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Business performance



Whether forecasts work

Much of an accountant's training concerns reporting past events, rather than anticipating the future. But as accountants move into senior roles in business, looking forward becomes an important part of the job. James Moore considers whether techniques for forecasting are getting any closer to the mark.

Predictions are integral to the running of a business. When you work out your cash flow requirements, plan expenditures for the year, or try to estimate demand, you are looking for the best way to accommodate your expectations for the future.

Forecasting is an opportunity to put your company's expectations and targets down on paper. While fixed costs and capacity constraints can be known with some certainty, every forecast is at the mercy of the unknown. If your predictions turn out to be right, you can modestly claim you were just doing your job. If performance falls short of expectations, you can fall back on profit warnings and quarterly revisions to your annual budgets.

Company forecasts can be a good way to get staff working to a future goal, but they often fall short in acknowledging the risks. So what can people do to create more realistic forecasts?

The inexact science

The management guru Peter Drucker had plenty to say on the future. "The important thing is to identify the 'future that has already happened' – and to develop a methodology for perceiving and analysing these changes." He continued; "In human affairs, political, social, economic and business, it is pointless to try to predict the future, let alone attempt to look ahead 75 years."

That may be true, but it hasn't stopped people trying.

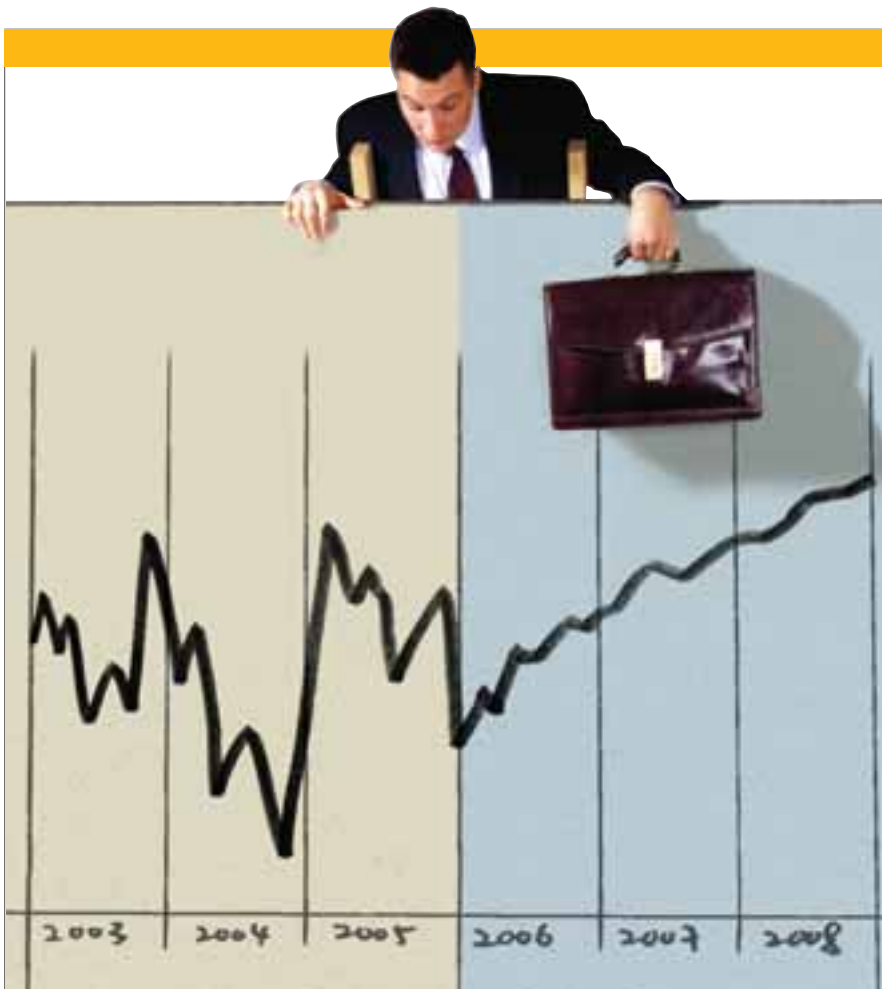
Over the decades, methods of forecasting have developed around a number of statistical or comparative models. When a company is introducing a new product on the market, real option models and benchmarking can help test expected returns and how the product might affect the overall business. Game theory, first developed by American military strategists, has also been applied to business. It allows a company to consider responses from competitors and

customers and understand how people make purchase decisions, based on their expected goals or rewards.

There are limitations in all forecasting methods. Management accountants will recognise the truth of Drucker's remarks; the accuracy of a forecast always rests on the consistency of the underlying trends and assumptions. James Smith, finance director of Typhoon Media in Hong Kong, sees particular problems in forecasting for companies without historical results. "This was particularly evident with the start-ups of the dot.com boom," he says. "Forecasts were wildly optimistic and built in excessive and unrealistic targets. Unless you have a track record, what are forecasts based on?"

From theory to practice

Edward K.F. Chow, chairman of CIG Yangtze Ports and immediate past president of the Hong Kong Institute of CPAs, sees two inherent problems in forecasting. First, there is the difficulty



Improve your outlook

1 Get other views. Take in as many views as you can when identifying the macro outlook for your business. Look for contrary arguments and ask why people are taking a different position.

2 Use your judgement. Amalgamating different forecasts into an average may only create an unrealistically steady trend line, so look for cyclical patterns.

3 Be aware. Improve your awareness of existing trends. For example, improve your systems business performance monitoring. Look for nonfinancial key indicators that could affect your future profitability.

4 Follow the markets. Futures markets can be a powerful indicator of future trends, and they don't just track prices for oil and coffee. Events futures markets like Intrade (www.intrade.com) allow people to speculate on anything from an election result to the timing of a policy decision. They have often proved accurate in predicting events and trends.

in applying academic models to real business situations. He cites the mobile phone market as an example of how quickly underlying assumptions can be thrown out of the window. The constant development of new products by competitors creates a perpetual state of market agitation. "No wonder mobile phone manufacturers in Europe seem to take turns in posting profit warnings these days," he reflects.

Chow feels he can build some certainty into his forecasts for the shipping industry because capacity is often pre-booked and new ports are not built overnight. But he faces another concern, namely how the market – and the regulators – will react.

In Hong Kong, anyone who has had to prepare a forecast for a listed company will be familiar with the severe rules and restrictions in place. A company cannot talk openly about its revenue or profit expectations for the coming year without the Securities and Futures Commission (SFC) demanding a detailed breakdown. "For this reason, people tend to be shy," Chow confirms. "Internally they can predict what they want, but this kind of information will often affect other people and businesses. If a bank is helping to arrange a finance deal, for example, this kind of information can no longer be considered simply 'in-house.' There is also the problem of leaks."

Elizabeth Law, a CPA and president of the Association of Women Accountants, says changing accounting standards will affect the way forecasts are put together. She expects the Institute's shift from historical cost-based accounting to fair-value accounting will lead to higher levels of transparency. "Fair value accounting is important to investors who prefer to know what their stake is worth now, rather than what it was worth at the time of acquisition," she points out.

“The accuracy of a forecast always rests on the consistency of the underlying trends and assumptions.”

“A lot of principles rely on forecasting cash flows or returns in order to assess the values reported in the financial statements,” Law adds. “Unless independent valuers or surveyors are used, accountants must rely heavily on information and assumptions supplied by management, and use the various methods to forecast the returns on that basis.”

According to Chow, regulatory scrutiny is one reason why companies prepare several versions of a forecast. One might be a pessimistic, worst-case account, which bankers want to see. The second forecast would be an optimistic prediction that includes more discretionary areas such as staff bonuses. More confident predictions can bolster the price-earnings ratio and serve as a target to motivate staff. A third version might be a more realistic description of baseline performance for management and analysts.

The eye of technology

Increasingly, companies are forecasting more than just financial information, factoring in environmental

Fanatical forecasts

The story of English football club Leeds United plc is a good example of failed forecasting. The club secured huge loans for new players on the back of forecasts predicting success on the field. However, things fell through in spectacular fashion.

Initially, failure to qualify for the European Champions League meant a loss of up to US\$31 million per year in revenue. A string of poor results meant the club then dropped out of the Premier League, causing further losses of US\$40 million a year in sponsorship, television cash and gate receipts. Even the players lost value, because the market at that time had fallen. The chairman went for broke, but had no track record to justify his level of spending.



considerations, the availability of labour, political and legal risks, and changes in the tax regime. All this requires increasingly complex, multidimensional models.

Matthew Mok, senior manager of the financial intelligence practice SAS Institute Ltd., claims that matters have progressed from the days of forecasting using an Excel spreadsheet. “These days, we are talking about software that is sophisticated and intelligent,” he says. “It allows a company to explore potential scenarios in great detail.”

Monte Carlo Analysis was the original technique used to harness the power of computers, applying random and expected variables to equations. Analysts could conjure up thousands of possible scenarios to predict cash flows or identify periods of risk or vulnerability. The approach could also be used to calculate an average rate of return or a discount rate for a net present value.

Many new software systems work on similar principles, allowing users to create tailored models to suit their business or industry. Jeannie Chiu, general manager of software company Systems Union, is well aware of the changing use of IT in

forecasting. “Forecasts cannot be static, they must change constantly. Month to month figures will never be the same, so the whole forecast must adapt. It may be difficult, but let’s face it, that’s also what makes it interesting.”

Technology can help not just in applying the most suitable technique to predict trends and accommodate volatility, but also by integrating and centralising pieces of information that may be available in different formats, from various sources and from many locations. Systems such as Time Series Forecasting can also allow for the inclusion of outside indicators such as interest rates, GDP and inflation.

Chiu is a supporter of Online Analytic Processing (OLAP), a new tool on the market. This system allows an analyst to build up a multidimensional database of information that can produce both time series and trend analysis views, thereby making more interactive, and hopefully precise, forecasts. But as Mok points out, “Ultimately, it’s still up to the user to ask the right questions – and then interpret the findings.” A⁺