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| Description: Approved shield 25mm | | BPM Community  **Determining your approach to Budgeting and forecasting** | | |
| **Author** |  | | **Date** |  | |
| **Company** |  | | **SBU** |  | |
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| **Purpose of guideline** |
| Most organisations, and their finance functions in particular, spend significant time and resources on budgeting and forecasting activities and most feel that the process is excessively time consuming, inefficient and fails to produce aligned behaviour. Some organisations promote abandoning budgeting altogether.  This guideline provides advice and references to help you decide the appropriate approach to take in your organisation. It helps determine your overall approach and then provides guidance on how to implement the most effective process. |

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| **Overview of template** |
| This template explores the necessity for budgeting systems and largely concludes that despite issues with many budget processes, abandoning budgets is a step too far for most organisations. It then sets out how to overcome the objections to concerns about poor budgeting systems, explores the role technology can play and then sets out the attributes of an effective budgeting system. |

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| 1. **Why do budgeting and forecasting?** |
| The traditional Management control system assumes that rational organisations set strategies, determine plans and budgets, monitor performance against them and then take corrective action, including revising strategy and budgets. In this process, budgeting and forecasting are essential components.  However, some organisations such as Beyond Budgeting Round Table are vociferous in portraying the dysfunctional consequences of traditional systems as found in practice as evidenced by the extract form their website, below: *Ten reasons* *Here are 10 reasons why budgeting causes significant problems today and needs to be replaced:*   1. ***Budgeting prevents rapid response****. You need to respond rapidly to unpredictable events but the annual budgeting process was never designed for this purpose.* 2. ***Budgeting is too detailed and expensive.****Budgeting is highly bureaucratic and very expensive (absorbing around 20 percent of management time).* 3. ***Budgeting is out-of-date within a few months.****Many of the key assumptions change frequently (such as commodity prices, exchange and interest rates and of course customer demand) causing confusion and much rework.* 4. ***Budgeting is out-of-kilter with the competitive environment.****Today’s drivers of success are concerned more with fast response and continuous innovation than managing people and budgets.* 5. ***Budgeting is divorced from strategy.****Budgets are based on functions and departments rather than strategic themes. The chances of the goals and plans of many disparate functions and department being aligned with a coherent corporate strategy are often negligible.* 6. ***Budgeting stifles initiative and innovation.****Budgets tend to support an authoritarian management regime that stifles innovation* 7. ***Budgeting protects non-value-adding costs.****Cost budgets are usually compiled and agreed based on prior year outcomes. There is little time or incentive to understand and challenge the root causes of costs allowing huge amounts of waste to fester and grow.* 8. ***Budgeting reinforces command and control.****Budgets were designed to enable functional leaders to manage the organization from the centre thus local decision-making is usually delegated within strict budgetary controls.* 9. ***Budgeting demotivates people.****When starting a new job most people are highly motivated to maximize their performance. But soon they learn not to fight the system but to ‘go with the flow’. This means doing little more than their job description specifies and the minimum to achieve their targets. Budgets are aligned with McGregor’s Theory X. The assumption is that people will only do the minimum required unless there is an additional incentive to do more.* 10. ***Budgeting encourages unethical behaviour and increases reputational risk.****Aggressive targets and incentives drive people to meet the numbers at almost any cost. This can lead to unethical selling and ‘creative’ accounting placing the CEO’s (and the company’s) reputation in jeopardy.*   For more details see the Beyond Budgeting website [www.bbrt.org/beyond-budgeting/bb-problem.html](http://www.bbrt.org/beyond-budgeting/bb-problem.html)  However, other organisations point out that abandoning budgeting is akin to throwing out the baby with the bathwater as shown in this quote from the Deloitte report: ‘Don’t throw the baby out with the bathwater. Making planning, budgeting and forecasting work for you in Consumer Products.’ (Full reference at the end of this guideline).  **“Stop the insanity**  For decades, companies have handled planning, budgeting, and forecasting pretty  much the way they always have. Each year brings the hope that things will be  different this time. But the result is almost always the same. Some say that’s the  definition of insanity.  It may be time to rethink your approach to planning, budgeting, and forecasting.  An effective approach is to focus first on high-level strategic questions, then drill  down to tactical choices like level of detail, planning horizons, and internal  communications. Sort what works for your company from what doesn’t work.  Confirm your thinking in conversations with stakeholders. Look beyond your  organization’s walls for valuable information and practices, borrowing those that  make sense. Your goal is retain practices that add value and eliminate the rest.**”**  So the key issue to decide is whether you want to try the radical approach of rejecting budgeting and forecasting or whether you want to retain these approaches but improve them to reduce the disadvantages they often bring. Your choice will be influenced by the nature of your business and organisation but it is assumed from here on that you have made a conscious and rational choice to go with a budgeting and forecasting process as part of your overall management control process. |

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| 1. **Can you design an effective budgeting system?** |
| The Beyond Budgeting concerns about many budgeting systems are based on observation of common practice, but does that make these failings inevitable? A good idea badly implemented remains good idea.  So is it possible to address these concerns? The table below attempts this and points to the features you need to include:   |  |  | | --- | --- | | ***Budgeting prevents rapid response*** | Use technology to support the budgeting process along with a high level monthly reforecasting process. | | ***Budgeting is too detailed and expensive*** | Use cost effective technology and empower end users to update budgets and forecasts with intranet tools. Users can be allowed to determine the appropriate level of detail subject to minimum prescribed levels. | | ***Budgeting is out-of-date within a few months*** | So supplement with reforecasts – many organisation update forecasts monthly but also retain the original budget as an anchor to ling back to annual strategic plan. | | ***Budgeting is out-of-kilter with the competitive environment*** | The budgeting model should recognise value drivers such as location, brand and pricing and external inputs. Such as exchange rates, interest rates and competitor pricing. | | ***Budgeting is divorced from strategy*** | By definition only bad budgets are divorced from strategy – good budgets are derived from strategy and assessed against impact on strategic objectives. See the guideline on linking financial and nonfinancial measures for approaches. [www.icaew.com/bpmtemplates](http://www.icaew.com/bpmtemplates) | | ***Budgeting stifles initiative and innovation*** | Not necessarily – budgets aren’t inconsistent with innovation although very innovative organisations might decide differently. But as they grow such businesses will frequently end up embracing these disciplines | | ***Budgeting protects non-value-adding costs*** | Zero based budgeting and other techniques address precisely this issue – so it’s a question of implementation | | ***Budgeting reinforces command and control*** | Not necessarily – it’s a conscious decision at what level to budget and a devolved approach to business units is still consistent with budgeting | | ***Budgeting demotivates people*** | Conversely “what gets measured gets valued” and “what gets measured gets done” and many people respond well to the challenge of meeting targets . | | ***Budgeting encourages unethical behaviour and increases reputational risk*** | A proper set of measures and a good risk system should be in place to avoid these risks but budgeting per se is unlikely to be a root cause of unethical behaviour |   The above shows that many of the concerns can be addressed but also demonstrates that implementation is key. |

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| 1. **How do you design an appropriate budgeting and forecasting system?** |
| The trite answer is you design an appropriate system by tailoring it to the needs of your organisation. The Deloitte report reference above gives examples of the questions you need to ask to do this  Questions such as:  What businesses are we in?  How will we compete?  Which choices will make us more money?  How will we align resources with our strategy?  How will we measure our progress?  How will we ensure accountability and encourage the behaviours needed to execute the strategy? How will we adjust to reflect changing conditions?  Similarly a PwC report for the National Audit Office ‘Good budgetary processes: ‘Comparators: Case studies from the public and private sector’ showed that there is no ‘silver bullet’ but that key conditions had to be met to have an effective process [(see](http://www.nao.org.uk/wp-content/uploads/2012/10/NAO_Good_budgeting_Research.pdf) full references, below).  The report reads:  “Budgeting processes that effectively integrate operational planning, financial budgeting and the overall performance management regime of the organisation are high on the aspiration list of research participants across all sectors.  “…no single organisation considered that it had all the answers. Instead organisations view the budgetary process as a complex mix of environment, rules, practice, values, people and behaviours that is evolving and requires constant effort and work to drive forward and improve.”  The key finding is that there is no off the shelf help package or process that will solve the issues for you, but that there is plenty of guidance on what questions to ask to get to the answer that is right for you. For example, you need to be clear about the adequacy of your organization’s strategic plan as a starting point, the level of detail you need to gain organisation wide commitment, the likely speed of change and hence need for reforecasts and the types of behaviours you want to encourage. |

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| 1. **The attributes of an effective budgeting system** |
| In an effective budget system:   * Managerial responsibilities are clearly defined – in particular the responsibility to adhere to their budgets * The linkage of the budget to corporate strategy is clearly visible * Individual budgets lay down a plan of action rather than just a set of numbers * Performance is monitored against the budget * Corrective action is taken if results differ significantly from the budget * Departures from budgets are permitted only after approval from senior management * Unaccounted for variances are investigated * Users have access to sufficient information to prepare their own budgets based on performance drivers * There is a challenge process to prevent overly optimistic or pessimistic budgets from being presented * The process from dealing with differences between top down targets and bottom up aggregation is clearly defined and understood * The process for allocating costs is clearly understood and accepted * The process is reviewed to reduce unnecessary complexity and requirements “creep” * There are clear timetables and monitoring of actions during the budgeting process   Meeting these requirements requires a collegiate approach but with a strong lead from finance and generally requires some IT investment given the limitations of excel based systems. |

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| 1. **What role can technology play in this?** |
| Complex budget processes can be aided by effective deployment of technology solutions and it is a major and competitive market. Deploying analysis and reporting tools to end users helps achieve buy in and ownership and helps position Finance as an analytical function rather than as a pure number cruncher. Similarly a good budgeting system should reflect the organisation’s business model and so should capture “driver” and external data.  Technology should allow process such as :   * Consistent definitions of data * A streamlined budgeting process which integrates with actual reporting to allow users to project off current data * Standardised input sheets but normally with an excel upload facility as well * Web enabled process control * Agreed approach to processing high level adjustments * Standardised output reports but with end use interrogation facilities   The ICAEW IT Faculty has published a review of budgeting software, ‘Forecasting and Budgeting software, second edition: Chartech software product guide’. This is available to all BPM Community members and makes a good initial introduction. (See references below).  With such a competitive market, the software products continuously evolve and leap frog each other so the key to successful purchase is more in articulating requirements than in choosing between competing vendors.  However, in many cases, it is well worth using an outside specialist to help elicit the real requirements, to help structure the models and then to configure the software to deliver the expected benefits. These organisations specialise in planning and budgeting systems, often as part of an integrated business intelligence suite, and help first time users avoid traps and pitfalls. |

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