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Managing in the fog

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Illustration by David Simonds



The struggle to make meaningful forecasts in a downturn

"NOT to beat around the bush, but the budgeting process at most companies has to be the most ineffective practice in management." Thus Jack Welch, the former boss of GE, in his book "Winning", which was published several years ago. Many firms that put their 2009 budgets together at the end of last year will no doubt agree with him. Most of them will have already been consigned to the shredder, as the economic crisis has blown away the assumptions on which they were based.

Faced with exceptionally volatile business conditions, senior executives are finding it harder than ever to gauge how their companies are likely to fare in the months ahead. According to a recent global survey of 1,300 chief financial officers (CFOs) by Tilburg University in the Netherlands, America's Duke University and *CFO Europe* magazine, a sister title of *The Economist*, finance chiefs say that the struggle to produce accurate forecasts now tops the list of things that keep them awake at night.

With even short-term horizons as obscure as the San Francisco skyline during a summer fog, companies are finding their standard budgeting and forecasting of little use. The usual trick of plugging figures from operating units into spreadsheets appeals to number-crunchers, but can often generate misleading

targets, especially when conditions change fast. "The annual budget is even less of a meaningful document this year than usual," argues Cynthia Jamison of Tatum, a consulting firm that also provides clients with interim CFOs.

What can companies do? A few forward-thinking firms can provide inspiration. Hugh Courtney, a professor at the University of Maryland's Robert H. Smith School of Business, thinks more companies should be using "scenario planning" alongside their financial models, which do not produce a large enough spread of possible outcomes to capture the flavour of today's uncertainties. Sten Daugaard, the finance chief of Lego, a Danish toymaker, says his firm generated a number of different scenarios as part of its 2009 budget, the first time it had used such an approach. It has developed contingency plans for each scenario so that it can react swiftly whatever the coming months throw at it.

Lego has also been using a monthly meeting of senior managers, known as the operations board, to pool knowledge of what is happening in its various markets. At each get-together, the firm's executives not only discuss what has been going on that month, but also make their best guess about what is likely to happen in the 12 months to come.

Some companies have formalised this kind of approach by creating "rolling forecasts". At the end of, say, the first quarter of a financial year, managers forecast the remaining three quarters again and then add an extra quarter's projections, worrying about only the most important financial variables. Many companies in Europe already use such systems, says Emery Sinclair of Revelwood, an American software-services provider, and firms in America are suddenly taking a lot more interest in them. One benefit of rolling forecasts is that they discourage executives from becoming too fixated on the present at the expense of the future.

In praise of short-termism

Yet with economies in free fall, managers also need up-to-date information about what is happening to their businesses, so that they can change course rapidly if necessary. Cisco, an American network-equipment giant, has invested over many years in the technology needed to generate such data. Frank Calderoni, the firm's CFO, says that every day its senior executives can track exactly what orders are coming in from sales teams around the world, and identify emerging trends in each region and market segment. And at the end of each month, the firm can get reliable financial results within four hours of closing its books. Most firms have to wait days or even weeks for such certainty.

Admittedly, Cisco's financial results have not made happy reading recently because, in common with many other large technology companies, it has seen demand for its products falter in the downturn. In early February it announced that its fiscal second-quarter revenues of \$9.1 billion were 7.5% lower than the same period in 2008 and that its profit had fallen by 27%, to \$1.5 billion.

In response to hard times, Cisco plans to cut \$1 billion of costs this year by, among other things, harnessing its own video-conferencing and other communications technologies to reduce the amount its executives travel. It is also using these facilities to relay information from employees on the ground to its senior managers, and to get instructions from Cisco's leaders back out to its 67,000 staff. A rapid exchange of information and instructions is especially valuable if the company wants to alter course in stormy times.

If everybody in a company can rapidly grasp what they have to do and how it is changing, they are more likely to get the job done. But some firms are reluctant to share their goals with the wider world. Unilever, a big Anglo-Dutch consumer-goods group, has decided against issuing a 2009 financial forecast to investors, arguing that it is difficult to predict what is going to happen, given the parlous state of the world economy. "We're not just going to provide numbers for the sake of it," explains James Allison, the company's head of investor relations. Other companies that have decided not to provide annual earnings estimates for 2009 include Costco, a big American retailer, and Union Pacific, an American railway

company.

Some firms, such as Intel, seem to have chosen to take things quarter by quarter. The giant chipmaker said in January that it would not issue an official forecast for the first quarter of 2009 after its fourth-quarter 2008 profit plunged by 90%. Several retail chains have also stopped providing monthly sales estimates because they cannot see what the future holds. Retailers, chipmakers and firms in many other industries may have a long wait before the economic fog finally lifts.

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