„Why Budgeting Fails: One Management System Is Not Enough“

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Why Budgeting Fails: One Management System Is Not Enough

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Péter Horváth, cofounder and chairman of Germany-based Horváth & Partners and chaired professor at the University of Stuttgart, is Europe’s foremost thought leader on management accounting, controlling, and budgeting. Author of the recently published How to Implement Beyond Budgeting, Horváth was one of the first voices to oppose the traditional budgeting process, calling it counterproductive. Here, he and his colleague Ralf Sauter present what’s wrong with the current approach to budgeting — and how to fix it.

When Jack Welch described the budgeting process as “the bane of corporate America,” he was articulating the frustration of many senior executives and academics who recognize that this annual exercise is rarely justified in today’s fast-changing, highly competitive environment. We couldn’t agree more. In fact, we believe that if budgeting is to have any value at all, it needs a radical overhaul. In today’s dynamic marketplace, budgeting can no longer serve as a company’s only management system; it must integrate with and support dedicated strategy management systems, process improvement systems, and the like.

The Problems with Budgeting

What exactly is wrong with budgeting?

It’s inefficient. The traditional budgeting process takes too long and consumes too many management resources. Our research shows that senior managers spend about 10% to 20% of their time on budgeting, and finance planning departments spend as much as 50% of their time on it. Yet only a small percentage of these two groups regard the budgeting process as a valuable use of their time.

It rapidly becomes obsolete. With their annual focus, most budgets are outdated soon after they’ve been set. Nonetheless, people still try to hit these outdated numbers — a particular problem for companies operating in dynamic, highly competitive marketplaces.

It doesn’t motivate the right behaviors. Traditional budgeting fails to move people to act in their company’s best interest. It fosters bureaucracy and dysfunctional behavior instead of entrepreneurship. Cost-center managers often request more than they will need to ensure their allocations aren’t cut the next year or else deliberately lowball their financial targets to make their performance appear better. In many organizations, the budgeting process, rather than helping to coordinate and plan the execution of a forward-looking strategy, is little more than a gambling exercise.

It’s out of sync with the strategic plan. Perhaps most important, traditional budgeting emphasizes financial performance over and above the pursuit of strategy. It focuses managers’ attention on the next year-end rather than on supporting medium-term strategy execution. Why? The emphasis on “making the budget numbers” makes managers reluctant to spend money, which, in turn, prevents them from executing strategic initiatives as a first priority. Adding to this disconnect, in many companies strategic planning and budgeting are not linked.

The Traditional Role of Budgeting

When it was first developed nearly a century ago, the corporate budget was designed to serve three main purposes.

1. Coordinate the organization’s financial activities and picture. The budget is where all the financial components of an organization — from the individual units, divisions, and departments — are assembled into a coherent master picture that expresses the organization’s overall operational objectives and strategic goals. The point of the budget isn’t merely profit planning; it’s designed to align the individual units to the organization’s strategic and operational objectives. It’s also supposed to allocate resources so that senior management can make decisions about savings and revenue objectives. While the budget was the first management system devised to do this coordinating, other systems exist today that fulfill this function more effectively.

2. Communicate financial expectations. A budget is designed to give (decentralized) managers a clear understanding of the company’s financial goals, from expected cost savings to targeted revenues. As budgets evolved toward higher levels of detail, they’ve ended up supporting bureaucratic, centrally controlled leadership. While budgets make financial expectations explicit, due to their annual nature they make it difficult to implement adjustments called for throughout the year by dynamic market conditions — a reality that only reinforces bureaucratic decision making.
3. Motivate managers to act in the company’s interest.
Rewarding managers for achieving challenging objectives is probably the most important — yet most debated — function of budgeting. Budgets more often than not encourage dysfunctional behavior such as “padding” or “slacking” (spending funds that remain at year-end to prevent having one’s allocation cut the following year). This problem isn’t unique to budgets, though; it’s a shortcoming of fixed targets, whether financial or nonfinancial, in a decentralized organizational structure.

The problem is not with budgeting per se; the budget still has an important role to play in the financial management of companies, one that cannot be isolated from strategy execution. The real problem is that the traditional approach to budgeting is no longer suited to the realities of today’s dynamic marketplace. Companies (particularly those in fast-changing markets) that continue to rely on the budgeting system as their only management system are following a prescription for failure.

Guiding Principles for an Advanced Budgeting System
We propose six guiding principles for an advanced budgeting system that optimize the role of budgeting while supporting strategy execution.

1. Align budgeting to strategy.
In many companies, strategic planning and operational planning and budgeting are disconnected. An advanced budgeting system will integrate the planning and review processes. The Balanced Scorecard is a helpful alignment mechanism for this purpose. A well-designed BSC cannot entirely replace the operational coordination and profit-planning aspects of the budget. But it can supply the coordinating functions that budgets were originally designed to perform: it can communicate the strategy to managers and give them direction, and it can help managers identify and oversee strategic initiatives and link them to their company’s financial activities. In addition, the BSC’s clear depiction of strategic priorities helps to set firm guidelines for budget planning.

Many companies that use the BSC nonetheless still struggle with budgeting because they do not use either system to its greatest advantage. When implementing the BSC, it’s crucial that companies de-emphasize the importance of budget-related objectives to the benefit of BSC-related objectives, while reducing the level of detail in the budget. Otherwise, they’ll only double their work and increase their frustration level.

2. Link relevant nonfinancial performance measures to budgeting.
Many organizations still use predominantly financial (budget-derived) information to manage their business, even though financial data is a lagging performance indicator. State-of-the-art management systems focus on important performance drivers, both financial and nonfinancial, and link them to the world of financial results represented by the budget.

3. Reduce detail through the use of aggregated budgets.
Excess detail is a major reason why the budgeting process has become so lengthy and time-consuming. This sidetracks management from focusing on major success factors and performance drivers. Worse, it does not reflect or support decentralized decision making and leadership. The emphasis on detail also reduces the organization’s speed and flexibility in decision making, thus weakening its competitiveness. Many companies have taken the first step toward reducing detail by focusing budgeting on major product groups, organizational units, processes, and cost types. Among progressive companies, we are already seeing a trend toward aggregated instead of detailed budgets, which allow decentralized leaders to be just that. Instead of having to document every single departmental cost, they are given discretion in allocating resources to departments and activities under their jurisdiction.

4. Use rolling budgets instead of fixed budgets.
Once detailed budgets are abandoned, the annual budgeting exercise can be transformed into a continual planning process. In competitive and dynamic marketplaces, companies need more frequently updated budgets so they can adapt to changing conditions. In addition, companies should set direction not just through year-end but also for the near future. Therefore, state-of-the-art budgeting systems use such approaches as the five-quarter rolling forecast, which can then be translated into an aggregated rolling budget. (See box.) Constantly focusing management on the next five quarters (rather than just on the year-end) helps to balance short- and mid-term thinking.

5. Use relative targets instead of a fixed budget to reward people.
Instead of encouraging managers to meet their fixed budget (which is set in advance), we advocate measuring success by comparing manager performance against relative, self-adjusting performance measures whenever possible. Relative targets can motivate the right behavior, guiding people to act in the company’s best interest. For example, from a cost perspective, a call center manager should not concentrate on her $20 million budget but rather on the center’s productivity.

With a fixed budget, if the manager experiences an unexpected flood of incoming calls, she is in trouble. With no allocation to support these new sales, she’s
Fixed vs. Rolling (Forecasts and Budgets)

A fixed budget covers a fixed period of time. Once it’s set, you compare quarterly performance to the budget. The year-end forecast tells you how much you have to spend for the rest of the year. If conditions change — a new competitor launches an advertising blitz or financing costs drop suddenly — you’re stuck. Either you don’t act and stay within budget, or you make the unforeseen expenditure and cut later on.

The rolling forecast looks five quarters ahead — through the following year, plus one quarter — and is updated each quarter. On March 31, for example, you look at the remaining three quarters of the year and the next two quarters of the upcoming year. Rolling accomplishes two things: it gets managers away from their year-end focus, and it allows for targets to move as conditions change. That lets companies take advantage of unforeseen opportunities or shore up resources. It also forces less detail — another positive.

The rolling budget gets set based on the rolling forecast and additional resource allocation decisions.

held back from realizing exceptional sales performance. It is much better to assess the manager's performance in hindsight, based on such benchmarks as the number of calls per full-time employee and comparisons with external (industry peer group) benchmarks. This will motivate her to beat the competition, not just to make the numbers, and to better manage the center's capacity. Customer-facing managers, after all, know market conditions best.

While it is important to connect nonfinancial performance to the company’s overall financial situation and budget, managers today should be rewarded for achieving a set of nonfinancial as well as financial objectives. A progressive company incentivizes such performance by basing bonus compensation on multiple factors, not just on whether the manager makes his or her numbers. Such factors might include, for example, whether all five departments in the division hit financial targets, whether the company makes a profit or beats the market average, and whether the manager has contributed to boosting customer loyalty or reducing departmental turnover.

6. Increase the focus on processes instead of on departmental and organizational unit performance. Many successful companies focus their management system and their budgeting effort more on cross-functional core processes (such as streamlining operational efficiencies or fostering greater customer value through cross-selling) instead of on isolated departments. This reflects the idea of managing processes to drive success in the marketplace. It also focuses management on major cost drivers, not single cost figures. The result: managers are more attentive to organizational strategy and goals, and the company fosters collective effort and teamwork instead of internal competition for resources, which can create divisive, sometimes counterproductive behavior.

Will Budgets Survive?

Management guru Peter Drucker once said (referring to multinationals), “Traditional [corporations] tend to be organized along product or service lines....They are held together and controlled by ownership. By contrast, the multinationals of 2025 are likely to be held together and controlled by strategy.” If he is right, we predict that management systems, budgeting among them, will be completely different.

Does budgeting have a future? Not the traditional, detailed-oriented, bureaucratic system developed nearly a century ago. Budgeting, as a part of the suite of management systems, must follow strategy. Happily, many companies have already started to redesign their budgeting system, adapting it to their competitive environment, level of decentralization, leadership style, and corporate culture. We foresee the growing use of rolling forecasts and aggregated budgets (except perhaps among organizations in more stable industries). Increasingly, companies are turning to other systems, such as the BSC, to perform strategy implementation and its communication. Along with other systems, such as activity-based costing (for process improvement) and Six Sigma (for quality), companies can integrate these robust, targeted tools into a total management approach. Clearly, one management system is not enough to meet the competitive challenges of the 21st century.

TO LEARN MORE

How to Implement Beyond Budgeting, by Horváth & Partners, Schäffer-Poeschel, 2004 (available in English in late 2004).


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