ANNUAL BUDGET

TIME TO THROW IT AWAY?

New Zealand based accountant **David Parmenter** says the annual budgeting cycle takes too long and is not linked to strategy, strategic outcomes, or critical success factors. This article is an extract from a book he is writing, *Management Summitting - A Guide to the Top.*

Accountants are commonly criticized about the lack of linkage of their work to strategy. The monthly/annual reporting and budgeting processes absorb large amounts of an organisation's resources, with little linkage to strategy or critical success factors. So it's no wonder that organisations put pressure on accountants to add more value.

Some accountants have made radical improvements to their organisations by building processes that enhance performance and behavioural change. They are benefiting from linking their work through the organisation's critical success factors and thus back to the strategies. They have done this in the following three ways.

1. Ensure all layers of staff have an understanding of the linkage between the organisation's mission, values, vision, strategy and performance-management processes

Organisations are beginning to understand that this linkage must be understood for staff to be "fast, focused and flexible", says Bruce Holland, a well known strategic planner and communicator. Strategic-planning processes must be much more inclusive for organizations to reap benefits.

"If you've done your job properly, you should be able to rip up the final document, as staff and management have the linkage imprinted in their memory," he says.

He found that achieving this level of understanding is much quicker and easier than most managers and CFOs believe. There are ways to getting people across the organisation involved that would generate more understanding, energy, goodwill and commitment.

This caused me some confusion, so I set down the linkages as part of a learning and reinforcement exercise:

- ☐ The **mission** is like a timeless beacon that may never be reached, eg, Walt Disney's "to make people happy"; 3M's "to solve unsolved problems innovatively".
- ☐ The **values** are what your organization stands for - eg, "we believe …" A public-sector entity has the values to "seek innovation and excellence, engage constructively, ask questions, support and help each other, bring solutions and see the bigger picture".
- ☐ The **vision** is where we want to go. This is the tool to galvanise your organisation. There are some very famous ones, such as when John F Kennedy said: "I believe that this nation should commit itself to achieving the goal, before this decade is out, of landing a man on the moon and returning him safely to the earth."
- ☐ **Strategy** is the way organizations intend to achieve their vision. In a competitive environment, your strategy will distinguish you from your competition. In the public sector, your strategy is the way you can best marshal your resources to achieve the desired outcomes.

2 Throw away the existing annual budgeting cycle. It was once a management tool but is now a barrier to performance

Companies in Asia, Europe, America and New Zealand are beginning to recognize that the existing budgetary process can't continue. Many see it as a hindrance to management rather than a help.

A 1998 survey by US consulting firm Hackett Benchmarking & Research came up with a frightening statistic. There were 25,000 person days invested in the budget process for every $1 billion of revenue. The study also found that:

- ☐ The average time for a budget process was 4.5 months
- ☐ 66% of CFOs said their budget was influenced more by politics than strategy
- ☐ Nearly 90% of CFOs were dissatisfied with the budget process
- ☐ 60% of CFOs acknowledged that there was no link from the budgets to strategy.

As one management writer said: "There was a strange sense of pride for the negotiating skills of our manager. Every year he promised less and asked for more. The incessant game-playing extended the budget round and limited the need for us to stretch or seek breakthrough solutions." Does this sound familiar?

The answer is to throw out the annual budgeting cycle, because:

- ☐ It takes too long and isn't linked to strategy, strategic outcomes or critical success factors
- ☐ It doesn't help companies focus on the performance drivers of today's organisations - eg, innovation rates, service levels, quality and knowledge sharing (these are best seen in a balanced scorecard)
- ☐ It treats employees as costs, whereas a team's talent, innovation and commitment are more important in determining performance than personnel costs
- ☐ The process builds silos and effectively compartmentalises a company into small units.

But there is hope. European companies have got together to form the Beyond Budgeting Roundtable to free themselves from the shackles of budgetary processes. See a useful case study on a famous cider maker, H P Bulmer, UK, at www.infoedge.com/ samples/ BI-3037sam.pdf

It clearly sets out the doubts and concerns that exist in organisations, and offers a pathway forward. It will revolutionise a company if acted upon by the senior management team, budget holders, the finance team and the board.

Bulmer's breakthrough started with the CFO attending a beyond-budgeting roundtable seminar and obtaining permission from the board to assess the implications and way forward.

Their first steps were a series of indepth workshops across the company to ascertain the net worth of the existing budget system. But they didn't find anybody who supported the present budgeting process.

A s the CFO said: “We were absolutely overwhelmed by what we heard.”

As in many organisations, accountants work every weekend for two months on the budget only to find out that nobody uses it. Their only use is the variance analysis that commonly states “this variance is due to a timing difference because …” Sound familiar?

H P Bulmer now works on a 12-week cycle. They focus on sales-growth targets, comparing sales against last year's actuals. They also focus on the brands that have the potential to perform, and investment is targeted to enable this capability. Costs are managed by measuring against a set of key-performance measures - eg, the manufacturing function's performance is measured against the KPI of cost per hectolitre rather than a fixed budget.

> *“It's pointless having a fixed budget when you don't know exactly how much is going to be manufactured.”*

Manufacturing now plans its timetable on a rolling 12-week basis to be more responsive to product-mix changes. As the CFO said: “It’s pointless having a fixed budget when you don't know exactly how much is going to be manufactured.”

The change proposed by the Beyond Budgeting Round - table is challenging - throwing out a process that has been around for centuries is a difficult quantum leap. The beauty is that all you need to do is simply research these changes and apply them to your organisation.

You’ll be surprised to find that the board and senior management team will want to be involved once they read the case study.

There are examples of this breakthrough in New Zealand, mainly through local offices of European multinationals. Swedish telecommunications giant Ericsson has replaced yearly budgets with quarterly rolling forecasts. The word budget does not exist.

The new process gives them forewarning of events that they expect to take place, which in turn allows them to take corrective action at appropriate times.

3M has used similar forecasting methods for a long time and was one of the early pioneers in "beyond budgeting". This new process has enabled leading companies to finalise numbers for the next three months while giving flexibility to management, providing they operate within key benchmarks and comply with existing strategy. This development is a huge breakthrough, just like the balanced scorecard is.

3 Develop a performance-reporting regime that ties to critical success factors and back to your strategy

If you throw away the budget, month-end reporting takes on a completely different dimension. Management and the board, besides wanting to see actual performance against forecasts and trends, will want to see KPIs that are aligned to the critical success factors.

I believe many KPIs are not KPIs, but merely performance indicators. Therefore, it’s important to revisit your performance measures, as you may not have mined deep enough for the true KPIs.

It is my belief that there are three types of performance measures as set out in Diagram 1. Many performance measures used by organisations are an inappropriate mix of these three types.

Diagram 1

Hierarchy of Performance Measures

Critical success factor

Result indicator

Performance Indicator

(Peel more layers off to find the KPIs)

Key Performance Indicator

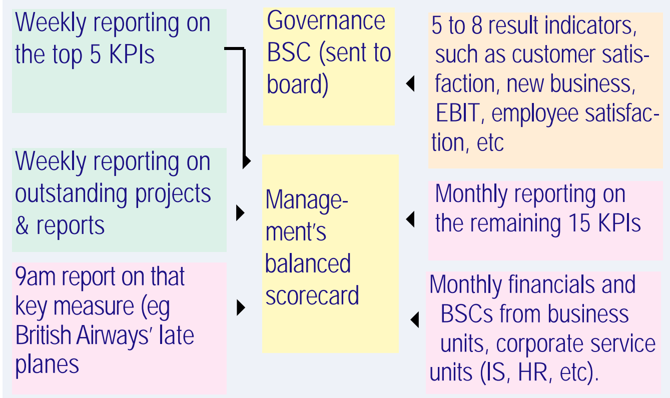
Diagram 2

Amended Kaplan & Norton BSC

Financial Areas where the finance team impacts (expenditure capex etc)	Customer Activities that increase satisfaction	Environment / Community Activities that contribute to a better environment
Internal Quality, response time, state of ledgers	Employee satisfaction Activities that increase satisfaction	Learning & Growth Developing your key asset - your staff, monitoring, innovation, etc

Diagram 3

How they fit together



Result indicators include:

- ☐ Customer satisfaction
- ☐ Net profit before tax
- ☐ Profitability of customers
- ☐ Employee satisfaction
- ☐ Return on capital employed.

The common characteristic of these measures is that they give a clear picture of whether you are going in the right direction, but don't tell you how to correct the situation. Therefore, result indicators are information that is ideal for the board, who shouldn't be involved in management.

KPIs should never go to the board, as they are clearly deeply embedded in management, whereas result indicators are ideal tools to communicate the senior management team's competence.

If you've embarked upon balanced reporting, then you'll be facing the dilemma of who is the balanced scorecard for - management or the board? The answer is simple. You have two balanced scorecards (BSCs) - a governance BSC made up of five to six result indicators and a management BSC comprising up to 20 KPIs.

As Diagram 1 suggests, the KPIs which management needs to focus on sit many layers beneath these result indicators. Between result indicators and your true KPIs are all those other indicators of varying merit which may be useful as team performance indicators.

Performance indicators lie between result indicators and true KPIs. Examples include:

- ☐ Profitability of the top 10% of customers
- ☐ Net profit on key product lines
- ☐ Percentage increase in sales with the top 10% of customers
- ☐ Employees participating in the suggestion scheme
- ☐ Duration of the cash-to-cash cycle.

Characteristics of a good KPI include:

- ☐ Being easily identified by an organisation
- ☐ Affecting more than one BSC section (eg, late planes)
- ☐ Significant impact of movement in a day / week
- ☐ Responsibility being tied down to teams / individuals
- ☐ Positive movements affecting many other indicators in a positive direction.

How should you report these key measures? I suggest incorporating the six perspectives in Diagram 2 in some balanced way. In Diagram 3, you can see how reporting can link better to critical success factors. For example, critical KPIs can be reported electronically daily at 9am - British Airways is constantly updated theirs.

In most organisations there will be a top five of KPIs that need to be reported at least weekly (these exclude the critical KPIs above). I advocate reporting late projects and late reports to the senior management team each week. These two simple reports will revolutionise completions in your organisation, especially where these projects have a high linkage to the organisation's critical success factors.

The remaining KPIs can be reported monthly along with team and business-unit BSC reporting. The introduction of BSCs promotes more concise and prompt reporting.

The board will receive a summarized one-page governance-based BSC covering five to six result indicators.

Year-end reporting needs to be completed in the first month of the year.

Many organisations manage this task within 10 working days of year-end. It's simply not worth investing any more time on year-end reporting as there is little or no linkage to strategy - it's merely a compliance tool that needs to be handled efficiently in cooperation with your auditors.

Last words

- ☐ Make your strategy come alive. Involve management and staff
- ☐ Visit your vision statement. If it doesn't appeal then rewrite it
- ☐ Search the internet for beyond budgeting roundtable - the evidence for change will become clear
- ☐ Read the H P Bulmer case study
- ☐ Rediscover the true KPIs that link to your critical success factors and strategy.

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