, year after year, where good managers like Jack trotted out the same old excuses for their overspending.

In the financial director's opinion, the explanations for **the first four variances added no value whatsoever**. They are "excuse variances" explaining that the assumptions and guesses made at budget time were not what happened in reality. The really important item in this meeting is the **fifth variance,** which focuses on waste, loss and inefficiency.

What is your opinion? Do annual budget systems and monthly budget meetings help managers like Jack to do a better job? Or do they just create more confusion?

1.2. Annual budgets don't work anymore.

The idea of budgeting for a year ahead was developed in a time of stable markets, static costs, and predictable inflation. Fixed plan business models can't be used to run businesses in today's rapidly changing world. In consequence, some leading organisations have abandoned budgets and changed to rolling forecasts to inspire and lead their organisations to better performance. Rolling forecasts direct management's attention towards the future, and ensure that planning is ongoing, as opposed to an annual exercise. Finance departments are also rethinking their role and contribution, and how they add value. In a world demanding shareholder value creation, finance departments focus on value adding activities such as:

- Rolling budgets and cash forecasts.
- Business cases and financial appraisals for projects.
- Scorecards and benchmarks.
- Building a low cost culture.
- Incentive reward schemes.

Of all these activities, rolling forecasts are the most important and most likely to add value. In a recent survey by the Economist, 70% of financial directors in Europe ranked planning and budgeting reform as their top priority.

Many organisations still begin their financial year by preparing an annual budget. This practice is a legacy from the 20th century, when directors tried to force managers to commit to achieving their plan, no matter what. But fixed budgets and inflexible directors are ineffective in a rapidly changing world. Companies report performance on a calendar basis, but floods, stock market crashes, strikes, and a competitor's new product announcement, happen continuously. The 2001 attack on the Twin Towers in New York invalidated most corporate budgets in the United States. It eroded belief in fixed plans for business and government, and demonstrated the necessity for planning systems that are dynamic, responsive and flexible.

The fifth variance (part 3)

The group financial director wondered why the Board was resisting his proposal to move from annual budgets to rolling forecasts. In a system of rolling forecasts, Jack would be required to forecast his fuel expenditure at the start of each month and have it approved by his boss. At month end, actual spend would be reported against this forecast, not against a budget set ten months ago. And in this instance, the financial director thought to himself:

- Jack's forecast would be based on the ruling fuel price.
- The Lowveld Steel contract volumes would be incorporated.
- He'd take the policy change from diesel to petrol into account.
- The timing of the Richards Bay fuel purchase would be correct.

And any variance reported against this forecast at the end of the month would arise almost entirely from waste and inefficiency, **the fifth variance**, which is what management should be focussing on in the first place!

Companies that can update plans and forecasts quickly are in a better position to take advantage of opportunities and respond to threats. Although managers recognise the importance of flexibility, the annual budget endures in many parts of the world.

In South Africa, most companies still budget on an annual basis, and issue monthly reporting packs which use a fixed annual budget as the benchmark for judging performance. Spreadsheets, particularly Excel, are pervasive for collecting data, consolidating, and analysing budgets.

In the Northern hemisphere by contrast, many more companies have changed to shorter planning horizons, and a growing consensus regards rolling quarters (a four-, five-, or six-quarter basis) as best practice. The lead is being taken by companies in Europe rather than the United States, beginning with Scandinavia. The pioneers in rolling forecasts are in the information technology, telecommunications and financial services industries.

Companies who have abandoned annual budgets and changed to rolling forecasts include:

- American Express, Bank of Scotland, Credit Lyonnaise, and Svenska Handelsbanken.
- Brown Boveri, Belron, Borealis, Electrolux, Ford, and Volvo.
- Cisco Systems, and Microsoft.
- DHL, and Federal Express.
- British Petroleum and Shell.

1.3. But we already do it…

Many companies say they already update their budgets more than once a year. On closer examination it turns out that these "latest forecasts" are stand alone exercises to check whether the organisation is still likely to meet the original annual budget target. But isolated updates are not rolling forecasts. They are one-off spreadsheet projections prepared by accountants at head office, who may not be close enough to the action to understand the dynamics of the key business drivers. In addition, even when such forecasts are prepared, they tend to be extrapolations not forecasts, and large differences between forecasts and subsequent actuals can destroy the credibility of the forecasters and the process itself.

As one senior executive stated: "Extrapolating from the past is like driving down the road looking in the rear view mirror – fine until you come to a bend in the road!"

A proper rolling forecast system requires line managers to provide forecasts of the key business drivers which form the backbone of the forecast system. The accounting staff translates these driver forecasts into financial projections. Actual results are then compared against the most recent forecast as soon as possible after period end.

1.4. Features of 21st century management systems

Companies who have changed their management model for the 21st century, use monthly or quarterly rolling forecasts instead of annual budgets. They optimise their use of information technology, using data bases and trend analysis for better forecasting, and high level financial modelling software instead of spreadsheets. Revenue and costs are forecast and reported in less detail. Instead of the traditional budgeting approach - by ledger account within cost centre - items which have the same cost drivers are grouped and forecast together. One of the world's leading software companies, for example, prepares monthly rolling cost forecasts using only three lines – office costs, selling costs, people costs - although it collects costs for reporting purposes under about 30 cost codes in its chart of accounts. Departmental managers may choose to overspend on stationery if they can save the same amount on telephones.

Board-level strategy sessions steer away from mission, vision and value statements focussing instead on choices; choices about future product and market growth and changes to the business model. The Board sees its role as giving strategic direction to the portfolio while embracing the best governance principles. Board decisions and directives contain clear and specific performance measures with tough measurable goals. The Board continuously initiates projects and feasibility studies.

The executive group communicates the strategy and goals down the line, making sure the Board's decisions are quantified in the rolling forecasts and measured and reported each month. The targets are directly linked to the performance appraisal process and the incentive bonus scheme. Management accountants focus on better faster reporting, oriented to line managers not accountants, incorporating non financial dashboards and scorecards, graphs, charts and benchmarks.

1.5. Annual budgets vs. rolling forecasts – a summary

	Annual budgets	**Rolling forecasts**
Timing	Annual	Monthly or quarterly
Focus	Cost control	Value creation
Link to strategy	Tenuous	Direct
Mentality	Beat the budget	Information for decisions
Understanding reports	Easy	Difficult
Report variances	Not too useful	Very useful
Owners of the numbers	Finance manager	Line managers
Basis of preparation	Last year's numbers	Forecast business drivers
Locus of control	Centralised	Decentralised

Exhibit 1.1 Annual budgets vs. rolling forecasts

1.6. When budgets don't work

A giant state utility wasn't meeting its sales and service delivery targets. With hundreds of people on the accounting staff, the organisation overspent on costs which are easy to budget, like stationery and telephones, yet was unable to spend its full salary and capital budget allocations due to poor planning and lack of capacity. The monthly budget reports were issued 20 days after each month end, and no one complained that the figures were late. Budget reports were filed away by cost centre managers without any analysis, action plans, or follow up.

At budget time, department heads submitted their budgets long after deadlines passed, after several reminders from budget accountants. Management reviews resulted in arbitrary percentage directives to all departments to cut back costs. The final budget was only approved some months after the new financial year started.

Line managers running cost and profit centres viewed budgeting as a “have to” exercise to produce a set of figures to satisfy head office and the treasury. They said that some of the budget figures were outdated even before the budget was approved. They reported that strategy, budgeting, and performance contracts were independent systems that sometimes contradicted each other, with champions and process owners in different parts of the business.

Rolling forecasts won’t solve these problems. Before you embark on a rolling forecast project you need to be sure that you have:

- the right people in management and supervisory positions;
- available capacity and talent in your accounting department;
- technical systems support; and
- the right level of strategic planning and leadership from your Board and top management.