Forecasts will always be inaccurate. We aren’t fortune tellers, and we don’t have crystal balls. No matter how sophisticated your planning algorithms are, there will always be unknown factors and a healthy margin of error. While you can’t eliminate inaccuracy, a robust demand planning and S&OP process can eliminate bias.

Best-in-class forecasting accuracy is around 85% at the product family level, according to various research studies, and much lower at the SKU level.

While you can’t eliminate inaccuracy from your S&OP forecasts, a robust demand planning process can eliminate bias.

There are two types of bias in sales forecasts specifically. In terms of profit impact, neither one is better or worse than the other. Forecasting high and selling low will undermine margins just as readily as forecasting low
and selling high. Over-production leads to excess inventory and deep discounting. Unanticipated sales cause capacity and supplier issues, expedited shipping, low fill rates and missed deliveries.

Part of the challenge is psychological. As humans we want to under promise and over deliver. So sales people sandbag; they underestimate what they think they can sell in order to look good. Compensation schemes are another factor. When we are compensated based on hitting a certain target, we push to keep that target as low as possible. Failing that, people will do what they need to do to hit the target without regard to the impact on costs or margins. We’ve all experienced these tensions. They start around this time of year. Every leadership team goes into the annual planning and budgeting process with the desire to grow the business by a certain amount. That’s an objective. It’s not bias, at least not yet.

**The Roots of Forecast Bias**

Say your executive team wants to grow revenues by 10% in 2017. That strategic target is pushed down to the business units to create a month-by-month budget and action plan for hitting the objective. Those action plans then roll up into a planning forecast.

If business managers can’t identify how to get to the target during the planning process – maybe there’s a 2% gap – it might be bookmarked as “unknown.” But as the months unfold, and the 120- to 180-day material release time fence gets closer, if there’s still no action plan, the forecast has to be adjusted downward. When it’s not adjusted is where bias comes in.

A methodical demand management process will eliminate this bias. This starts with having the right mindset and objective. The goal is not to create a dollar or unit forecast at the SKU level. The goal is a directionally-correct forecast at the product family or subfamily level for a rolling 12- to 18-month window.

Most S&OP programs—of which demand management is a key part—don’t look far enough ahead. No more than 10% of the time in S&OP meetings should be spent discussing the current month or quarter. You have to start with the longest lead time for critical components, and then plan to that point. Production needs time to plan capacity, labor and material deliveries. Finance needs time to make sure the company has enough working capital to cover spending fluctuations.

Because they emerge from different teams and processes, another shortcoming of demand planning is that the S&OP forecasts are often disconnected from a company’s strategic plan. They need to be integrated and aligned. After all, it doesn’t take long for a rolling 18- to 24-month S&OP forecast to start overlapping a 3- to 5-year strategic plan. An S&OP forecast for May of 2017, for example, will have implications on the strategic
plan for 2019. If the strategic plan is to grow the business by 25% over five years, there’s no way the company is going to get there if it doesn’t grow 4.6% per year on average.

Failure to hit such targets often starts with a poor understanding of what’s happening upstream with the supply base and what’s needed downstream by customers. Developing such knowledge and maintaining alignment with the strategic plan is why the S&OP process—while it may not be executed by them—has to be owned by the executive team. The CEO, CFO and division presidents need to understand that S&OP and annual operating plan discussions are directly connected to the strategic plan. Failure to make adjustments to all three as circumstances change introduces unnecessary bias.

The first few S&OP meetings can be painful because it forces everyone to look beyond the current year, beyond the next 12 months, and into the next 18 to 24 months. You’re asking people to give you data for all of these months at one time.

Subsequent meetings become a little easier because you’re only adding one month at a time. However, as these months are added, they need to connect to what’s being called for in the strategic plan. A strategic plan will lay out financial targets.

As part of the demand planning process, these financial targets are translated into unit targets, which inform sales and production planning. The S&OP team’s job is to recognize and close any gaps between the current and planned capabilities required to hit those targets. To fill the gap on the sales side, for example, might require deeper market penetration driven by changing price points or changes to the product portfolio. On the supply chain meeting the projected demand growth might require additional equipment, labor, outside sourcing and so on.

Demand management will always be a challenging element of the S&OP process. Complaining about forecast inaccuracy is a waste of time because there will always be demand uncertainty. Eliminating as much bias out of your planning process, however, is both within your control and an essential tactic for protecting your margins.
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