

Business Guidance Note

Guidance Note 9

As part of the Institute's ongoing efforts to provide members with guidance and information on key issues, the Institute has developed a Business Guidance Notes series which presents guidance for members written by members.

'Typical time horizons for rolling forecasts are between 12 and 24 months.'

Techniques for preparing forecasts quickly include focusing on:

- > **Main business drivers**, which determine the main items of income and expense. A common business driver is volume, such as sales and production volumes which drive revenue and direct variable costs
- > **Fixed costs**, when they are significant. Although there are additions to them and deletions from them periodically, by definition, being fixed makes them relatively easy to forecast accurately
- > **Rules of thumb**, which are broad, simple relationships between two or more numbers. For example, between the rate of population growth and demand for housing and the time lag between building approvals and orders being placed for building materials.

'Typically, businesses update their forecasts monthly or quarterly but some do so weekly.'

Rolling Forecasts

Business managers need the best information available when making decisions. While having information about actual business performance is essential, historic information is not necessarily a good indicator of future performance. It is therefore important to provide management with forward looking information, including forecasts of financial performance.

This guidance note explains 'rolling' financial forecasts (i.e. forecasts that look ahead on a 'rolling' time horizon), their preparation and use.

Benefits of rolling forecasts

Rolling forecasts allow businesses to regularly monitor their expected performance compared to their target over the forecast period. They also enable management decision making to be unconstrained by financial year ends. Decisions affecting the medium term can therefore be made at any time based on rigorous forecast information.

Component features of rolling forecasts

The 'rolling' time horizon

Managers need forecasts that look ahead as far as possible with reasonable accuracy, irrespective of when they are prepared and when the financial year ends. The forecast horizon differs depending on how fast the industry and the business change (generally, the faster the change, the shorter the horizon) and the forecasting ability of the business.

In addition to being useful for decision making, forecasts with a time horizon of more than one year provide an early view of the upcoming financial year which can be useful for setting expectations for directors, shareholders and financial markets.

Level of detail and speed of preparation

As forecasts are inherently uncertain predictions about the future, attempts to prepare precisely accurate forecasts are pointless. Materially accurate forecasts that are prepared quickly are of most use to businesses. The column to the left includes techniques for preparing forecasts quickly.

Update frequency

Forecasts are based on assumptions that can date rapidly in today's fast-changing world. Examples of assumptions that can materially impact forecasts include exchange and interest rates, the weather and the aggregate level of demand. Therefore, it is necessary to update forecasts regularly, depending on how quickly the assumptions on which they are based become dated or the business environment changes materially. Generally, the faster the industry changes, the more frequently forecast updates are needed.

Preparing rolling forecasts

Each business should determine its own forecasting processes which will differ to some degree from that of every other business. Common features of good forecasting processes include:

- > Concise, clear instructions and assumptions centrally provided by the corporate head office, to use when preparing forecasts for consistency and clarity, (e.g. exchange rates and wage increases). It is important that forecasts are 'owned' by business managers, with Finance ensuring rigour in the data and facilitating the forecast preparation process.
- > Concise analysis, including any key 'local' assumptions made so readers can properly understand the forecasts.

Continued overleaf >

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Impact of business decisions

- > Tactical actions - relatively minor adjustments to business actions that occur frequently.
- > Business plans, when it is clear that a plan needs to be changed in order to achieve the desired outcomes. Businesses are unlikely to change their plans frequently but, for agility, the business should be able to do so whenever necessary rather than at some fixed time each year.
- > Business strategies, when it is clear that a strategy is no longer appropriate. Strategies are likely to be changed even less frequently than business plans but, for similar reasons, the business should be able to do so whenever necessary.

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To prepare accurate forecasts requires a good understanding of the business, its competitors, customers, suppliers and the industry generally. This includes, for example, technological and political developments. Therefore, forecasting promotes business understanding and enhances management decision making. Linking managers' remuneration to the accuracy of their forecasts encourages them to take forecasting seriously and promotes forecasting accuracy.

Using forecasts

Business decisions

The prime purpose of preparing forecasts is to assist in management decision making. Forecasts that are reported to management seamlessly with historic financial and business results provide managers with more powerful input than reporting them separately.

Forecasts are used as an input to management decisions to assist, among other things, in achieving targets, including incentive remuneration targets. When the business is assessed relative to its competitors or comparable others (refer to Business Guidance Note 6, Performance Targets Without Budgets), rolling forecasts can be especially useful in enabling the business to respond rapidly to unexpected developments as they are quick to prepare and unconstrained by financial years.

Impacts of business decisions are in the left hand column of these notes. Good governance requires that changes to business plans and strategies have board approval and appropriate communication around the business, so such changes should not be undertaken lightly.

Learning from mistakes

Mistakes made in forecasts can indicate changes that are occurring in the industry and the business. If actual results differ materially from those forecast it may be that a long-established rule of thumb is changing, that there is unexpected competitor activity or that fashions are changing. Analysing the reasons for inaccurate forecasting is important and is enabled by understanding the main business drivers, fixed costs and rules of thumb on which forecasts are based.

Conclusion

In a fast-changing world in which past trends often do not indicate future performance, rolling forecasts are an important management tool. Preparing forecasts accurately requires skill, business understanding and focus on what really matters.

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