

CFO Insights

FP&A: What's risk got to do with it?

If you asked CFOs to list the major uncertainties they've grappled with over the past couple of years, you might get consensus on risks such as the economy, regulation, commodity pricing, and consumer demand. Many businesses might also cite brand and reputational risk. But you would probably get little agreement on how they've factored such risks into their financial forecasts and planning.

Why? Well, one reason may be that some companies haven't fully factored them in.

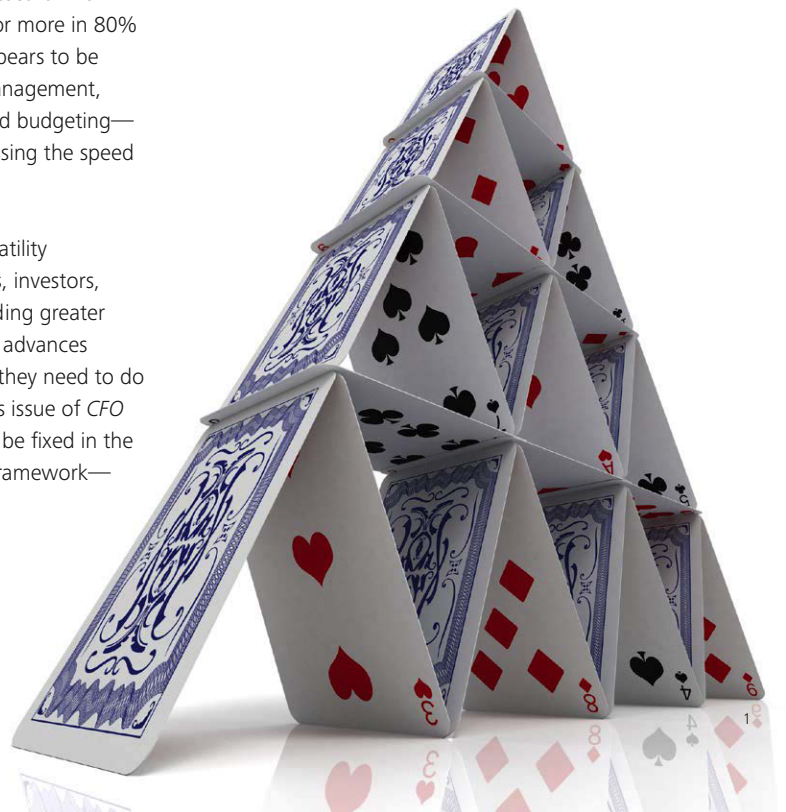
Part of the problem is that financial planning and analysis (FP&A) has not changed fundamentally from the way it was done 10 years ago, despite the onslaught of new and more-strategic risks. Many CFOs, controllers, and FP&A teams still spend months working toward group-level numbers that they agree to communicate to the market. (In fact, according to new global research from Deloitte LLP, budgeting takes eight weeks or more in 80% of organizations.¹) Moreover, there still appears to be very little process integration across risk management, strategic planning, financial forecasting, and budgeting—integration often considered vital to addressing the speed and range of risks many companies face.

There is clearly a need to reliably reflect volatility more explicitly in the process. Many boards, investors, regulators, and rating agencies are demanding greater accuracy in forecasting. Plus, technological advances mean many CFOs have access to the tools they need to do proper risk adjustment of their plans. In this issue of *CFO Insights*, we will discuss what still needs to be fixed in the FP&A process and introduce an analytical framework—risk-adjusted forecasting—that seeks to tame the uncertainties in that process.

Identifying and incorporating risks

For CFOs, risks are everywhere—and they're multiplying. In the 4Q 2013 *CFO Signals*TM report, the chief worries of North America's CFOs who responded to the survey centered on concerns over long-term growth and the impact of government actions on the economic recovery (see sidebar: "Endless risks: What are CFOs worried about now?").²

What's more, many CFOs are well aware that the risks they face pose high risks for their companies. In a survey Deloitte conducted recently with *Forbes Insights*, strategic risks—those that affect or are created by business strategy decisions such as the pursuit of increased market share—have become a major focus, with 81% of surveyed companies now explicitly managing strategic risk rather than limiting their focus to traditional areas, such as operational, financial, and compliance risk.³



Yet, despite this heightened awareness, current FP&A processes are often still woefully inadequate. Granted, many companies typically incorporate “safety buffers” into their forecasts. But safety buffers tend not to have been linked explicitly to the drivers of risk and volatility. Sensitivity analysis typically tackles risk on a variable-by-variable basis rather than simultaneously. Even Monte Carlo analysis simulation is often an experiment rather than actually embedded into the processes. In fact, some common problems in today’s current FP&A processes include:

1. **Static view.** Traditional forecasts and plans typically use single-point estimates and metrics with little or no discussion of risks and possible variances, and without showing correlations among multiple risks.
2. **Guesses rather than facts.** Forecasts are often developed by aggregating best guesses from across an enterprise without focusing on risks that could have a major impact on performance, such as competitor actions, talent shortages, cost volatility, and regulatory pressures.
3. **Inadequate stress testing.** Many companies don’t normally stress test their forecasts, and when they do, the efforts tend to be limited and focused on a single generic parameter such as price, demand, or input costs.

Given that risks happen in aggregation and often interact, it is a serious oversimplification to look at the drivers of uncertainty in isolation. As the head of strategy at a FTSE 100 company expressed it, “What is required is the ability to make connections, see linkages and patterns that can clump together dangerously.”⁴

Endless risks: What are CFOs worried about now?

Based on the results of the 4Q 2013 *CFO Signals* survey, North American CFOs face a litany of risks:

- **Effects of “quantitative easing” and unwinding.** Worries have escalated about the long-term effects of U.S. monetary policy and nearer-term effects of tapering or unwinding the bond-buying program.
- **Government gridlock.** Worries that the ability of government to make and implement policy continue to accelerate.
- **Industry regulation.** Concerns that the government will take a more active role within industries have grown. This factor was mentioned in all sectors except Retail/Wholesale and Energy/Resources.
- **Margin pressures.** Concerns remain about competition, pricing, and the ability to align cost with revenue.
- **Execution.** Companies continue to worry about their ability to execute well on current and new strategies and successfully implement large, complex projects.

Source: *CFO Signals*, Deloitte CFO Program; see 4Q 2013, January 2014

Moreover, without a cross-functional view of risk, it can be very difficult to address the burning risk questions that currently face finance and the organization overall: How can we grow our brand and improve our revenue growth, operating margins, and asset productivity in the face of increasing volatility? How can we reliably analyze exposure to emerging risks and develop cost-effective mitigation strategies? And, ultimately, as CFOs, how can we have greater confidence in the delivery of the budgets and plans to which we are committing?

Enter risk-adjusted forecasting

Far from a theoretical solution, risk-adjusted forecasting can offer the answers—and the comfort level—many CFOs seek. Using established analytical modeling techniques, the process generates a range of possible outcomes and probabilities based on multiple risk variables, rather than a single variable. Cash-flow and earnings-at-risk measures are calculated by analyzing how financial forecasts could be impacted by major risk drivers and generating a probability distribution (for example, a bell curve) of likely outcomes for each period. Once the model has been fully populated, it can analyze the aggregate impact of multiple risks and also produce a high-level summary of how much each driver may contribute to overall risk levels.

The process works by capturing risks and planning assumptions in a quantitative way that augments traditional estimates and intuition. The number and types of risk drivers may differ for each company depending on the industry and business/operating model, and are likely to change over time (for example, reservoir uncertainty for an energy company or patent rejection for a pharmaceutical company). But the expanded view can help many companies address interconnected risks, some of which may have been previously identified, others that may have gone unnoticed. The methodology also helps improve strategic planning by providing executives with a better understanding of asset performance, capital allocation, and profitability by setting metrics against a backdrop of related risks.

For finance chiefs, the process can offer a powerful decision-making tool. Given that the model can produce earnings or cash-flow distributions in individual years, companies can compare the differences between the budget, the expected value, and the realistic worst- and best-case scenarios. That probability of “best” and “worst” cases can then be set at whatever level of confidence a CFO seeks—say, 1 in 10 or 1 in 8. And this facilitates a discussion around what an acceptable level of downside uncertainty is, which very often supports the articulation of what the risk appetite of the company and the management group is.

Moreover, since the ranges produced allow CFOs to visualize the impact of true volatility, the process can expose errors or inconsistencies in inputs or assumptions and help to promptly correct for them. Say, for example, a company shocks its commodity input prices with (\pm) 5% in markets that have a monthly volatility of 10%. Visualization of the data can effectively showcase that risk has been underestimated, and adjustments can be made. In other words, the process can provide a much deeper assessment of the uncertainties a company faces in its cash-flow and earnings forecasts, as well as a clearer quantitative understanding of which risks contribute most of the exposure.

Start small, then spread the word

There are multiple hurdles many CFOs may have to overcome to fully embrace risk-adjusted modeling at their organizations. For example, despite the potential for bolstering management’s confidence in forecasts, there appears to be an overall lack of awareness about the approach as well as loyalty to the status quo (accentuated by a hefty dose of inertia). In addition, there can be a perceived complexity associated with multivariable stress-testing analysis, which some executives view as intimidating, as well as worries that corporate IT systems may not support the process.

To help overcome such hurdles, consider the following:

Start with a pilot. Companies interested in risk-adjusted forecasting may want to start with a pilot project focused on group-level forecasts or a particular business unit or product P&L. Input to the model (which could just be done on Excel) should be a balanced mix of quantitative data and qualitative insights from subject-matter specialists—information that in many cases already exists within the organization or can be easily obtained. Over time, the pilot can evolve and expand in response to future business requirements. But some benefits of keeping an implementation focused are that it targets specific problems, makes significant quick wins and tangible contributions to competitive positioning, and keeps costs to a minimum.

Make planning top-down and bottom-up. The bottom-up part of planning involves identifying those business drivers that have historically had a greater impact on operations and are actionable, such as increasing or decreasing production levels. The top-down part involves a strategic framing process, especially for identifying the forward-looking factors that could impact operations in the future. Many businesspeople are more comfortable examining available data (the bottom-up step) than having an open-ended planning or brainstorming discussion (the top-down step). For this framing process to work effectively, keep in mind three key principles: invite a broad representation of stakeholders that captures the business's full value chain, create an environment where participants can speak openly and noncritically about risk and uncertainty, and then ask the hard questions (for instance, How could we be wrong? What would cause outcomes to be much worse than we expect?).

Don't boil the ocean. Risk-adjusted forecasting may allow you to compare a range of possible outcomes. That doesn't mean, however, that you should include the full range of possibilities in your planning. Trying to capture the effects of more than, say, 10 or 15 risk drivers on your company's prospects can lead to excessive complexity, calculation time, and data points. Instead, consider the benefit of each incremental step of complexity that you're adding, in terms of data availability, practicality, and perceived importance. For many companies, 10 to 15 risk factors is probably a suitable balance between getting valuable insights and not overburdening the organization.

Use existing processes—and technologies. Many companies already have the functionality to deliver risk-adjusted forecasts—they just don't know it. In fact, much of the ERP functionality required to produce such forecasts already exists, but is likely not being leveraged. A structured discussion between the CFO, the CIO, and the head of FP&A can help identify any gaps that need to be filled.

Risk-adjusted modeling: A phased approach to implementation

How do we build the business case?

- Articulate core benefits
- Outline quick wins and long-term value
- Set up internal working group

Where should we start?

- Initiate pilot project or proof-of-concept
- Use group-level forecasts
- Build executive buy-in

What level should we go to?

- Limit input to top 10-15 risks
- Mixture of data and SME input is required
- Consider SME challenge of risk inputs

What is the basis of the technical approach?

- Outline desired outputs
- Build and validate technical model
- Provide consistent set of risks and forecasts

How do we start to use the output?

- Plan a road map for "first use"
- Build into existing frameworks
- Consider how to use in market communication

Source: Deloitte Dbrief, "Risk-adjusted Forecasting and Planning: Balancing the Risk-Return Equation," October 31, 2013

Visualize the outputs. In many cases, there is a disconnect between how CFOs want their forecasts to reflect risk and what those forecasts actually look like. That isn't the case in all industries, of course. In energy and resources, for example, management is often more familiar with risk analysis, and typically delivers forecasts that reflect high volatility and changes in capital expenditure. But one way to close the gap and start the conversation among the stakeholders in the process is to visualize what the new set of outputs and insights might be (see Figures 1 and 2). Knowing what you want out of FP&A can allow you to bring risk and return together in terms of how you plan, invest, and allocate capital within your business.



Figure 1. Risk-adjusted forecasting outputs

This example shows how existing “single point” forecasts can be extended to include a quantitative measure of risk (from several specific risks), such as a cash-flow-at-risk metric.

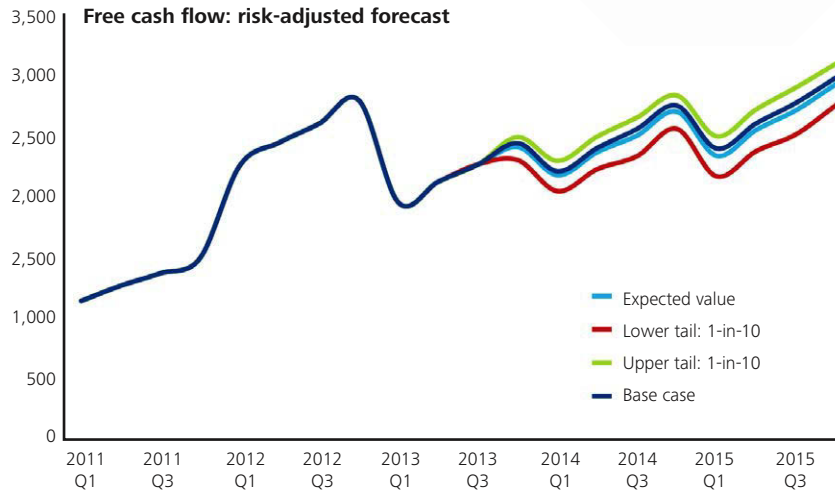
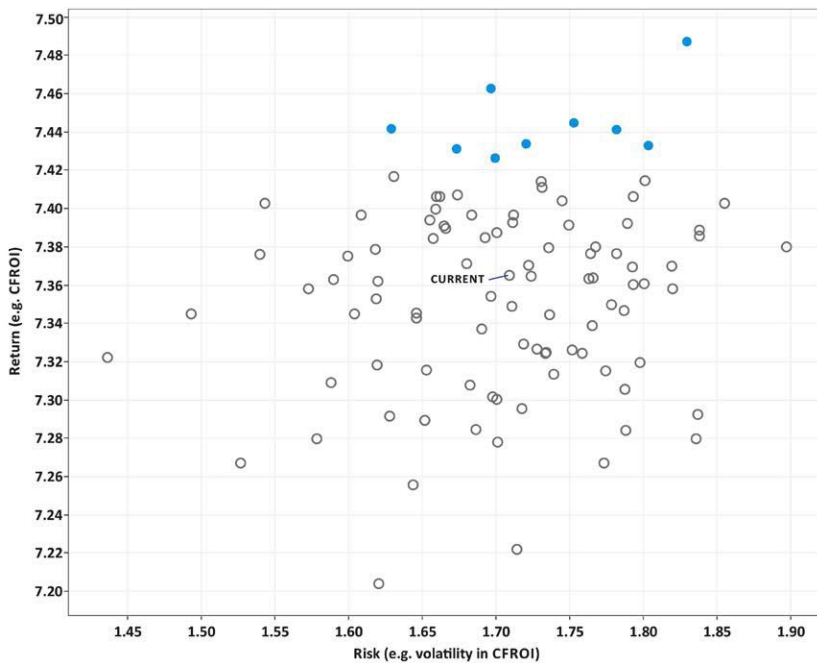


Figure 2. Risk-adjusted capital allocation model output

This example shows how allocation of investment resources can be improved by considering the risk-return position of different capital-allocation options. In this example, the current risk-adjusted return on capital (center) could be improved by changing the allocation of investment resources to those options nearer the top of the plot.



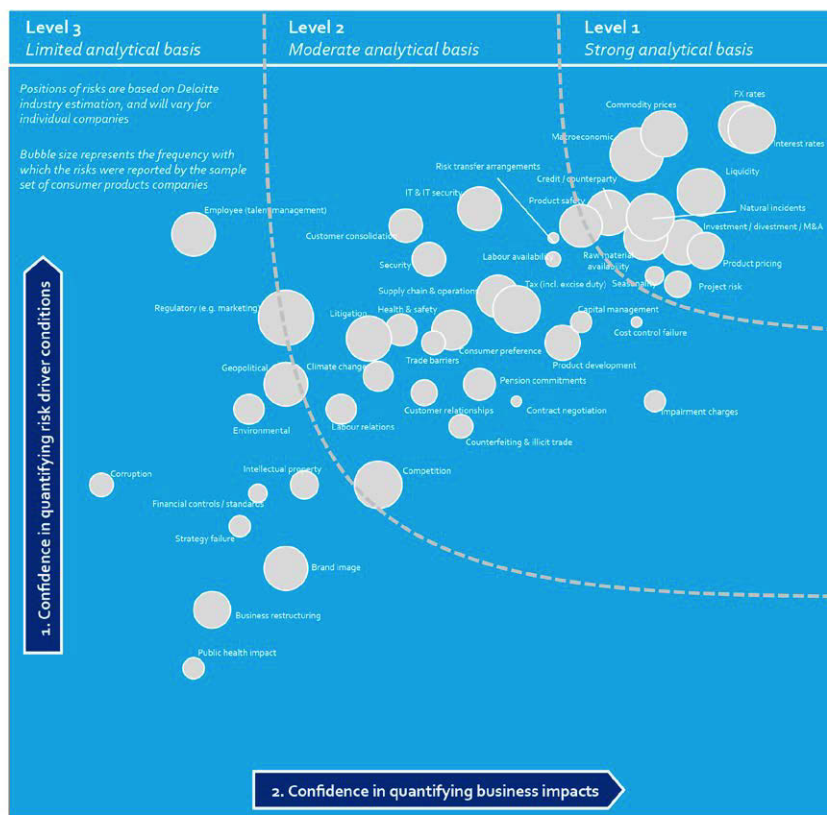
Categorize your risks. Risk factors obviously vary for different industries as well as for different companies. Knowing what the common risks are, however, can help create a foundation for a pilot program. Take consumer packaged goods, for example. For that industry, we've outlined 45 potential risks that can serve as reference points and classified them into three categories: those that immediately lend themselves to inclusion in a fully quantified risk-adjusted framework (see Figure 3); a second tranche of risks that are harder to model, but can still be incorporated into such a framework; and a third tranche that might be treated separately, potentially using scenario-planning approaches, due to potential difficulties in securing supporting data. Understanding common risks, and how they cascade and interact, provides a basis from which risk-adjusted forecasting frameworks can be developed and then deployed throughout the wider organization.

Be an ambassador. Without the backing of the CFO, a risk-adjusted forecasting project will not get off the ground. It is no different from other finance processes or methodology-reengineering-type projects that require tone—and action—from the top. Once a finance chief becomes convinced of the forecasting process's application in finance, however, there should be a road map that allows the CFO to roll it out across businesses, geographies, and products. Otherwise, the inertia that troubles many such projects will likely ground this one. But with the right backing, risk-adjusted forecasting actually offers a way to turn a reactive reporting process into a more dynamic contributor to decision making and insight.



Figure 3. Risk landscape example—consumer packed goods (CPG)

This “risk landscape” example is based on a review of the risks reported by 20 of the world’s largest, globally focused CPG companies, with a combined market capitalization of more than \$1.8 trillion. More than 530 individual risks were reported across the 20 companies, with the comparable risks further grouped to develop the landscape of 45 key industry risks (shown in this plot).



Source: Deloitte analysis, company reports

The benefits of integration

In a recent Deloitte Dbrief titled “Risk-adjusted Forecasting and Planning: Balancing the Risk-Return Equation,”⁵ participants were asked what they viewed as the most difficult step in risk framing. Almost half of the 2,600 respondents cited identifying the full set of value and risk drivers; 25% said facilitating an honest, constructive conversation with relevant stakeholders; 16.6% thought using framing results to guide modeling and data collection would prove most difficult; and 8.6% worried about assembling a broad, relevant set of stakeholders.

Admittedly, each could be a barrier to implementing risk-adjusted modeling. Yet, armed with an improved understanding of uncertainty, many companies can react faster to unexpected events. They can also develop more-consistent assumptions both within and across business units, which may foster stronger communication internally and externally. And CFOs as custodians of the forecasting process can gain confidence in the delivery of the plan. Furthermore, the practical application of risk-adjusted approaches within the businesses can help integrate strategic planning with risk and finance, driving more value at the business-unit level and preparing the company to be more nimble. Given the level, speed, and global impact of risks currently facing many companies, such an integrated approach should be considered not only a necessity, but also a competitive advantage.

End notes

- ¹“Planning, budgeting, forecasting: Global survey”; Deloitte LLP, October 2013.
- ² *CFO Signals*, Deloitte CFO Programs, see 4Q 2013, January 2014.
- ³ “Exploring strategic risk, 300 executives around the world say their view of strategic risk is changing”; Deloitte LLP and *Forbes Insights*; Spring 2013.
- ⁴ “The myth and reality of the corporate CRO,” Deloitte LLP UK/Hedley, May 2011.
- ⁵ Deloitte Dbrief, “Risk-adjusted Forecasting and Planning: Balancing the Risk-Return Equation,” October 31, 2013.

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