

Scenario Planning

PLOTTING A COURSE THROUGH AN UNCERTAIN WORLD

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What is the issue?

Uncertainty, volatility and unpredictability characterize the environment in which most organizations now operate.

Why is it important?

It challenges how an organization makes key decisions, which reinforces the need to develop and implement a robust decision-making model.

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Introduction to the concept

Imagine you are sitting at your desk. It's September 2007, the Dow Jones Industrial Average (DJIA) is close to 13,900; U.S. unemployment is 4.5%; oil is at \$45 a barrel; the U.S./Canadian dollar exchange rate is 0.95; and the U.K. economy is growing at a healthy 3% rate. You are in the middle of developing your organization's plans and budgets for 2008. How likely is it that the assumptions in your 2008 plan will accurately forecast that one year from now (October 2008) the DJIA will be below 9,000; U.S. unemployment will have risen to 6.5% on its way to more than 10%; oil will rise to over \$140 per barrel before falling back to below \$40; the U.S./Canadian dollar exchange rate will rise to more than 1.25; and that the U.K. economy will shrink by 5%? Never mind the impact of terrorist bombs in Mumbai, a collapsing housing market in the U.S. and the U.K., a global H1N1 pandemic, and an almost total freeze on credit. An aberration? Maybe; however, there is no doubt that volatility and uncertainty are here to stay, and managers are questioning

the logic of basing strategies, plans and budgets on a single, static view of the future that is derived from an extrapolation of past performance.

Increasingly, managers are realizing that the past is not a good predictor of the future — hence the growing interest in tools such as rolling forecasts, dynamic budgeting, contingency planning, and scenario planning.



For professional accountants, a working knowledge of scenario planning can help to apply core accounting disciplines such as cost management, profitability analysis, risk management, and performance measurement, as well as forward-looking strategic and operational planning, budgeting, and forecasting. Leading or participating in scenario planning programs:

- provides professional accountants with an opportunity to demonstrate real added value to their organizations,
- reinforces finance and accounting's role as a business partner, and
- is a significant addition to a professional accountant's skill set.

What is scenario planning?

Scenario planning provides a structured method for managers to evaluate alternative views of what may happen in the future as an aid to strategic, operational and financial planning. A scenario is a cohesive set of assumptions that describes a view of the future that is then used to develop a forecast or to test a strategy, plan or decision. Scenario planning is largely focused on answering three questions:

1. What could happen?
2. What would be the impact?
3. What are the implications for our organization?

For many organizations, scenario planning is now an integral part of their overall planning and risk management processes. As agility, flexibility and responsiveness have become prized strategic capabilities, scenario planning has become an important tool because it allows organizations to envision how their behavior will change in different situations. Scenario planning techniques are being used to help organizations better understand the implications of a broad range of decisions impacting business strategy, investment prioritization and operations. Of particular note to professional accountants is that many organizations are looking to integrate aspects of scenario planning into near-term management processes such as risk management, business case development, budgeting, forecasting and competitive analysis.

Why is scenario planning relevant?

Uncertainty, volatility, and unpredictability have come to characterize the environment in which most organizations now operate. For many, the luxury of relying on detailed long-term plans or budgets predicated on a stable view of the future has long gone. The global economic crisis of 2008–2009 served as a powerful wake-up call: On the one hand, managers began to understand the futility of trying to plan future performance in great detail based on a single set of assumptions and, on the other, they began to understand the value of addressing risk and uncertainty in all aspects of the management process. Scenario planning can help by explicitly contemplating alternative views of the future.

Investors, boards of directors, regulators, and managers are all seeking greater insight into both the positive and the negative impact of risk on future performance. Although most companies have made good progress to improve the quality and availability of financial information (with the occasional push from regulators), leading companies are simultaneously upgrading the processes, measures, and tools they use to manage business risk. Risk identification, monitoring, and management are now integral parts of any effective performance management process.

Scenario planning is all about asking questions:

- What if our view of the future turns out to be wrong?
- What if the unexpected does actually happen?

Scenario planning provides a structured framework for evaluating the possible linkages between what is known today and what could happen tomorrow. It is not a precise science and there is no right answer. The objective is to provide a framework for evaluating different courses of action. The answers to these questions are not certainties, and many financial professionals find the subjectivity and ambiguity embedded in scenarios unsettling. The future, by definition, is unknown. So rather than ignore it, embrace it!

Critics of scenario planning question the relative subjectivity of the approach and also its applicability to all but the largest organizations. However, many of these concerns are due to a failure to use the tool properly or engage the correct constituencies to ensure that:

- senior management actively sponsors the use of scenario planning,
- the scenarios have credibility, and
- most importantly, the results are effectively integrated into management decision-making processes.

How professional accountants add value

Like most management tools, the key is to use scenario planning in the right situations and ensure that the right parties are engaged in the process. Scenario planning is as much about the process an organization undertakes as it is about the results. The dialogue and debate that is inherent in effective scenario planning inevitably leads to the discovery of new insights about the interaction of different drivers of both the external and internal environment. The willingness to contemplate the impact of alternative future scenarios on strategies, plans and decisions equips managers to navigate through uncertain times with greater confidence and an increased awareness of the choices and options open to them.

Enabling value

- **Planning process:** Professional accountants support the strategic planning process as management considers the financial implications of alternative strategies under different future scenarios.

- **Strategic management:** An understanding of scenario planning equips professional accountants with tools that can help advance their careers into more senior finance or general management roles through a richer understanding of how to effectively manage in a volatile and uncertain world.

Creating value

- **Financial planning:** Professional accountants understand the value of developing alternative financial plans and forecasts under different scenarios and along with testing key assumptions and financial measures.
- **Conducting analysis:** Many organizations are integrating aspects of scenario planning into financial planning, budgeting and forecasting processes, and are looking to professional accountants to support in conducting rigorous and insightful analysis. □

This publication is one in a series on *Scenario Planning*. Guidance and Case Studies are also available on our website. For additional information, please contact Carol Raven, Principal, Strategic Management Accounting & Finance at 416-204-3489 or email craven@cpacanada.ca.



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