BUDGETING AND FINANCIAL PLANNING: IMPROVING THE PROCESS

IOMA

Budgeting & Financial Planning

Improving the Process

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Editor:
Andrew Dzamba
Managing Editor:
Janice Prescott
Desktop Editor:
Eleni Giakamozi
Editorial Coordinators:
David Solomon
Gale Shangold
Group Publisher:
Perry Patterson
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IOMA'S REPORT ON
Financial Analysis, Planning & Reporting
THE LEADING SOURCE OF INFORMATION ON THE LATEST TECHNIQUES, STRATEGIES & PRESENTATION REQUIREMENTS

Introduction

This publication features two of the best, recent articles from *IOMA's Report on Financial Analysis, Planning* & *Reporting* that address the thorny subject of financial budgeting and forecasting. With increased regulatory controls now in place, controllers and CFO's now have to ensure that financial forecasts are both accurate and grounded in reality.

In publishing this guide, we hope to provide a framework for improved budgeting, forecasting and financial planning to our readers.

Andrew Dzamba
Editor

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Editor: Andrew Dzamba
Special Reports Manager: John Pitsios
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Six Ways to Reconnect Your Budget Process With Economic Reality

During times of economic volatility, the accuracy and usefulness of the corporate planning process is crucial. The trouble is, the process is out of whack at most companies—they are not getting the results they should. Therefore, it's critical that companies take a close look at the speed, detail, and overall quality and efficiency of their planning, budgeting, and reporting processes.

This was the main message given by David Axson, chief intellectual capital officer at Answerthink, a consulting firm. Axson addressed corporate financial planning professionals at IOMA's *Financial Analysis, Planning & Reporting Institute* conference in New York last month. Answerthink's best practices research arm, Hackett Benchmarking & Research, has an ongoing study that examines the corporate planning process.

What to Do

"Our study indicates that companies have far to go in incorporating best practices such as tightly integrating planning; tying incentives to the achievement of strategic goals, rather than just making budget; creating a planning cycle triggered by material events rather than on fixed schedules; and deploying and leveraging technology more effectively," says Axson. With this in mind, he spells out some key pieces of advice for making the process more effective.

1. Consider a rolling time horizon. The forecasting time horizon at most companies is bound by the calendar. That is, companies tie their planning to a fiscal year rather than consider it a continuous exercise in operational decision making, resource allocation, and performance management. Almost two-thirds (63%) use the current fiscal year as their time horizon for forecasting.

However, more companies are moving to rolling forecasts, which are better suited to a rapidly changing environment. More than a third (37%) use a rolling process, with the most prevalent horizon being six quarters (see Figure 1). "The number of companies moving to a rolling forecast has doubled in recent years," says Axson. This is the single biggest trend in

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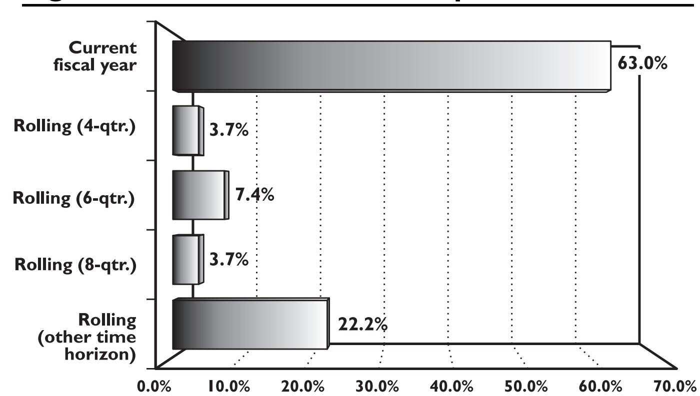
Figure 1. Time Horizon for Corporate Forecasts



(Source: Hackett Benchmarking & Research)

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forecasting, according to Axson.

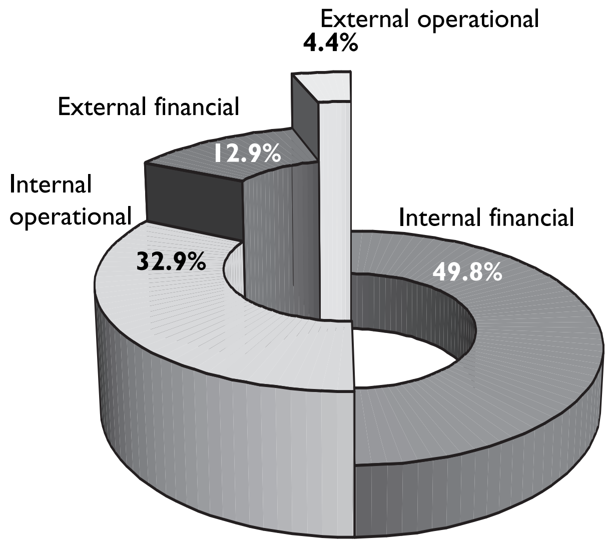
2. Move beyond an internal financial focus. Companies are striking a more effective balance between financial measures and operational measures, such as productivity and quality, in their planning processes. However, over 60% of decision-making, resource-allocation, and performance-management metrics are still financial in nature (see Figure 2).

Axson points out that budgeting and planning are simply making sure we put the right resources in the right place at the right time and that the productivity of those resources is maximized. Therefore, the process must focus on the things that differentiate the performance of a company from that of its competitors. What moves companies forward is their ability to make better decisions faster. However, most companies do not include any competitive measures in their planning process, according to the Hackett research.

Another key external factor is geared to customers. Simply speaking, companies increase their revenues in three ways: (1) find new customers; (2) cross-sell to existing customers; and (3) do a better job at retaining customers to keep them from defecting to competitors. "Very few of the budgets we view today have information such as how much are we going to spend to attract new customers, to cross-sell our existing customer base, to retain customers," says Axson. "We still tend to follow the general ledger chart of accounts." Therefore, the budgeting process should identify the current investments and results around customer strategies. These strategies include customer relations, supplier partnerships, innovation, execution capabilities, and the like.

"What we are increasingly seeing is the refocusing of performance measurement around the linkage between strategy, tactics, and results," says Axson. This goes against the grain of the traditional accounting view of the world, which is used because the only credible information typically comes from the general ledger.

Figure 2. Mix of Performance Measures



(Source: Hackett Benchmarking & Research)

3. Incorporate more predictive measures. "Much of the reporting today is the equivalent of telling management they crashed into a brick wall at 70 miles an hour yesterday," says Axson. In other words, reporting and planning today focus too much on the historical—comparing this month to last month or last month to budget. Companies spend a significant portion of their time explaining why the budget was wrong in the first place rather than focusing on how to improve performance going forward.

Only 25% of companies incorporate predictive metrics in their plans, says Axson. Top

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performers, by contrast, strike a balance between the financial and operational perspectives, both leading and lagging. "If you ask yourself which top management values more, a speculative guess about what may happen tomorrow or absolute certainty about what happened yesterday, just in terms of making better business decisions, I would hypothesize that the former is more valued," says Axson. "Yet, if you begin to look at the measures and processes in companies today, we have absolute decisions about what happened yesterday, and it usually took us several weeks to get that absolute decision, given the nature of our closing process and our accounting cycle."

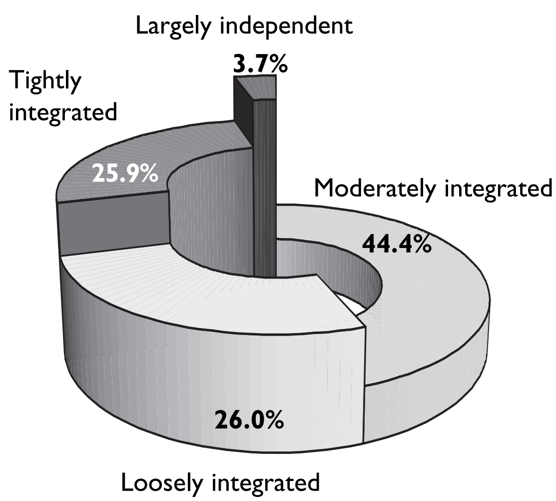
Of course, it is not easy to develop predictive measures or measures that give insight into what's going on in the market. However, it's a mistake to design performance measures and reporting on data that is easy to collect. If these measures are so easy to monitor, then every company will use them.

4. Don't get bogged down in detail. For many companies, the planning process is hampered by excessive levels of detail. The typical monthly performance report contains 140 different measures, while world-class companies plan and manage their business with as few as 15, according to Axson.

In the Hackett benchmarking study, this is one of the biggest issues companies are grappling with, according to Axson. "What we've found is that the average company is budgeting 220 line items. That's a massive amount of detail." He reports that 25% of companies are budgeting less than 40 line items. Also, 70% of companies use the same amount of detail for all budgeted periods. The point here is that it may be better to focus on the detailed analysis of a few material variances than on a superficial analysis of hundreds of minor variances.

5. Integrate the process. Only one-quarter of participants consider their planning processes tightly integrated, though team-based planning processes are becoming the norm (see Figure 3).

Figure 3. Degree of Integration Between Planning Processes



(Source: Hackett Benchmarking & Research)

"What we are seeing is that the measurement process is very disconnected." says Axson. "What we mean by disconnected is the ability to take a specific action, such as selling or serving the customer, and the financial end-game you are looking for—return on equity, EVA, whatever measure you choose to focus on."

Another result of a disconnected process is that cycle times for key planning processes have barely changed in the last few years. For example, it takes companies an average of 4.7 months to develop a strategic plan and 4.1 months to do an annual plan.

6. Make better use of technology. Many companies are falling short of gaining the maximum business benefit from their significant

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technology investments. For example, just over a third report that they have significantly or fully implemented key technologies such as ERP or OLAP, according to Axson. As a result, a "paper mentality" remains strong among senior managers, with only 30% taking advantage of electronic decision-support tools.

Exclusive IOMA Survey:

Financial Mgrs. Reveal Best Ways to Improve Your Budget Process

The corporate budget is a company's most powerful tool for financial analysis, planning, and control. If you can improve your budget process, you can make a dramatic impact. When we recently asked readers for the ideas that have worked best for them over the past year, almost two-thirds (65.3%) cited "a new approach to budgeting" as being their number-one strategy to enhance corporate value.

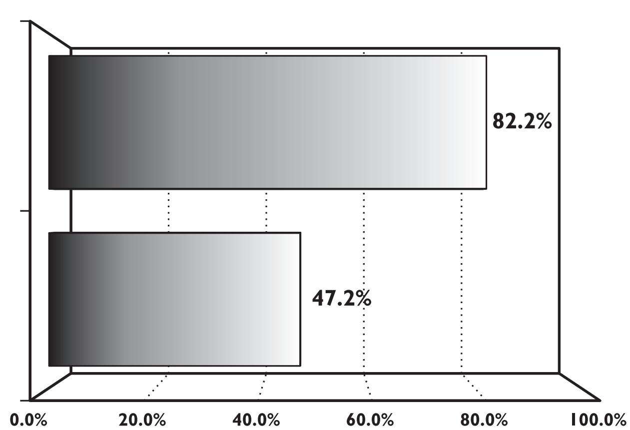
Smaller companies (those with no more than 250 employees) cite this strategy as their number-one idea as compared to their larger counterparts (see chart). *Reasons:* Larger companies may have already found out that this strategy produces top results, so smaller firms are playing catch-up. On the other hand, smaller companies may be more agile to change their processes than larger companies that may be suffering from cultural inertia.

We also asked readers to share with us some details of the techniques they are using to improve their budget process. We're certain that every company can benefit from one or more of these ideas.

1. Push the Budgeting Process Down.

"We implemented a strategic plan at the plant level that has focused plant personnel on goals to achieve the desired results we see that are needed to remain a world-class manufacturing facility," says a plant controller (manufacturing; 5,500 employees; WV).

Companies That Cite New Budgeting Approaches as Best Strategy to Enhance Corporate Value



(Source: IOMA)

As this reader points out, pushing the budgeting process down to the departmental or business-unit level is a key element in the overall strategy of enhancing the budgeting process. In fact, readers mentioned this idea most often.

Making your operating units more involved in the budget process yields several benefits. A cooperative approach can cut the amount of time needed to develop the budget in half. Driving the budget down the line also increases accountability. All of the time and effort that's spent on creating the budget will be wasted if individuals aren't held accountable for staying on budget numbers.

One of the hurdles to this idea is getting others to accept it. "We implemented a new budgeting

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process that forced the department heads to take ownership of the budget process and monthly variance analysis for their group. The first step was getting their buy-in to the approach," says a director of financial planning (transportation; 2,000 employees; NC). However, the mere fact that you are involving others in the process helps nail down internal buy-in and cooperation.

Another by-product of including more people in budget planning is the additional level of detail that is contributed to the process. While some companies are striving to cut down on details to simplify the process, a certain amount of detail is necessary. Also, details can help identify hidden opportunities for cost savings, as one reader points out: "In the last year, we shifted all budgeting and planning activities to individual department managers," says a controller (construction; 120 employees; TX). "This forced each department to become concerned with overhead and non-job-related spending items. As a result, our G & A expenses are falling overall, and the savings are flowing straight through to the bottom line."

If you go this route, make sure you give managers the data they need to prepare accurate budgets. "We gave individual managers more budgeting control, but we also had to enhance reporting to them," reports a controller (gaming; 300 employees; CT).

Readers also suggested several ways to support the notion of giving managers more involvement in their budgets. One is to have regular budget reviews—conducted by senior-level people—to see where departments are vs. their budget. If they are off-budget, you should discuss why and how they are going to get back on track. The operations people will come into these meetings knowing they are accountable for budget overruns and they will be prepared to present their plans to correct it. However, do not hold managers responsible for costs they cannot control.

Training is key: When opening up the budget process to the operating units, you will need to give them constant guidance and input to make sure the process doesn't take too long. And, like any new process, they will need to be trained. In particular, they may need help on how to make decisions and what key budget factors they should focus on.

Preparing a budgeting manual may also help a great deal. This will be particularly useful if your operating managers are not financially oriented. However, be flexible. *Reason:* You can't always force people to handle things in a certain way. As part of this process, you'll also need to give business unit managers information on past operations, expenses, revenues, labor costs, and the numbers they've achieved in the past.

2. Revamp Performance Metrics.

The second most frequent comment we received on improving the budgeting process has to do with taking a fresh look at financial performance metrics.

"We changed our approach to budgeting project costs by re-evaluating the

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factors used to measure performance," reports an accounting manager (manufacturing; 87 employees; ME). "Specifically, we break down allocated overheads through imposing stricter department operating budgets and introducing new performance metrics. Our contribution margins (profit before SG & A) improved, going from 22% to 29% of sales."

Some readers note that this approach is allowing them to weather the tough economy by saving substantial costs. "Rather than taking a blunt look at plant P & L's, we now use performance metrics tied to best-practices initiatives that are closely monitored by top management," says a manager of financial planning (manufacturing; 5,000 employees; PA). "This initiative, despite its loopholes, has saved the company valuable dollars in a declining economy.

Benchmarking is an important element in implementing new performance metrics. "We now measure a profit center manager's performance against prior year and budget/forecast," says a controller (Wholesale/retail; 121 employees; WI). "Measurement is based on several criteria including expense-to-gross-profit ratio (a new measure); results vs. forecast (sales, gross profit, and expenses); and profit per employee vs. prior year. These new metrics are implemented through monthly managers' meetings."

As part of this strategy, readers report an increased use of the balanced scorecard—an approach that uses key performance indicators, including financial measures, to give managers quantifiable targets to achieve. The results can be significant.

"The manufacturing company I'm with never measured itself until month-end. As a result, it was slow to understand opportunities," recalls a vice president of finance (manufacturing; 150 employees; MN). "I used a balanced scorecard previously, and it worked great. Here we took each department and determined the most important metrics (operational and financial) and started tracking weekly against goals. It has improved profitability by at least 10%."

It's important to note that the balanced scorecard approach is not confined to financial performance, so it can give a valuable overall picture of how the company is doing.

3. Use an Automated System.

Budgeting software has come a long way—and readers are quick to point out that these powerful new systems have helped out in a big way. Also, because budgeting software for companies comes in all shapes and sizes, every company can reap the benefits.

"We enhanced our budgeting analysis and management reporting with upgraded Hyperion report-writing system," says a senior vice president controller (wholesale/retail; 8,500 employees; WA). "Because of the new system, we're working on two-day monthly close with upgraded analysis and feedback."

New systems for analyzing costs are also being used. "Using an activity-based

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cost model and a variety of access databases, we created tools to evaluate product-line profitability. Through further refinements, we hope to model cost/profit performance at various levels of production to enhance forecasting accuracy," says a controller (manufacturing; 1,550 employees; OR).

4. Change Cost Centers to Profit Centers.

A number of readers mentioned that they changed from structuring their budgets along the lines of cost centers to profit centers.

"We moved from a single P&L for the entire company to individual profit/budgeting centers. This helped determine where more effort should be put to achieve higher margins or where we could better control costs," says a CFO/controller (service/construction; 90 employees; OR).

5. Keep It Simple.

Using less detail to slim down the budget process is a definite trend. According to Hackett Benchmarking & Research, the average company is budgeting 220 line items, which is a massive amount of detail. Around a quarter of companies budget less than 40 line items. Focusing on the detailed analysis of a few key variances rather than on hundreds of minor ones may be better. Some readers agree.

"Previously we created an extremely detailed budget at the beginning of each year based on our annual revenue projection," says a CFO (private practice firm; 700 employees; CA). "As our revenue estimates changed throughout the year, rebudgeting was extremely time-consuming and difficult, resulting in great reluctance and difficulty in matching spending with current revenue forecast. By greatly simplifying our planning, we have become more adaptable to market developments."

Potpourri of Ideas

Here are several more noteworthy ideas on enhancing the budgeting process:

Zero-based approach: "We began a process of zero-based budgeting for expenses. For example, all contracts over $25,000 are competitively bid to ensure maximum value," says a controller (nonprofit health/welfare; 200 employees; IL). "Most of our contracts run on a three-year cycle."

Product costing: "We changed our product costing methodology to allow us to evaluate outsourcing opportunities more clearly and realize true margins on current product," offers a vice president, finance & administration (manufacturing; 220 employees; WI).

Daily budget variances: "Instead of waiting until month-end, we now report budget variances on a daily basis," says a CFO (manufacturing; 300 employees; CT). "This is giving plant management day-after report cards so that corrective action can be started quickly."

Continuous improvement: "We modified our budgetary goals to include continuous improvement/cost reduction activities," reports a CFO (manufacturing;

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1,800 employees; MI). "These heightened goals forced managers to stretch to accomplish higher levels of cost savings and efficiency improvements."

Final Tip

We're happy that several readers pointed out an idea that is often overlooked but can make a big improvement. "We revised budgeting to more realistic levels," says a controller (manufacturing; 110 employees; OH) "In the past, the company owner demanded 15% sales growth per year, which is not realistic."

No matter what idea you use to fine-tune your budget process, it will not be effective if goals are overly optimistic. Budget goals should be challenging—but achievable. ❏

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