CFO

No Time For Budgets

BY EDWARD TEACH

Yesterday's budgets are too slow for today's volatile world. Here's how to pick up the planning pace.

Has any corporate financial tool come in for as much scorn as the annual budget—and has any tool so richly deserved it? CFOs, managers, consultants, academics: all have long pointed out the flaws in both the budgeting process—the politics involved, the sandbagging—and the final product, which becomes less relevant with each passing month.

"The fundamental problem I have with budgets is that they are all based on assumptions that turn out to be wrong," says Steve Player, North America program director for the Beyond Budgeting Round Table, a learning network with more than 60 corporate members in North America. "Sometimes the economy comes in stronger, sometimes it comes in weaker. The budget locks everyone in to an annual cycle. We need to be moving faster than that, to be more agile."

Player is one of the most prominent of a growing number of consultants who are trying to persuade companies to reduce their reliance on—or eliminate altogether—a planning tool that they say is ill-suited to an ever-more volatile and competitive world. They want companies to speed up the tempo by using techniques such as rolling forecasts and scenario planning, made increasingly feasible by user-friendly planning and forecasting applications that can parse huge amounts of data in near real time.

Below, Player and three other consultants tell how they are helping companies adopt faster, more frequent, and more accurate methods of setting targets and allocating (and reallocating) resources. Also, a CFO tells how her company moved to rolling forecasts—and gave up the annual budget for good.

LET IT ROLL

No organization has tried harder to wean companies from the annual budget than the Beyond Budgeting Round Table, and Steve Player is its chief evangelist. The problem with traditional budgeting, he says, is that it tries to do too many things—and does none of them well.

Take target setting and rewarding, for example. "We say we're going to pay people to hit their targets in the budget," says Player. "But once pay is connected to hitting targets, people want to negotiate and minimize those targets. Immediately, we're not adding value, we're at cross-purposes."

Moreover, a target is only as good as all the assumptions that go into making it—about the economy, the competition,

key commodities, and so on—"most of which are going to be wrong," says Player. "People naturally mitigate against that uncertainty, and they try to negotiate as low a target as possible. Then they're focused on hitting the target, instead of saying, 'I want to do the best I can.'"

It's no wonder that a budget can be outdated even before it's printed, says Player. "In February or March, you might have management accountants explaining why the actuals are different from the budget. In April, the same. When May comes, they have to get creative—but by then the operating people have stopped listening."

Switching from annual budgets to rolling quarterly forecasts is "a good start," says Player, but more is required. "You still need to plan," he says. "You have certain cost and income relationships you're trying to hit and improve on. But it's got to be a much more flexible plan."

That means, for example, shifting from fixed targets and rewards to relative targets and rewards. "It isn't how well you do, it's how well you do versus the opportunity you have, and versus the competition," says Player. "Would a stock investor invest in your company or a comparable company?" Rewards should be "based on what people actually deliver, in the actual economy they had to deliver it in."

Planning has to be dynamic, able to respond more quickly to changes in the industry and the economy. "We want to update those assumptions and track what's really happening, instead of what we thought would happen last summer," says Player. "Make the organization adapt and move on a regular basis." Resource allocation has to be coordinated across the organization, and it can't be a once-a-year event; "the 'investment bank' has to be open year-round."

"If you do those things," continues Player, "then from a leadership point of view, you can create a whole different organization, a whole different culture—one that has far greater trust, far greater transparency, and is much more accountable."

A MONTHLY PROCESS

"The budget is always a starting point, and most companies will probably never give up the budget," concedes John Macrae, a principal at accounting and consulting firm CohnReznick. "They view it as that command and control document—the thing they have to hold people accountable."

Often, however, Macrae and his firm are called in by companies (generally ranging in size from $25 million to $1 billion in revenues) that say their budgeting and planning process is broken—that it's too complex and consumes too much time and resources for the value it provides. "Nine times out of 10, what we find is that this process they are devoting so many resources to is just used as a report card, not a planning process," he says.

Macrae nudges companies toward using the budget as the initial input and then adopting a collaborative planning approach, involving operations and finance, where a continuously refreshed forecast supplements the budget and drives the business. The collaborative approach emulates sales and operations planning at product-based companies, says Macrae, which integrate their sales forecasts with purchasing, production management, and inventory management.

"The first thing we say is, let's accept the concept of going to a quarterly reforecast," at least for a rolling four quarters, he says. "Then, as we start getting the process down pat"—integrating sales, operations, and finance and building a driver-based forecast—"that's when we can start having monthly planning meetings." The ultimate goal is a monthly process where managers evaluate business performance and update the forecast with actuals, and then reforecast on a rolling 12-month or even 18-month cycle.

Perhaps the biggest challenge of moving from a budget to a forecast is changing the way compensation is tied to the new process, says Macrae. He recommends using team-based incentives, tied to the key factors that a team can control. A sales and marketing team, for example, should be rewarded for the accuracy of the sales forecast. Moving to a forecast "can and should eliminate sandbagging," he says. "You don't get that push to close out a period to hit your numbers, because the next period is just as important."

Technology is key to frequent forecasting, says Macrae. "It's cumbersome enough to do annual budgeting with spreadsheets," he says. "When you tell people they have to do something that they hate more frequently, that just doesn't work." There are a number of planning and performance management systems on the market, he notes, many cloud-based and suited for both large and smaller companies. "But we approach change by getting the new process down first, then showing how technology can be used," says Macrae.

Whether a company calls it a budget or a forecast, "the document still exists," he says. "Investors can look back and see, based on the past 12 months, how the company did—what was the plan, what were the actuals, the variances.

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Resource allocation can't be a once-a-year event. "The 'investment bank' has to be open year-round," says Player.

The real benefit is that they can understand much more about the business, and how it plans to achieve its goals, as opposed to whether it hit its goals, because they are looking at the forecast."

RADICAL REALLOCATION

"The world is changing more quickly now," says Paul Cichocki, a partner at Bain and leader of Bain's Americas Performance Improvement practice. "You see it in technology—take BlackBerry, which was once at the top of the heap, and now will be lucky to stay in business. Sometimes a company doesn't have several years for their traditional budget process to increment toward the right resource allocation. They need a more radical method, and zero-based budgeting is that method."

Radical yes, but not new. Zero-based budgeting came in vogue in the 1970s, when President Jimmy Carter mandated its use in the federal government. Over the years, zero-based budgeting never really caught on, simply because it is so arduous to start with a clean sheet of paper and rejustify every budget item from the ground up, with zero as the starting point.

Yet, the technique is making a comeback, according to Cichocki. "We have seen a resurgence in zero-based budgeting in industries that are under pressure," he says. One such industry is health care, "which has gone through 30-plus years of real pricing increases over and above inflation," he says.

Zero-based budgeting is also appropriate for individual companies when changing market dynamics require them to change their cost structure and how resources will be allocated. If a company's strategy changes significantly, the traditional incremental budgeting process "falls apart," says Cichocki. "The 'start with last year's budget and adjust it' mentality doesn't apply in situations where the industry context has changed, or a company's own competitive position has changed."

Cichocki doesn't sugarcoat the effort involved in starting a budget from scratch. "The truth is, it is very daunting," he says. "It is a resource-intensive process—full stop. However," he adds, "it also happens to be a cost-transformation process that is the least risky to implement. Zero-based budgeting greatly reduces unintended consequences"—the kind that results when you "squeeze the balloon in one area, only to see it explode in another area because you didn't understand the relationship." Also, he says, "it is the only tool that is going to enable a company to routinely take 25% or 30% or more out of its cost base."

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Finally, Bain's objective is to improve the capabilities of the function in which zero-based budgeting is applied—the speed and quality of decision making, the strength of processes, and so on, Cichocki says.

Bain's approach to implementing zero-based budgeting has eight stages (see box this page). Stage two may seem counterintuitive, says Cichocki—"aren't we supposed to start with a blank sheet of paper, and just see where the chips fall?" In theory yes, but that doesn't necessarily work in the real world, he says. "The very fact of setting a transformative cost target—a quarter, a third, even half of the costs be removed—enables all minds to think transformatively," he says.

To be sure, zero-based budgeting is not something Bain recommends doing on an annual basis. "You don't need to do it again unless you need to reset your strategy again," says Cichocki.

THE EIGHTFOLD WAY

How Bain approaches zero-based budgeting

1. Align the G&A function with the corporate strategy
2. Establish a transformational target cost structure based on benchmarks and judgment
3. Take a financial and nonfinancial inventory of all activities, processes, deliverables, and so on associated with a given function
4. Draw up the ideal state of affairs—the new activities, processes, deliverables, and so on
5. Compare the ideal state with the existing state and apply a "realism lens" (what realistically can and can't be done)
6. Based on that comparison, draw up the future state of affairs
7. Build the organization around the future state
8. Draw up a road map for implementation

Source: Paul Cichocki, Bain

TECHNOLOGY RISING

"The last five or six years have been a wake-up call for most organizations," says David Axson, managing director at Accenture Strategy. "The speed, depth, and length of the downturn were not well anticipated by anybody. It caused a lot of senior managers to take a long, hard look at the way they plan and forecast the business."

Responding to increasing volatility, companies and CFOs are placing more emphasis on short-term planning and forecasting, says Axson. "The biggest trend I see is gaining the ability to adapt and react to the volatile environment with speed and confidence, and the ability to leverage technology to do that," he says.

But Axson doesn't think replacing budgets with rolling forecasting is the answer, explaining that while in theory it "makes great conceptual points," it is "a lot harder to do in practice." Instead, he advocates short-term, driver-based forecasting, coupled with frequent scenario and contingency planning, "so companies can react and respond to events in the marketplace."

Axson is currently helping a large consumer-products company adopt this approach. "That's the heart and focus of what we're looking to do here: beginning to build the explicit evaluation and analysis of variability into the planning and forecasting process." Such companies, he says, are sensitive to changes "at the margins—changes in consumer spending patterns, GDP growth rates, foreign exchange rates."

Key to such forecasting is the availability of increasingly powerful analytic tools. "We are finally seeing the hype get matched by the reality when it comes to technology—the ability to take large volumes of data, consolidate them, and make them available to business managers to support the planning process," says Axson. Planning and forecasting tools have evolved to the point where a company can do pretty much what it wants to do, he says. "If you want a very detailed budget, the technology will allow you to do that. If you want to run scenarios, the technology will allow you to do that."

Cloud-based tools are leveling the playing field, enabling smaller companies to deploy sophisticated functionality quickly and at relatively low cost. Now, "a one- or two-person staff can still have online analytics, still do mobile delivery of management reporting," says Axson. He says another of Accenture's clients (a large company) is currently implementing a cloud-based planning system to do SKU-level budgeting and forecasting across the enterprise. Everyone uses the same tool, and the data is updated with actuals in near real time.

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"Organizations are really now beginning to reap the value of all these worthy communication tools, collaboration tools, cloud-based app functionality, mobile apps, analytic apps," says Axson. "They are all coming together to help companies better adapt to the volatile marketplace and the global marketplace."

As for the annual budget, "it's somewhat naïve to think that it will ever disappear," says Axson. "Rightly or wrongly, the fiscal calendar still marks time for companies. If you're a public company, you still commit to quarterly and annual projections. If you're private, you're still doing the same, committing to your investors, to your owners. And frankly, I think companies have said that there's some value to having an exercise where you get everyone on the same page, understanding that that view of the future will change."

But there are ways to eliminate the drudgery from traditional budgeting and make it more effective, too. Axson names three. "One: Get the level of detail right. Plan the things that really matter. Instead of sending out the same spreadsheet with the same 120 line items to every department and manager in your company, simply send out the line items that matter.

"Two: instead of building every number up from scratch, prepopulate as much of that data as you can—80% to 90% of line items. Build in algorithms that will take your current trend rate in each area and project that out for the year, to give a baseline. Focus on the zero base for the line items that really matter.

"Three: dashboards and scorecards are getting automated, with alerts and early warnings built into the system. They don't require someone to sit down and sift through a monthly report that has 200 variances and try to work out which ones are important. Set limits, so a variance gets flagged when you hit that limit." CFO

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