Innovation in Action Series
April 2009

IBM

‘Useful budgets’ is not an oxymoron

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Information Management

Cognos software

We are pleased to present David Axson's article, 'Useful Budgets' is not an Oxymoron. Co-founder of The Hackett Group and having years of experience with financial and executive management of sophisticated organizations around the world, David is an unflinching advocate for innovation in business management practice. He is uniquely suited to call into question the effectiveness of the status quo, and to urge our companies toward better ways of doing business.

We are proud of David's association with the IBM Cognos® Innovation Center for Performance Management. We are confident you will find this article both intriguing and useful, as you seek measurable and sustainable improvement in the planning, forecasting, and performance management practices of your company in the coming year.

We look forward to being of service.

Jeff Holker
Associate Vice President
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Place the budget in the right context

The sole purpose of a financial plan or budget is to translate an organization's operating plan into a set of financial statements that define the allocation of resources against specific tasks and projects, and to estimate the results that are expected to accrue from implementing the operating plan. The operational and financial plans should clearly state where the organization expects to be relative to its overall strategy at the end of the plan period. Collectively, the strategic plan, the operating plan, and the financial plan define key management reporting requirements. They also define the set of measures that should be built into the forecast process.

Tactics drive budgets

One of the most common flaws in business planning is a failure to define tactics adequately. All too often, the communication of a plan target triggers an immediate leap to develop a financial plan or budget. By allowing the operational planning process to default to a primarily financial exercise, a key step is missed.

The importance of devoting adequate time to developing an operating plan was described by Larry Bossidy: "An operating plan is not about green eyeshades putting numbers together…. It ties a thread through people, strategy, and operations, and it translates into assigning goals and objectives for the next year." [1]

Defaulting to a budget at the expense of developing a sound operational plan can be even more damaging when the process is seen as being controlled or owned by the finance organization. In this case, the plan that emerges is finance's plan rather than the business's plan. This is very dangerous, since the level of ownership—hence accountability—by operating management will be limited at best.

Best practice organizations start by identifying the alternative actions available to them for meeting a particular target. For example, if the target calls for a 20 percent increase in sales, the discussion will start by evaluating the pros and cons of the sundry options for increasing sales, such as entering new markets, launching new products, or selling more to existing customers. The process becomes an iterative one with each possible tactic being evaluated for its ability to deliver the required level of operational and financial performance. The result is a series of tactics that can collectively deliver the targeted level of performance.

A well-developed operating plan makes the financial planning process relatively easy to complete. Best-practice companies devote two to three times more effort to developing the operating plan than they devote to the financial plan.

The fundamental purpose of a budget is to describe in financial terms the planned future performance of the organization. Unfortunately, many organizations have budgets that bear little or no resemblance to the tactics that will be employed in meeting the agreed-upon objectives. The budget may state exactly how much the organization will spend on office space, but provide little to no insight into how much will be spent on the acquisition of new customers. If one cannot discern the major tactics or initiatives an organization is going to pursue by reviewing the financial plan, monitoring future progress will be very difficult.

Decimate detail

Many organizations have an insatiable desire for detail. No matter what the situation, the immediate response of many managers is to ask for more detail prior to making a decision. In many situations unfortunately, having more detailed information simply makes decisions harder. Managers have to digest much more data, which takes more time and does not necessarily increase their confidence.

Developing very detailed budgets is time-consuming, expensive, and rarely results in a more accurate plan. Quite the contrary, the more line items that are budgeted, the less time there will be to develop a good estimate for each. It also stands to reason that the more items in the budget, the more variances will be created as actual results are tracked against each line item. Each variance will require analysis and explanation.

Reducing the level of detail allows managers much greater flexibility to adapt to changing circumstances within the broad parameters of the agreed-upon plan.

The dangers of detail

At a large brewing company, the budgeting process started in June or July for the following calendar year. The process was so detailed that managers were asked not only to estimate sales by beer type, but also to estimate sales by packaging configurations. Managers had to estimate, for each beer type, the mix between cans and bottles, the sizes of each—12-ounce or 16-ounce—and the package size—6-pack, 12-pack, or case. They had to create 144 separate volume estimates to develop the budget.

Needless to say, most of the estimates were worthless, since managers had no rational basis on which to develop them. The inefficiencies were not restricted to wasted time. One purchasing manager thought he saw an opportunity to save the company money. He noticed that the consolidated budgets projected the exact volumes of each packaging type that would be needed for the following year. Using these estimates, he was able to negotiate purchase contracts with the company's packaging suppliers. By placing a bulk order in advance, he realized a significant reduction in the total cost. The discount added fractions of a penny to the margin on all products, producing a reasonable improvement in overall profits.

On the surface, this looked like a substantial benefit for the company.

Unfortunately, as the year unfolded, it became clear that while the estimates of overall volumes by beer type were reasonably accurate, the more detailed packaging estimates were way off the mark. The company faced significant shortages of some package types while possessing excess inventory of others. Management was forced to stockpile unwanted cans and rush-order much-needed bottles at significant cost.

The root cause of the problem was not an error by the purchasing manager. The issue was the requirement that detailed budgets be developed for all plan periods regardless of whether the organization had the capability to estimate the numbers effectively. The fix was simple. The packaging detail was taken out of the budget and integrated into the six-week rolling production planning process. Doing this allowed for much more accurate estimates that were based on current information. Not only was packaging inventory more effectively managed, freeing up cash, but two weeks were taken out of the budget cycle by eliminating the need to develop the package-level detail for a full 12-month period.

People mistakenly believe that more detail translates into more accuracy. The comment, "That's a very detailed plan," is almost always seen as a compliment. In reality, the more detailed the plan, the more wrong it is likely to be.

On the other hand, best-practice organizations match desire for detail with predictive capability. Trying to develop a budget number with no reasonable basis for estimation can do far more damage than simply wasting time and effort.

An unintended side effect of driving plans and budgets to a very detailed level is limiting the speed of decision-making. Rather than making immediate resource reallocation decisions in light of actual events, managers tend to be constrained by the budget. Reducing the level of detail allows managers much greater flexibility to adapt to changing circumstances within the broad parameters of the agreed-upon plan.

Focus on materiality and volatility

Besides matching the level of detail to an organization's predictive capability, best-practice companies also balance detail based on relative materiality and volatility of the planning variable. Traditional planning processes have always recognized that big numbers are more important – more material – than smaller numbers. The impact of increased speed and complexity introduces another variable into the mix – volatility.

Volatility focuses on the speed with which a particular variable can change. The combination of materiality and volatility can be very useful for selecting those items that are most relevant for planning, forecasting, and management reporting. Items that are neither material nor volatile probably merit little or no attention in the planning process. They can be managed through direct monitoring of actual spending levels. If the profile of an item in this category changes and it begins to increase in materiality and volatility, then it will move into one of the other quadrants and be subject to an increased level of scrutiny.

Tracking the importance of variables based on their relative materiality and volatility allows an organization to direct its planning efforts toward those items that will have the biggest impact on meeting its performance objectives.

Tracking the importance of variables based on their relative materiality and volatility allows an organization to direct its planning efforts toward those items that will have the biggest impact on meeting its performance objectives. Spending more time on a few important items is a much more efficient use of scarce planning resources than spending a little time on many relatively unimportant variables.

Explicitly address alternative scenarios

Many executives have said that the process of planning is often more valuable than the end result. The planning process is the only time they have the luxury to ask 'what-if' questions without directly impacting day-to-day operations. Planning focuses on asking three questions. The first two are straightforward: Where are we going? How are we going to get there? The third asks: What if things do not turn out as planned? The answers to this question provide the most value during implementation, since things never turn out exactly as planned, and success is a function of the speed with which variances are identified and the organization can react.

Best-practice organizations understand that it is highly unlikely that all their assumptions about the future will prove correct; in fact, they know that most of them will be wrong. Recognizing this allows them to make sure that the planning process allows adequate time to ask 'what-if' questions.

Prize flexibility

Most budgets or forecasts present a relatively static view of the world that is updated at discrete points in time. Best-practice organizations recognize that this significantly handicaps their ability to make and implement crucial resource allocation decisions in a timely manner. A dynamic process integrates the flow of actual results into the budget and forecast process, providing a continuous view of progress and alerting managers to potential problems and opportunities. For example, during the planning process, management may define a series of contingencies in the event that sales do not meet a certain level by a certain date. Such contingencies could include increases in promotional spending and advertising combined with a freeze on hiring and reductions in materials purchasing. The dynamic forecast process will identify when the threshold for triggering these actions has been reached, and automatically alert managers that they need to trigger the contingency plan.

> *The deeper the understanding of the relative impact of each driver and of the interaction between drivers, the more accurate the forecast.*

The power of such tools is compelling: On September 12, 2001, Wal-Mart's systems alerted the business to the increased demand for U.S. flags and automatically triggered increased orders from the company's suppliers, ensuring that Wal-Mart was able to meet demand while many of its competitors found the supply of flags exhausted because of Wal-Mart's superior execution.

The power of driver-based forecasting

One distinguishing feature of a best-practice forecasting process is that the forecast is not solely based on the analysis of financial measures. The forecast is constructed by estimating changes in the key drivers of the business. The quality of a financial forecast improves dramatically if the projected change in financial results is based on a rigorous understanding of the likely changes in the key drivers of each financial measure.

For example, developing a meaningful sales forecast requires the consideration of a broad range of drivers, including the number of salespeople, the productivity of each one, the schedule of planned new product introductions, product pricing relative to competitors, and future advertising and promotion. All these factors can influence the number of new customers the company expects to acquire, the level of sales to existing customers, and any change in the customer attrition rate. The deeper the understanding of the relative impact of each driver and of the interaction between drivers, the more accurate the forecast.

Forecast fewer things more often

In the last few years, best-practice organizations have moved in the direction of forecasting more frequently and reducing the amount of detail in each forecast. These organizations understand that not only does more detail not equate to more accuracy, but also that excessive detail limits the rigor that they can put into each element. By forecasting fewer items more often, these organizations are able to develop more experience and knowledge that can only enhance the quality of the forecast. Organizations that rely on real-time information as a source of their competitive advantage have made forecasting of the most volatile or fast-moving elements of their business a near-continuous activity. The emergence of tools and technologies to support rapid forecasting offers organizations much more choice in the frequency, level of detail, and scope of their forecasting activities.

A forecast that limits itself to a financial view of the business will demand that additional work and investigation must be done to determine the real driver of a variance.

Less detail the farther out you look

The basic rule governing the level of detail in a plan or forecast is that near-term periods can be planned in more detail than longer-term periods. This idea is predicated on the simple fact that an organization's predictive capability declines the farther into the future you look. Many organizations demand the same level of detail for all time periods for which the forecast is being created. A common mistake is to take the line items from the chart of accounts or the financial plan and require that the forecast be completed at the same level of detail. This has two major flaws. It limits the organization to a financial accounting view of the world, and not all line items are created equal. A forecast that limits itself to a financial view of the business will demand that additional work and investigation must be done to determine the real driver of a variance. It is important to strike the right balance between materiality and volatility in defining the items that should be forecast.

By simply stepping back from the myriad columns and rows of the traditional budget spreadsheet and asking what are we trying to accomplish and what can we realistically accomplish, organizations can develop budgets that are both useful and relevant.

Now there's an interesting thought.

About David Axson

This article is adapted from the book Best Practices in Planning and Management Reporting by David A.J. Axson copyright 2003 by David A.J. Axson and The Hackett Group, published by John Wiley & Sons Inc. Hoboken New Jersey. David Axson is the founder and president of the Sonax Group and an advisor to the IBM Cognos Innovation Center.

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Produced in Canada
April 2009

Endnotes

1 Larry Bossidy and Ram Charan, *Execution: The Discipline of Getting Things Done* (New York: Crown Business, 2002), p. 228

IML14063CAEN