

budgeting IS DEAD!

Malcolm Simister, a principal of LMN Consulting and chairman of the Victorian Regional Council of the Institute of Chartered Accountants in Australia, believes that traditional budgeting encourages poor management practice and should be replaced by rolling planning and forecasting.

BY USING BUDGETING as a key governance process, directors are constraining business agility, increasing costs and encouraging poor management practices, but an alternative process eliminates these problems and still provides good governance.

Budgets have served countless businesses well for many years when life was slower and change more gradual. However, in today's rapidly changing world, setting targets for 12 or more months ahead is futile. Business conditions often change significantly during a financial year, so the budgeted financial targets directors set at the beginning of the year become inappropriate. Budgets can also inhibit business growth as budgeted allocations of resources take no account of changing circumstances.

Worse, in many companies numerous people, including highly paid senior managers, spend countless hours over many weeks or months preparing budgets in tedious detail. This makes budgeting a very expensive exercise that results in large volumes of near-useless data. For example, one natural resources company budgeted separately the membership fees of its Chartered Accountants and CPAs, reflecting the different professional bodies' fee levels. But one year completely omitted \$70 million worth of essential capital expenditure until the error was discovered by an unimpressed CEO. The accountants had taken so many hours calculating the minutiae that they forgot a material item.

If that wasn't enough for you to question budgeting, the reality is that budgets are often negotiated targets used to determine management bonuses rather than being expectations that anyone believes. Even if the budget is realistic, most managers are adept at 'gaming' their results to maximise their bonuses, not necessarily to their company's benefit. At one retail company, managers were experts in deferring income to the following financial year once their current year's bonus targets had been met. This gave them a head start for the next year; good for their bonuses, bad for the company's profit.

Rolling plans and forecasting

The good news is that an approach exists that not only provides directors with a good governance mechanism, it also gives a company the agility to adapt as circumstances change.

A cycle of rolling plans and forecasting, if implemented correctly, has significant advantages in both providing good governance and in promoting good business. Here is how it works.

1. Annually, directors stand back to review corporate strategy. Based on the agreed strategy, which includes ongoing financial objectives, the

company develops its medium term (3-5 years) business plans. This step typically occurs in most companies.

2. Actual monthly, year-to-date and the last 'rolling' 12 months' financial results are compared to ongoing financial objectives enabling directors to hold management accountable during the financial year. Results for the last rolling 12 months are important as ongoing financial objectives are likely to be expressed in annual terms, such as returns on capital employed.
3. At intervals appropriate to the business, say quarterly, management produces a forecast by quarter for the next 12-18 months to enable directors to review the appropriateness of the plans and to assess whether the ongoing financial objectives are being met.

As with any new process, there is a learning curve with rolling plans and forecasting. 'Jumping at shadows' is a real danger whereby a company reacts to a perceived change that is just a temporary 'blip' in a trend. Nevertheless, a controlled, quarterly process that permits, but does not force, changes to business plans is surely preferable to persisting with outdated plans for several months.

Importantly, the forecast to the end of the financial year will inform directors whether or not the current financial year will meet expectations and ongoing objectives. No one pretends that a forecast for 18 months ahead is going to be completely accurate, but it at least enables management to present to the board their current expectations, given the latest information available.

Forecasts should be prepared quickly by concentrating on the relatively few elements that really matter. In most businesses, a few items such as number of employees, cost of goods sold and marketing campaigns constitute the majority of costs. By concentrating on key expense items, other less important expenses can be forecast as a lump sum.

Based on stated fundamental assumptions that directors provide (eg inflation, interest and exchange rates expectations), the starting point is usually a sales forecast. But the process should be iterative until managers in all business areas are satisfied that their element of the forecast is realistic. Managers must use their expertise and 'gut feel', supported with some data to produce a forecast that is reasonably realistic rather than attempting a futile exercise in precision. Finance should facilitate the process, ensure integrity and provide a reality check, not own the numbers.

For example, one natural resources company gathered senior sales and senior operations managers around a table and, facilitated by finance,

in two or three sessions spread over a few days agreed on the forecast production and sales. Naturally, they came armed with their own ideas of the future and took time out to verify changes with others. Yet this relatively simple process allowed sales and production to efficiently combine their expectations with integrity.

Governance – holding management accountable

Although under a rolling plan and forecasting process there are no fixed targets, directors must still set objectives for management and hold the chief executive to account. In essence, budgeted targets must be replaced with something else.

Rather than annual financial targets, minimum ongoing financial and non-financial objectives can be set, such as returns on capital employed coupled with growth in market share. However, management should not assume that if these ongoing objectives are met they will receive handsome bonuses. Rather, their performance relative to comparable others, such as companies buffeted by the same winds of change, should be used to determine their incentive payments. Comparable companies include those in the same or related industries in Australia and, for truly international businesses, those overseas.

No comparison is perfect, but a practical difficulty can be obtaining comparable and reliable data. In addition to obtaining data directly from the comparable companies, other sources include summarised statistics from industry bodies, the Australian Bureau of Statistics or even through comparable companies using an independent intermediary to collect data and disseminate rankings confidentially.


Internally, comparisons include those between subsidiaries in different countries or business units in different but comparable geographic locations. For example, one leasing company categorises its subsidiaries around the world depending on the maturity of the market and other criteria, and benchmarks them within each category. Retail companies commonly rank the performance of similar size stores in comparable demographic areas. Whatever the comparison, managers' rewards are higher the better their comparative performance.

Managers are unable to 'game' their results because there are no fixed targets and the comparison cannot be made until after year end, encouraging them to continue doing their best at all times. Further, in good times, all companies do well so managers are not paid bonuses for simply showing up. In bad times they can still earn bonuses if the company performs better than comparable others. Effectiveness is more properly rewarded.

During a financial year, comparison of actual results to ongoing objectives enables directors to hold management to account. Comparison of forecast to actual results should be used as a learning exercise to understand why reality is different from expectations, assess the quality of the forecast and to improve the forecasting process.

Implementing

Naturally, implementing a significantly different process that replaces an important governance mechanism should not be undertaken lightly. A good approach is to introduce rolling plans and forecasting alongside annual budgeting until directors and managers have sufficient expertise and confidence in the new process.

It is important that managers, as well as directors, understand why and how to forecast and develop expertise in it and not be constrained by financial years. Many directors say they need the detail to understand the bigger picture, but another issue can be their reticence to replace an established process, no matter how inadequate, with something new. For the benefit of their shareholders, they should try! 

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