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Stress test your business plan

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Most budget forecasts are wrong from the day they are written. The federal budget - which turned last year's forecast of a $20 billion surplus into a $57.6 billion deficit - is testimony to that.

Two years ago, a forecast might have been reasonably accurate. These days, it's unpredictable. Sales have vaporised, the dollar is more volatile, and input costs are rising - and no one is absolutely certain where the world is heading.

In his 2005 book "Winning", former GE chief Jack Welch ripped into budgeting and forecasts. "Not to beat around the bush, but the budget writing process at most companies has to be the most ineffective practice in management," Welch wrote.

With the markets in turmoil and forecasts way off beam, most companies now would agree. Many budget forecasts in this climate are next to worthless and not worth the memory stick they're stored on.

"It's a bit of a crap shoot as to what's going to happen with the Australian dollar, unemployment, interest rates and venture capital," says John Downes, a partner at Deloitte who runs the firm's small to medium enterprise consulting business.

"It's also very difficult to understand what's happening with consumer confidence and business confidence, which is driving buying decisions and which, in some cases, is quite delayed."

Still, the only way to remain in business in this climate is to plan. Scenario planning and stress testing become more important than ever before.

Building the plan

Downes recommends his clients run a series of forecasts for the next two years. A business-as-usual scenario, for example, might have flat growth. He then advises clients to impose other scenarios on their business plan, like a 10% drop in revenue and a 20% increase in input costs as a result of a stronger Australian dollar.

"The reason for doing that is that it allows the business decision maker to look at his business under a range of scenarios, none of which he can guarantee are going to happen," Downes says. "What it does allow him to do though is then actually identify the trigger points in his monthly reporting as he goes through the year."

Downes says that allows the business to develop and implement an "agility plan" to mitigate those forces.

"If they are forecasting a 10% reduction in one scenario, they may have in place a set of decisions already modelled which say if we have two consecutive or three consecutive months of declining revenue, we have to drive for a harder sales program, but if we feel that's not delivering, then we may have to look at some significant cost reduction activities."

That might mean developing contingency plans to consolidate sites, or reduce marginal growth services or those that are likely to suffer more when demand crashes. If the worst happens, the company is not caught off-guard and is quick to act.

"The reality is we can't guarantee what's going to happen over the next 12 to 24 months, so it's about being forewarned and forearmed. It's prudent to model some of those scenarios that they can reasonably expect might happen, and establishing some plans should they occur," he says.

Scenario plans need to look at what happens if the company loses customers and suppliers. It is more than likely that some will not be there two years from now.

Downes says: "Having those scenarios modelled and action plans written down give you the ability to make those decisions in an informed and considered manner as opposed to getting the fax on the Monday morning from the receiver saying ‘we have been appointed to one of your key clients' and that you are likely to get X cents in the dollar in two years time and ‘we are not going to continue looking to you as a supplier'. That's when you get knee-jerk reactions."

How customers and suppliers can help

What else can business owners do to track customers and suppliers? Downes has a simple enough solution. "The key place you get it from is from speaking to your customers and suppliers and actually having the heart-to-heart conversation with them about what's actually happening in their business and how is their business going," he says.

"If you have two or three key suppliers, or two or three key customers, then you need to be having those same conversations, just the same way you would be having those conversations with your bankers."

The business plan, covering such areas as market analysis, company description, organisation and management, strategic analysis, marketing and sales management, service or product line, the amount of funding needed to start or expand the business, and financials is critical. The best business plans are updated every three months.

One reason why many small companies do not have plans is lack of time. Faced with the choice of serving a paying customer or writing a plan, any small business would go for the money. The answer for some businesses is to prepare the plan on the weekend. It might take an entire Saturday, but those that do it say it's a worthwhile exercise.

Many small businesses think they don't have the tools to prepare one. But Toby O'Brien, a director and co-founder of BPM Financial Modelling says it is not that difficult to pick up information and develop tools.

Clients and suppliers, for example, might offer good insights. Financial services clients, for example, could offer information about the economy; retail clients about customer demand and service; IT clients about the latest trends in technology; and insurance industry clients would know all about risk.

"Most companies would, if they sat down and thought about it, have access to a lot of good information that helps them try and predict what's going to happen to their business," O'Brien says.

The right tools

He says small businesses are at a disadvantage in this climate because, unlike the big corporations, they lack the resources and sophisticated tools that can make forecasts. But they can do certain things to plan ahead.

"What they should be doing is building at least basic financial models using Excel spreadsheets," O'Brien says. "As a business operator, if they can't build a basic spreadsheet or sheet that represents what the business does, then there are some fairly fundamental concerns about whether they should be running that business.

"Small businesses, including a milk bar or a 20-person manufacturing operation, should be capable of doing a basic Excel forecast model and the process of doing that is really not that complicated. It's a very structured process where you look through the historical financial statements and the balance sheet history."

He says this allows the business to create scenarios, including catastrophic ones like no sales for a year. In that instance, the company would have to look at its cash reserves to see how long it could keep paying staff.

It also forces them to draw up plans to create other ways of drawing revenue, like discounting, or going to other markets or changing production. "At least knowing what the critical threshold is means thinking about how they can mitigate it," O'Brien says.

Key performance indicators and targets

Michael Griffiths, director of business services and taxation at boutique accounting firm Prosperity Advisers, says constantly stress testing in this environment requires businesses to be across their monthly financials.

Griffiths says those that only process their results every three months as part of their business activity statement are running a risk. Similarly, they need to have their key performance indicators like sales targets in place.

"If you are just doing your balance sheet every three months then you are not close enough to your business," Griffiths says. "Yes, you can calculate how much GST you need to remit and how much tax you need to remit, but you are not all over your business, you don't know it as well as you need to know it.

"You need to have the KPIs each week, have the monthly financials done pretty promptly after month's end, and then analyse the financials by comparing the actuals with your budget and saying here is what we did well and here is what we didn't do well."

Still, Griffiths concedes businesses can only forecast for a limited period of time. The days of three to five year plans, he says, are over.

"You can have three and five year plans but they are not going to have as much substance as they would have had 12 or 18 months ago, because things were pretty normal then, we were growing pretty well and we thought we knew where we were going.

"Anything more than 18 months now, and anyone would be dreaming."

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