Reforecasting Your Budget

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Most organizations have an established budgeting process. Whether the entity uses a robust performance management tool or a spreadsheet, there is likely a thoughtful process to predict the next year's revenues and expenses. The budget is usually approved by the board of directors and/or other committee and memorialized in the meeting minutes. Once the budget is final, how an organization utilizes this tool varies. Most organizations utilize the budget as a tool for comparing actuals on a periodic basis while some revisit the budget and make changes based on certain events, and a rare few actually revisit the budget on a rolling schedule and update forecasts routinely.

Based on a survey conducted by KPMG in 2007 with the Economic Intelligence Unit[1] (consisting of 544 global companies) only two-thirds of organizations surveyed incorporated rolling budgets. Although experts often say reforecasting or rolling budgets are important, many organizations continue to operate with a static budget, citing time or computer system limitations. A static or fixed budget occurs when the organization prepares an annual budget, which remains untouched for the fiscal year. The organization compares actual performance to the budget at periodic reporting intervals. This common type of budgeting is a good tool for keeping spending within a predetermined threshold. A static budget remains useful when spending is generally predictable and consistent. However, it can become cumbersome and unhelpful when the organization sees major changes, and the variances, while explainable, render the static budget meaningless.

Consider the current reality of our unprecedented economic and social times. On January 30, 2020, the World Health Organization (WHO) announced a global health emergency because of a new strain of coronavirus originating in Wuhan, China (COVID-19) and the risks to the international community as the virus spread globally. In March 2020, the WHO classified COVID-19 as a pandemic, based on the rapid increase in global exposure. The world is still determining the ultimate impact of the global pandemic. In the United States, shelter-in-place orders seem to change daily and differ not only by state, but by county or even potentially by neighborhood. Economic stimulus packages were enacted on March 27, 2020, under the Coronavirus Aid, Relief and Economic Security Act, with new grant opportunities, tax changes, and ever-evolving lending programs. In addition, we have seen historic stock market changes based on seemingly every announcement from the Centers for Disease Control and Prevention (CDC), the president and/or major corporations. Now, more than ever, organizations need to understand how to reforecast static budgets so that the executive teams can make real-time informed decisions.

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Per an article from Kshitjil Dayal, Workday, "... from March 23 to 27, our [Workday] cloud planning platform processed up to 30 times more forecasts and build-out scenarios than in a typical week. Since the emergence of the COVID-19 pandemic, we've [Workday] seen an overall average increase of 15 times the amount of modeling and recalibrating as organizations everywhere attempt to make sense of the ripple effects."[2] Based on that evidence, organizations seem to be aware of the need to reforecast budgets for fiscal year 2020 and beyond. Was your organization ready?

Historically, the most common reason noted for using reforecasting or a rolling budget was the constantly changing nature of the business environment, whether it be technology innovations, stock market fluctuations or management changes, and the belief that a static budget would not provide organizations with a useful tool when making key decisions. In the past, your organization may

have concluded your environment was not constantly changing, or that the headache of the reforecasting process was larger than the benefits. Now every organization is in a state of constant change, and reforecasting is critical.

Budgeting is a bit like road trip directions. In the past, you pulled out the road atlas, plotted your course and headed out. It was a surprise when you hit a major traffic jam or detour, and you were forced to wait patiently. Now, you put the destination into your favorite mapping app and start your route. As you drive, the app periodically notifies you of a shorter available route, or a major road blockage ahead that requires rerouting. Your mapping app provides all of the information you need to quickly make the decision to take a new course or stay on the original one. A budget that can be reforecast quickly gives your organization the same ability. If you want this capability for your organization, the next step is to decide whether you will use a reforecast or a rolling budget.

What is reforecasting?

Reforecasting means updating the entire budget based on new facts and circumstances, taking a holistic look at your original budget and updating any elements as necessary. In the end there is a separate, fully revised budget, not an adjustment to just a line or two. The reforecast allows the operational group to understand the new route to follow and what will be ahead on the new path. It provides a more relevant decision tool than the static budget.

When should an organization reforecast?

As noted above, a reforecast should happen whenever there is a large or unexpected trigger event, such as the COVID-19 pandemic. However, it doesn't have to be that big of a trigger. It could be a large or unexpected change in one of the organization's major revenue streams or cost drivers, such as winning (or losing) a major contract. When the main driver of your budget is expected to change as a result of the event, a reforecast should be completed.

Organizations should also consider reforecasting when trends show that the original budget was not accurate, and you start to see recurring, significant variances in line items between actual and budgeted amounts.

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How should an organization reforecast?

Before you determine the next steps in reforecasting, consider the budget process in your organization. Do you have a zero-based budget? In a zero-based budget, the organization builds the budget from scratch, considering each expense driving the budget from the expense side and attempting to grow profit by reducing expenses, rather than increasing price per unit or units sold. Or, does the organization look at historical trends and adjust revenues and expenses according to expected growth or shrinkage? Either way, break down the assumptions to the original drivers, whether it is variable costs or variable revenue sources that drive the bottom-line budget. This may require more thought if your organization has not done a zero-based budget recently. If you are struggling to identify your organization's drivers, consider what key performance indicators you report to the board of directors or what benchmarks you are tracking. These are likely the drivers to consider when you are reforecasting.

Once you have determined which costs or revenues are variable, then reforecast what impact the event will have on your variable drivers. If you budget based on costs, think about what costs are variable, such as operational payroll or supplies. Will these costs increase or decrease? If your costs increase, what will the organization need to do to increase revenues? Another approach is to start with the variable revenue drivers (such as patients served, units sold or students enrolled). Will the visit/unit sales rate increase or decrease? If the unit sales increase or decrease, what is the impact on costs? Will prices need to change? If prices change, what must the organization do in response? Remember as you change the cost driver, consider the impact on revenue, or vice versa.

Next, consider fixed costs and if there are any changes to these based on the trigger event. Typically, fixed costs would not be subject to change; however, in response to an event such as the COVID-19 pandemic, organizations may be renegotiating administrative payroll or rent expenses and, therefore, those fixed costs should be reforecast as well. Perhaps the original fixed-cost assumptions were not accurate in the first place. It is

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worth looking at all significant line items to ensure the accuracy of the forecast. Take this time to be critical of all original assumptions. Review future debt payments, rental agreements or other recurring charges to ensure that the terms of those contracts have not substantially changed since the budget was originally prepared.

The main drivers of the budget are always program/operational related. Therefore, it is critical that you speak with the managers of each division to understand what their projections entail. Accounting and finance personnel must understand if a change to the budget is realistic and if operations can function with the parameters that have been assigned. For example, if you cut expenses to balance the budget from anticipated revenue losses, make sure operational/ program managers agree that there are enough expenses to produce whatever is needed to meet anticipated demands. Finance teams have noted that siloed operations or lack of integrations are main reasons for preparing only a static budget and finding a lack of value in other models.[3]

While working on reforecasting, time is of the essence. The sooner the data is reforecast, the sooner the organization can use it as a tool for their decision making. It may be difficult the first time the organization works through a reforecast. Take notes on lessons learned and consider how you can set up the next period's budget in a format that may be easier to reforecast in the future.

How do I predict the unpredictable?

Reforecasting for a trigger event, such as a new contract, is relatively straightforward. Program managers will understand how drivers will be impacted and what considerations should be made. However, what should organizations do with something like the COVID-19 pandemic? How can the future be predicted?

Financial analysts have made a living out of creating models that consider scenarios such as these. Those scenarios are then stress tested to see what happens if certain assumptions change. Using the same thought process can help you "predict" the future.

One way to create a model is to understand your organization's cash burn. Most CFOs are acutely aware of cash trends. Look back at historical cash flows and calculate what your average spend rate is compared to your average collection rate. With this knowledge, you could model a few scenarios.

Consider the worst-case scenario first. If the organization is unable to collect cash from any revenue for an entire quarter, what reforecast is needed on the budget? What happens if cash from revenue is only reduced a certain percentage over that same quarter? Essentially using this theory, you can start to build steps to respond to a prediction and implement those steps as necessary.

As an example, Organization Y has noted that the current cash position is $1 million, and that fixed costs requiring cash for the next quarter are $200,000. This leaves $800,000 of potential spending. If the organization's variable expenses are $900,000 a quarter, what steps would need to be taken to cover the shortfall of $100,000 ($1.1 million of variable and fixed costs for the quarter less cash on hand of $1 million)? With a predicted shortfall number, the organization can decide if that means taking on new debt, curbing capital expenses or potentially cutting salaries.

The worst-case scenario may not be the most likely. But rather if Organization Y forecasts that instead of the typical cash from revenue of $1 million a quarter, they anticipate $500,000 in cash from revenue this quarter. Now the organization has $1.5 million ($1 million of cash on hand plus the $500,000) to spend over the quarter. If the cash needs are $1.1 million, they know going into the next quarter that they have $400,000 of cash available.

It is easy to establish the worst-case scenario. It is harder to picture a realistic scenario, especially during situations like the COVID-19 pandemic. To assist your organization in determining the most realistic scenarios when reforecasting, look at what is happening in your industry in particular. If you are a member of a trade organization, it is likely that they are polling members and publicizing what member organizations are experiencing. You can also look to other sources of benchmarking, such as public companies, to see what the quarterly earnings or filings look like.

Economic sources like IBISworld, Moody's Analytics, Morgan Stanley Economic Outlook, Morningstar Economic Outlook, or Placer.ai on Retail Foot Traffic provide data and information on economic trends experts are seeing. Organizations often forget to look at external sources to help predict the course of the budget drivers, which can be detrimental when creating an accurate forecast. When preparing any kind of budget, looking at external data sources is critical.

Even if your organization struggles with defining the most realistic scenario, the reforecast is still a helpful tool as it

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starts to put parameters (Organization Y has somewhere between a shortfall of $100,000 or a surplus of $400,000 to consider) that management can work with to make informed decisions about the best next direction rather than driving blind.

What is a rolling budget?

A rolling budget is similar to a reforecast, except a rolling budget was never intended to remain static and has a set time of when it should be adjusted (rather than waiting for trigger events). A common example of a rolling budget is where an organization would budget four quarters ahead. Each quarter the organization updates the next three quarters and adds a new fourth. Meanwhile monthly comparisons would be made to the monthly budget planned in the rolling budget. The organization would set a time period at which point the budget will be reviewed and updated using the same techniques as noted above for reforecasting. The rolling period could always be adjusted if a trigger event occurred outside of the normal update period. The rolling budget is always anticipating change, so an organization is set up to continuously monitor the trends and update either revenue or cost predictions, or both, to stay nimble.

Which one is better?

The best budget method depends entirely on the attributes of your organization and the industry it operates in.

A static budget is likely the best option for a small organization with relatively small fluctuations year over year. It may also be helpful in organizations that are grant-driven where the grant budgets will not change once adopted. While the budgeting process can be long, it only occurs once a year in this environment, which makes it easier for a small staff and limited software capabilities. If your organization utilizes a static budget, to ensure that the budget stays relevant, the organization should routinely compare actual results to budget.

Reforecasting is not always necessary, especially if there is no trigger event and no major variances from the static budget. However, because events like the COVID-19 pandemic are rarely foreseen, the ability to reforecast a static budget is beneficial for any organization. Right now, every organization should prepare a reforecast budget using the steps outlined above based on the impacts of the COVID-19 pandemic. While working on the reforecast, use this time to set up a process and policy of how and when to reforecast your budget in the future. For example, as a policy, an organization could define a trigger event. Try to use thresholds such as an event that would likely change the main budget driver by 20%. When a “roadblock” like the COVID -19 pandemic comes up, the organization needs the tools to create a new fiscal road map. It will likely also lead the organization to identify areas to improve in the static budget process.

If your organization is in a more volatile industry where the drivers are constantly changing and strategy is ever-evolving, then the rolling budget is most likely the best method for your organization. Another benefit of a rolling budget is that it inherently pushes the organization to a forward-looking approach, as governance discussions center around how the budget was adjusted and why, versus the historical approach of comparing the static budget to actual and repeating oftentimes the same variances each time. To be successful, a rolling budget requires an ongoing assessment with quick changes to ensure that the periodic budget to actual reporting can be maintained. Reforecasting with a rolling budget also needs to be fairly quick since it is continuous.

If the organization adopts a rolling budget or a reforecasting model moving forward, it is important to make sure careful thought goes into preparing the original budget. Drivers should be clearly identified, and formulas used to show how the variable revenues and costs build from the drivers.

Does my organization need budgeting software?

A budget could be a simple spreadsheet or prepared using budgeting software. The team should consider how complex the organization’s drivers are when considering whether to utilize a spreadsheet or software. Organizations with multiple streams of revenue with different corresponding variable costs may find it necessary to utilize software. Software often allows for more complex planning and reforecasting, allowing the organization to create various scenarios to see what an impact such as changing the price of a unit by 5% versus 7% would be. Software can aid collaboration amongst different teams or units, while using a spreadsheet could make maintaining version integrity when sharing with multiple users problematic.

Consider what the likely trend in budgeting will be for your organization to select a tool. In a study done by the Chartered Institute of Management Accountants in 2006, The Reforecasting Report, the authors note that “buying an increasingly complex software platform without full cooperation and negotiation may fail to reduce ‘noise’ in the planning and budgeting process.”[4] In addition, bad data in, bad data out, no matter what the tool, so an organization should first make sure the budget basics are in place and reliable data can be easily obtained to ensure a software or spreadsheet’s ability to create a proper forecast is enhanced.

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