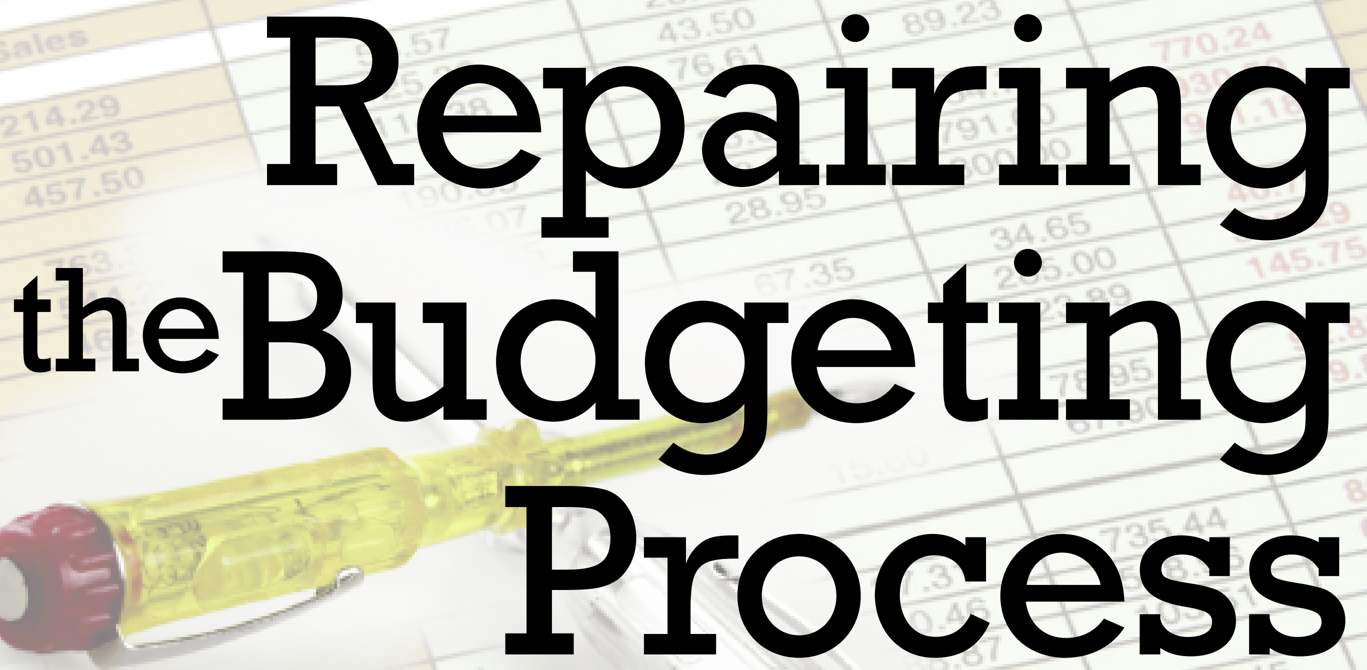
Repairing the Budgeting Process



The budgeting process often gets in the way of successful strategy achievement

By Gary Cokins

Organizations cannot succeed by standing still. If a company is not improving, then its competitors will soon catch up. This is one reason why Professor Michael E. Porter, author of the seminal 1970 book on competitive-edge strategies, *Competitive Strategy: Techniques for Analyzing Industries and Competitors*, asserted that an important approach option is to continuously differentiate products and services to enable premium pricing.

Yet, strategy execution is considered one of the major failures of executive teams. Dr. David Norton, co-author of *The Balanced Scorecard: Translating Strategy into Action*, says that executives can formulate good strategies, but a formal process should be in place to manage them.

One of the obstacles preventing successful strategy achievement is the annual budgeting process. In the worst situations, accountants administer the budgeting process as a fiscal exercise that's typically disconnected from the executive team's strategic intentions.

A better scenario, but still not a complete solution, is one in which the accountants consider the executive team's strategic objectives, but the initiatives required to achieve the strategy are usually not adequately funded in the budget.

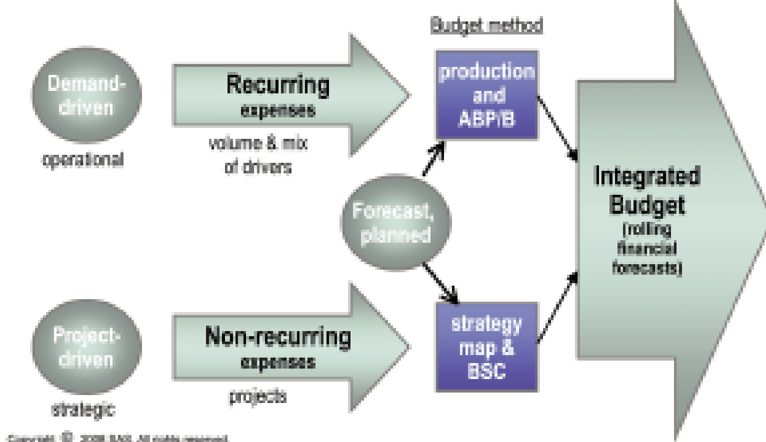
In addition, the budgeting process tends to be insensitive to changes in future volumes and mixes of forecasted products and services. The next year's budgeted spending for each cost center is typically incremented or decremented by a few percentage

points from the prior year's spending.

Many managers are wise to this practice. As they approach the last quarter of the fiscal year, they say: "Use it or lose it." This is both sad and laughable. Imagine a primitive budgeting method using spreadsheet software where the first line item of actual expense, typically wages, is multiplied by a percent increment. Next, copy-and-paste that formula into a budget column for every line item of spending below it. Look familiar?

Two components of the performance-management framework, strategy maps and activity-based costing principles, can be drawn on to resolve these limitations. Ideally, the correct and valid amount of future spending for capacity and consumed expenses should be derived from two broad streams of workload that cause the need for spending: demand driven and project driven.

Demand-driven expenses are operational and recurring from day to day. In contrast, project-driven spending is strategic and nonrecurring, and the projects' time duration can be from days to years.



Create Value from Projects

A popular solution for failed strategy execution is the evolving methodology of a strategy map with its companion, the balanced scorecard. Their combined purpose is to link operations to strategy.

By using this methodology, alignment of the work and priorities of employees can be attained without any disruption from restructuring the organizational chart. The balanced scorecard directly connects the executive team's strategy to individuals, regardless of the departmental or matrix-management arrangements.

The strategy map is arguably many orders of magnitude more important than its companion, the balanced scorecard. The scorecard is just a feedback mechanism to inform users how they are performing compared with their targets on pre-selected measures; the direction setting is in the strategy map.

In an ideal scenario, executives should delegate budgeting tasks to lower-level managers. As such, managers would first propose the projects and initiatives based on the strategy map's various theme objectives, and subsequently derive the key performance indicators (KPIs) with their target measures.

This approach assures that managers will understand the executives' strategy, which is key to executing it. Plus, it will create more conviction and buy-in as the managers are increasingly being held accountable — with consequences — for attaining their performance measure targets.

What if the managers and employee teams that identified the projects are not granted spending approval by the executives for those initiatives? Presuming that key performance indicators with targets were established for those projects, these managers will score poorly and unfavorably.

But worse yet, the strategic objectives that the projects are intended to achieve will not be accomplished — resulting in strategy execution failures. By isolating this spending as strategy expenses, the organization protects this mission-critical spending; otherwise, it is like destroying the seeds for future success and growth. On the other hand, capital budgeting is a more mature practice and does not have the same issues as strategic project and initiatives budgeting.

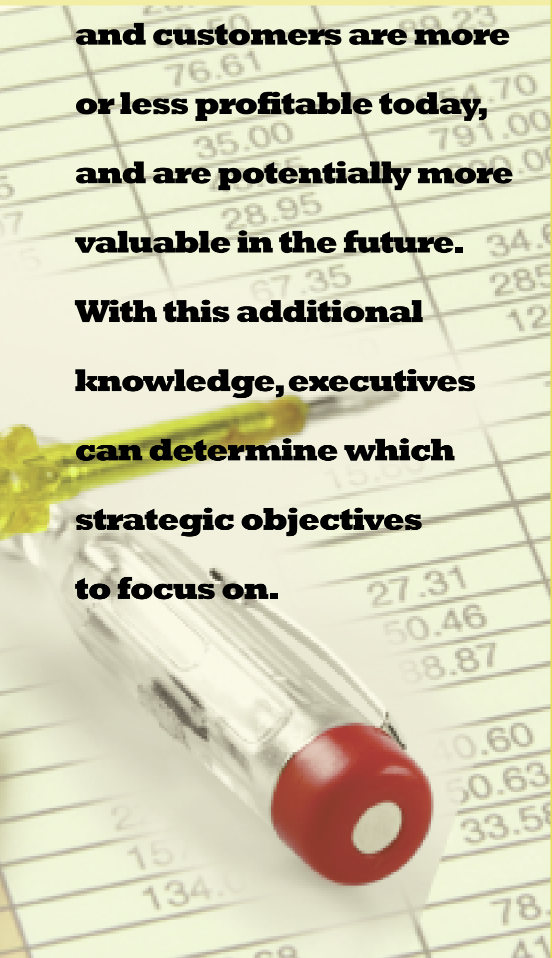
Value creation does not directly come from defining mission, vision and strategy maps. It is the alignment of the employees' priorities, work, projects and initiatives — with the executive team's strategic objectives — that directly realizes the planned value creation. Strategy is executed from the bottom to the top.

Norton uses a fishermen analogy to explain this: Strategy maps tell you where the fish are, but it is the projects, initiatives and core business processes that catch the fish.

Driver-Based Capacity Planning

For daily operations where the normal recurring work within business processes occurs, a future period's amount of product- and service-line volume and mix will never be identical to the past.

In future periods, some customer-demand quantities will rise and others decline. This means that unless the existing capacity and dedicated skills are adjusted, an organization will have too much unnecessary capacity and not enough capacity that is needed. These are dual prob-



Ideally, strategy creation leverages meaningful managerial accounting information, such as understanding which products, channels and customers are more or less profitable today, and are potentially more valuable in the future. With this additional knowledge, executives can determine which strategic objectives to focus on.

lems. The former results in unused capacity expenses and the latter results in missed sales opportunities, or customer-infuriating delays due to capacity shortages. Both drag down the organization's profits.

Advances in applying activity-based costing (ABC) minimize this planning problem. ABC principles solve operational budgeting by leveraging historical consumption rates to be used for calculating future-period levels of capacity and spending.

As an oversimplification, future spending is derived by calculating the ABC cost assignment network backwards; ABC practitioners refer to this as activity-based planning and budgeting (ABP/B). That is, the organization starts by forecasting its activity-driver quantities (those were the actual driver quantities for past-period costing).

Then, it uses the calibrated activity driver unit-level consumption rates from its historical costing to compute the required work activities in the operational processes. Next, it equates these work loads into the number and types of employees and the needed non-labor-related spending. It also adjusts for economic relationships of fixed, semi-fixed and variable expenses.

This technique provides the correct, valid capacity and spending requirements. With this knowledge, management can intelligently intervene and approve adjustments by adding or removing capacity.

It is a logical way of matching supply with demand. Once the capacity interventions (e.g., employee headcount) and planned spending are approved, then a true and valid driver-based budget can be derived — not an incremental or decremental percent change from last year 's spending level — for each cost center.

Types of Spending

The diagram on page 46 illustrates the two techniques for demand-driven and project-driven budgets that draw on components of the performance management framework:

- **Operational budget:** ABP/B using calibrated consumption rates and activity-driver forecasts.
- **Strategic and capital budget:** strategy maps for identifying one-time projects and initiatives.

Some budgets and rolling financial forecasts may distinguish the capital budget spending from operational budget spending; but rarely do organizations segregate the important strategic budget spending.

Ideally, strategy creation leverages meaningful managerial accounting information, such as understanding which products, channels and customers are more or less profitable today, and are potentially more valuable in the future. With this additional knowledge, executives can determine which strategic objectives to focus on.

In the operational budget, the expenses required to continue with day-to-day, repeatable processes are calculated based on forecasted volume and the mix of process drivers. These drivers, such as the sales forecast, are multiplied by planned consumption rates that are calibrated from past time periods (ideally with reduced rates reflecting planned productivity gains).

This demand-driven method contrasts with the too-often-primitive budgeting method of simply incrementing the prior year's spending level by a few percentage points to allow for inflation. The operational budget spending level is a dependent variable based on demand, so it should be calculated that way.

Organizations should define their strategic initiatives based on their executives' strategic intent. Subsequently, it is important to develop the strategy spending budget in a manner similar to how the capital expenditures budget is developed.

Too often, the strategy funding is not cleanly segregated anywhere in the budget or rolling financial forecasts. It is typically buried in an accounting ledger expense account. As a result, when financial performance inevitably falls short of expectations, it is the strategy projects' "seed money" that unfortunately gets deferred or eliminated.

Organizations must protect strategy spending and allow it to go forward because it's a key to competitive differentiation and successfully accomplishing the strategy. Once the strategy spending is protected, the only other lever is to plan for productivity improvements in the consumption rates. It is in this way that focused cost reductions (or future

cost avoidance) become part of the overall performance management framework.

Putting Money Where Strategy Is

Most executive teams request frequent updates and revisions to the financial budget. These are referred to as "rolling financial forecasts" because the projection's planning horizon may be as much as 18 months to two years beyond the fiscal year-end date.

Imagine if you are a CFO or financial controller required to reprocess the budget as a rolling forecast quarterly (or even monthly). There are not enough spreadsheets to do it!

Only computer automation that integrates several of the methodologies of the performance management framework, including good predictive analytics, allows an organization to produce valid, derived rolling financial forecasts.

Organizations that do not adjust budgets for future operational volume changes on all workloads, including indirect and shared expenses, will not adequately determine the correct required capacity.

In addition, organizations with a formal strategy-execution process dramatically outperform organizations without formal processes. Building a core competency in strategy execution creates a competitive advantage for organizations.

Financial executives can learn to manage strategy. It is important to include and protect planned spending for strategic projects and initiatives in budgets and rolling financial forecasts. Those projects lead to long-term, sustainable value creation.

Budgets are models that should reflect the nonfinancial behavior of the organization in financial terms.

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