

The Art of Budgeting – Or Not

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Overview

- Pros and Cons of the Corporate Budgeting Process
- Should You Let Go of the Budget?
- If You Can't Let Go – How to Improve the Budgeting Process

Pros and Cons of the Corporate Budgeting Process

- Pros

- Increase participation in company financial decisions
- Create an objective criteria by which departments can be judged
- Incentivize or motivates employees

Pros and Cons of the Corporate Budgeting Process

- Increase participation in company financial decisions
 - Each department gets a say in the corporate budgeting process
 - This can make the company more responsive to individual departments' needs, and it can make department managers feel better about their role in the organization

Pros and Cons of the Corporate Budgeting Process

- Create an objective criteria by which departments can be judged
 - Monthly and annually, you can compare actual hard financial numbers to the budgets and easily determine whether departments are doing what they are supposed to do (at least in terms of spending), according to the corporate budgeting process

Pros and Cons of the Corporate Budgeting Process

- Incentivize or motivates employees
 - Having specific financial goals in budget-form helps employees understand what is expected of them
 - Employees will feel motivated to achieve corporate budget goals by the very existence of the budget; bonus incentives can be added to increase that motivation (e.g., a financial reward for members of a department that meets its budget)

Pros and Cons of the Corporate Budgeting Process

- Cons –
 - Creates conflict
 - Motivates departments to distort financial numbers
 - Distorts incentives
 - Time consuming and expensive
 - Part 32 is not budget friendly

Pros and Cons of the Corporate Budgeting Process

- Creates conflict
 - It can lead to conflict as department managers compete for their pieces of the company's budget pie
 - It is necessarily a zero-sum game, with winners and losers, and any time you have losers, you also have resentment
 - This negative side of budgeting can easily outweigh the positive feelings generated by department managers' participation in financial decision making

Pros and Cons of the Corporate Budgeting Process

- Motivates departments to distort financial numbers
 - Although it is useful to have a corporate budgeting process to create objective criteria by which to judge a department's behavior, such criteria can inevitably tempt department heads to distort their financial reporting in order to meet expectations (cook the books)
 - Because there are no set "rules" of the budget process, department managers might disregard ethical concerns about altering their behavior to meet budget requirements

Pros and Cons of the Corporate Budgeting Process

- Distorts incentives
 - Any time you create employee incentives, you run the risk of unintended consequences
 - In actual corporate budgeting situations, there are often difficult-to-see incentives and matching behaviors

Pros and Cons of the Corporate Budgeting Process

- Time-consuming and expensive
 - The budgeting process is quite time consuming and often fails to provide the value it's designed to produce
 - Sometimes the data is not altogether trustworthy, is limited in scope, and fails to factor in key assumptions or data relationships
 - Also, the rapid pace of change, both inside and outside of businesses can render much of the information irrelevant far too quickly

Pros and Cons of the Corporate Budgeting Process

- Part 32 is not budget friendly
 - For regulated entities, Part 32 is not always budget friendly
 - Due to allocated costs, managers do not have control of large expense dollars

Should You Let Go of the Budget?

In his book *Winning*, General Electric's Jack Welch famously griped: "It sucks the energy, time, fun, and big dreams out of an organization. It hides opportunity and stunts growth. It brings out the most unproductive behaviors in an organization, from sandbagging to settling for mediocrity."



“It” is the corporate
budgeting process

Should You Let Go of the Budget?

- Most companies produce an annual budget
- However, a few companies are doing what others fantasize about: getting rid of the budget altogether, stomping out the century-old process for good
- Steve Player, program director at the Beyond Budgeting Roundtable, has rallied against budgeting for years

Should You Let Go of the Budget?

- Player is using the word “budgeting” as an alternative term for “command and control” management (with budgeting at its core)
- Budgeting was designed to enable senior executives to “command and control” the organization from the corporate center

Should You Let Go of the Budget?

- Player asserts that budgets can foster unethical behavior and conflicts of interest
- When incentive compensation is tied to reaching budget goals, a huge conflict of interest is created
- As a method of cost control, budgets are wanting, since managers tend to spend every cent they've been allocated, fearing they won't get the same allocation the following year

10 Reasons for Replacing the Budget

- 1) Prevents rapid response to unpredictable events
- 2) Too detailed and expensive
- 3) Out-of-date within a few months.
- 4) Out of kilter with the competitive environment
- 5) Divorced from strategy

10 Reasons for Replacing the Budget

- 6) Stifles initiative and innovation
- 7) Protects non-value-adding costs
- 8) Reinforces command-and-control
- 9) Demotivates people
- 10) Encourages unethical behavior and increases reputational risk

Source: Beyond Budgeting Round Table

What Beyond Budgeting Companies Do Instead of Budgeting

1. CONTINUOUS MANAGEMENT: Shift to rolling forecasts, thus eliminating the huge work-spike caused by the annual budget exercise while keeping finance focused on the future
2. TARGET SETTING: Shift management's focus to medium-term targets (three to five years out) that focus employees on reaching them quickly, rather than negotiating a fixed annual target

What Beyond Budgeting Companies Do Instead of Budgeting

3. **INCENTIVES:** Convert the current pay-for-negotiated-results system into a pay-for-performance system measured against peers
4. **ACTION PLANNING:** Focus management on making the organization more agile to provide faster responses to changing conditions

What Beyond Budgeting Companies Do Instead of Budgeting

5. **RESOURCE ALLOCATION:** Free up the time wasted in annual budgeting negotiations and putting it into continuous planning to quickly improve the business
6. **ACCOUNTABILITY:** Make teams more accountable by shifting control to relative key performance indicators, focusing managers on continuously improving costs

Source: Beyond Budgeting Round Table

Why a Rolling Forecast?

- Enables business owners to plan as little as 90 days ahead – and amend their plans along the way
- Unleashes the restrictions imposed by annual budgets
- Can provide business owners with a more up-to-date financial picture

Why a Rolling Forecast?

- 3 key reasons Player considers the rolling forecast essential:
 - “It forces people to think proactively about what can go wrong and what can go well”
 - “It doesn’t lock you in, allowing you to remain flexible and adaptive, because the world often turns out different than what we had planned”
 - “It keeps everybody focused on how to optimize, rather than hitting a fixed number”

If You Can't Let Go – How to Improve the Budgeting Process

- For most companies, the annual budget works well enough
- So, you may still hate budgets, but what can you do to improve the process instead of discarding it?

If You Can't Let Go – How to Improve the Budgeting Process

- Use a financial forecast in conjunction with a budget
- A good financial forecast should make the budget process more efficient and accurate

If You Can't Let Go – How to Improve the Budgeting Process

- Forecasting is primarily a prediction of how the company will perform over the next fiscal year, utilizing past history and projected income and expenses
- Budgeting is the act of planning for income and expenditures for a period of time, typically a year, using specific, measurable data and verifiable assumptions

If You Can't Let Go – How to Improve the Budgeting Process

- Analyze your actual and budgeted differences on a monthly basis, not just at the end of the year
- Monitor your financial situation and revise the parts of your forecast and budget that change when circumstances – and your own financial objectives – shift

If You Can't Let Go – How to Improve the Budgeting Process

- It is important to remember that a budget is simply a written estimate or plan of how an entity will perform financially
- It is a financial roadmap for a company's business operations

If You Can't Let Go – How to Improve the Budgeting Process

- Thus a budget should not:
 - Be considered absolute or infallible – as President Eisenhower said, “In preparing for battle I have always found that plans are useless, but planning is indispensable”
 - Place managers in a financial “straitjacket,” but rather hold them responsible for keeping the organization on schedule in reaching its objectives
 - Be an end to itself but rather a means to an end

Summary

- We've talked about the pros & cons of the budget process
- We've addressed the concept of letting go of the budget
- We've looked at ways to improve the budget process, if you can't let go of the budget

Summary

- Whatever you decide to do, whether that's to keep the process you have in place or ditch the budget in favor of rolling forecasting, just remember:
 - Continuously monitor your financial situation
 - Just like following a GPS, you sometimes have to make adjustments to the route to get to where you want to be



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