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The Annual Budget May Be Past Its Useful Life

Most companies don't generate an adequate return on investment on their budgeting processes.

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Unfortunately, in our experience advising hundreds of companies in how to create long-term shareholder value, we find most do not generate an adequate return on investment (ROI) on their budgeting processes. This, of course, is no small matter when you consider that for many companies, the annual budgeting process takes months and consumes thousands upon thousands of employee hours across virtually all business functions (sales, operations, finance, human resources etc.). In fact, despite its virtues in many companies, the annual budget can create dysfunctional behavior that over time does more harm than good.

So now, once again, as we find ourselves in the budget time of year, rather than encouraging employees to focus on the business at hand, managements are thrusting them into the rote budget process of templates, spreadsheets, and presentations. This will culminate in an unending series of back-and-forth negotiations and rework to get to an "agreed upon" budget. Maybe it's time for financial executives to step back and ask themselves: Is our budgeting process worth it?

How can something so pervasive be bad? The problem lies not in the budget itself but in the way it is prepared and used. Indeed, having a twelve-month, forward-looking view of the business, its revenue, expenses, and capital needs is a sound component in an overall financial management framework. So where do companies go wrong?

The budget process often derails because many companies apply it in too many situations. Using the budget for purposes other than its original, so-called "planning" objective can be dysfunctional.

Confusing a Budget for a Plan

In many companies the terms "budget" and "plan" are used interchangeably. But by definition, a budget represents only one possible future scenario. And it's probably not even the most likely scenario to unfold over time.

The rate of change in business today is far faster than it was in the 1950s when budgeting became a cornerstone of financial management. To adapt to the rapid changes in the corporate ecosystem, companies need a dynamic planning function that allows them to course-correct and adapt quickly. However, the budget by definition is static and often stale – and can stand in the way of dynamic change. This is exacerbated by how remarkably detailed and granular budgets have become – making them hard and expensive to update as new information comes in.

The time and resources spent preparing and approving the annual budget creates an Illusion of precision. It leads decision makers to put more faith into the budget than they probably should. They feel “safe” because countless people have spent considerable time developing the budget, and they can track variances at a minute level. Yet they may not be aware of the danger that lies ahead if they simply track performance against the often stale budget.

In fact, many senior executives willingly admit that their budget is out of date the moment it is approved. Too much time has elapsed from the beginning of the process, and in that time much has changed in the business. Therefore, the act of simply “achieving” the budget really doesn’t tell them anything about how they’re navigating the competitive landscape.

Many companies overcome this challenge by instituting a rolling forecast process. Typically done at a much higher level than previously and with more recent information, the forecast becomes the management tool used to steer the company throughout the year.

In many cases this is an improvement. Yet it is still imperfect. For example, consider a business with no available budgeted headcount in its sales organization but that has an opportunity to add a new hire widely regarded as the industry’s top sales person. In many cases the head of sales will request a waiver from the annual budget to hire this person, and the slowness of this process sometimes ends with the candidate taking a job elsewhere. Is that really the right way to go about it? How can the bedrock of prudent financial management be a process you have to work around to get the right thing done?

Linking Budgets and Annual Incentive Targets

Potentially even more damaging than confusing a budget for a plan is the use of the budget as incentive targets. As Gregory Milano wrote in the January 2014 CFO article “Ugh! It’s Budget Approval Time,” “Whoever first decided to link performance measurement to budgets may have done more damage to business effectiveness than anyone else in history.”

From our experience, this all-too-common practice weakens both the budgeting and the incentive process simultaneously. However, it’s easy to see the appeal of having the two linked as it creates an Illusion of control. After a series of “tough but fair” discussions, a manager and his or her boss agree to what can be achieved for the year, and the manager will be held accountable for meeting that goal. Of course, what this does is reduce the budgeting process down to a negotiation. The manager has no incentive to discuss the maximum potential or aggressive plan that could be pursued for fear that if that becomes the budget than any slippage will have a direct negative impact on his or her annual incentives.

In fact, the manager is encouraged to sandbag the budget and to hold back items that can later help the company make its numbers. As a result, the boss may never see a case that demonstrates the true potential of the business

As the process rolls forward, the managers that are better at this budget-negotiation game wind up getting easier budgets and earn higher bonuses. At many companies, a careful analysis over time shows no correlation at all between pay and performance because the ease or difficulty of budgeting can matter more than the results. Tying bonuses to budgets reduces the emphasis on actually improving performance as long as targets can be negotiated.

Further, beyond the potential misalignment between incentive compensation and performance, a sand-bagged budget almost always leads to sub-optimal resource allocation across a business. After all, the original purpose of a budget is to forecast revenue, profits, and returns on investments. It is typically used to direct the capital budget and the company's capital structure. If senior management isn't getting an adequate picture of the business, then, really, of what use is the budget anyway? And if someone is rewarded simply for beating an artificial target that is typically sandbagged by different amounts, how "fair" is the compensation system?

On the fringe, the linkage between budget and incentives can create truly perverse behavior. For example, consider a manager nearing year-end that who has already maxed out his or her achievement of budget for the year and cannot earn any more incentive compensation. When this manager gets a call from a new customer, he or she has an incentive to push the sale into the following year so as to already be one step ahead of next year's budget

Over time everyone learns the game, and the budgeting process quickly descends into a race to the bottom.

Conclusion

The annual budget may be past its useful life. If most companies stepped back and assessed whether they're really earning an adequate ROI from their budgeting processes through superior decision-making and optimal resource allocation, we believe, many companies would curtail their current practices. We recommend to our clients that they develop alternatives for planning and incentive compensation target-setting that decrease the dependency on the annual budget. Once that is achieved, the budgeting process can be significantly simplified, and once again become a cornerstone of prudent financial management.

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