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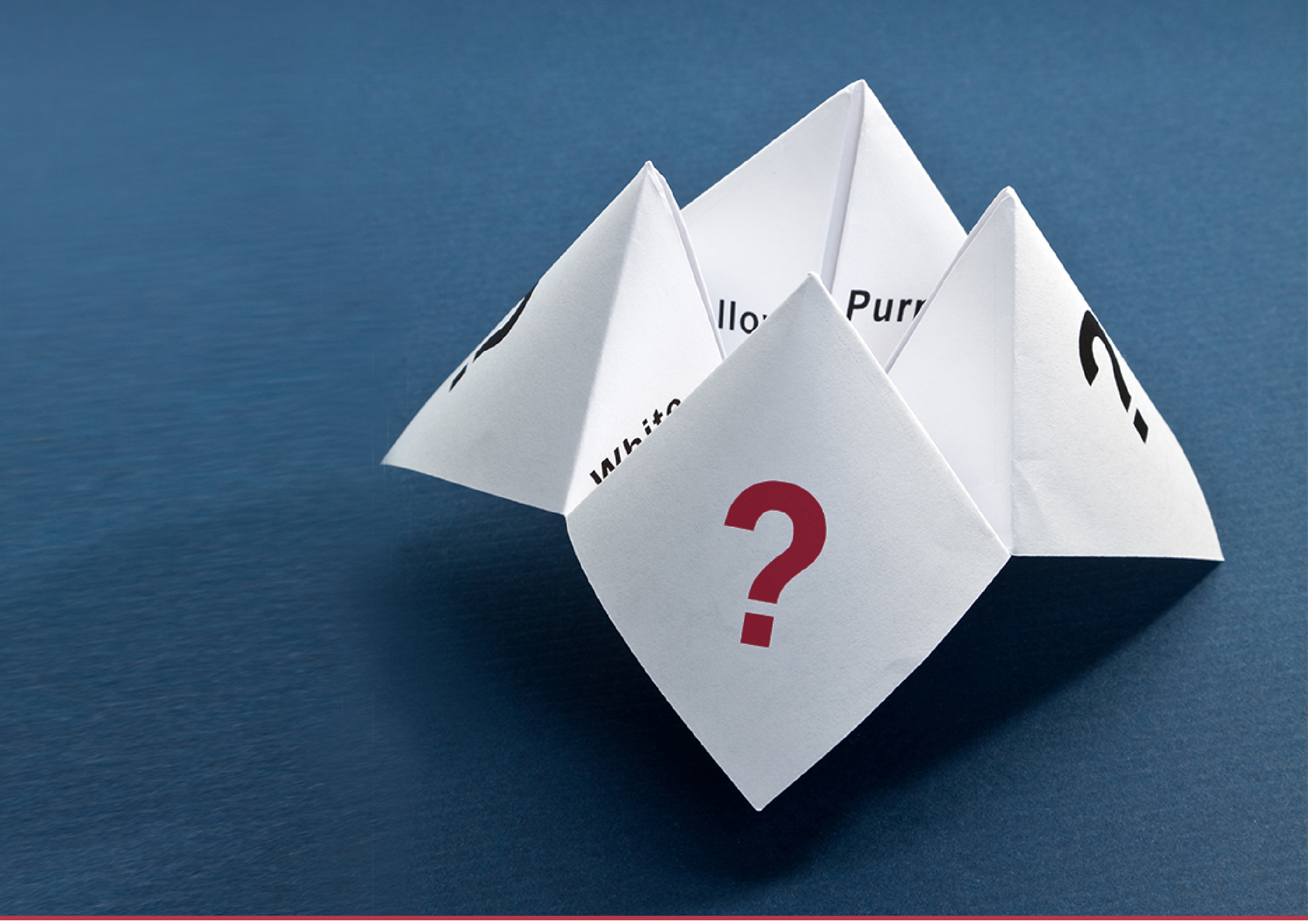

FP&A Scenario Management: How Scenario Planning Has Evolved to Deal with Uncertainty

Authors:
Larysa Melnychuk, CEO and Founder at FP&A Trends Group,
Michael Coveney, Author and FP&A Thought Leader

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1 Role of scenario management

Scenario planning has evolved from being a strategic level activity with static situations to one that is far more dynamic.

"The problem with the future is that it is different. If you are unable to think differently, the future will always arrive as a surprise."

Gary Hamel
professor and business thinker

Scenario management plays a vital role in a world of irrelevant budgets and inaccurate forecasts. The traditional practices of planning, where there is only one future, are no longer viable in a world dominated by uncertainty. Instead, organizations must face the prospect of **multiple futures, driven by an ever-changing business environment**, most of which involve events that cannot be predicted.It is only by adopting a fast and agile scenario management process that organizations can steer their way towards achieving their short and long-term goals.

2 Scenario planning to scenario management

Scenario planning has its roots with the military but entered the business arena in the 1950s through Herman Kahn at the Rand Corporation. This was an American non-profit global think-tank which stressed the benefits of using scenarios as a strategic planning tool. This use of scenario planning gained traction in the 1960s and 70s when Royal Dutch Shell claimed the technique to be key to their success in navigating their way through the oil crises at that time. Since then, scenario planning has evolved from being a strategic level activity, that used static best, worse, and expected situations, to a far more dynamic, analytical method that is applicable to all levels of the organization.

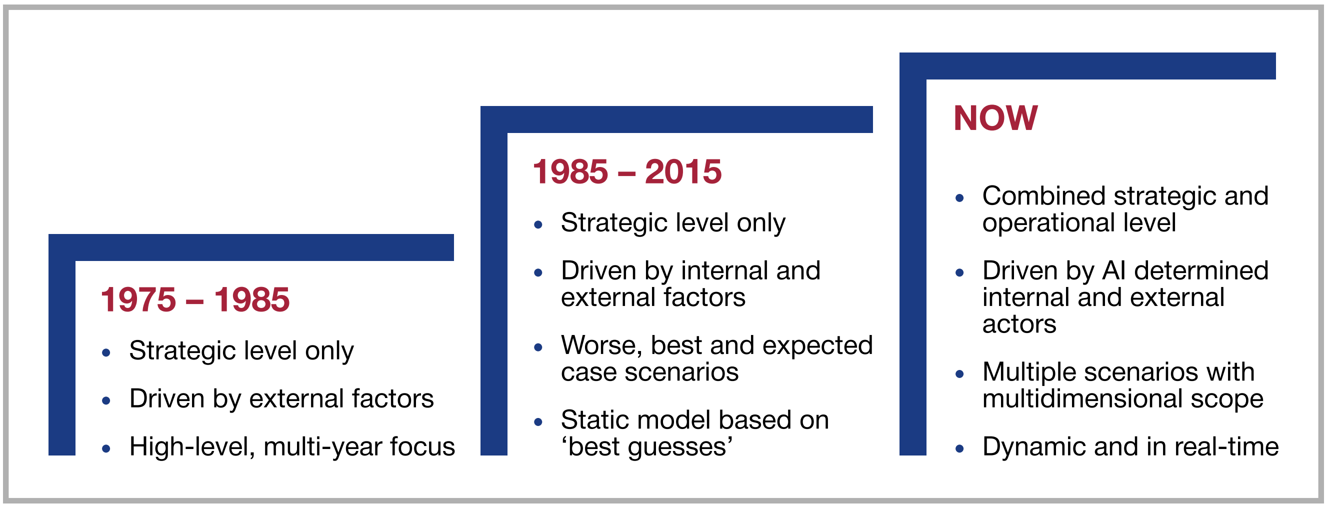


Fig 1: Evolution of Scenario Planning

As a reflection of its evolution, John Murphy, CFO of Coca-Cola, prefers to call it scenario management as opposed to scenario planning. In an article published on CFODive.com in December 2020, he claimed that today's world changes so quickly that organizations need to **focus more on the management of what could happen**. To focus on this involves modelling the potential impacts of threats, the decisions that will need to be made, the time they will need to be made, and how resources may need to be allocated. Murphy goes on to say that organizations need to sharpen their approach by having Plan B, Plan C, and Plan D available and ready to be implemented quickly.

This approach is endorsed by organizations such as the Lego Group, Cartier and Citi who have been making extensive use of scenarios to manage their businesses through these uncertain times. In fact, **scenario management is the only method of planning**, whether strategic or operational, that makes sense when you cannot predict the future. **In short, it is the *next normal* of planning**.

3 Traditional planning vs scenario management

Scenario management is not about predicting the future but managing future uncertainty within any part of the business.

"In the business world, the rear view mirror is always clearer than the windshield."

Warren Buffett
investor

Traditional approaches to planning typically include fixed timescales on a specific timeline. For example, a three-to-five-year plan is often updated annually, based on forecasts, which then forms the basis for a 12-month budget. However, these timescales are often unrealistic. Many organizations cannot forecast that far in advance with any degree of accuracy. Even if they can, a window of only 12-months is too narrow to allow management to consider the long-term effects of unforeseen events.

These shortcomings are where scenarios play a vital role, but they do not replace the need for forecasts. The following graphic provides a good illustration of where they both fit. It is all down to the span of predictability

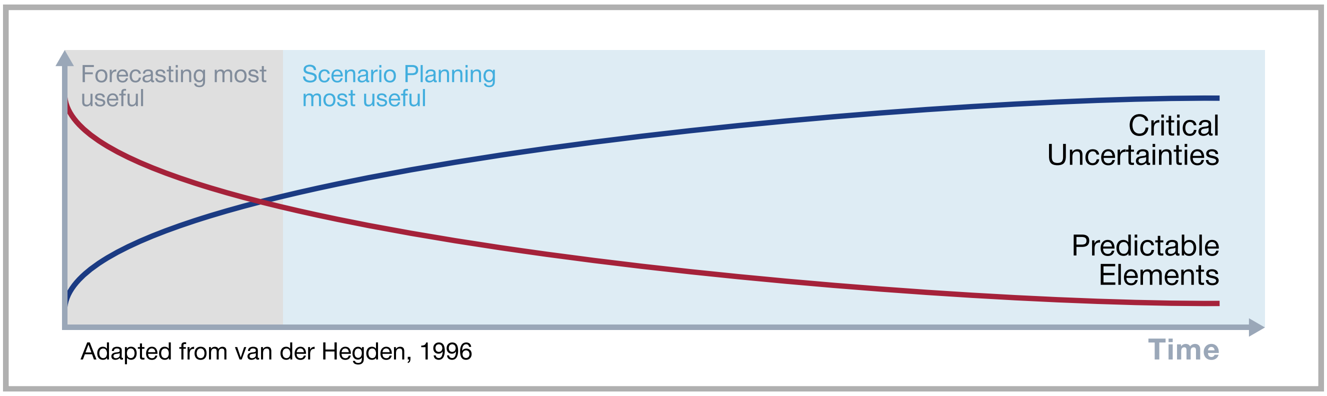


Fig 2: Deciding when to use forecasting and when to use scenarios

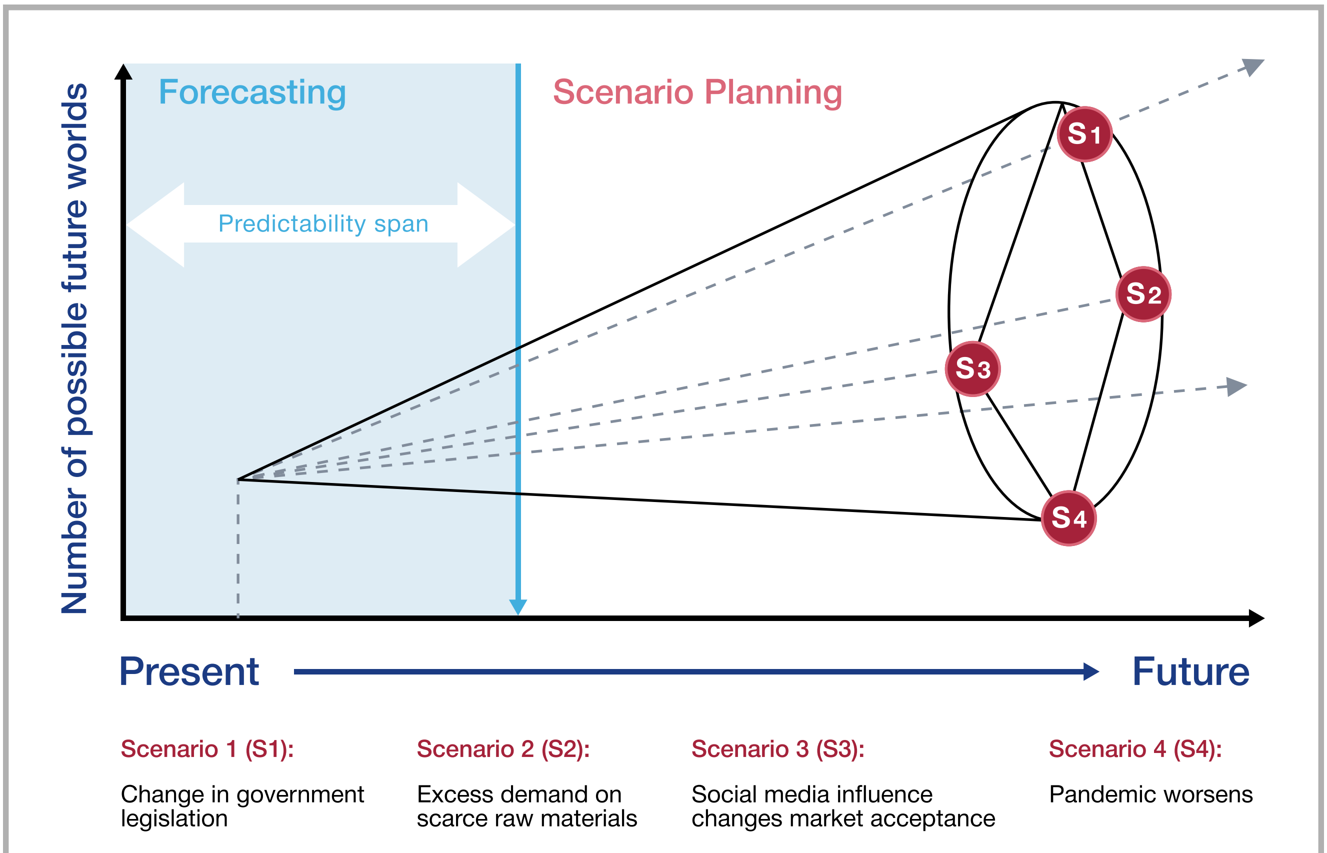
Forecasts are good when the values they provide can be relied upon, which for some companies may only be a matter of months or even weeks. The span of this future is determined by two factors:

> **Critical uncertainties** which are often considered to be unstable or unpredictable. These include things such as consumer tastes, natural disasters, or disruptions caused by new technologies and products.
>
> **Predictable elements** which are things we can be fairly certain will occur, often because they are subject to legislation or some form of contract.

Of course, there is a lot of subjectivity here, yet scenarios become essential when critical uncertainties overtake predictable elements. It is at this point where the future becomes unclear and there may be a range of possible futures.

Scenario management is not about predicting the future, unlike conventional planning and forecasting processes. Traditional planning looks to extrapolate current trends and provide a *best estimate* of what the future could be, so that organizational strategy can be adjusted accordingly.

By contrast, the focus of **scenario management is on managing future uncertainty** within any part of the business, as indicated in Figure 3. Its purpose is to assess changes of multiple drivers in certain combinations in order to get a sense of the variety of possible futures that may occur. For each of these futures, company strategy would need to change or be transformed accordingly.



Source: Adapted from the 'Uncertainty cone to bound the future' by Paul Schoemaker

Fig 3: Managing the cone of uncertainty

4 Benefits of scenario management

In times of uncertainty, 'business as usual' is constantly changing, as are the drivers.

Scenario management is seen as the *next normal* of planning that has a number of distinct benefits not provided through traditional methods. Based on our discussions with many organizations at the meetings of the International FP&A Board, these benefits include:

"As far as the laws of mathematics refer to reality, they are not certain; and as far as they are certain, they do not refer to reality."

Albert Einstein
German mathematician and physicist

Anticipating the impact of black swan type events

Black swans are those unpredictable events with severe consequences that no one thought could ever happen. By definition these events cannot be planned for in advance. However, organizations can test how resilient they are to potential threats and make plans accordingly.

Following the financial crisis of 2008, all banks in the US were mandated to perform regular stress tests and specific reviews, namely the comprehensive capital analysis and review (CCAR). José Nazario, FP&A and CCAR Director of Global Consumer Banking at Citi, explains that this requires the bank to run nine different scenarios, with defined levels of severity. These check whether the bank's system could theoretically handle a future economic shock.

To handle this challenge, Citi developed two systems. The first forecasts the total Citi balance sheet, revenue and expenses for the next 60 months. The second looks at credit risk and the potential costs to the bank in different scenarios. Each system is fed by models that contain assorted drivers, such as consumer behavior, unemployment and foreign exchange rates. The models produce the submissions that go to the regulator. The most important factor in this process is the continuous engagement between departments across FP&A, the business, treasury and risk. They all review and challenge both inputs and results.

Scenario management has allowed Citi not only to comply with the government regulations but also to identify future recessions and be prepared. **It has made them more resilient**, which has been especially important during the latest COVID-19 crisis.

José believes there are some important learnings from the pandemic including how customers react to a crisis and the impact government decisions can have on any business. This can help companies improve their forecasting models by incorporating all newly acquired data. José concludes that scenario management at Citi is not an exercise that they do twice a year, it is now **ingrained in their regular decision-making process**.

Challenging mental models of the business world

All organizations have a mental model for the way they believe their part of the business world operates at any particular moment in time. This is reflected in their use of drivers and how they affect future performance. The question though is how accurate is their understanding?

In times of uncertainty, 'business as usual' is constantly changing, as are the drivers. Denis Ranke, VP Finance at Diethelm Keller Holding, found that their business drivers had changed completely within only a few days of the start of the COVID-19 crisis. They were now faced with new drivers including lockdowns, government subsidies and peak online demand. This gave rise to a completely new baseline where seasonal patterns were wiped out leading to forecast scenarios of extreme magnitudes, where cash became king.

To manage this new world, Diethelm Keller Holding needed to **discard their existing mental model** to understand the new drivers and the new patterns of supply and demand. Scenario management provided them with such an approach that was both agile and could be performed at an operational level. With this they were able to **adopt a rolling plan approach to the budget** with weekly and monthly updates as required as events unfolded.

Being proactive to new opportunities

Michael Tweedie, Senior Director of Global Finance at the LEGO Group, found that uncertainty often leads to new opportunities, assuming of course that the organization is agile enough to take advantage of them.

Like other companies, LEGO runs regular scenarios to evaluate high, low and mid-growth conditions. Each scenario clearly identifies assumptions made and is presented to leadership. However, the distinguishing feature of LEGO is that the finance team work alongside the risks and opportunities group. To mitigate risks, the finance team put plans in place as far as possible. For example, they worked on adjusting payment terms to help customers though the recent COVID-19 crisis.

LEGO also used these scenarios to **identify opportunities that could boost business**. For example, they were able to re-invest savings made on lower staff travel to **bring forward other growth plans**. Scenario management helped them facilitate product supply choices when factories were disrupted. They were also able to react quickly to the *Black Lives Matter* movement with support programs that had not originally been planned.

Reallocation of resources based on need

Abu Dhabi Health Services Co. (SEHA) is a major health system provider based in Abu Dhabi. When COVID-19 struck they were expected to significantly increase capacity and do things they had never done before. The situation was so concerning that it required **a major rethink of their financial planning processes**. Between March and April 2020 the FP&A team developed a new integrated financial model that used predictive analytics to produce automated trends and forecasts, giving a 360-degree view of the business. These models included external drivers such as COVID-19 infection rates that were developed in collaboration with relevant stakeholders to support capacity utilization planning.

Now, as results come in, the team are able to run different scenarios so that management are kept aware of what could happen, and **where resources can be re-directed if necessary**.

Expand and challenge thinking

One company we interviewed operates a price comparison website in a fast, dynamic market where things develop all the time – there is no static stage. Their philosophy is to test *and learn*, in recognition of the fact that not everything will work. In a market where delivery speed is important, they have had to move away from static spreadsheets to use heavily automated forecasting systems that apply artificial intelligence (AI) and machine learning (ML) techniques. This allows finance staff the time to work alongside business managers and look at the key trends currently driving the business.

The company is always looking for better ways to help consumers engage with them and maximize revenues. Each week they analyze what is happening in the business by day and hour to see what initiatives would improve this. They **challenge management to expand their thinking** on what could cause a step-change improvement in performance. These potential changes are then played out as different scenarios to see **how the company can improve** on their current forecasted predictions. Chosen scenarios are then quickly actioned to get them into real business as soon as possible. It is an iterative process that reacts constantly to a dynamic business environment.

5 Moving towards scenario management

For organizations that want to use scenario management effectively, a new mindset is required, backed up by a different approach.

There is a world of difference between traditional planning and scenario management. Although they share a common objective – meeting corporate objectives through strategy – the method, content and output are very different. That is because the activities of traditional planning were developed in times of relative certainty, whereas **scenario management has been the product of today's volatile business environment**. Figure 4 contrasts these differences.

	Traditional approach to planning	Scenario management approach
Timespan:	Annual 12 month focus with mid-term updates	Rolling planning window based on product life-cycles
Approach:	Separate strategic, financial and operational models	Single integrated strategic, financial and operational model
Content:	Negotiated budgets, investment decisions based on corporate 3-5 year plan	Driver based forecasts that are played on demand
Method:	Modelling driven by strategic objectives and extrapolation of past performance	Modelling driven by constant evaluation of drivers based on internal / external events
Tools:	Manual Excel / Consolidation systems.	Automated, advanced analytical systems
Duration:	Typically 1 – 3 months	Typically 1 - 3 hours
Output:	Single financial plan with corporate set KPIs on which to make a decision	Multiple scenarios with supporting documentation on which to make a decision

Fig 4: Key differences between traditional planning and scenario management

For organizations that want to use scenario management effectively, **a new mindset is required**, backed up by a different approach as outlined below.

Ensure plans cover the complete lifecycle of products / services

Mike Huthwaite, a thought leader in the area of strategic finance, believes strongly that plans need to **take into account the whole life cycle** of an organization's product or service. Some products will need more resources because they are in the development stage, while others will be more established and therefore more capable of generating above average returns. It is only by looking at this level of detail, on a rolling basis over multiple years, that allows businesses to make the right investments at the right time.

Ensure plans are driver-based

To be able to produce scenarios quickly, plans need to be driver-based. In other words, 80 percent of the organization's results can be explained by 20 percent of the identified drivers. Entering only a few numbers into the model. allows for the production of a combined profit and loss statement (P&L), balance sheet and cash flow statement.

Drivers are typically found through analysis of past results, and in collaboration with end users. Laurent Claes, Group Controlling Director at YOOX NET-A-PORTER GROUP, believes that **collaboration at a local level is essential for setting drivers**. It helps identify the real drivers and instils a sense of ownership. It also helps everyone understand how the business truly operates and therefore allow everyone the knowledge to identify required changes as the business environment evolves.

Monitor chosen drivers at a detailed level

In times of uncertainty, drivers will change and so they need to be monitored constantly at a detailed level. This will require constant access to internal and external data sources, that can be analyzed quickly, so that differences can be presented to management teams. Drivers will be **updated in collaboration with the stakeholders** that have been directly affected.

Use the right tools in conducting scenarios

Spreadsheets and simple consolidation tools are not capable of handling the requirements of scenario management. This approach requires modern flexible systems that can automate the analysis of data and production of forecasts, while supporting real-time collaboration with the business.

John Murphy, CFO of Coca-Cola, made the point "If you're not already thinking about how you operate in a truly digital world, and how you're building out your capabilities to do so, **you're going to get left behind**". The price-comparison website organization we mentioned earlier, found that when they used spreadsheets, scenario planning was not an option for them due to its complexity. However, once they had implemented a modern planning system, they were able to generate a forecast and run multiple scenarios in only 30 minutes including a full audit trail of assumptions.

Produce action plans for the most likely scenarios

The output generated from the scenarios represent multiple possible futures. For those scenarios considered to be the most likely, **action plans will need to be developed** that can be put in place should those situations arise. These plans will show how resources are to be reallocated and the overall impact on organizational goals.

6 Summary

Scenario management is an **ongoing**, **organization-wide process**, driven by events and exceptions. It recognizes that all of our reliable and factual knowledge is about the past, whereas all of our required decisions are about an uncertain future. As a result, scenario management is a formal response that makes everyone aware that the future view is not perfect, so when something unexpected occurs, there is now a procedure in place to deal with it.

However, organizations struggle to plan scenarios. In a recent webinar poll (October 2020) 75 percent out 110 organizations found the whole process time consuming, with only 18 percent able to conduct them in less than a day. This is largely due to the use of inappropriate technology, only 25 percent of organizations had suitable systems.

To be effective, scenario management needs to be **embraced by the organization** as its main planning method, preferably in real time. The process needs to be performed at both levels of the organization, operational and strategic, and information should be made available to all stakeholders in a timely manner.

To do this requires a good understanding of the organization, the business area in which it operates, and the factors that affect the global economy. Scenario management also needs driver-based models that can be implemented through modern, analytical solutions and allow for automated analysis of large amounts of data, in real-time.

Organizations that implement scenario management are in a **much better position to handle uncertainty**. To start with, managers readily acknowledge that there could be a number of different futures, and that there is a mechanism where these can be discussed and their impact evaluated. This allows the organization to be prepared and ready to change as events unfold. By contrast, those that rely on a fixed, annual forecast view based on negotiated numbers have none of these benefits, whose plans will not reflect reality, and where their ability to change quickly is severely reduced.

Larysa Melnychuk

Larysa is a passionate Financial Planning & Analysis (FP&A) professional and influencer who has held senior FP&A roles at leading organizations before setting up the International FP&A Board in 2013. In the last three years, she successfully expanded the Board into 27 chapters in 16 countries across 4 continents.

Larysa is also the founder and CEO at FP&A Trends Group, the leading online resource for FP&A professionals. She chairs the Global AI/ML FP&A Committee and runs a number of high-profile initiatives in the area of modern financial analytics.

Larysa holds a Master of Science degree in physics of materials and is a qualified chartered management accountant (CIMA), chartered global management accountant (CGMA) and is a holder of an FP&A certification. She is also a member of the exam content writing team for the Association of Finance Professionals (AFP) FP&A certification.

Michael Coveney

Michael Coveney has over 40 years of experience in designing and implementing software solutions that combine 'best management practices' with technology to improve the efficiency and effectiveness of planning, budgeting, forecasting and reporting processes.

He has conducted senior management workshops with leading organizations around the world and led courses for the American Management Association and Antwerp Management School on the topic of Corporate Performance Management.

His energetic style and extensive experience led him to become a regular speaker at many international events and the author of many articles and books. His latest, 'Budgeting, Planning and Forecasting in Uncertain Times' is published by John Wiley & Sons. In recent years he has focused on the role of IT within FP&A departments.

If you have any questions or comments, please feel free to contact us via email info@fpa-trends.com.