Is the budgeting process still fit for purpose?

In this series, Palladium asks expert strategy practitioners to share their experiences and opinions. We asked:

Jack Welch famously said that the budget was “an exercise in minimization” and that “it should never have been invented.” Yet the budgeting process remains the central framework by which organisations set targets, allocate resources and pay bonuses.

Given today’s market dynamics and the increasing speed of change, is the budgeting process still fit for purpose? Are there alternative planning approaches that can replace or supplement the usual budgeting process to enable planning agility? What implications do alternative approaches have for strategy execution?

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Most leaders know that the budget process has its problems; I have yet to meet anyone who claims otherwise. For example, studies show that 20-30% of companies believe that the budget is obsolete even before the budget year begins, and 60-70% believe that this happens during the first half of the year. The level of waste as expressed by these figures is horrifying – where else is such waste accepted year after year?

As well as generating waste, it sub-optimises performance. The budget is supposed to be the detailed plan for year one in the strategy period. However, experience shows that very little of the budget work has anything to do with strategy. This has much to do with the relatively short (one year) budget horizon and is often due to the link to bonuses – as a result, the budget process is reduced to a fight for less ambitious targets and more resources. It has little to do with creating value, either short-term or long-term.

Indeed, the budgeting process is a constraint on value-adding activities. When considering an expense or investment, we ask: *Is it included in the budget?* If so: go ahead. If not: no go – wait for next year's budget. During the year, new and unexpected threats and opportunities will appear, things that could not be foreseen when preparing the budget. Sticking to the budget will inevitably lead to a less than optimal use of resources simply because it is impossible to foresee what will happen.

Logically, a company's forecasting horizon should be determined by the nature of the company's industry. However, in a normal budget environment the forecasting horizon lasts to the end of the budget year. This is purely driven by the financial year-end focus and has nothing to do with the underlying business needs.

In a budget environment, you are a success if you reach your budget, and this often comes with a bonus.

This has several negative effects:

- Rational managers will fight for relatively unambitious targets, thus increasing their chances for personal gain.
- Since conditions (and budget assumptions) always change during the year (currencies, oil prices, interest rates, etc.), it is very difficult to determine what success will look like beforehand.
- Even if the cost budget is met, this is no guarantee for the most optimal use of resources. Some parts of the organisation could probably have managed with less, and others may have underspent and missed opportunities.
- Even if the revenue budget is met, this is no proof of success – maybe the competitors did even better and the market share came down.

It is our experience that the separation of the budget process into sub-processes for target-setting, forecasting and resource allocation has a positive impact on an organisation's performance. Simply by changing the process, you will achieve better and more meaningful targets, more relevant and timely financial forecasts and an improved use of resources – with less effort. The separation also opens up opportunities for significant process improvements that are impossible to achieve with one common budget process.

Anders Olesen
Director, Beyond Budgeting Institute

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Most companies make budgets for three very different reasons: target setting, forecasting and resource allocation. But these are all different things. The three purposes can't be meaningfully handled in one process resulting in one set of numbers. A target is what we want to happen. A forecast is what we think will happen, whether we like what we see or not. And resource allocation is about trying to use our resources in the most optimal and efficient way. An ambitious sales target can't at the same time also be an unbiased sales forecast. And you rarely get a good cost forecast if the organisation believes this is their one shot at access to resources for the next year.

At Statoil (a Norway-headquartered oil and gas company with about 23,000 employees and 2014 revenues of about $108 billion USD), our solution to this serious problem was simple. We separated the three purposes, which made it possible to optimise each one in much more tailored processes. This allowed for different numbers, updated on different frequencies and time horizons, for each of the three processes.

For target-setting, we try to use relative instead of absolute and decimal-loaded targets. Relative targets address how we are doing compared to others, internally or externally, instead of a myopic focus on fixed and decimal-oriented numbers. I have yet to hear a team coming out low (given they find the benchmarking fair and relevant) announce that they have no ambitions about climbing on the ranking. This is a much more self-regulating approach compared to the traditional budget game, which stimulates the very opposite mindset, the one that drives managers to negotiate for the easiest achievable number.

Because we have taken out much of the gaming bias that came from target setting or resource allocation, the quality of our forecasting has also improved. The dynamic forecasting we have introduced is different from what is often called rolling forecasting. A rolling forecast is done on a fixed frequency and on a fixed time horizon across the company, often quarterly and five quarters ahead. We want forecasts to be updated when something happens, and as far ahead as relevant for each unit.

We also introduced a dynamic resource allocation, which provides much bigger and more flexible decision authorities to local teams and a much more dynamic rhythm. Imagine a bank informing its customers, "We have now changed our hours, so if you want to borrow money, we are now only open in October." It sounds ridiculous – but isn't this exactly what people in companies experience every year in the budget process?

When making cost decisions we do not want managers to ask, *Do I have a budget for this?*, but:

- *Is this really necessary?*
- *What is good enough?*
- *How is this creating value?*
- *Is this within my execution framework?*

In addition, we must always consider capacity, both financial and human. As things look today, can we afford it, and do we have the people to do it? This information would typically come from our latest forecasts.

Last, but not least, we have introduced a more holistic performance evaluation, with hindsight insights as a key component, and with how we have achieved our business results counting for 50%. As Albert Einstein put it: "Not everything that counts can be counted, and not everything that can be counted counts." We therefore use hindsight insights: the wealth of information unavailable to us at target setting time. We ask, for instance, *have we really moved towards our longer term objectives?*

Bjarte Bogsnes

Vice President, Performance Management Development, Statoil

Was there significant tailwind or headwind that should be taken into account? Are results sustainable, will they stand the test of time?

Statoil is on an exciting journey, which is in no way over and where the direction is clearer than the destination, if there really is one.

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At many organisations, budgeting is an engrained process. It's one of those things that is done year after year, the way it has always been done, because it has always been done that way. Engrained processes are not necessarily a bad thing. In fact, the act of "engraining" can even establish a competitive advantage – Toyota and its Lean Management are probably the best and most well-known example.

However, in my experience, unlike Lean Management at Toyota, budgeting is usually not engrained as a result of a conscious decision. If it were, most organisations would be able to explain exactly what value budgeting brings then in terms of furthering the overall business objectives, and at what cost. Only very few organisations are actually capable of doing so, however.

From a strategic perspective, the value in the traditional budgeting process is essentially control. Based on an expectation regarding the future, the organisation identifies the actions it believes will make it achieve its objectives. These actions are then priced to develop a budget, after which management regularly reviews actual expenditures in light of this budget to ensure only the pre-defined actions are executed – there isn't a budget for anything else, after all.

This value comes at a substantial cost. Most organisations use a substantial amount of resources for a substantial portion of each year (usually anywhere between three to nine months) for budgeting. Greater still is the cost that comes from the tendency of budgets to lead organisations towards doing what shouldn't be done, while preventing them from doing what should be done. The traditional budgeting process locks organisations into executing a pre-defined list of actions, as it doesn't have a mechanism to adjust the action plan if and when circumstances change in unforeseen ways.

In this day and age, however, unforeseen events are the rule rather than the exception. This rapidly changing business environment therefore requires a new budgeting process, one that maintains the control of the traditional budgeting process to facilitate considered resource allocation decisions, but at the same time provides the flexibility that is needed to navigate through a sea of ever-changing threats and opportunities.

I recommend three things in particular:

First, since it should be expected that the business environment will not change exactly as foreseen during the planning and budgeting exercise, organisations should stop detailing their budgets to the nth degree. In an unpredictable business environment, this is a waste of time, effort and resources.

Second, management should stop equating budgeting with management. The days of "as long as we follow the budget, we'll be successful" are over. The objective of budgeting should be to force an organization to think about the future, to develop preliminary action plans that would make it successful in that future and to make a preliminary decision on resource allocation that would maximize returns in that future – not a final decision.

Third, updates of the original budget should be developed regularly, based on the actions deemed necessary to achieve the objectives at that particular point in time. The expenditure reviews should then focus on understanding the reason for any differences between the original and updated budget: *What changed in the business environment so that we now believe we have to do different actions?* This shifts the focus of expenditure analysis from *Have you done what you said you would do?* to *Are you doing what needs to be done?* Only thereafter should the final decision on resource allocation be made, as close as possible to the actual event.

Andreas de Vries
Strategy Management Practitioner, Oil & Gas Industry

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Is there any point in creating a budget? At the risk of sounding like a stereotypical consultant, it depends. First, what is it used for, and second, how is it created? Unfortunately many organisations both use and create budgets improperly.

Many organisations treat the budgeting process as a substitute for strategic planning, and it simply doesn't work. There's a temptation to wrap everything together – financial planning, strategic planning, etc. – into a single package, but it ends up far too complicated and convoluted to be useful. Typically, the short-term detailed budget takes so much attention that little, if any, strategic planning gets done. We obviously need some kind of financial control mechanism to deliver on our financial commitments, but beyond that role, the budget is the wrong tool to use.

Most organizations create their budget only once a year, and few have the ability or the willingness to adjust it in the meantime. We also make it an incredibly onerous process by weighing down our budgets with unnecessary details. In a misguided effort to be comprehensive, we wind up with far more cost centers and line items than makes sense.

So much of the time, no, the budget isn't worth the effort that goes into it – but we can change that. I advocate for organisations to adopt two commonsense changes to their budgeting process.

First, it's time to jettison the annual budget in favor of rolling forecasts. In the modern business environment, we can't assume stability. A year is too long to go without adjusting the budget. Budgeting more frequently requires that the budget be higher level, and that's a tradeoff that makes plenty of people uncomfortable. Still, it's a tradeoff worth making: What value are you really getting from that bloated behemoth of a budget?

Second, finance departments should embrace driver-based models. This entails determining the drivers of major costs, then considering them according to two variables, rate and cost. The payoff is twofold: a simpler budget that can be adjusted with relative ease, and far more valuable conversations with internal customers.

For example, imagine asking your sales manager what she expects next quarter's T&E to be for the sales team. She's going to make an educated guess. Now imagine that instead, you know that the trips the sales representatives she manages make are a primary driver of cost for the sales department, so you ask her how many trips her reps will make (the volume), which is a number she already uses to manage her department. She can give you these numbers with confidence, and you can then calculate the average cost of each trip (the rate) and immediately set or adjust the budget. What's more, you can have a useful and productive conversation about opportunities for cost savings – what if we spent a $100 less per trip? – instead of handing down a budget cut.

These are commonsense actions to take, but we don't see them happening because change is hard, and there always seems to be something more urgent to do. When I redesigned the budget at my last job, as CFO for the corporate services division of a large financial firm, I decided it was better to ask for forgiveness than permission. At the time, we were itemizing individual subscriptions to the Wall Street Journal! When department heads saw the new budgets and asked where certain details they were used to seeing had gone, I simply explained that the expense of collecting that information outweighed the value of that information. Not one person disagreed.

The budget process *does* have value, but we've let it grow out of control. We're reluctant to prune it back to something manageable because we've gotten used to it being this way.

Don Ryder
Senior Managing Director,
Strategy Execution Consulting,
Palladium

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