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## *Business forecasting: lessons from the accounting malaise*

The charges are familiar: lack of transparency and credibility, distortion of numbers in response to short-term pressures, and narrow agendas, even betrayal of the professional duties and mission. No, it's not corporate accounting. These are the ills of business forecasting, the "other" accounting. Alas, business forecasting provides an eerily analogous, if perhaps less public, counterpart to today's accounting malaise.

The telecom bust of the past two years dramatically exposed the consequences of sloppy forecasting. Nortel, Lucent, Corning and other equipment manufacturers expanded capacity and even financed their customers, while Global Crossing, WorldCom, XO, Covad, and dozens of other service companies ordered more and more hardware. The forecasts unanimously called for continued growth, though the justification for the rosy forecasts was little more than wishful thinking.

Few took a candid look at the uncertainty of future demand growth, let alone the possible implications of such rapidly expanding supply if growth stalled. Such inquiry would have quickly raised doubts as to what might possibly drive this growth and where in the world the money to pay for it would come from. The consequences are well-known: In the past two years the telecom manufacturers alone erased more than one trillion dollars of shareholder value while many of their customers went bankrupt.

Whether overestimating demand for optical fiber, underestimating manufacturing capacity for a new blockbuster product, or just missing projected revenues, forecasting remains a frustrating pursuit, and frequently an object of derision. Yet its failure is largely shrugged off as merely part of our inability to know the future.

Unquestionably, the future is difficult to assess and

impossible to know precisely. However, much of the well-documented failure of business forecasting arises not only from its inherent difficulty but also from confusion about its mission and how it ought to be carried out. Directors and senior managers ask their experts for a forecast in order to make tough yet rational choices and justify them to employees and investors. But both the forecasters and the leaders interpret the task as a best-effort attempt to predict the future, as if to make the uncertainty go away.

The experts—middle management, analysts, engineers, consultants—aren't asked to provide a comprehensive view of possible futures and their probability of occurring but rather a single, factually complete description of the future. With remarkable precision, they end up describing something that has no chance of materializing.

Describing a single future scenario not only filters out important information, it also distorts it. Lacking an objective way to choose one scenario out of the many they can envision, the forecasters inevitably (if unintentionally) let biases shape the prediction. The choice of scenario can be influenced by wishful thinking (a.k.a. optimism), recent memory, individual agendas or simple "gut feel." All of these biases have one thing in common: They do not help management make a rational choice. Savvy executives, in turn, quickly learn to distrust expert forecasts and either intuitively correct the forecasts or ignore them altogether, creating a cycle of cynicism and missed opportunities.

To restore forecasting's tarnished reputation, we first need to return it to its true mission of providing insight, not certainty, and we need to restore its credibility through a combination of candor and transparency about the validity—not the absolute truth—of all our assumptions, interpretations and logic.

Consider how Texas Instruments addressed the future during the semiconductor boom of the mid-1990s. In 1996, the market for memory chips fell off a cliff, much as telecom did half a decade later. Fortunately TI saw it coming. The company's management looked systematically at sources of supply and demand, piece by piece, each with its many drivers, dynamics, uncertainties and probabilities. When TI added them all up, remarkable clarity emerged about what needed to be done. In what is now a textbook case of a strategic shift, TI reversed its expansion plans and eventually divested its business in memory chips, much to the benefit of its shareholders.

It is worth emphasizing that despite its superb forecasting work, TI did not *know* what the future price trajectory of memory chips would be; indeed, they were staring down the barrel of immense uncertainty regarding prices. But the lucid description of the range of possibilities, as

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well as their signposts and their likelihood, gave rise to distinct clarity of action. And that is the ultimate purpose of forecasting.

Uncertainties are part of the future, and the role of the forecast is not to eliminate them but to describe them in a way that allows rational decision-making. That means continually digging down to identify their underlying sources, sizing each uncertainty using the same ruler, and understanding their implications individually and in various combinations.

Unfortunately, that's not how most forecasting is done. The more common practice is to focus on getting the numbers "right" instead of understanding which numbers are hard, which are soft, why they are soft, how soft they are, and what could be done to firm them up.

The great irony of forecasting is that by embracing and quantifying uncertainty, rather than evading it, we achieve much greater clarity and insight in our view of the future. In the words of Francis Bacon, "If a man will begin with certainties, he shall end in doubts; but if he will be content to begin with doubts he shall end in certainties."

In short, the uncertainty of the future is no excuse for less rigor or clarity in trying to understand it. Nevertheless it requires disciplined execution and, most important, a willingness of the forecasters and their audience to abandon the false comfort of "predictions." This requires breaking the cycle of cynicism created by mock precision and embracing uncertainty as a means to clarity. Such change can only come from business leaders, as the ultimate consumers of forecasting and the ones who set the expectations of the forecasting discipline. **D**

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