LABOR COST FORECASTING

Process, Roles and Responsibilities, and Critical Success Factors

APQC spoke with FP&A SME Philip Peck about labor cost forecasting and controls. Peck is the vice president of finance transformation and advisory services at Peloton, a professional services firm helping organizations envision, implement, and realize the benefits of digital transformation across Enterprise Performance Management, Big Data & Analytics, Enterprise Resource Planning, Human Capital Management, Supply Chain Management, and data applications for the cloud.

APQC: What does labor, or personnel, cost forecasting involve?

Philip Peck: Labor cost modeling, planning, and forecasting are one of the key areas under the purview of the FP&A function.

Leveraging a purpose-built labor planning model and enabling technology platform that incorporate an array of business drivers, FP&A is responsible for determining the organization's overall forecasted labor costs. As part of the overall planning process, FP&A partners with departmental owners, HR, business division leaders, and the executive team to determine the anticipated headcount needs across the organization. FP&A then determines the fully-attributed cost of the expected resources. With the driver-based modeling orientation, FP&A is able to quickly evaluate different scenarios and "what if" analyses to develop the base labor cost forecast. They also add in some more enterprise-wide factors (e.g., merit percentage increase) to create the composite summary cost. Throughout the process, FP&A works closely with the key stakeholder groups and goes through numerous iterations of the forecast, refines core assumptions, and then finalizes the personnel cost forecast.

At Peloton we often help organizations streamline that process, plan and forecast personnel costs with an integrated business planning perspective, leverage enabling technology to systematize driver-based models and labor cost calculations, address critical data management business needs, and provide change management and solution adoption expertise.

APQC: What inputs inform labor cost forecasts?

Peck: You can start with data inputs at the employee level, such as an ID, a name, their department, a job code, or an account. Such employee attributes typically come from an HRIS. The organization looks at existing head count and employment status (e.g., salaried, hourly, temps, and contractors). Other individual-level inputs include numbers for job offers, open requisitions, attrition, near-term retirements, transfers, and promotions.

An organization will want to slice and understand these numbers across employee segments and calculate the expenses for them. This includes determining an average base salary for each employee segment, as well as salary by band.

I would encourage organizations to keep the inputs as simple as they can but cover the most salient factors. This might include salary increases over time, bonus considerations, benefit rates, tax rates, federal and state unemployment, FICA (social security), and state/federal unemployment taxes. Organizations can then calculate rates for the working days in a period, hours per day, and overtime percentages.

At an advanced modeling level, some organizations take into account sales revenue, operational statistics, core activities, and fixed labor per location. In these situations, the level of labor cost planning and forecasting sophistication is typically a by-product of operational labor planning that is needed for other purposes.

At an individual level, costs will shake out differently through the performance management process. But for planning purposes, applying numbers globally where feasible simplifies the forecast.

APQC: How is the responsibility for labor forecasting broken down between finance and HR?

Peck: FP&A typically owns the coordination of the overall budgeting and forecasting processes, including for personnel-related costs. They're the master coordinator, so they establish and then execute the planning calendar of activities, whether that's a budget process, a forecast process, or an ad hoc event driven update of forecasted financials.

This ownership involves collecting information from stakeholder groups including HR. But other functions are also involved from business operations such as a distribution center or plant. Functional leaders and department-level budget owners also provide information.

With inputs from all the stakeholders, FP&A updates and runs their labor cost forecast models. Ideally these models are deployed in purpose-built enterprise applications, but many organizations do still rely on Excel, Access, or home-grown systems applications. These models are populated with prior period actuals and then updated with a complete list of driver-based inputs that help FP&A forecast overall personnel costs.

So, FP&A typically brings it all together, but they're reliant on inputs from many areas.

APQC: So how do we differentiate HR's strategic workforce planning from FP&A's labor forecasting?

Peck: Strategic workforce planning relates to the systematic identification and analysis of what an organization is going to need in terms of the size, type, experience, knowledge, and skills of its workforce to achieve its objectives. It is a process used to generate business intelligence to

inform the organization of the current, transition, and future impact of the external and internal environment on the organization. Strategic workforce planning is a critical input into the more near-term operational workforce planning activities including annual budgeting and periodic financial forecasting. Whereas HR typically owns strategic workforce planning, FP&A coordinates and owns the labor cost forecasting process as part of the broader financial planning processes that address all elements of the financial statements (revenue, cost of sales, marketing, G&A, etc.).

It's best for HR and FP&A to have a highly collaborative relationship to make the optimal business decisions for the organization. HR and finance need to work together to align personnel needs with overall strategic objectives. Department owners may request more staff, but they still need to get authorization; so the forecasted numbers may different.

APQC: What are the technology drivers?

Peck: A key consideration enabling FP&A's ability to optimally support labor cost forecasting activities is the deployment of purpose-built, cloud-based enterprise technology solutions that incorporate predefined calculations that can be configured based on unique business requirements. These solutions provide robust driver-based modeling capabilities uniquely suited for labor cost planning and forecasting needs. Examples include factoring in and systematically calculating the impact of the timing of new hires, merit increases, attrition, and employee taxes. The platform should also provide the flexibility to adapt as an organization changes and to integrate with other enterprise performance management applications. Organizations also need to consider data sourcing, data integration, and data management needs associated with labor cost forecasting.

FP&A also needs reliable, up-to-date employee data from its HRIS and talent management systems to forecast labor costs. This needs to be as accurate as possible, so FP&A should look for potential process centric disconnects between source systems that may be problematic for downstream models and related labor cost forecasting activities.

APQC: How does the forecasting approach differ by industry? For instance, how does this work in the engineering and construction industry?

Peck: We've worked with some large construction organizations to forecast personnel costs in a true resource planning environment in order to optimize supply and demand. Project-oriented industries like that may have some unique concerns. For instance, a forecasting data source may include drivers from a project management system. Project-oriented organizations need to account for a very dynamic timeline and determine what project inputs (such as seasonality) are relevant downstream.

But most best practices in labor forecasting apply across industries. Organizations need to calculate labor costs using drivers such as salary, benefits, and taxes. And those drivers need to be accounted for in a systematic fashion using technology to automate data collection and

integration and to standardize data sources. Driver-based integrated modeling and planning will get you to the answer faster.

There are additional cross-industry best practices:

- All industries benefit from assigning accountability for labor forecasting. There needs to be clarity throughout the process for who owns what, including data sourcing and reviews.
- FP&A needs to secure sensitive information regarding personnel costs. Technology can compartmentalize data for role-based security.
- The forecasting process needs to be streamlined as much as possible to minimize cycle time while still ensuring quality inputs and outputs. APQC has a motherlode of great benchmark statistics on cycle time to reference.

APQC: Our planning and management accounting survey also tracks the percentage of errors per personnel cost forecast. What are your thoughts about forecast accuracy for personnel cost forecasting?

Peck: The percentage of error highly depends on the nature of the organization. I'm more interested in the quality of the input into the forecast and accuracy as an output thereof. You strive to be as accurate as possible, but sometimes it's not worth the investment to improve the error rate a very small amount.

For example, Peloton helped a sporting goods retailer plan for personnel costs. At each store, there are just a few people like the managers that are fixed costs. But the rest of the scheduling for employees is highly variable. So, we built a model profiled by department and roles. The key inputs were expected sales, expected volume by department, seasonality, overtime percentages, and so forth. But external drivers such as the weather could wildly affect the forecast accuracy.

In some circumstances, complex labor models may not benefit from individual-level data inputs that might swing forecast numbers. You don't necessarily want the same level of detail to feed into your financial forecast as is required for detailed operational labor resource planning models. You want to summarize it, aggregate it, and leverage those inputs as drivers for the labor cost forecast.

APQC: How can organizations improve their labor cost forecasting accuracy?

Peck: Again, integrated, driver-based modeling is key. You have to be able to model the labor that's relevant to your type of organization, be it engineering, construction, aerospace and defense, retail, or life sciences. The model needs to represent the reality of how labor manifests itself in the nature of your business.

In terms of integration, the system needs to account for key drivers and ensure they are up-to-date. This requires enabling technology. Excel is certainly wonderful, but there are far better ways to model, forecast, and plan labor costs. Emergent frameworks and applications can

enhance overall planning and forecasting. Whether it's a cloud-based application, AI, machine learning, predictive analytics, or predictive forecasting, organizations should explore using whatever improves the quality and accuracy of their output.

Organizations also need a streamlined standardized process, with consistent assumptions. This requires balancing a desire for detail and accounting for complexity with the level of effort needed to create an output that will help the organization make better decisions. Especially with highly variable labor models, you need to strike a balance between the level of detail and complexity and the value you'll get from producing a high-quality forecast in terms of enabling better business decisions and improving financial performance.

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