

# Predictive Accounting: Driver-Based Budgeting and Rolling Financial Forecasts

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**Data Labs India**

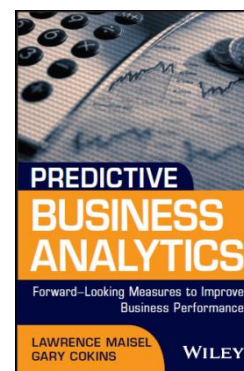
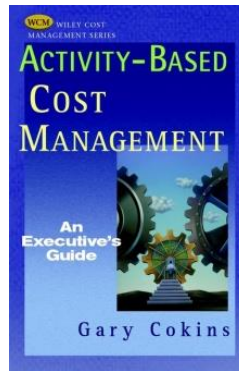
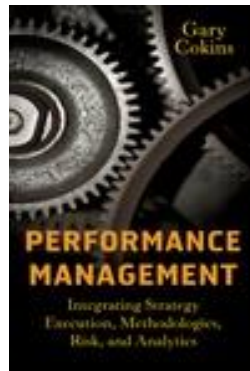
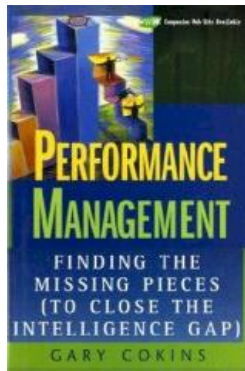
**June 8, 2024**

# About Gary Cokins

## Founder, Analytics-Based Performance Management LLC

B.S. Industrial Engineering & Operations Research;  
Cornell University, 1971

M.B.A. Finance & Accounting; Northwestern University,  
Kellogg School of Management, 1974



### Previous Associations:

- FMC Corporation
- Consultant with: Deloitte, KPMG, Electronic Data Systems [EDS, now HP]
- SAS (16 years)

# Who will benefit from this presentation?

Managers who have previously struggled at promoting rolling financial forecasts as an advance to the annual budget process.

Managers who intend to “champion” driver-based budgeting and rolling financial forecasts, and they need a compelling call to action.

# AGENDA

- **A basic primer on costing and EPM**
- **What is broken with budgeting?**
- **The shift to rolling financial forecasts**
- **Dealing with resource capacity planning**
- **Getting buy-in to overcome resistance**

# Drowning in data but starving for information.



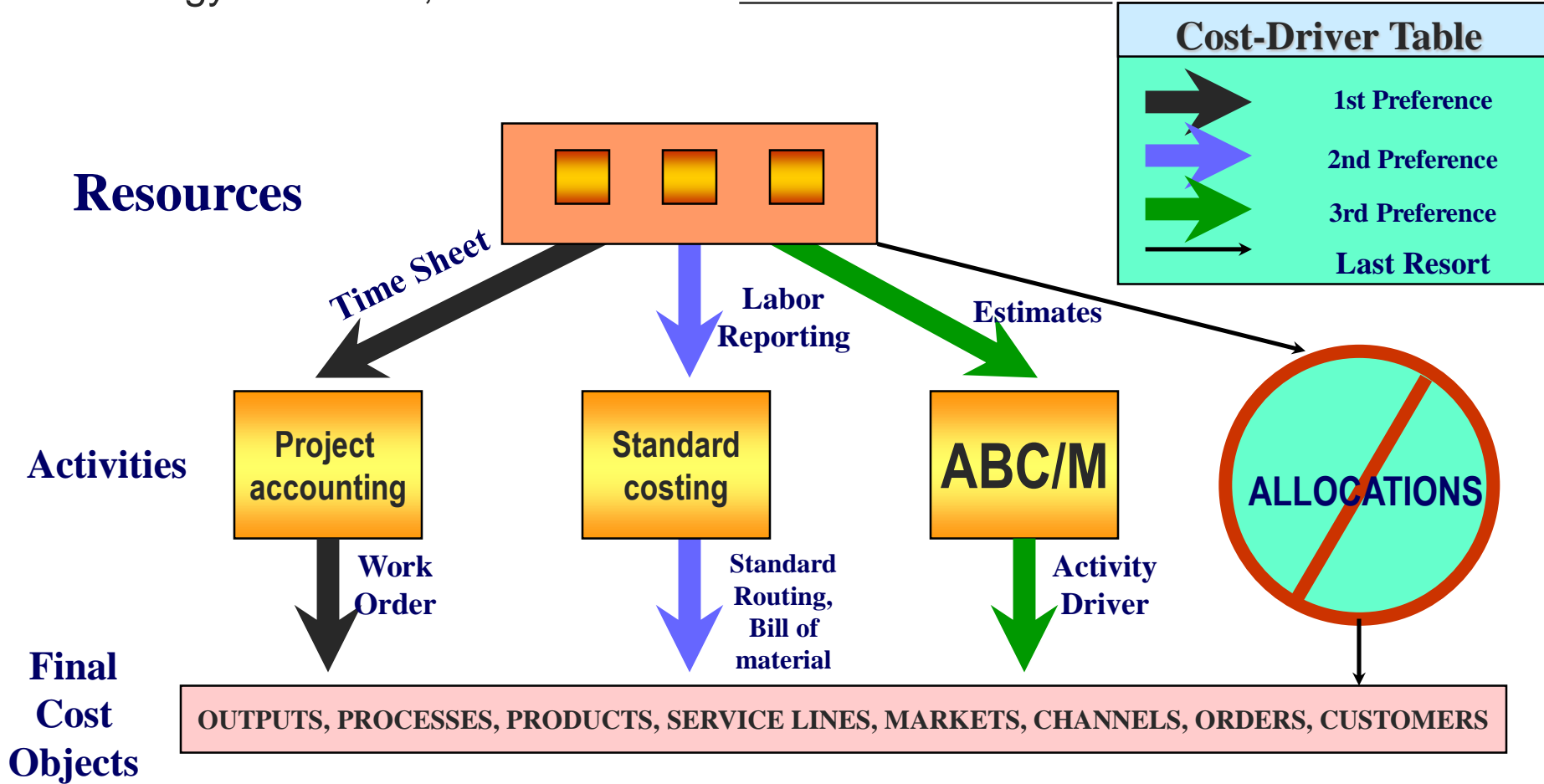
*“Looks like you’ve got all the data – what’s the holdup?”*

# Key Questions

**What? So what? Then what?**

# Direct and Absorption Costing

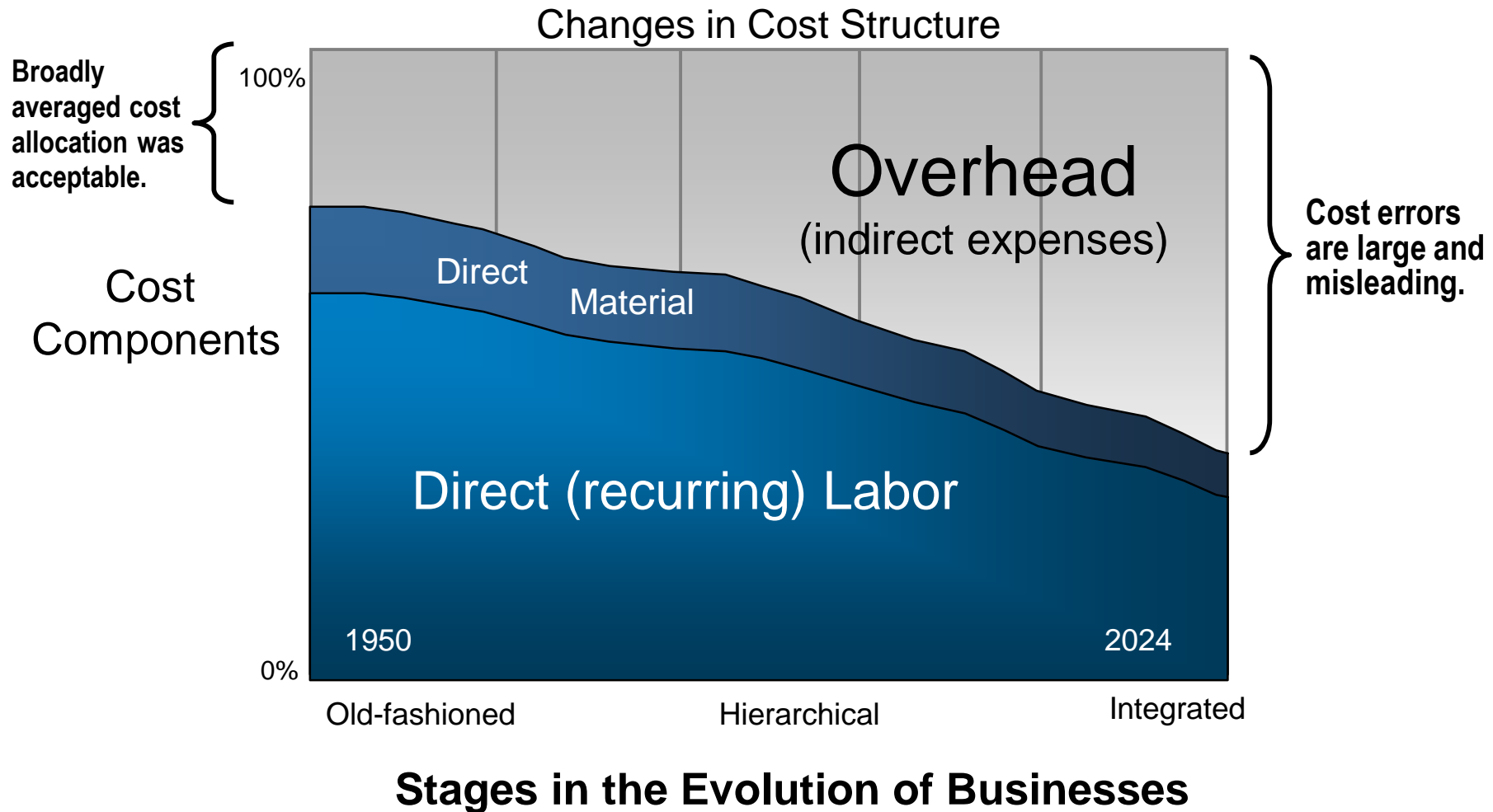
Ideally, all costs should be directly charged, but as variety, complexity, and technology increases, more costs are indirect and shared.



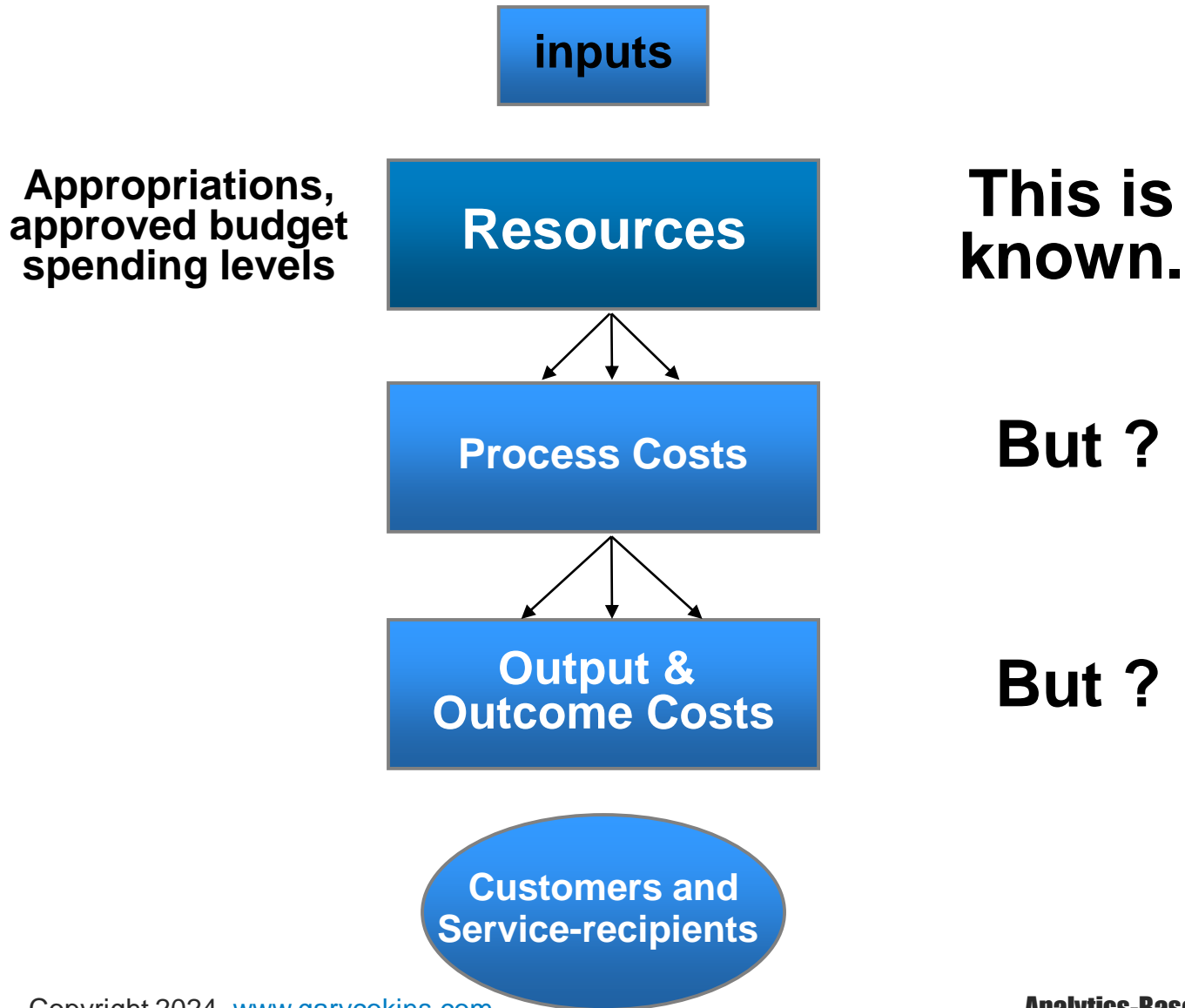
**A simple explanation of ABC ...  
that you can explain to your  
spouse (or boss) tonight.**



# The Need for Tracing, not Allocating, Costs



# The Primary View of Most Managers



# The General Ledger View is *Structurally Deficient for Decision Analysis.*

<b>Chart-of-Accounts View</b>			
<b>Insurance Claims Processing Department</b>			
	<u>Actual</u>	<u>Plan</u>	<u>Favorable/ (unfavorable)</u>
Salaries	\$621,400	\$600,000	\$(21,400)
Equipment	161,200	150,000	(11,200)
Travel expense	58,000	60,000	2,000
Supplies	43,900	40,000	(3,900)
Use and occupancy	30,000	30,000	—
Total	<u>\$914,500</u>	<u>\$880,000</u>	<u>\$(34,500)</u>

**When managers get this kind of report, they are either happy or sad, but they are rarely any smarter!**

# Each Activity Has Its Own Cost Driver

From: General Ledger

## Chart-of-Accounts View

### Claims Processing Department

	<u>Actual</u>	<u>Plan</u>	<u>Favorable/ (unfavorable)</u>
Salaries	\$621,400	\$600,000	\$(21,400)
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To: ABC Data Base

## Activity-Based View

### Claims Processing Dept

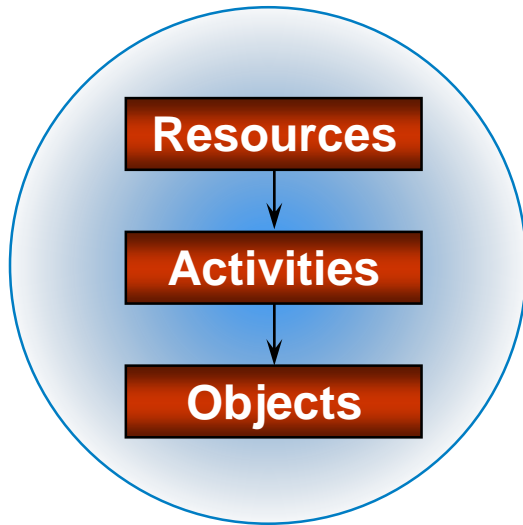
Key/scan claims	\$ 31,500	← #of —
Analyze claims	121,000	← #of —
Suspend claims	32,500	← #of —
Receive provider inquiries	101,500	← #of —
Resolve member problems	83,400	← #of —
Process batches	45,000	← #of —
Determine eligibility	119,000	← #of —
Make copies	145,500	← #of —
Write correspondence	77,100	← #of —
Attend training	158,000	← #of —
<b>Total</b>	<b>\$914,500</b>	

Activity cost drivers

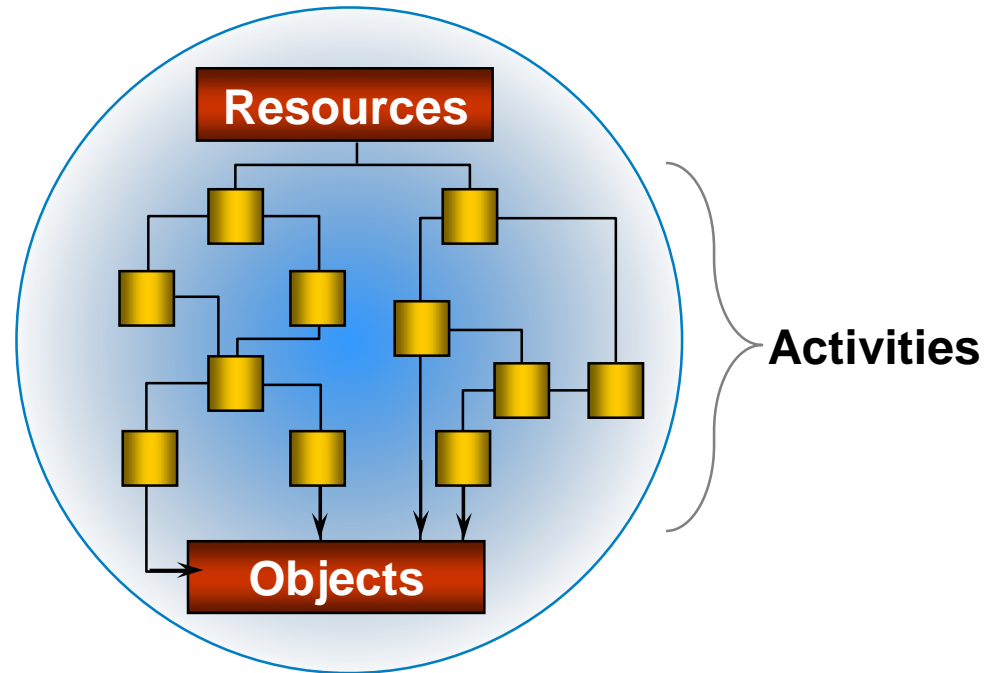
Products / customers

\$914,500

# Multiple-Stage Cost Flowing



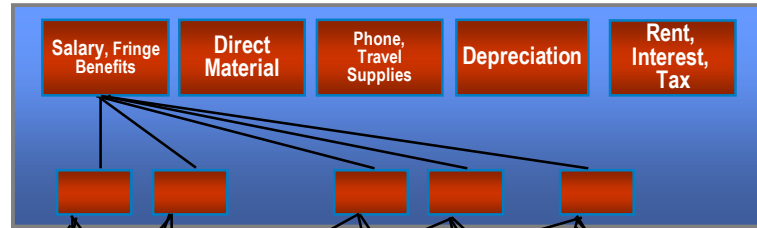
**Simple  
ABC**



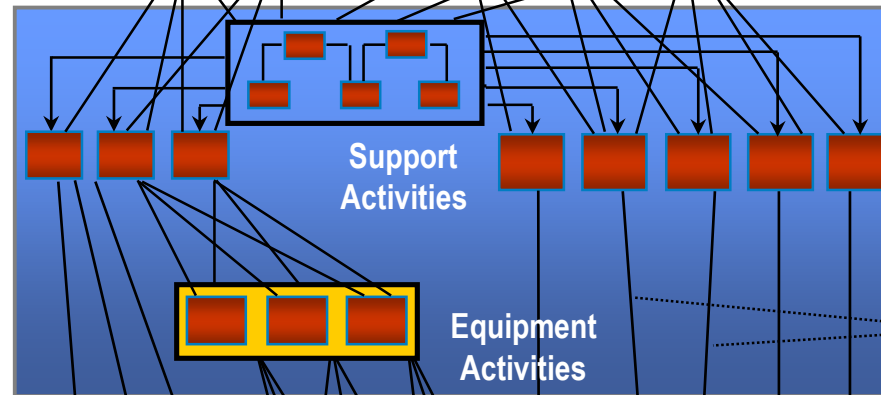
**Expanded  
ABC**

# ABC/M Cost Assignment Network

Resources  
(general ledger view)



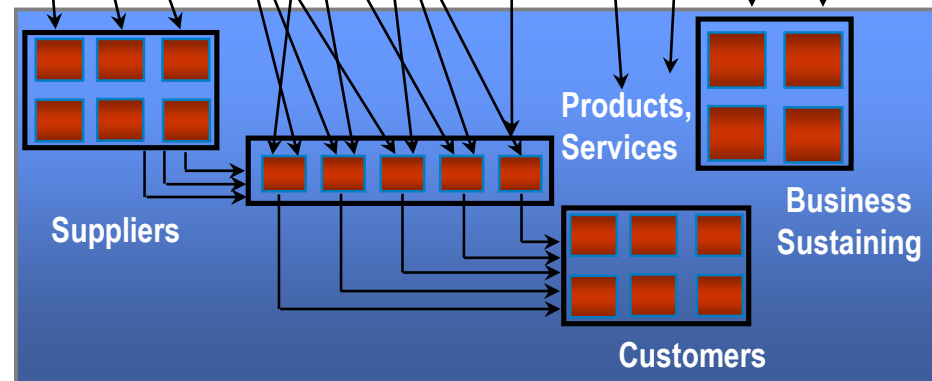
Work Activities  
(verb-noun)



People Activities

Final Cost Objects

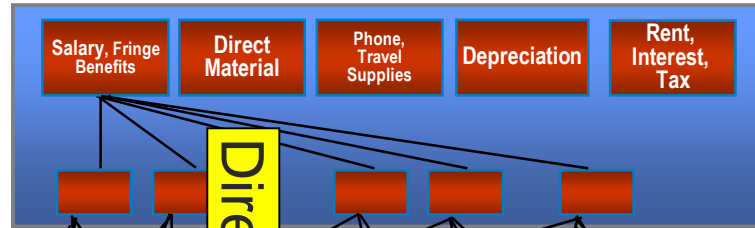
“Costs Measure the Effects”  
(1) Demands On Work ↑ Costs (2)  
↓



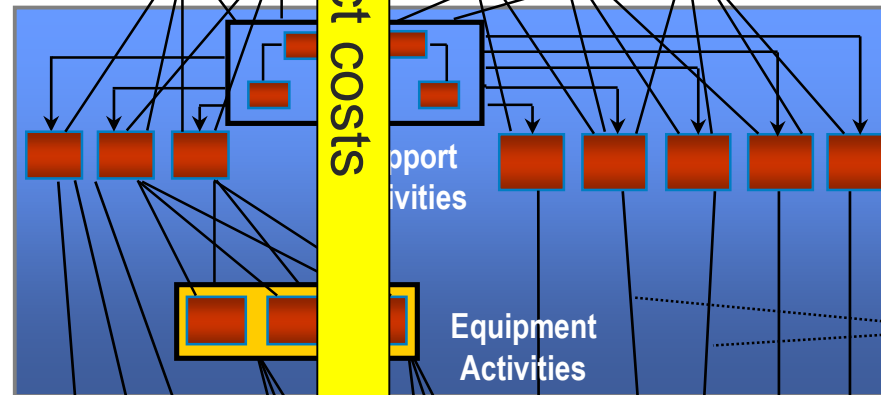
“cost-to-serve” paths

# ABC/M Cost Assignment Network

Resources  
(general ledger view)



Work Activities  
(verb-noun)

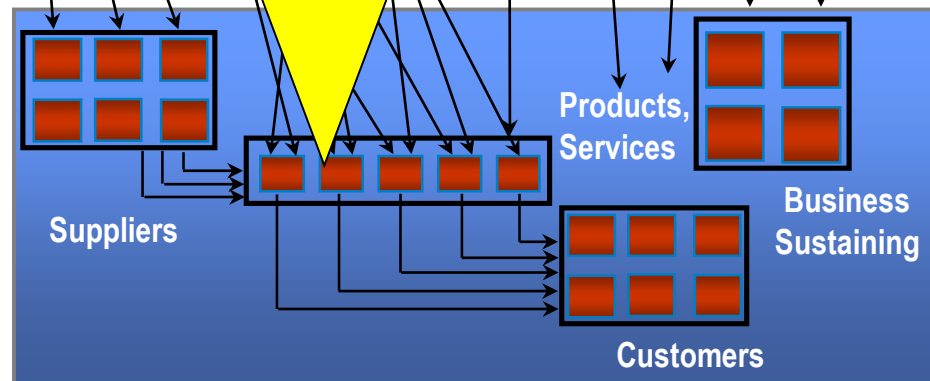


People Activities

"cost-to-serve" paths

Final Cost Objects

"Costs Measure the Effects"  
(1) Demands On Work  
↑ Costs (2)



# Further detail readings

To read in more detail about the multi-stage ABC cost assignment network, below is a link to content that I have authored.

It is titled “A Statement on Management Accounting – Implementing ABC”.

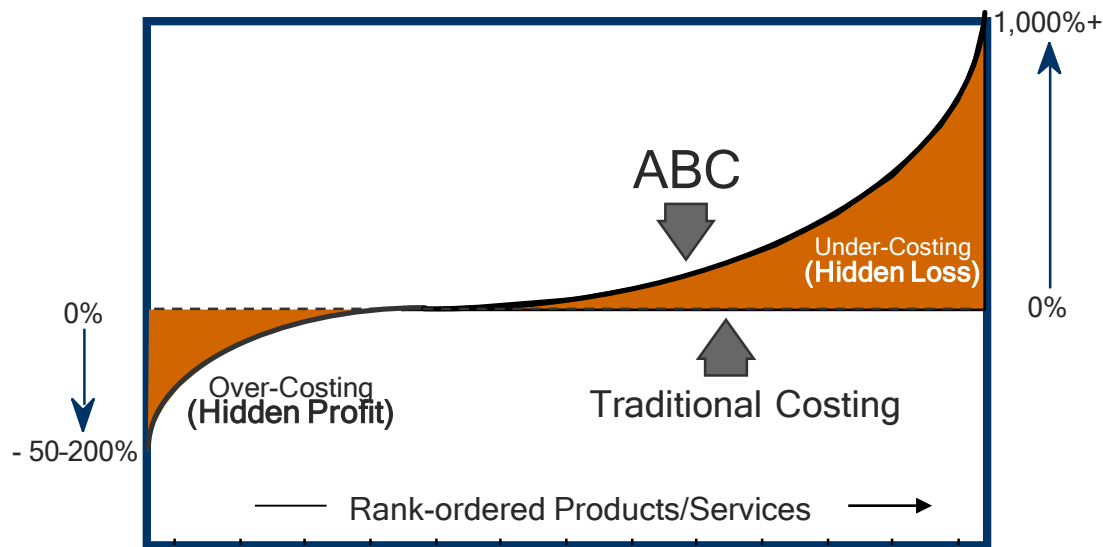
I wrote it for the Institute of Management Accounting (IMA) at [www.imanet.org](http://www.imanet.org)

<https://www.imanet.org//-/media/d5beff30c5864c7383e6ebb61556bab3.ashx?as=1&mh=200&mw=200&hash=E34259B80CE1AC68ED6AB8363D05635AE19BAB91>

# Standard Costing Over- and Under-Costs Products

% error distortion per unit

Competitors grab sales with a lower price that is profitable to them.

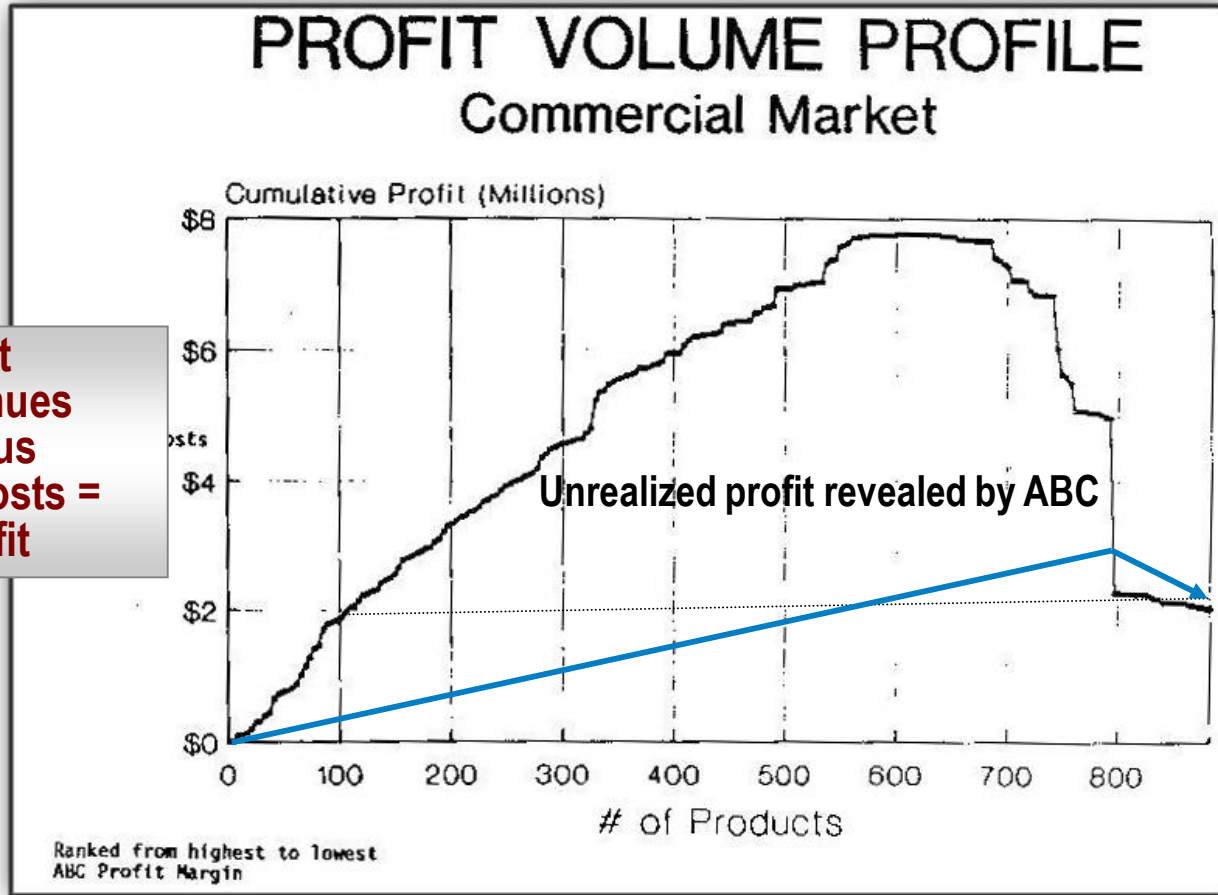


The sales force wins volume with prices that in reality are unprofitable.

- Simple Products and Services
- made through generic processes
- High Volume of Production

- Complex Products and Services
- made through specific processes
- Low Volume of Production

The “Whale Curve” – More important than a better costing method are its results. It is always a shock to the organization how many products and service lines are unprofitable. This is real information.



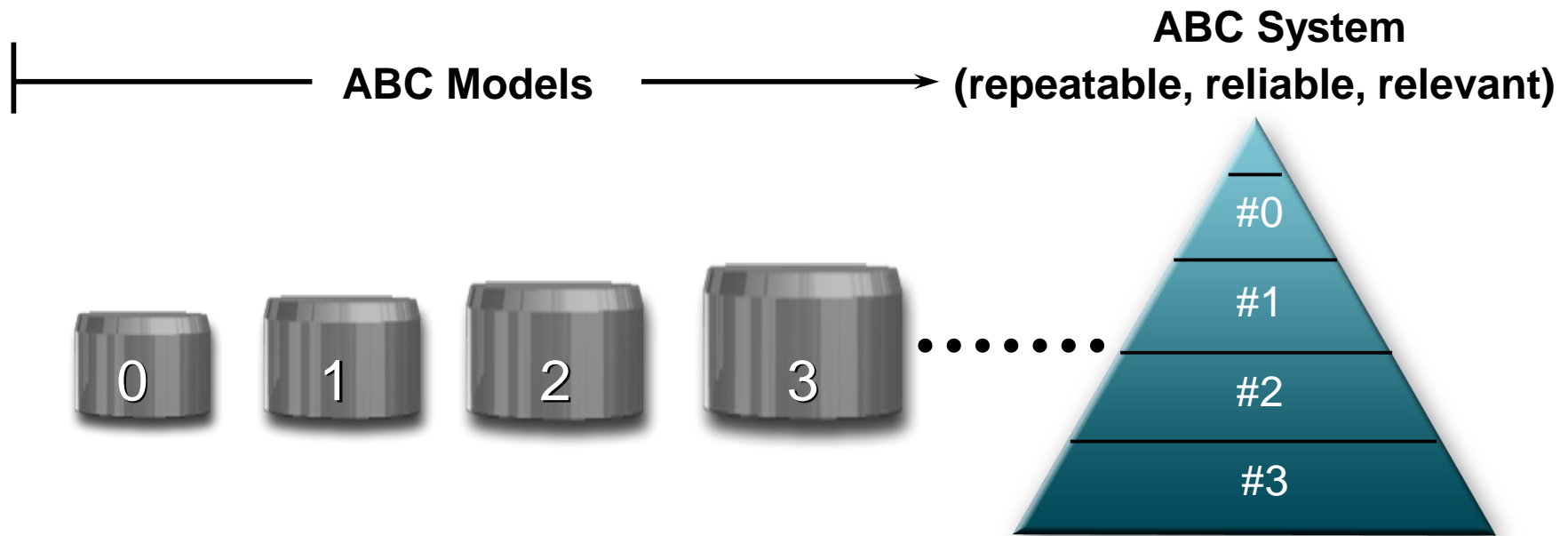
**Net  
Revenues  
Minus  
ABC costs =  
profit**

$$\begin{array}{r} \$ 30 \text{ sales} \\ - 28 \text{ expenses} \\ \hline = \$ 2 \text{ profit} \end{array}$$

← \$ 2 profit

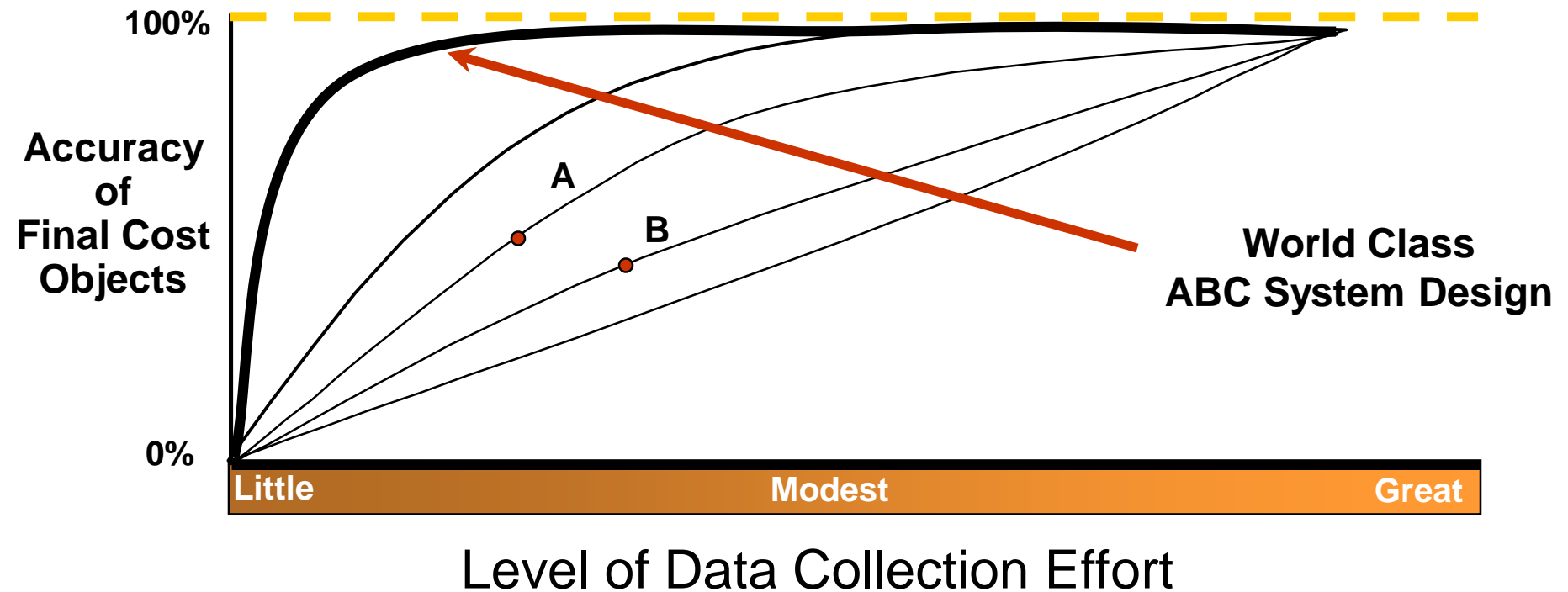
# Rapid Prototyping with *Iterative Remodeling (crawl, walk, run, fly)*

Each iteration enhances the use of a ABC system.



Make your mistakes early and often, not later when the system is too hard to change.

# Balancing Levels of Accuracy with Effort

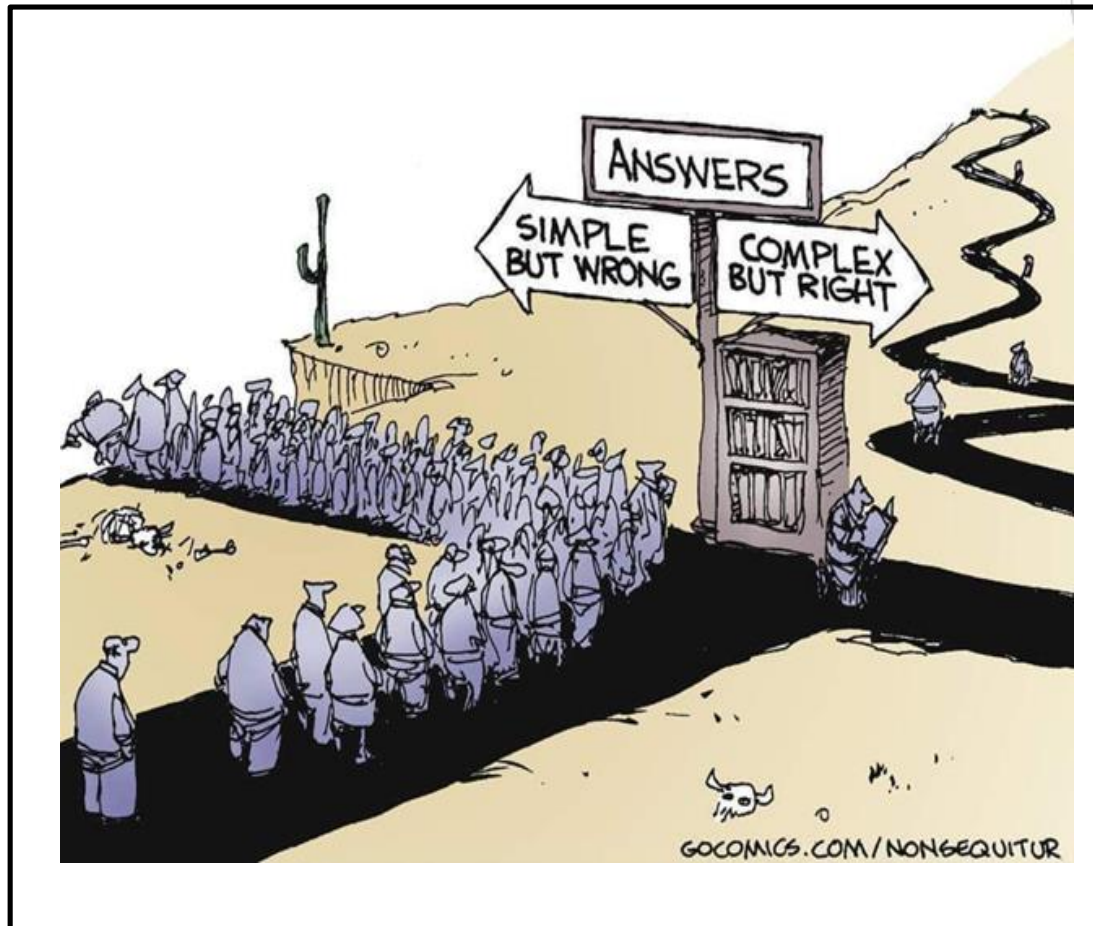


Is the higher climb worth the better view?

# Benefits from ABC/M Rapid Prototyping

- Accelerated learning
- Solving the thorny “leveling” problem
- Preventing “over-engineering” ABC model size
- Peer group: Pre-determining uses for the information
- Replacing misconceptions with reality.
- Getting ROI from earlier insights and decisions.

# Most CFOs take the left-side path!



# AGENDA

- A basic primer on costing and EPM
- What is broken with budgeting?
- The shift to rolling financial forecasts
- Dealing with resource capacity planning
- Getting buy-in to overcome resistance

# Why is the budgeting process broken?

The budget is typically a fiscal exercise by the accountants that is:

- disconnected from the executive team's strategy.
- not based on future driver volumes.

# A Quiz. “Our budgeting exercise ... “

- is invasive and time-consuming ... with few benefits.
- takes 6 months from start-to-end.
- requires two or more executive “tweaks” at the end.
- is obsolete in two months due to events and re-organizations.
- starves the departments with truly valid needs.
- caves in to the “loudest voice” and “political muscle.”
- rewards veteran sand-baggers who are experts at padding.
- incorporates last year’s inefficiencies into this year’s budget.
- Is over-stated from the prior year’s “Use-it-or-lose-it” spending.

# Spreadsheet Budgeting – It is Incremental !!

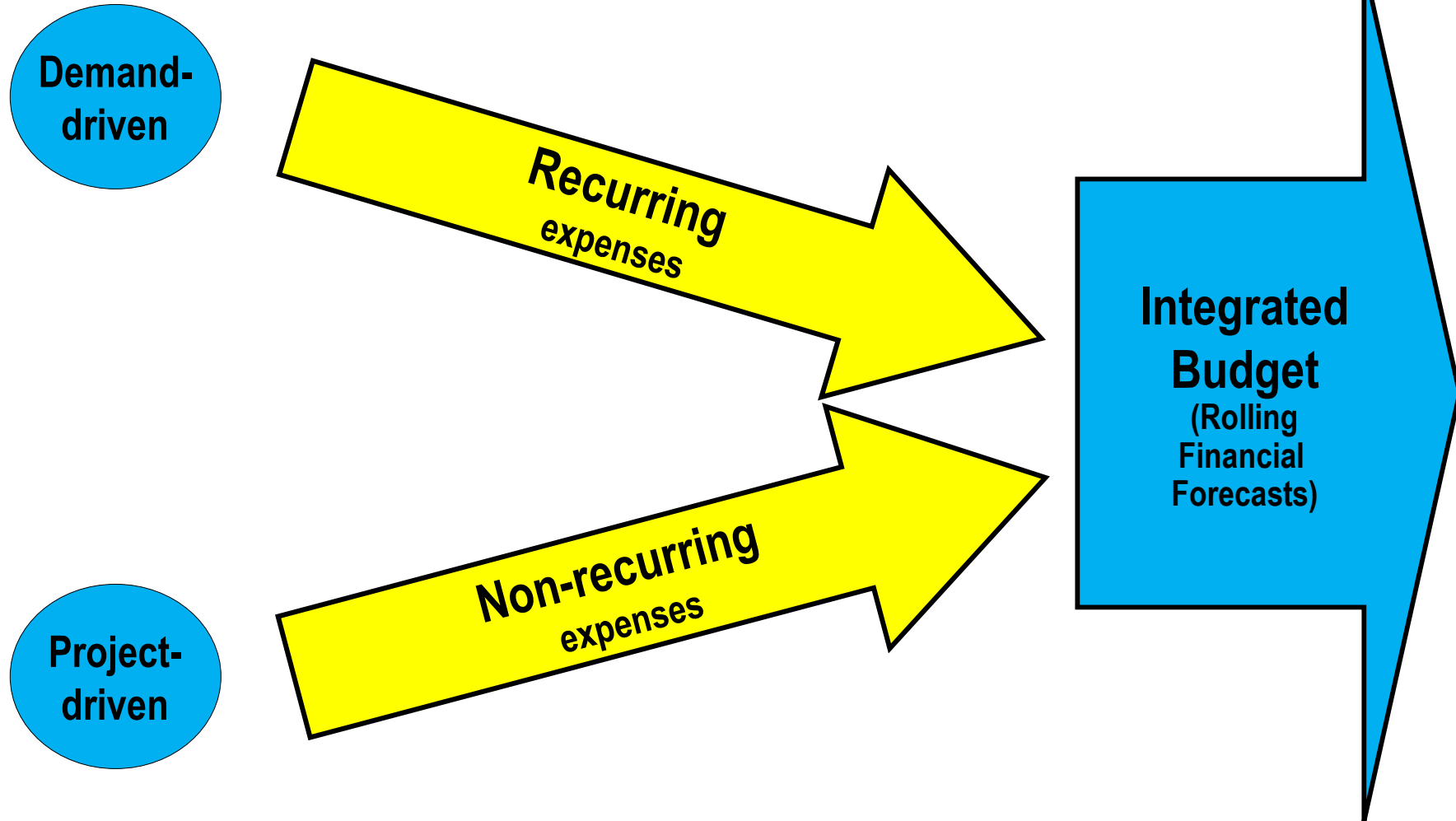
	a	b	c
1		<b>Current Year</b>	<b>Budget Year</b>
2	<b>Wages</b>	<b>\$ 400,000.00</b>	<b>Formula = Column B * 1.05</b>
3	<b>Supplies</b>	<b>\$ 50,000.00</b>	
4	<b>Rent</b>	<b>\$ 20,000.00</b>	<b>Copy down</b>
5	<b>Computer</b>	<b>\$ 40,000.00</b>	
6	<b>Travel</b>	<b>\$ 30,000.00</b>	
7	<b>Phone</b>	<b>\$ 20,000.00</b>	
8	<b>Total</b>	<b>\$ 560,000.00</b>	

Sheet 1

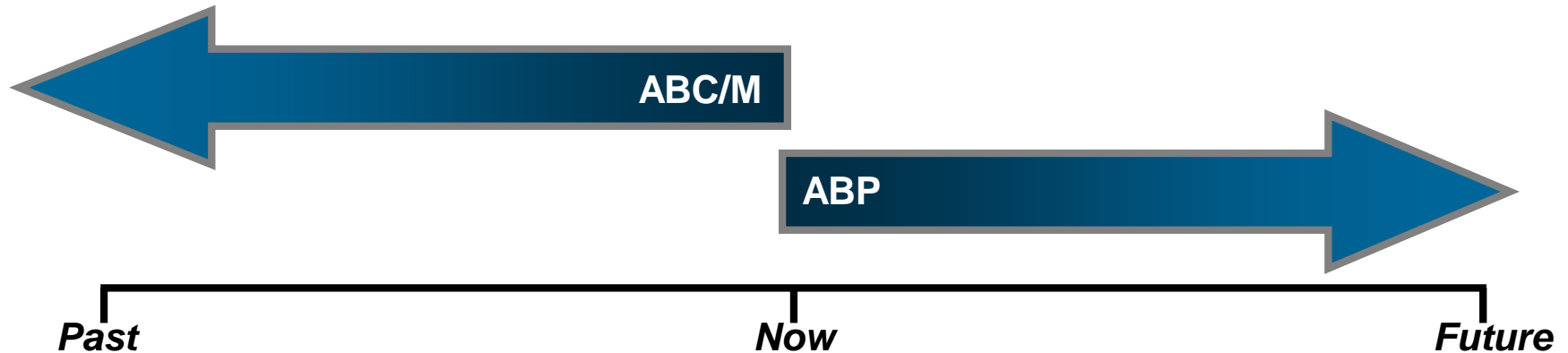
# AGENDA

- A basic primer on costing and EPM
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- Getting buy-in to overcome resistance

# Match the Budget Method to its Category



# Recurring Expenses // Future Volume & Mix



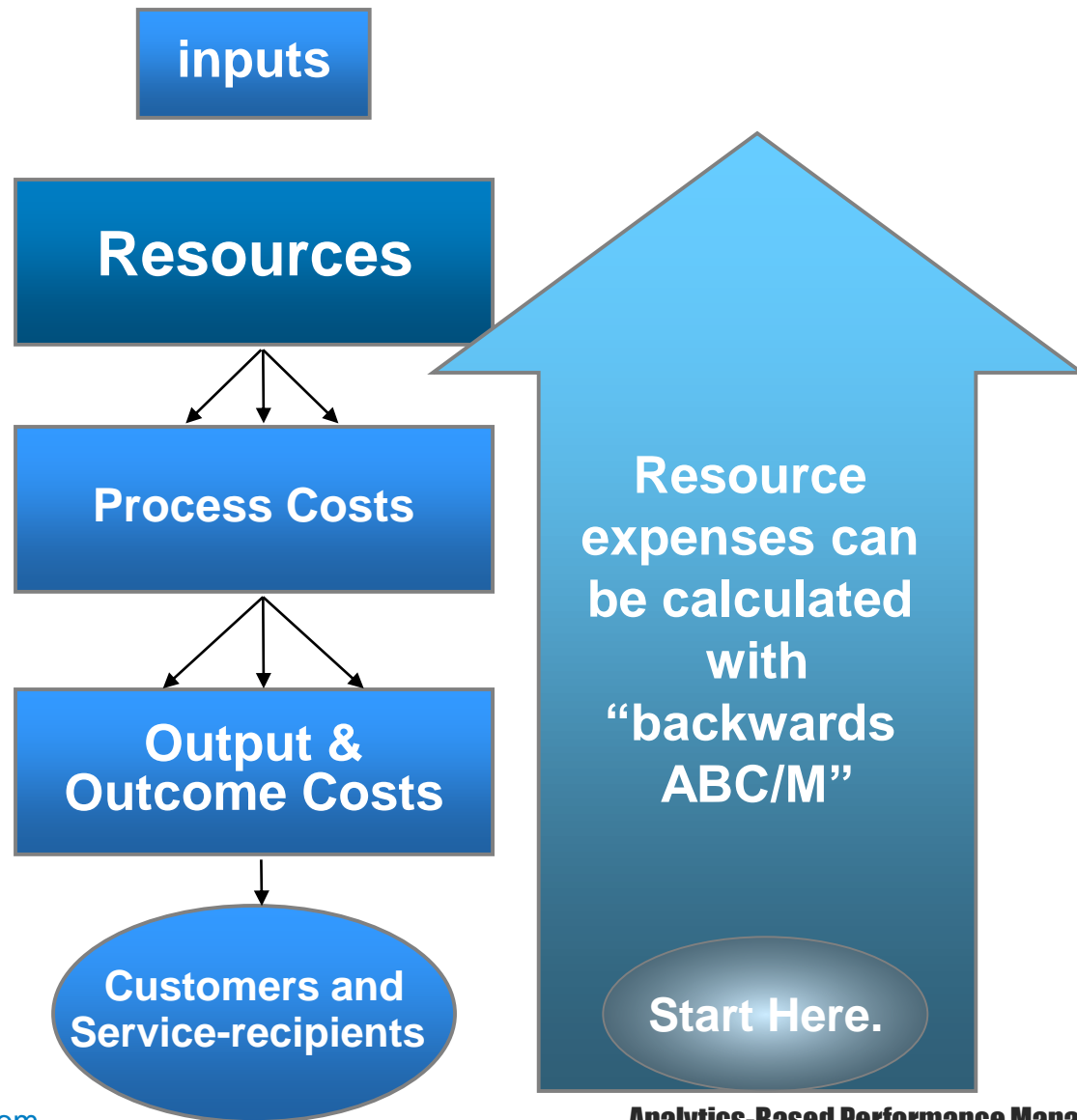
## ■ Activity-Based Costing

- Historical & Descriptive
- Starts with known:
  - spending
  - driver measures
  - output quantities
- Calculates “costs”

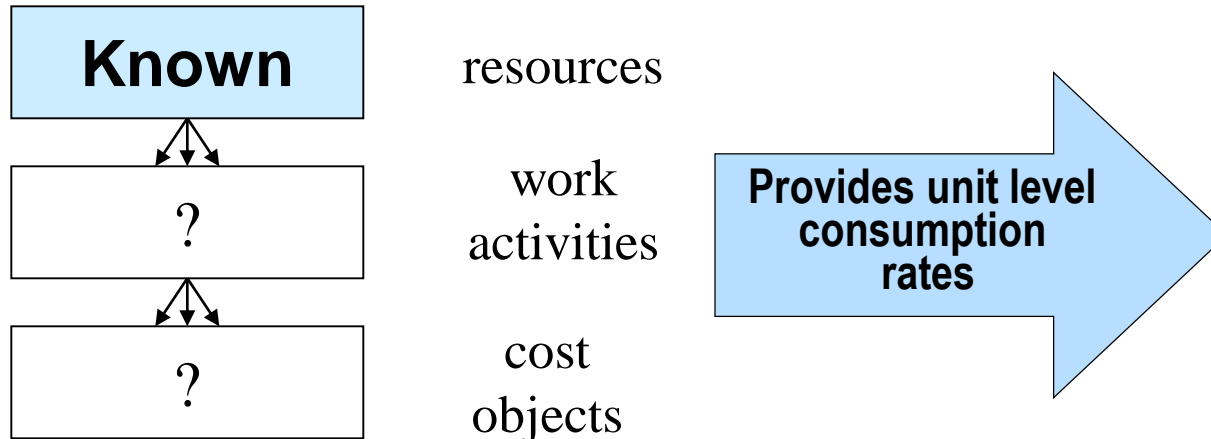
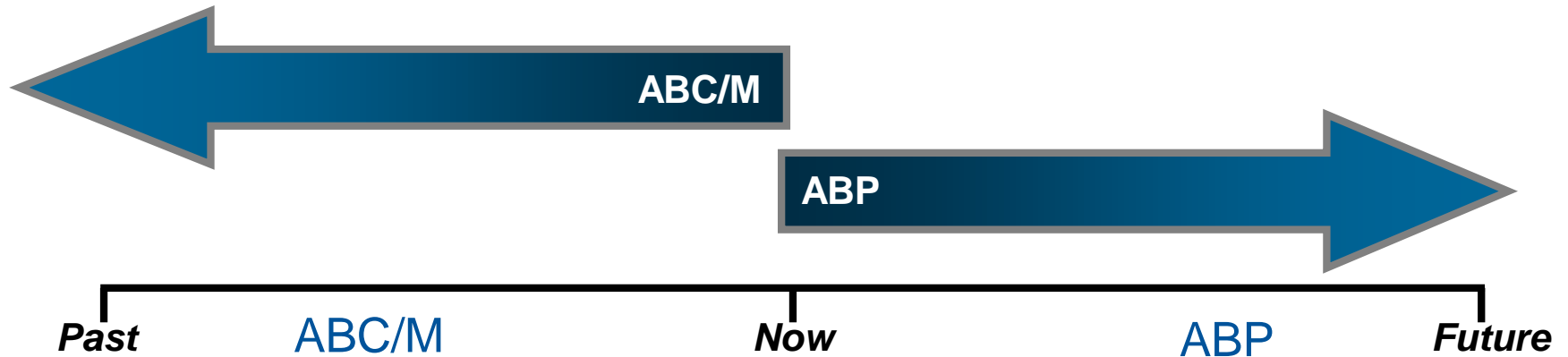
## ■ Activity-Based Planning

- Predictive
- Requires capacity analysis
- Starts with estimated outputs
- Applies ABC/M rates
- Solves for Resource “expenses”

# (1) Operational Resource Capacity Planning

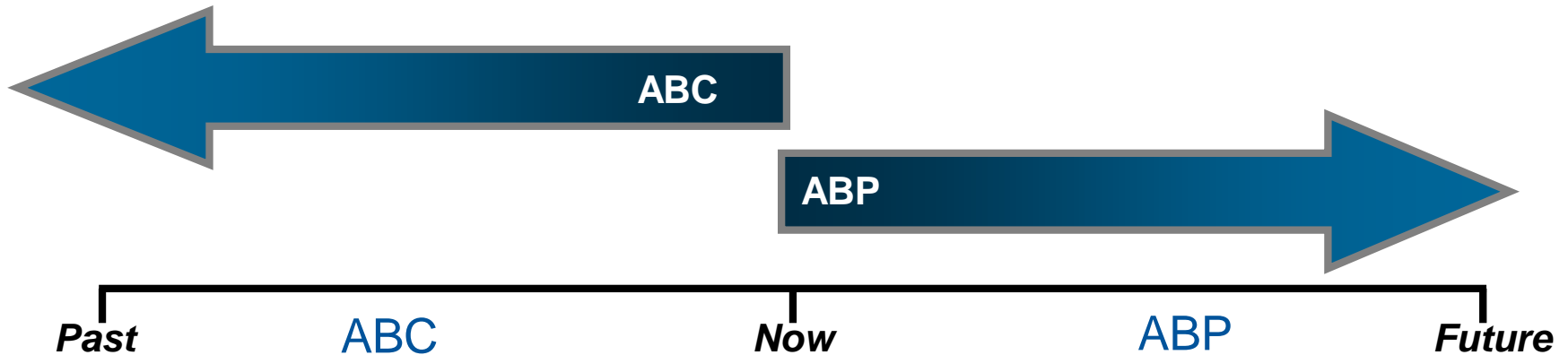


# Predictive Accounting



# Predictive Accounting ...

... calculate the historical cost network backwards



## Industrial Engineering 101

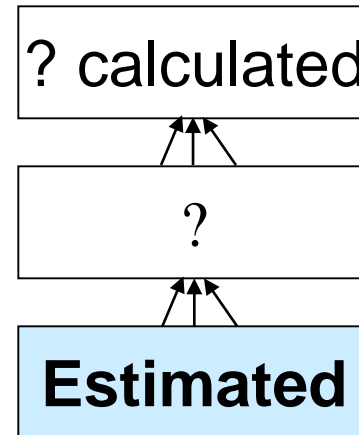
$(\text{demand volume and mix}) \times$   
 $(\text{unit level cost consumption rate})$   
 $=$   
 $\text{capacity required}$

(e.g., number and type of employees,  
purchases with suppliers)

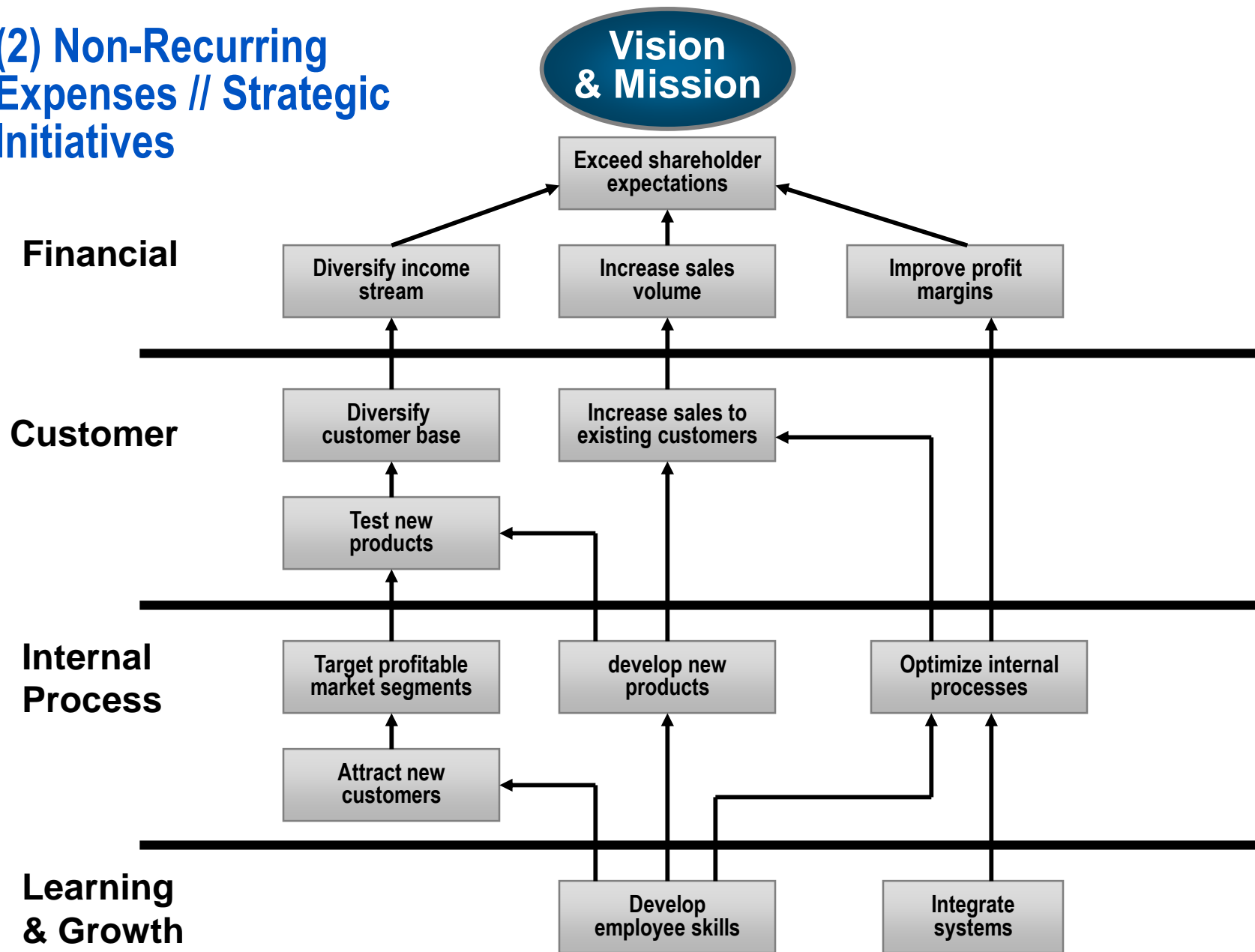
resources

work  
activities

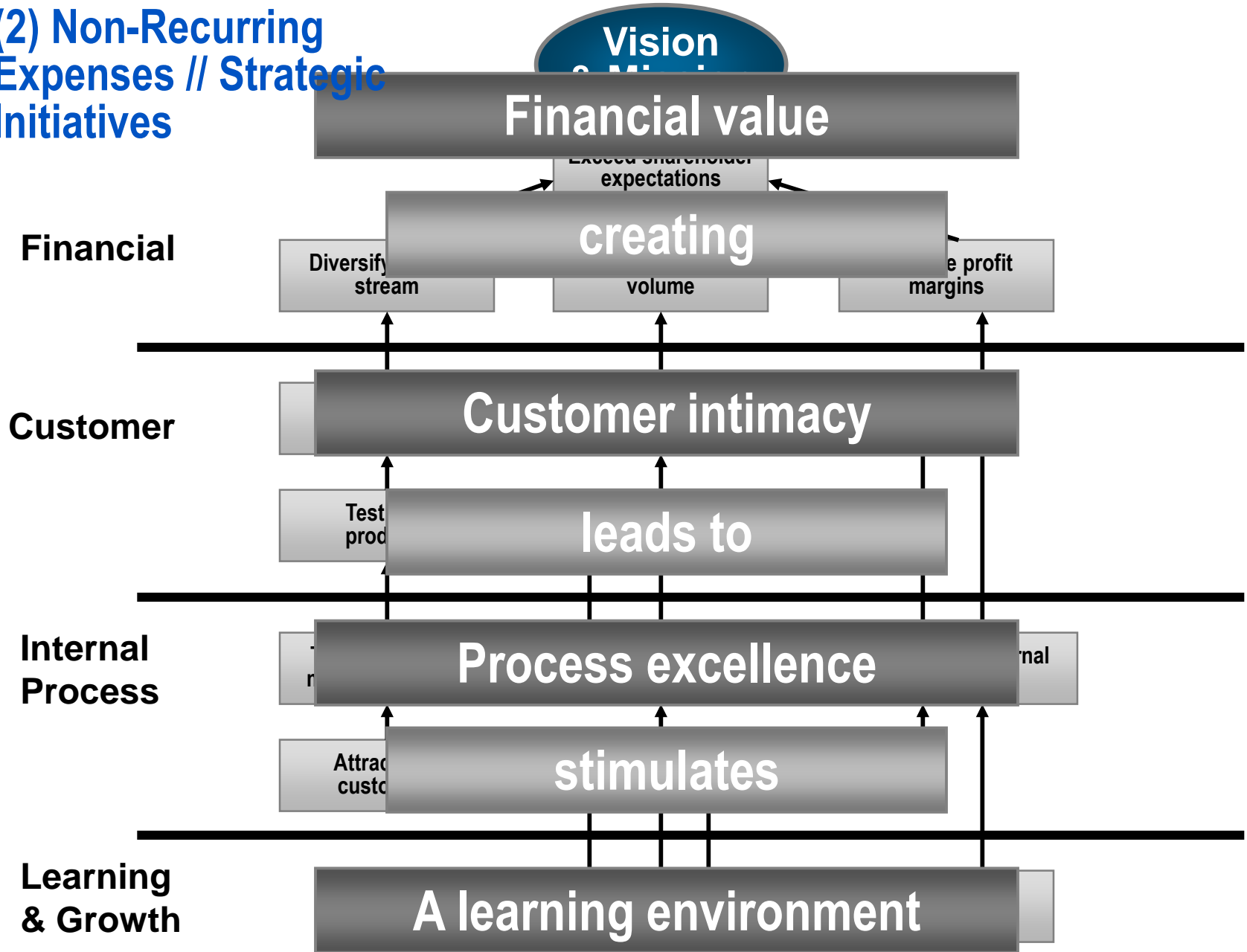
cost  
objects



## (2) Non-Recurring Expenses // Strategic Initiatives



**(2) Non-Recurring Expenses // Strategic Initiatives**



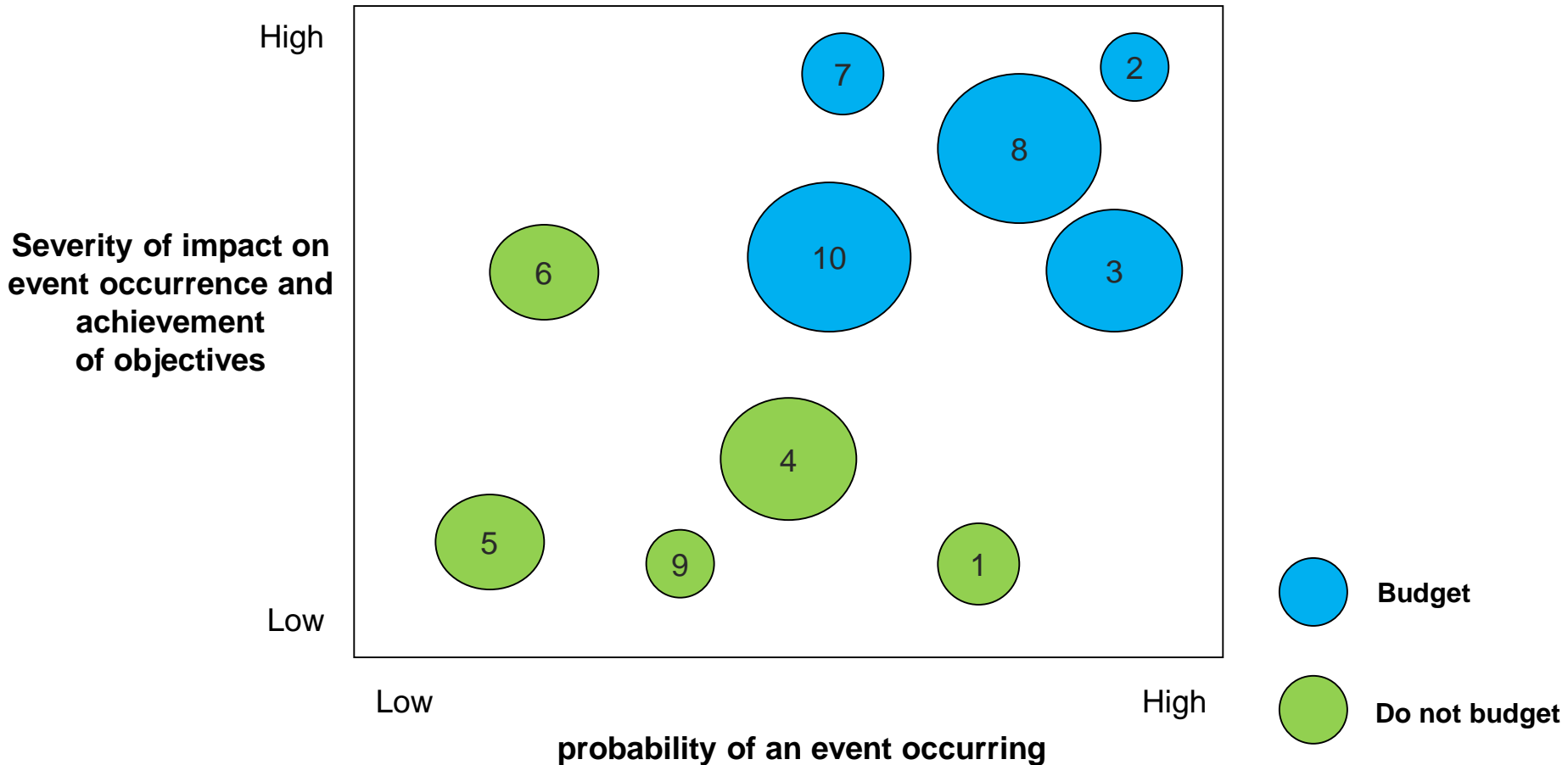
## (2) Non-Recurring Expenses // Strategic Initiatives

Measurement Period;	1st Quarter					
	Strategic Objective	Identify Projects, Initiatives, or Processes	KPI Measure	KPI Target	KPI Actual	comments / explanation
Executive Team	X			X		
Managers and Employees		X	X		<i>their score</i>	X
					<---- period results ----->	

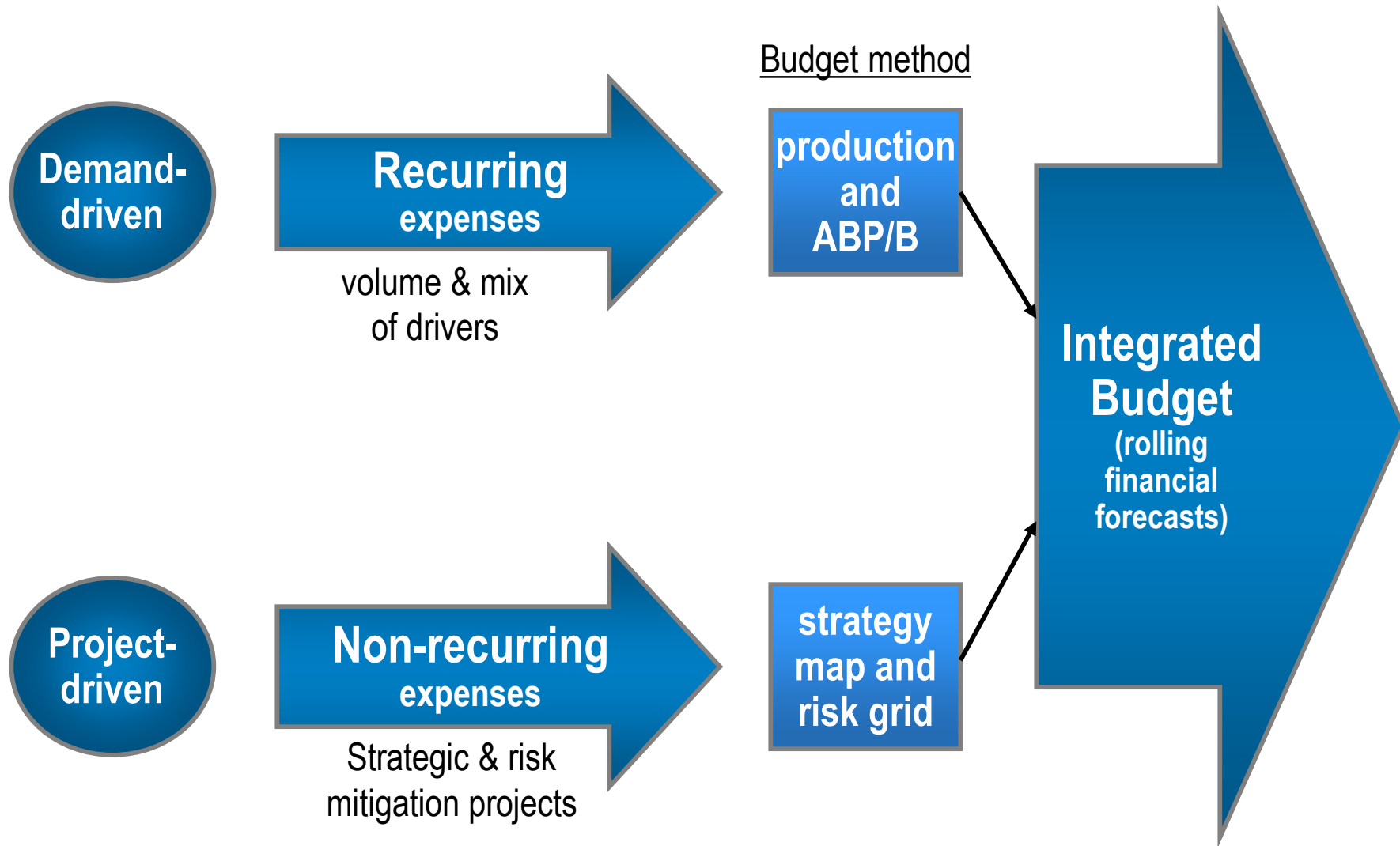
**Budgeting is typically disconnected from the strategy. But this problem is solved if management funds the managers' projects.**

# (3) Risk Assessment Grid

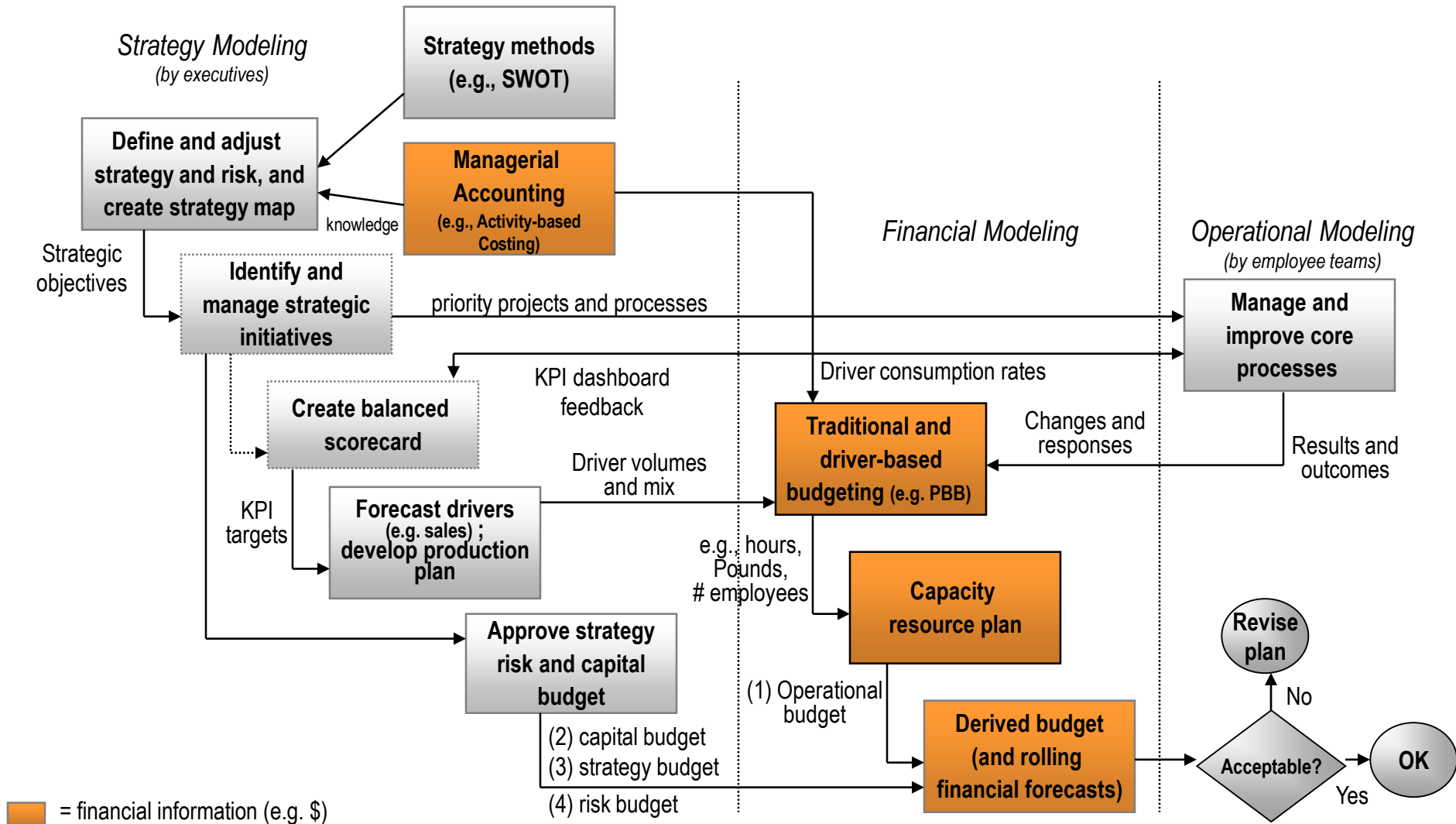
... ERM is not just contingency planning



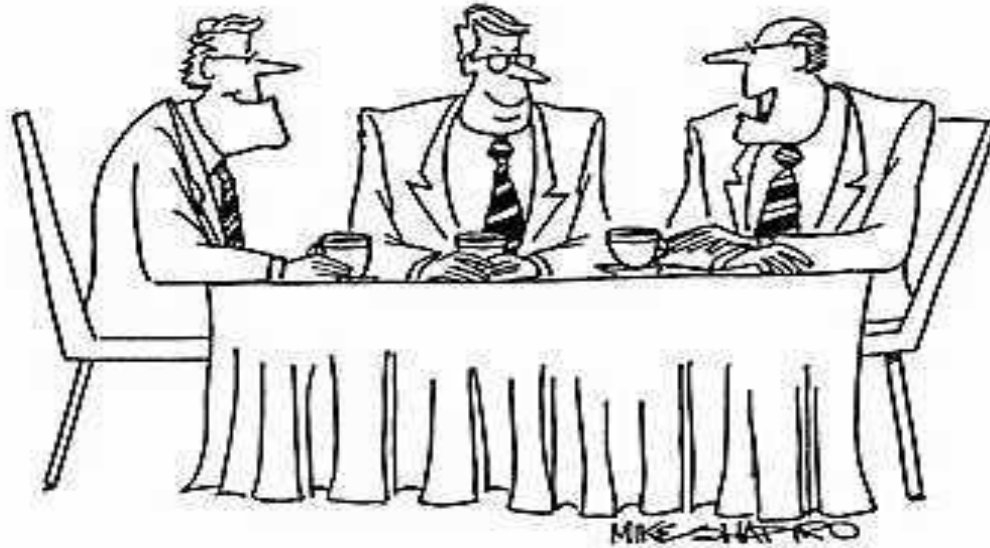
# Match the Budget Method to its Category



# Linking Strategy and Risk to the Budget



# Don't treat forecasting as a "special event."

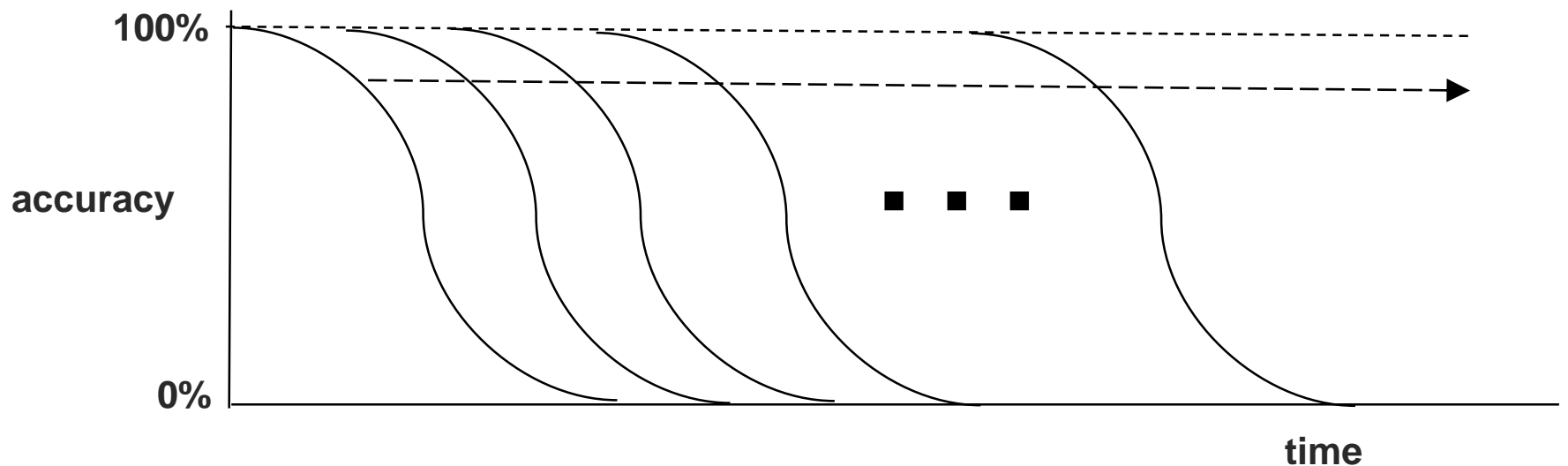


*We haven't forecasted in a while,  
maybe we should try that again....*

Forecasting should be an on-going part of monitoring the business.

# Continuous refreshing the rolling financial forecast

**More frequent forecast intervals assure better accuracy.**

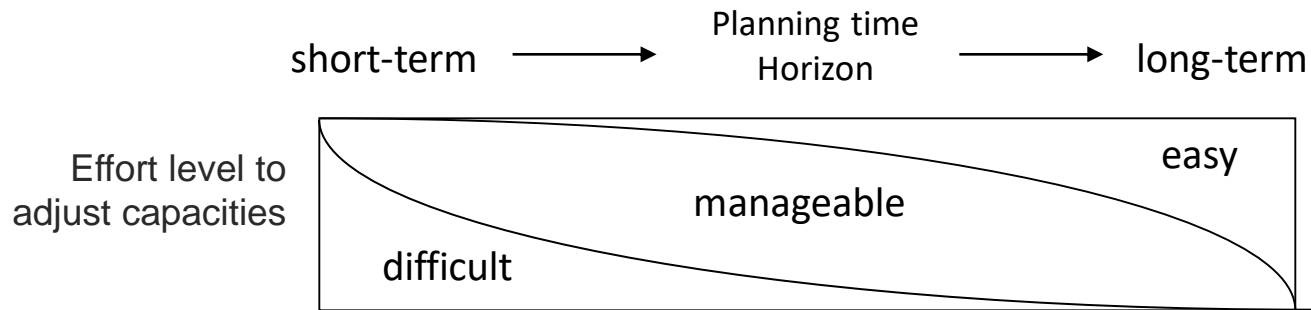


# AGENDA

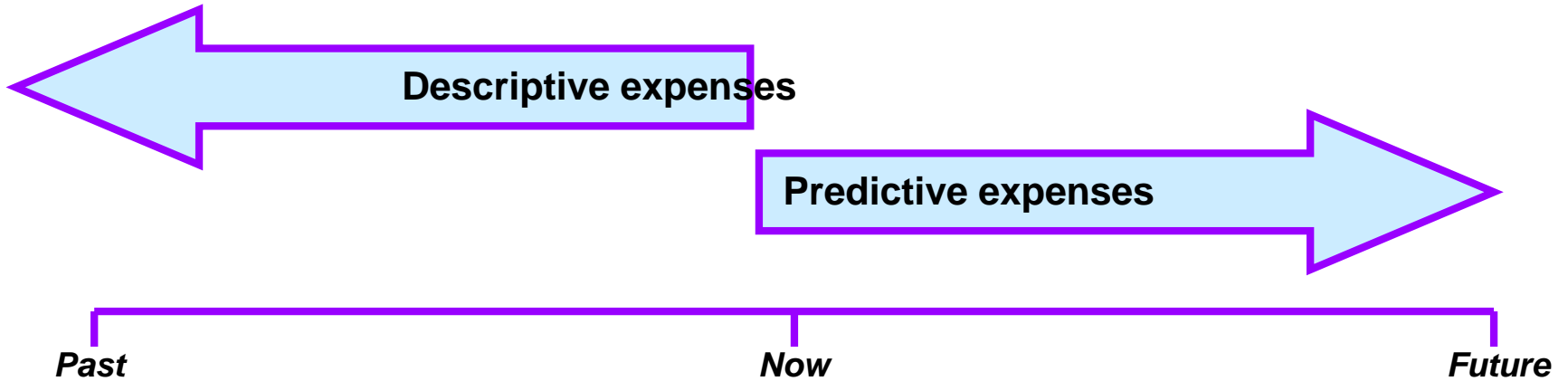
- A basic primer on costing and EPM
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# Capacity only Exists as Resources

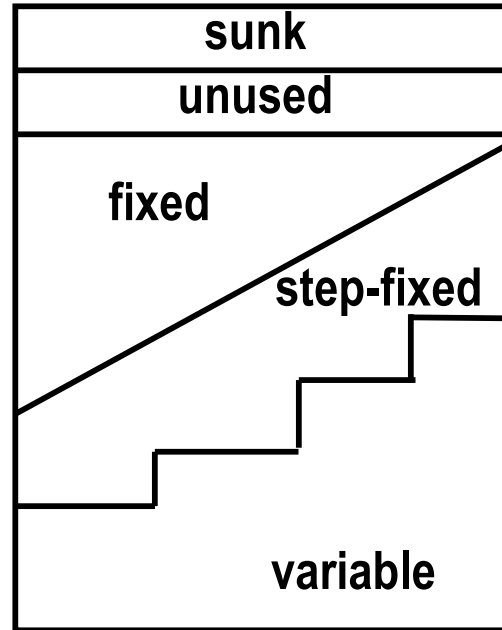
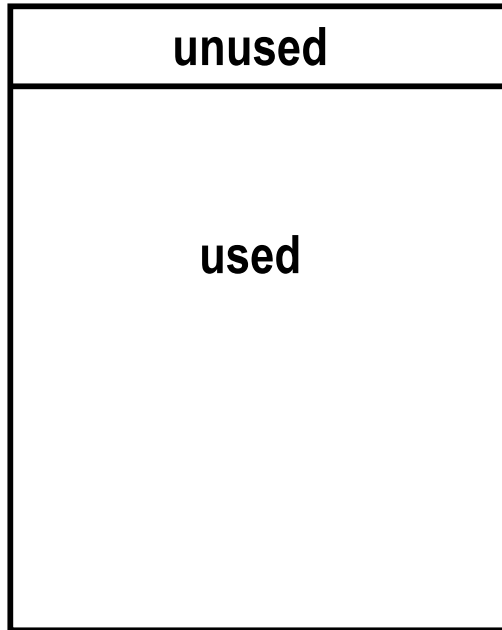
In the very short term, you would not fire employees on Tuesday due to low work load, but hire them back on Wednesday. But in the future you may replace full-time employees with contractors, or lease assets you might have purchased. In this way, so-called fixed costs behave variably.



# Predictive Accounting



*Traceable to costs of products, service-lines, channels, customers, and business sustaining*



# Marginal / Incremental Expense Analysis

**Most savvy managers know that some expenses are fixed short-term and variable long term.**

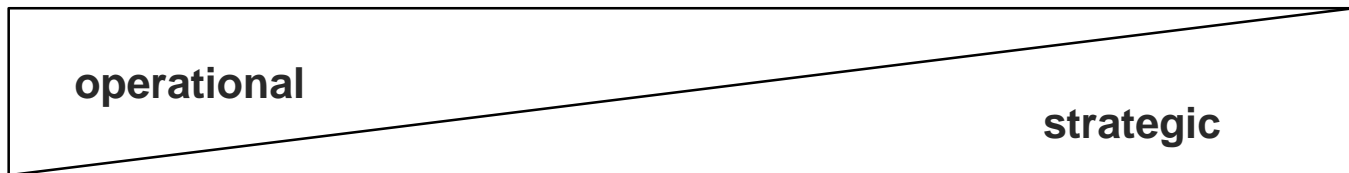
**They want to know the financial impact of a decision.**

## **Decision Examples:**

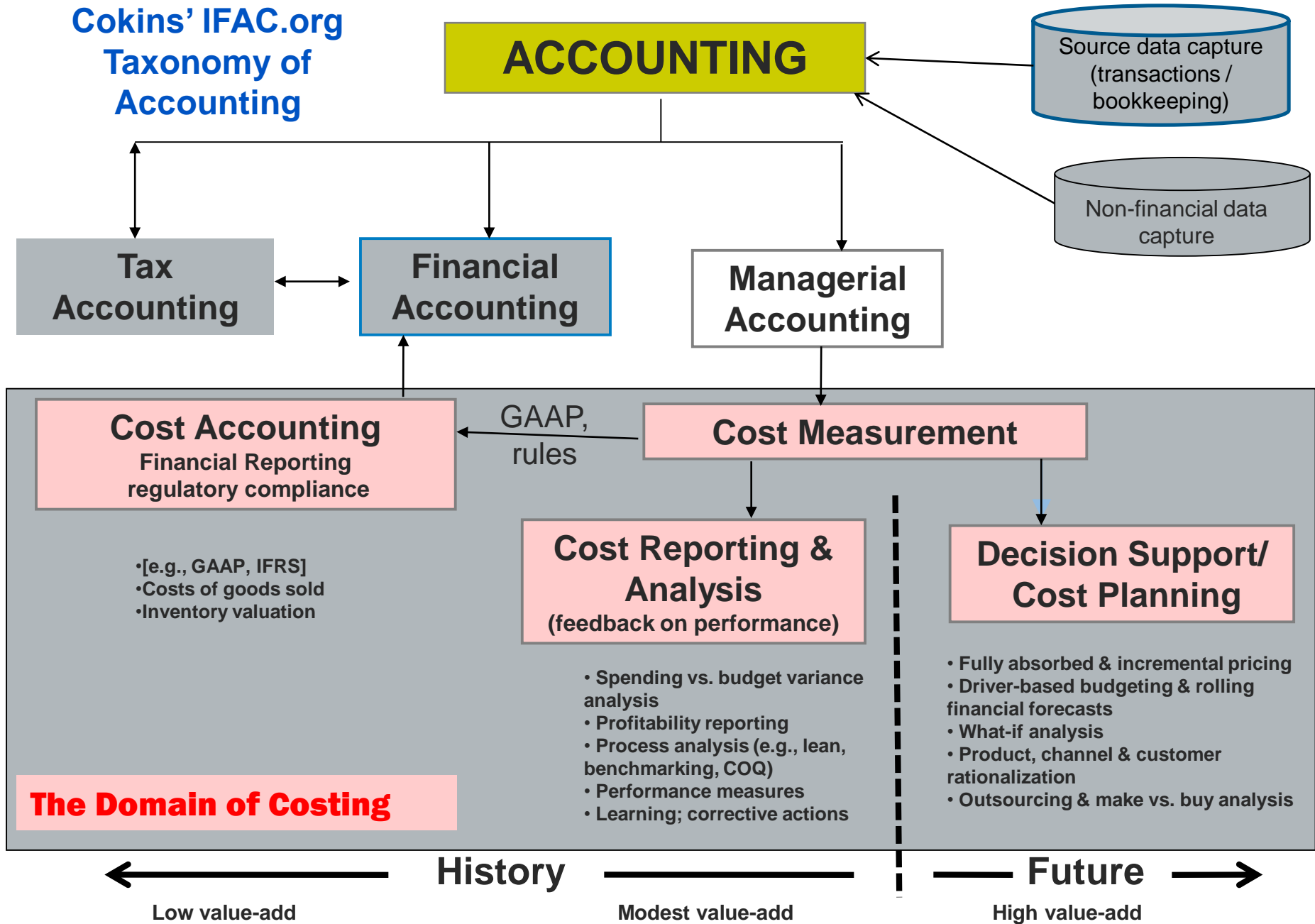
- **Adding / dropping products, channels, or customers**
- **Make versus buy**
- **Outsourcing or not**
- **Capital investment justification**
- **Budgeting / rolling financial forecasts**

# Resource classifying dependencies

<u>Expenses</u>	One-time order; demanded price	---- <i>type of decision</i> →		Large capital expenditure
Variable			■ ■ ■	
Step-fixed	X		■ ■ ■	
Fixed	X	X	■ ■ ■	
Sunk	X	X	■ ■ ■	X



**Cokins' IFAC.org  
Taxonomy of  
Accounting**

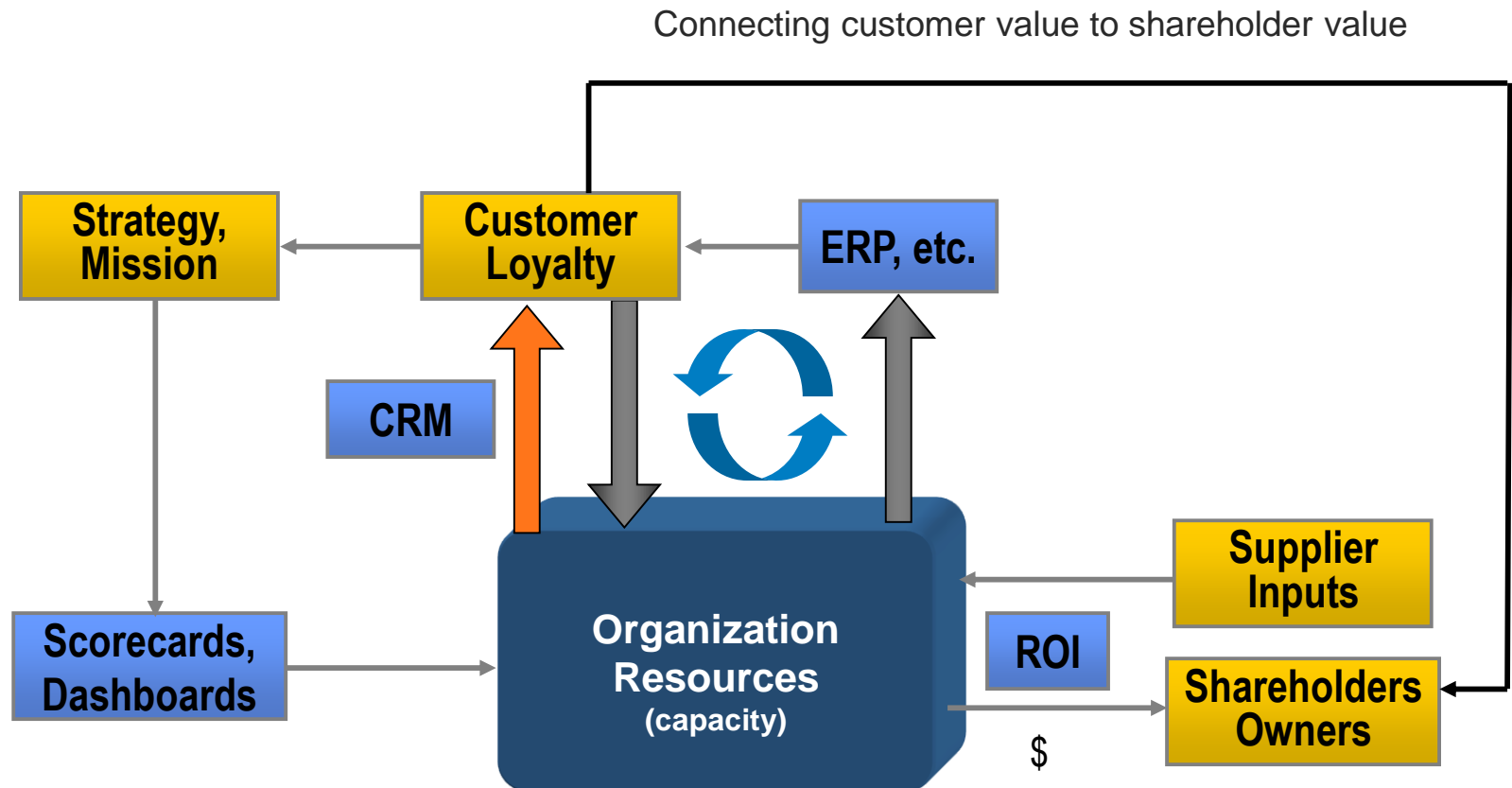


Source: PABC IGPG "Evaluating and Improving Costing in Organizations" published by the International Federation of Accountants, 2009

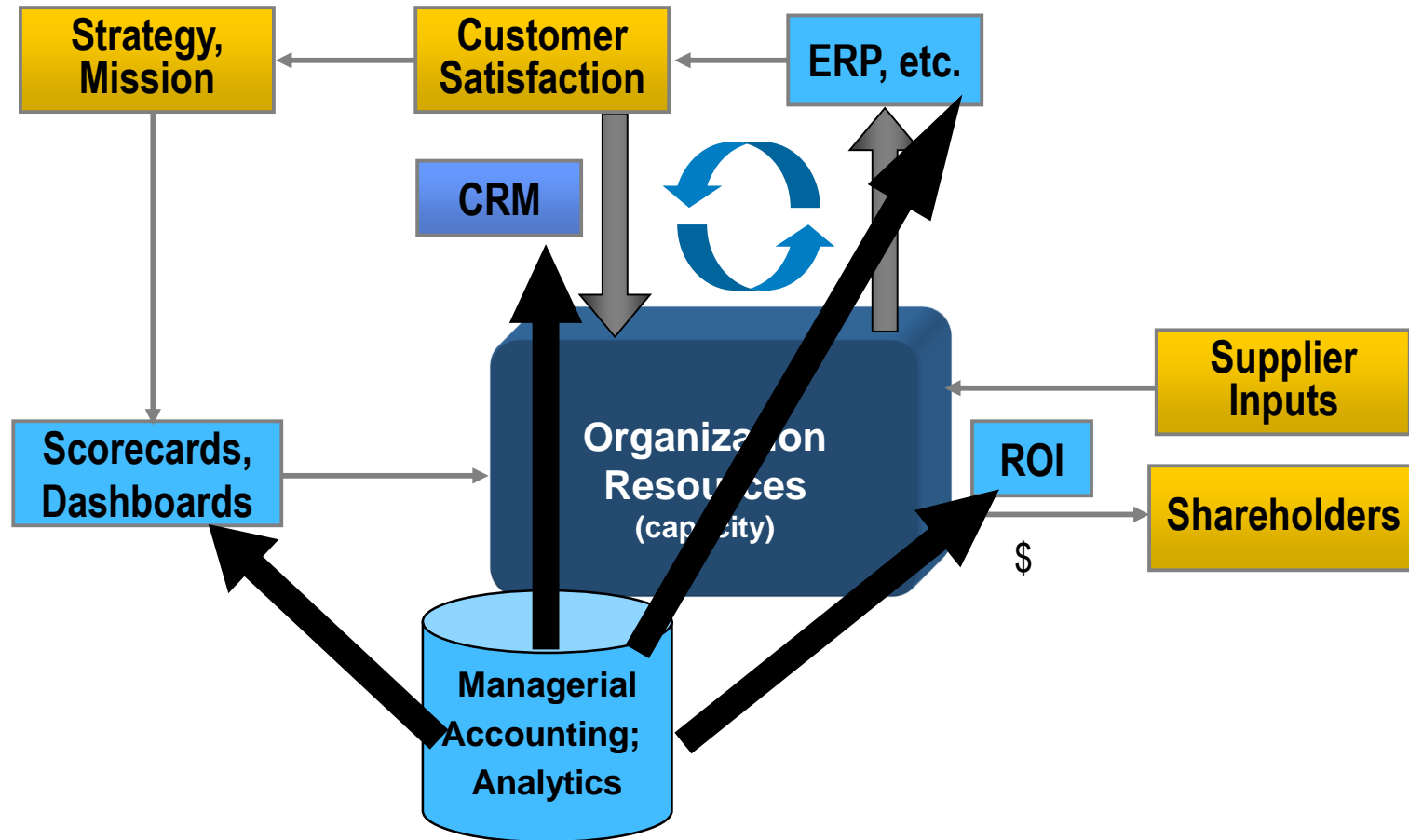
# AGENDA

- A basic primer on costing and EPM
- What is broken with budgeting?
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- Dealing with resource capacity planning
- ***CPM as a Value Multiplier through Integration***
- Getting buy-in to overcome resistance

# How Will It All Fit Together?

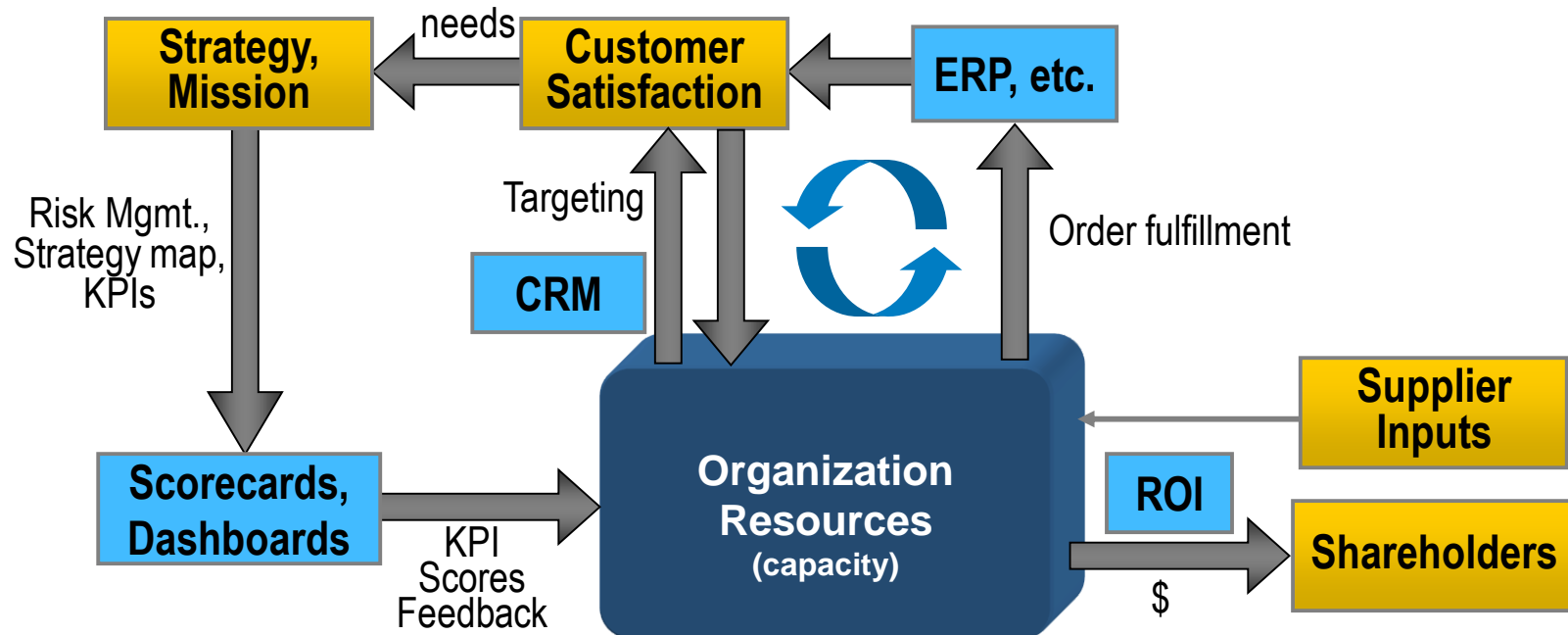


# In Summary ... first, we energize *with good managerial accounting.*



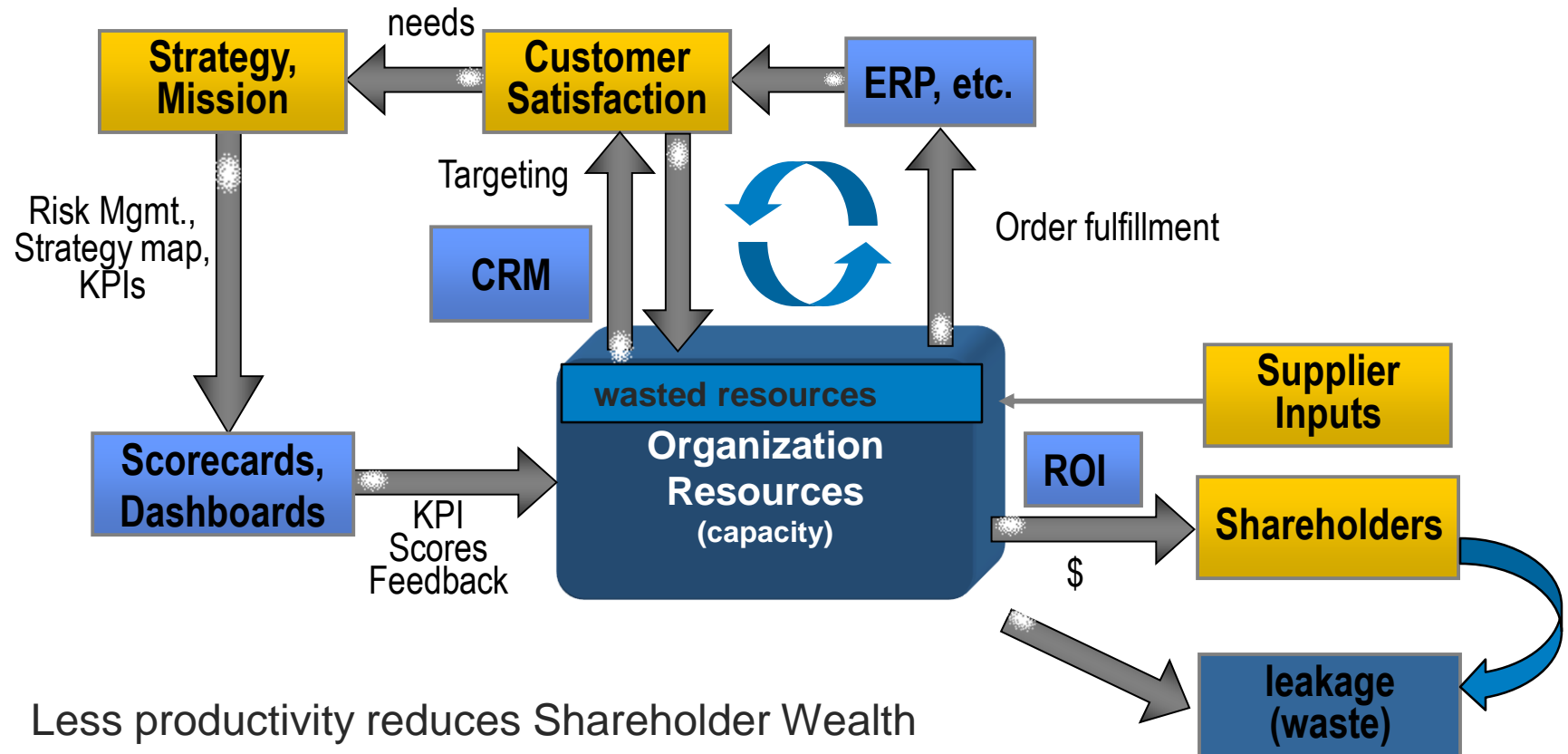
# CPM is Circulatory and Simultaneous

*Shareholder Wealth Creation is not a goal. It is a result!*



# CPM is Circulatory and Simultaneous

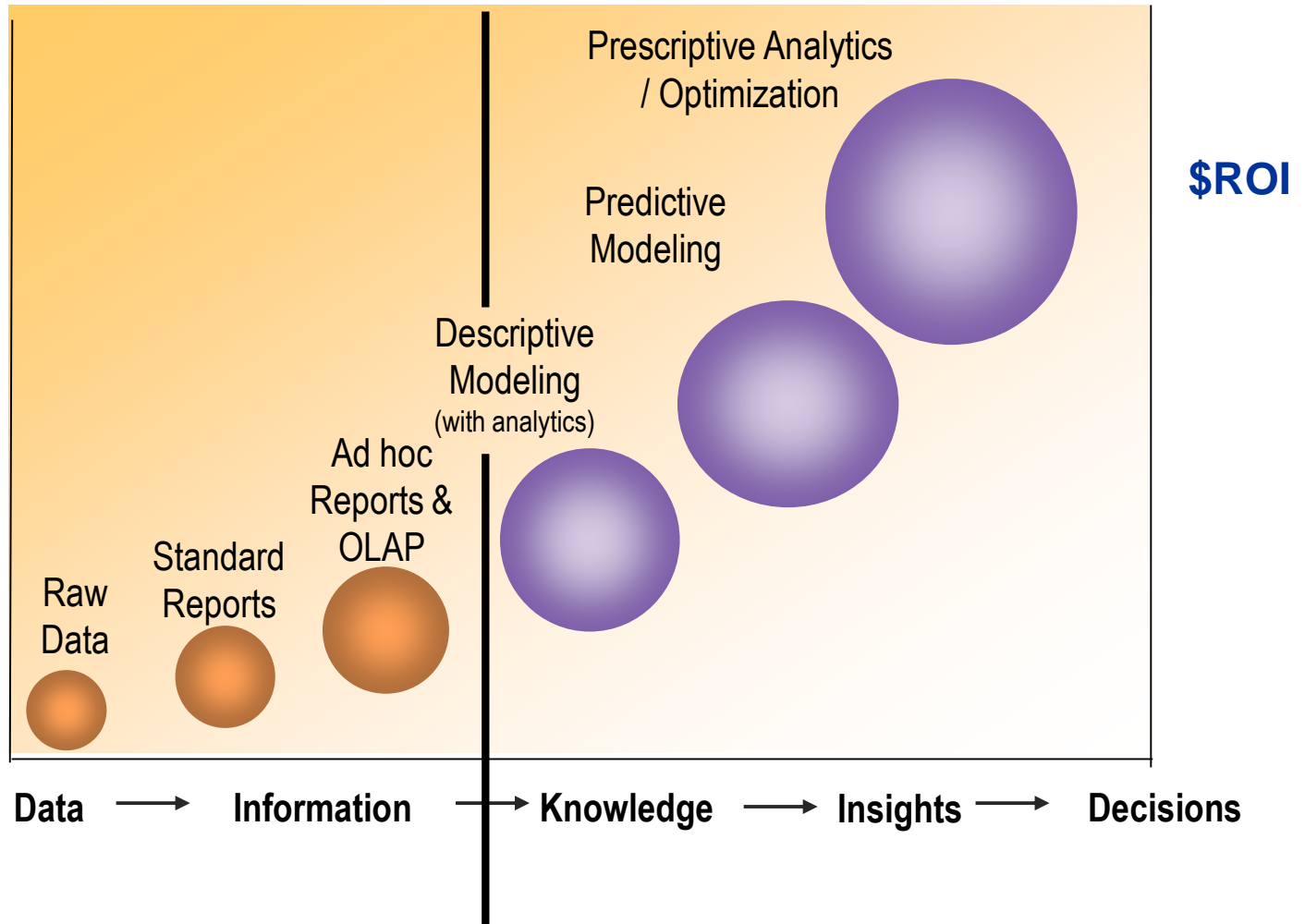
*Shareholder Wealth Creation is not a goal. It is a result!*



Less productivity reduces Shareholder Wealth

# The Intelligence Hierarchy

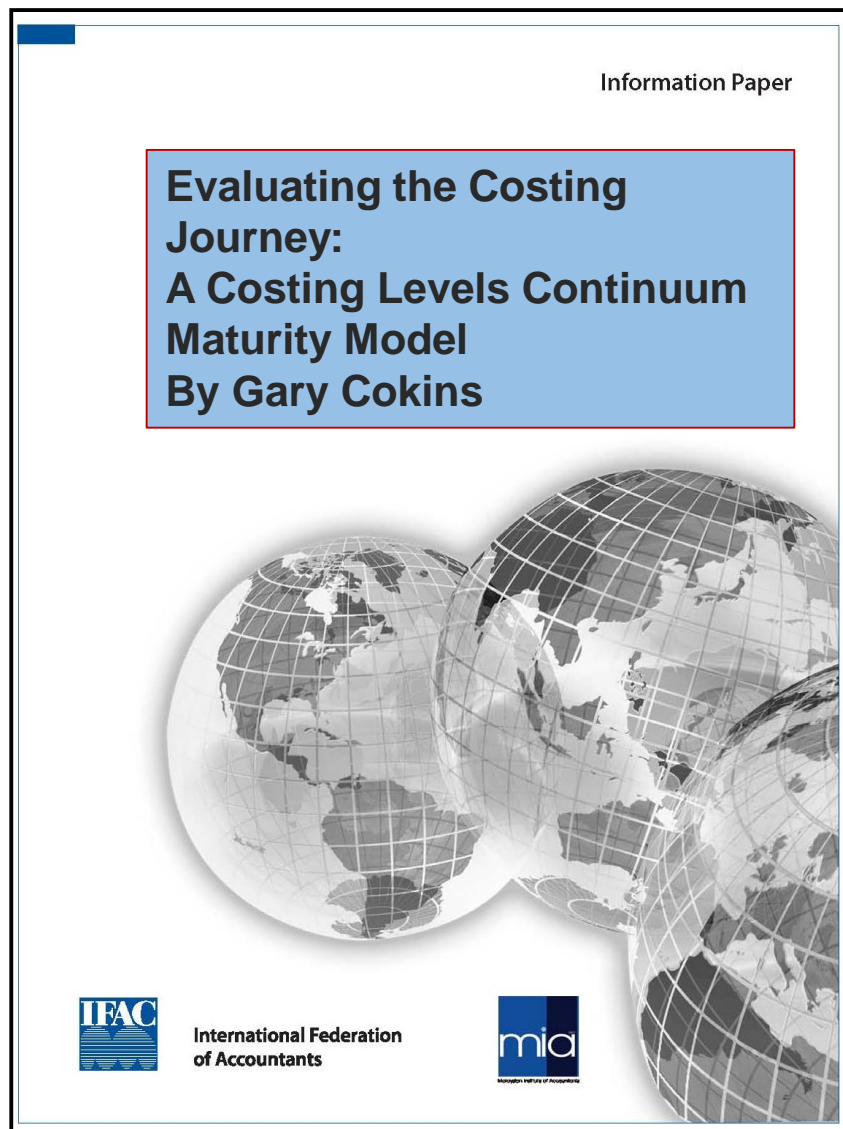
Power of Information



# AGENDA

- **A basic primer on costing and EPM**
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# International Federation of Accountants Report

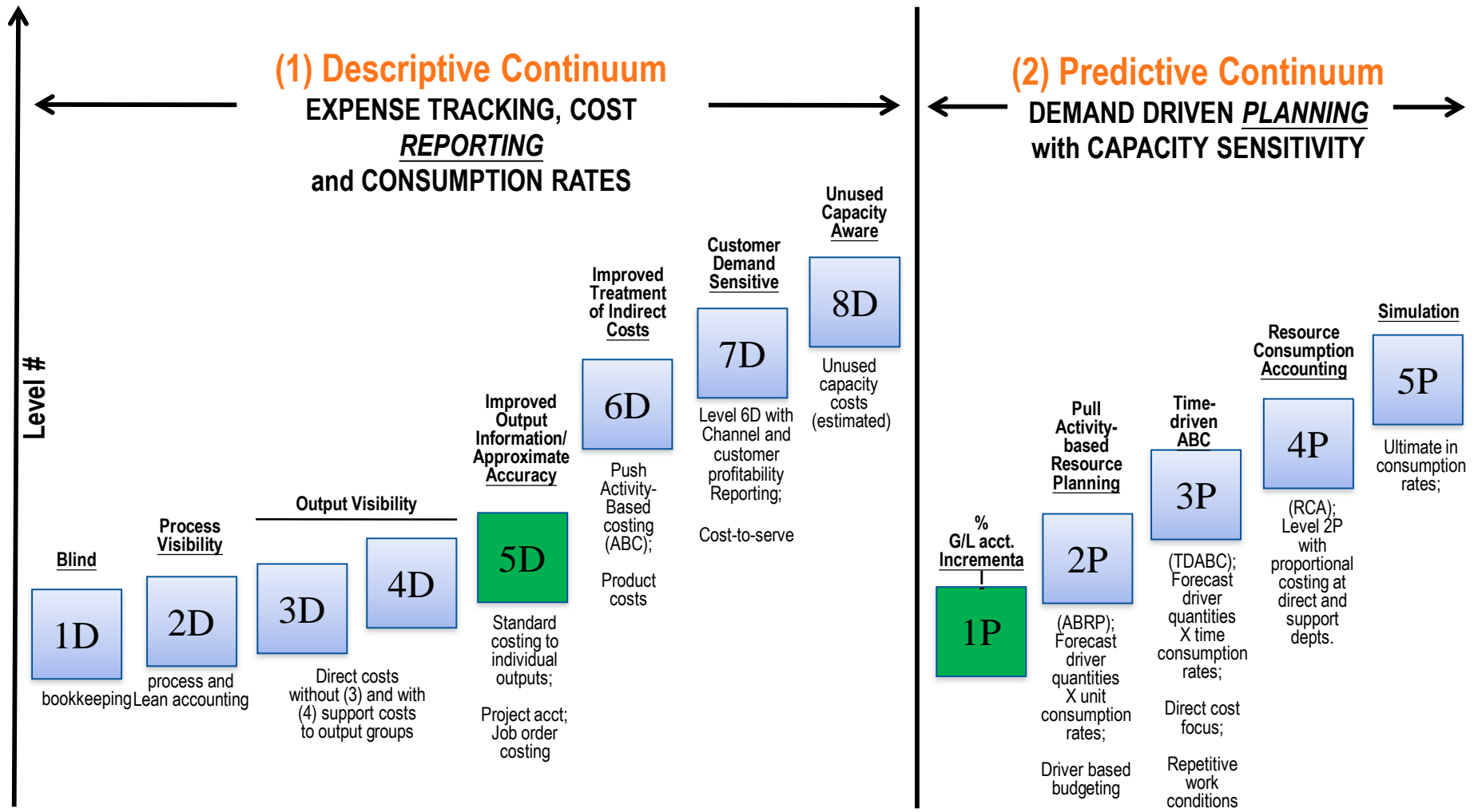


**Most organizations are typically at lower levels of maturity in adopting progressive managerial accounting practices, methods and systems.**

[http://www.garycokins.com/images/pdfs/20131105-IFAC\\_Evaluating\\_the\\_Costing\\_Journey\\_by\\_Gary\\_Cokins.pdf](http://www.garycokins.com/images/pdfs/20131105-IFAC_Evaluating_the_Costing_Journey_by_Gary_Cokins.pdf)

# Costing Continuum / Levels of Maturity

(most companies are Level 5D and 1P)



Source: "A Costing Levels Continuum Maturity Model" by Gary Cokins published by the International Federation of Accountants, 2016

# The Buy-in to Performance Management

Why has the adoption rate for driver-based budgeting (and EPM methods) been so slow?

# Why is the adoption rate so slow?

## What are the barrier categories?

- (1) Technical barriers include IT related issues.**
- (2) Perception barriers are excess complexity and affordability.**
- (3) Organizational behavior barriers involve resistance to change, culture, and leadership.**

# Typical Excuses Preventing Being Progressive

**We are profitable, so why does it matter?**

**We will purchase software that will fix our problems.**

**We already know our “true” costs from our general ledger financial reporting system.**

**We have done it this way forever. And we don’t do that here. We already know everything. It is in our heads.**

**We are a small organization. We’ll worry about better methods when we get larger.**

**All this hype is just made up stuff from highly paid consultants.**

**No one looks at the reports I create, so there is no point generating better reports.**

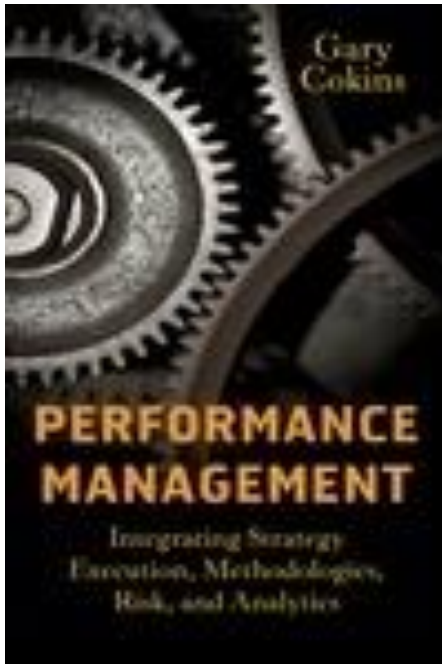
**We cannot afford better software to fix our problems.**

**We are way too busy doing other things.**

**We don’t know where to start or how to get started.**

Source: William Vaughn Company CPAs; IMA conference, June 20, 2018

# The Complete Vision of Performance Management



versus  
this



Make the RPM of the CPM and BA gears spin ...  
... better, faster, cheaper ... safer and smarter

# Getting Started Actions and Resources

## Action steps

- **Get educated. Get buy-in.**
- **Rapid prototyping. Start small; think big.**
- **Improve incentives. (Motivational theory)**

## Resources:

<http://fpa-trends.com/article/exceptional-epmcpm-systems-are-exception>

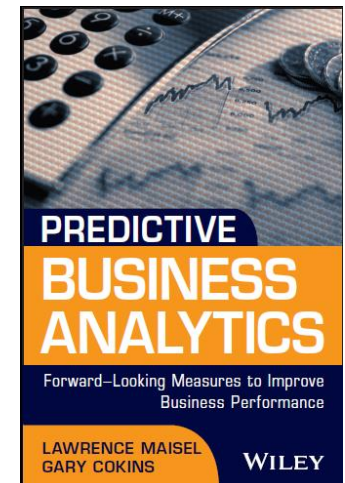
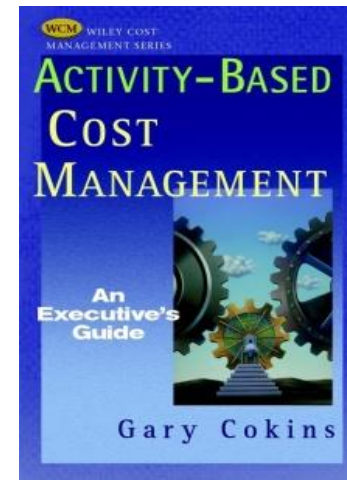
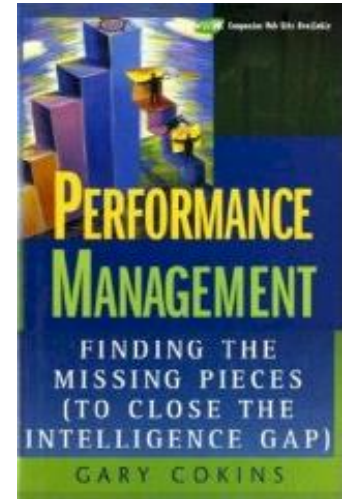
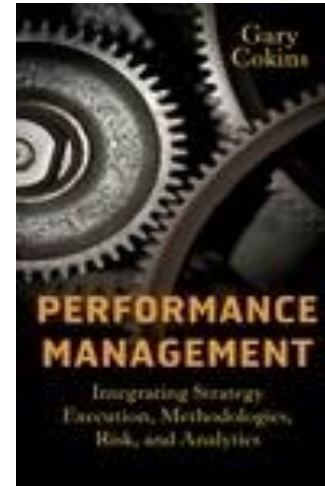
<http://www.cfothoughtleader.com/driver-based-budgeting-look-hood-top-finance-consultant-gary-cokins/>

<https://opexsociety.org/body-of-knowledge/enterprise-corporate-performance-management/>

**A suggestion: Have your management team read either or both of these educational pieces. Then schedule a meeting for discussion. Have each manager answer, “What did I learn? What issues and concerns do I have about EPM?” This will stimulate needed conversations.**

# From Theory to Practice

Your success depends on how well and how fast the right information and intelligence gets to the right people.



# Thank You

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