

*Note: This is a pre-print version of an article that will appear in an upcoming issue of the Wiley Journal of Accounting & Finance.*

## **Budgets: All Bad Things Must Come to an End**

*By Dominic Paniccia, Brilliant*

Jack Welch, the legendary former CEO of General Electric, once commented that “The budget is the bane of corporate America.” Welch’s sentiment is one that is shared by many people and often includes those involved with or ‘mired’ in the budgeting process. As we approach the final months of the year, individuals are beginning to prepare for their company’s annual budgeting process. With this preparation comes a degree of dread as they consider the time, resources and logistical or technical challenges often involved. Part of this dread also comes from the fact that people are often unsure of the impact or value of the budgets they create.

### **Why Companies Budget and Why It’s Broken?**

The typical answer is to understand and help achieve financial targets and goals. Traditional budgeting is often managed by a central group, and attempts to project the future by aggregating the budgets of business divisions, geographic markets, etc to arrive at an enterprise level budget. The pitfalls of this traditional budgeting approach are numerous including:

**Issue #1: Budgets are negotiations** – In the budgeting process, units or markets typically negotiate their targets with corporate in an effort to ‘low-ball’ their commitments for the coming year. It is in their interest to do this as it helps them demonstrate the best performance for their unit, but these low targets are not in the best interest of the organization as they’re not reflective of true, potential performance.



**Issue #2: They're not driver-based** - The budgets are built based on targets and historical performance and are generally not influenced or informed by external factors or current market conditions. Additionally, because they are based on past results and not predicated on driver-based models, it is impossible to understand the implications on performance from an increase or decrease in the performance of any driver.

**Issue #3: The long-term is not the next 12 months** – Budgets are generally oriented around the fiscal year and fail to consider the implications for performance beyond one year of actions taken today. There is nothing magical about December 31<sup>st</sup> (if your fiscal year follows the calendar) and so there is no reason for you to think of performance only until a somewhat arbitrary point in time.

**Issue #4: Driving using the rearview mirror** - Companies spend too much time comparing their results to last year's budget as part of a backward examination to understand what has happened. This time would be much better spent looking forward and developing insights and plans to tackle what they think could or will happen.

**Issue #5: When it's done, it's outdated** – Because of the nature and speed of business today, decisions and commitments made during the process are obsolete from the beginning. Given the importance ascribed to the budget, people still feel a need to manage to it even though it is perennially out of touch with organizational reality.

**Issue #6: Detailed to a fault** – Too often, budgets are made in excruciating detail with significant time and energy expended on forecasting office supply costs for instance when this detail is ultimately quite irrelevant to company performance. This trap of mistaking activity for progress is frequent with the budgeting exercise. People spend inordinate amounts of time forecasting those components where they have lots of data and MIS, e.g., office supplies, and then do things like simply grow revenue by



ascribing a growth rate to last year's revenue figure. This is not a smart use of time or effort as it is nearly impossible to deliver insight but requires significant effort.

**Issue #7: Every dollar of expense is treated the same** – Traditional budgeting is fixated on reaching revenue and profit goals with generally little attention paid to the nature of and drivers of the expenses that drive margins. While significant time maybe expended forecasting expense minutia, there is little utilization of the budget to manage expenses strategically.

**Issue #8: The best opportunities don't get funding** – Because the targets that corporate tries to set form the ceiling for unit performance in traditional budgeting, there is no incentive for units to increase their targets. In fact, as mentioned, they will negotiate them down if possible. These lower targets prevent the organization from receiving the best investment ideas because there is no incentive to outperform. Out performance merely creates a higher bar next year.

### **Is there a better way?**

Every year more and more firms are moving away from an annual budget to a rolling (continuous) forecasting model. A **rolling forecast** is the process of predicting profit and loss accounts for a company on rolling basis with the typical rolling forecast ranging between four and eight quarters ahead. In the rolling forecast, as a company completes a quarter of results it then continuously extends it forecast to capture the rolling quarters which lie ahead. It is also important to note that rolling forecasts are separate from corporate revenue and profit targets. The use of targets will only force business units to build a forecast to achieve these targets. In such instances, the forecast output becomes far removed from reality and hardly useful for management to use in decision making.

Jeremy Hope, author of the book *Beyond Budgeting*, contends that “Rolling forecasts, if well prepared, form the backbone of a new and much more useful information system that connects all the pieces of



the organization and gives senior management a continuous picture both of the current position and the short term outlook.”

The rolling forecast as it has been articulated closes many of the gaps discussed with traditional budgeting as discussed below.

**Solution to Issue #1: No more low-balling** – Since the forecast and corporate targets are separated, business units are no longer encumbered with targets. This process ensures the units do not waste a lot of time bargaining for lower targets and instead, it focuses their efforts on developing realistic and smart projections. It is incumbent upon management to make sure the only expectation in a rolling forecast is for units to deliver reasonable and well-constructed views into the future so that management is in the best position to make critical decisions. Management should reward units for realistic yet aggressive forecasts versus rewarding them for meeting a fixed target.

**Solution to Issue #2: Rolling forecasts are driver-based** – The focus in rolling forecasting is on understanding key business drivers; for example the cost of jet fuel for an airline. The forecast models create relationships between key drivers and financial performance. As these drivers are updated, the forecast reflects the changes in financial projections. This allows organizations to also perform sensitivity analyses by modifying the key driver assumptions and understand the severity of such impacts to financial results. Doing this also allows firms to incorporate sophisticated analyses such as econometric models and Monte-Carlo simulations into the process to improve their ability to predict drivers.

**Solution to Issue #3: Its outlook is longer-term** – The typical rolling forecast looks ahead four to eight quarters in to the future, on a continuous basis. This eliminates the narrow focus of the annual budget to a calendar or fiscal year.



**Solution to Issue #4: It's about future insights and not just looking back** – A rolling forecast is focused on the future and answering how will the organization perform given the current state of the business and latest projections for business drivers? For example, a manufacturing business would update key business drivers such as raw material prices and energy cost projections to predict future earnings. A significant change in the price of raw materials may have implications on future production planning as the firm can preemptively shift to a product with lower cost raw materials or these prices can inform their hedging strategies based on the financial risks a driver may present.

**Solution to Issue #5: It's constantly up-to-date** – As the company completes a quarter of financial results, it updates the forecast for the next four to eight quarters. This process is not about managing to an annual result but managing a business on a continuous basis. Also, it guarantees management is making decisions with a forecast informed by the latest information. Another benefit is that it reduces the pain of the annual budget cycle since the 'budget' for lack of a better term is always fresh.

**Solution to Issue #6: The right amount of detail** – This process cuts out the details that do not drive business results and that generally result in long, sleep-deprived nights. Planning teams no longer focus on how to forecast the cost of non-core expenses (like supplies) and focus on what drives growth and profitability, e.g., revenue and expense drivers.

Rolling forecasts as they're generally articulated handle 6 of the 8 pitfalls that budgets suffer from as just discussed. The rolling forecast does not have to stop there in becoming a more powerful management tool. There is significant opportunity for companies to leverage the rolling forecasting to actually combat the other two remaining pitfalls of budgeting.

**Solution to Issue #7: Some expenses are more valuable than others** – Expenses incurred for supplies and overhead do not have the same impact on the organization as expenses for marketing, advertising



or research and development. The former should be thought of as typical expenses which should be minimized over time while the latter drive the organization's strategy and future. If these expenses are treated equally (as most companies do in the budget process) then a dollar of marketing is being treated as the same as a dollar spent on accounts payable. Simply put, this is wrong; the way around this is to use the rolling forecast process to manage expenses strategically.

The first step is to separate all expenses into two categories; strategic (drive growth and innovation, e.g., marketing, sales, innovation, customer service, R&D, etc) and non-strategic (all other costs). The two categories should then be captured and forecasted as part of the rolling forecast process. On a continuing basis, as the company prepares the rolling forecast it will also perform a cost optimization exercise. The optimization process takes input from the rolling forecast and tracks and monitors strategic and non-strategic expenses separately. This information will provide senior management with the visibility into the expense structure and also allow them to provide the business units with strategic guidelines on expense management. These guidelines should promote the goal of maximizing strategic expenses as a % of revenue and total operating expenses while minimizing non-strategic ones as a % of revenue and total operating expenses. Obviously, both need to be kept in accordance with overall firm profit margin objectives. The process is powerful because it is done on a continuous basis and is linked to the rolling forecast. Doing this keeps expense management (cost optimization) current, adaptable and top of mind as opposed to something that the organization does every few years as part of a knee-jerk restructuring effort.

**Solution to Issue #8: The rolling forecast encourages merit-based resource allocation-**From the cost optimization efforts just discussed, an organization now has visibility into its strategic expense base which is the driver of organic growth and innovation. The key to successful management of these strategic expenses is to identify areas of the company that have the best opportunities and match



investment levels with the opportunities. This becomes almost impossible in a budgeting exercise because profits are based on predetermined targets. Again, since rolling forecasts are not linked to corporate targets, this leads to a forecast where all units strive (almost compete) to achieve the best growth scenario, and as a result, they are incentivized to put forward the best investment opportunities to capture investment dollars. Management can use the rolling forecast to determine the pockets of strength in the organization and allocate more investments dollars to units that have put forward the best opportunities and delivered historically. Also, because of the driver-based nature of a rolling forecast, decisions to reallocate funds can be made more quickly if a decline is seen in one portion of the organization. The result will be improved returns on strategic expenses and allow greater flexibility to react to changes in the business, whether internal or exogenous.

### **Empowering the Budget Makers**

The budget doesn't need to be the "bane of Corporate America" as Mr. Welch has articulated. The rolling forecast process offers multiple advantages to senior management and general managers as they control the organization because of usefulness of the information it offers – information which results from an increased focus on material items, always looking forward and staying current. While many companies have begun to adopt or study rolling forecasting as an option for themselves, they should be mindful that they can further enhance the value of the rolling forecast by using the data contained within it for strategic cost optimization and resource allocation decisioning.

Doing all this is possible with the same amount or less effort as your traditional budgeting exercise but the dividends to the organization are many as are the benefits to the people who are working on the budgets. They're no longer mired in an exercise of dubious value and are now working on helping managers understand risks and opportunities as well as informing major resource allocation and



expense decisions. Through the adoption of this type of holistic rolling forecasting, the traditional budget will stand transformed into a legitimate and powerful management tool. This might result in a few less sleep-deprived nights and might even make Mr. Welch reconsider.

Budgeting vs. Rolling Forecast		
Attributes	Annual Budget	Rolling Forecast
Process independent of corporate targets		
Based on key business drivers		
Longer term outlook		
Focused on future predictions		
Incorporates current business knowledge		
Focused on big picture financials		
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<i>Transformational Rolling Forecast</i>		
Promote expense and cost rationalization		
Influences capital/investment allocation		

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