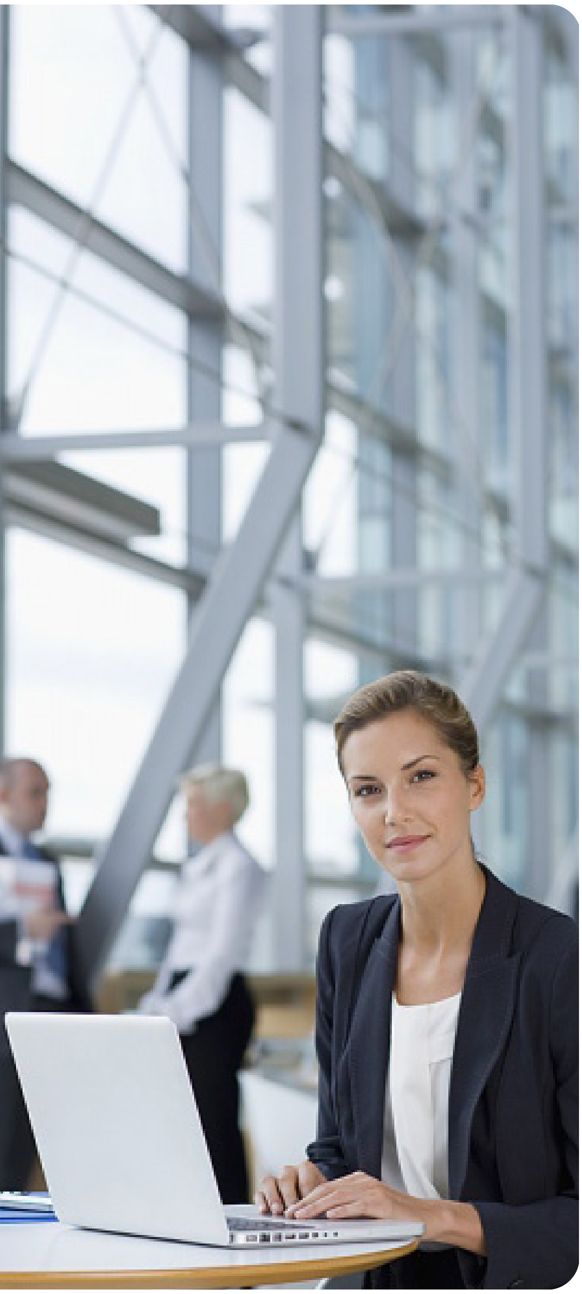
# How to create an advanced budgeting system

# Table of content



# Executive summary

"Budgeting is the process of expressing the predicted costs and resources for a planned course of action over a specified time period" (CIMA, 2006). Over the years this business process has revealed several shortcomings, such as:

- Being time and resource-consuming
- Having weak links with corporate strategy
- Not being flexible enough to deal with change

And there are more to be discussed later. Supporters of the Beyond Budgeting movement have been most eloquent in pointing out the inherent flaws of traditional budgeting. They suggest abolishing budgeting to trigger the improvement of management control within organisations. This involves a fundamental re-examination of alternative techniques used for better performance management, e.g., rolling forecasts, market-related targets.

However, most businesses are not discarding budgeting altogether, since it still has certain benefits. Therefore, in order to address the drawbacks of budgeting without having to abandon this process, organisations have looked for ways to improve it. With the help of technology, traditional budgeting can now evolve and survive after all.

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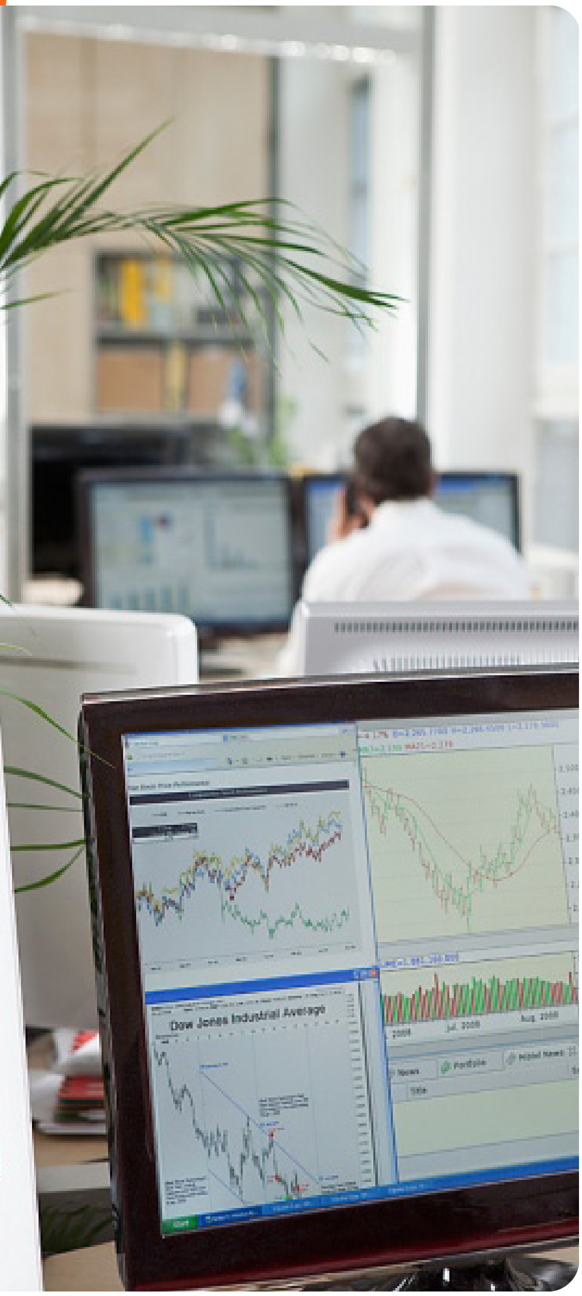

# What is traditional corporate budgeting?

Budgeting, argued to have begun about a century ago, is a method of managing costs and cash flows. Typically, the steps in budgeting include:

- Prioritising objectives identified in the planning process
- Assessing and quantifying total available resources, both financial and non-financial
- Identifying and quantifying the inputs and processes required to fulfill the stated objectives and the associated financial resources required
- Assigning proportion(s) of the total resources necessary to acquire/manage inputs and achieve the stated objectives

*(Source: CIMA)*

In a perfect world, the three main purposes of corporate budgeting are:

### 1. Coordinating the company's financial activities and presenting an overall picture

A budget is comprised of all financial elements of an organisation, from individual units to divisions and departments. It depicts an overall picture of the organisation's operational objectives and strategic goals.

Budgeting is not merely about profit planning. It is about aligning the individual units with the organisation's strategic and operational goals. Moreover, budgeting is about allocating resources so that senior management can make decisions about savings and revenue objectives. It is important to note that managers are supposed to consider their operations in relation to those of other departments. This ensures that no one is treading on each other's paths.

### 2. Communicating financial plans to those held accountable

Individuals are supposed to report to those, known as budget centres, that are held accountable for the outcome of departments or teams. A budget centre is defined as "a section of an entity for which control may be exercised through prepared budgets" (CIMA, 2005). Hence, a budget is designed to give decentralised managers a firm understanding of the organisation's financial plans, from expected cost savings to targeted revenues.

However, since budgeting has evolved toward higher levels of detail, it has given way to centrally controlled, bureaucratic leadership. The fact that budgeting occurs only once a year, and the adjustments needed to adapt to changing market conditions are hard to implement, only deepens the bureaucratic culture in decision making.

### 3. Motivating individuals to act in the organisation's interest

Since budgeting provides the authority for expenditure, key individuals can use this power to achieve challenging objectives and get rewarded. Nonetheless, this is the most debated function of budgeting as dysfunctional behaviors may occur.

For example, a manager can spend all the money that remains at year-end to avoid having an allocation cut the following year. Or this manager can deliberately submit a larger-than-actual budget proposal in order to receive credit for meeting this easier goal.

# Traditional budgeting approach: advantages and disadvantages

## ( - ) Disadvantages :

The previous section has touched upon some self-manifested flaws of traditional budgeting. Among the most fervent opponents of traditional budgeting are supporters of the Beyond Budgeting movement, who have listed several drawbacks of traditional budgeting. Four main ones are:

### 1. Inefficiency

Traditional budgeting consumes too much time and too many management resources. According to a study by Horvath & Partners in 2004, senior managers spend about 10-20% of their time on budgeting, while finance departments dedicate as much as 50% of their time. However, only a fraction of these two groups attaches much value to the budgeting process.

One of the reasons traditional budgeting takes up too much time is the use of spreadsheets. Even though they are the most common tool among companies, spreadsheets contain inherent shortcomings, such as:

- Prone to data entry errors
- Version control issues
- Difficulty in devising accurate formulations

### 2. Low change responsiveness

Most businesses have an annual budgeting cycle and this annual focus often makes the budget obsolete soon after its creation. Reviews are not conducted regularly enough to consider changes. Unforeseeable events may occur, such as severe weather, strikes, stock market chaos and the emergence of new competitors.

A survey conducted in 2009 by Business Finance found that two out of three finance executives expected their 2009 budgets to be out of date within the first six months of the year, while 28% said that their budgets were obsolete even before 2009 started.

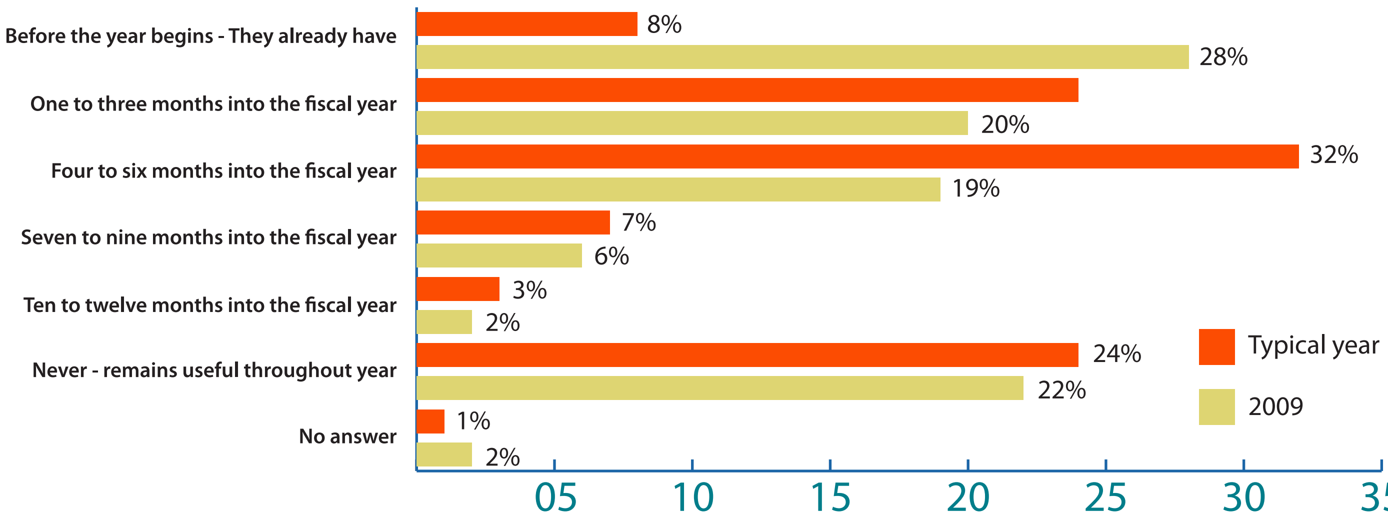


*Figure 1: Companies' responses to the question, "At what point do you expect your 2009 budget targets to become obsolete?"*

Also, it is not possible for two-thirds of companies to investigate the details of their budgets in real time (Ventana Research, 2008). This means budget reviews often take longer than needed, which defeats the purpose of change adaptation.

### 3. Failure to motivate desirable behaviors

"Today, traditional budgeting forces managers at all levels to commit to delivering specified outcomes, even though many variables underpinning those outcomes are beyond their control" (Business Finance Magazine, 2009). Therefore, traditional budgeting fails to motivate people to act in their company's interest, since:

- It encourages "gaming" and unprofessional attitudes in budget cost centre managers
- It strengthens bureaucracy and vertical control, making people feel undervalued
- Instead of enabling knowledge sharing, it reinforces departmental barriers

### 4. Disconnection from strategic plan

As managers are so obsessed with hitting the numbers right, they often miss the strategic purpose of budgeting. Traditional budgeting focuses on cost reduction rather than value creation, which means strategic initiatives are unjustly lower priorities.

Only 15% of organisations said they were able to closely align the budgeting process with scorecards and metrics management (Business Finance, 2005). This disconnection with corporate strategy and goals is often the reason finance personnel regard budgeting just as "something we do every year."

## ( + ) Advantages :

Even though traditional budgeting is problematic, as admitted by most managers in a 2005 survey by David Dugdale and Stephen Lyne, it is still considered an indispensable process. The reasons are:

### 1. It provides a framework of control

Since the original purpose of budgeting is to coordinate a company's financial activities, to some extent, budgeting creates a reference point. In other words, traditional budgeting provides a framework of control that makes it easier to manage activities with stability.

Large companies, especially, may struggle to operate in an orderly manner without a budgetary framework. Even small companies still need a budgetary road map that depicts their current position, their destination and how they can get there.

### 2. It is part of organisational culture

Budgeting has been around long enough to be part of organisational culture for most companies. Thus, it may be a risky decision to abolish this fundamental method of operating, as suggested by the Beyond Budgeting believers.

### 3. It accommodates the need to decentralise

Some organisations, especially banks and other financial institutions, recognise the benefits of decentralisation whilst maintaining standard operating procedures. Therefore, budgeting and the use of budget cost centres give managers the freedom to run their operations as long as they can meet the set parameters.

# Budgeting best practices

Budgeting, to many radical thinkers, is already dead. However, in reality, traditional budgeting still plays a significant role in corporate financial planning. Therefore, to neutralise the arguments for and against traditional budgeting, companies should take actions to improve the budgeting process. In the 2005 survey by Dugdale and Lyne, over 60% of organisations claimed to be improving their budgeting methods.

The reasons businesses plan to change their approaches to budgeting, according to a study by Ventana Research in 2003, are not just about saving time, but about what they can do with the time saved.

In order to be able to use this time, companies should implement these six budgeting best practices:

### 1. Align budgeting to strategy

An advanced budgeting system links the budget to corporate strategies. In other words, budgeting activities must have cause-and-effect linkages with corporate goals and objectives. Such activities and how they impact the achievement of strategic goals should be monitored.

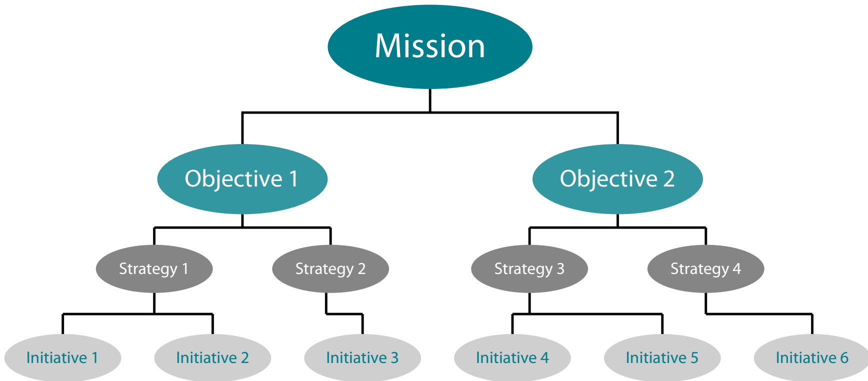


*Figure 2: Cause-and-effect linkages from good budgeting*

The Balanced Scorecard (BSC) is a useful alignment mechanism that merges the budgeting and review processes. Although BSC cannot completely replace the operational coordination and profit-planning aspects of budgeting, it can aid the coordinating functions that budgeting is supposed to perform. In short, the BSC can:

- Communicate the strategy to managers and give them a focus
- Help managers identify and oversee strategic objectives and link them to corporate budgeting activities
- Depict strategic priorities to help managers set guidelines for budget planning
- Provide feedback around internal business processes and external outcomes to improve performance

To get the most out of the BSC method, companies should:

- Focus less on budget-related objectives and more on BSC-related objectives (e.g., investments in long-term capabilities, customer relationships)
- Reduce the level of detail in the budget

### 2. Include non-financial performance measures in budgeting

Although financial information (budget-derived) is a weak performance indicator, many companies still use it as the main data with which to manage their business. Best-in-class management systems include both financial and non-financial performance drivers in the financial picture presented by the budget. These are high-level Key Performance Indicators (KPIs) that are strongly linked to corporate goals. Once determined, they should be clearly communicated throughout the organisation.

### 3. Use aggregated budgets to reduce detail

One of the major drawbacks of budgeting is the time it takes to create and consolidate budgets, especially for large companies. Excess detail makes the budgeting process longer than necessary, shifts attention away from KPIs, hinders decentralised decision making and reduces the organisation's agility.

Therefore, to reduce detail of the budget, companies can:

- Focus budgeting on major product groups, organisational units, processes and cost types
- Use aggregated instead of detailed budgets to accommodate decentralised decision making
- Allow decentralised leaders to allocate resources to departments and activities under their jurisdiction without the need to document every single departmental expense

### 4. Use rolling (flexible) budgets instead of fixed budgets

As soon as companies manage to abandon detailed budgets, they can start transforming the annual budgeting exercise into a continual planning process. This will help companies adapt to changing market conditions by frequently updating their budgets. Best-in-class companies adopt the technique of five-quarter rolling forecasts and translate it into aggregated rolling budgets.

| Fixed budgets and forecasts | VS | Rolling budgets and forecasts |
|---|---|---|
| • Cover a fixed period of time | | • Cover five quarters ahead, through the following year plus one quarter |
| • Once set, fixed budgets are used to compare with quarterly performance | | • Once set, they can be updated each quarter. Rolling budgets are set based on rolling forecasts and additional resource allocation decisions |
| • Year-end forecasts dictate how much companies have to spend for the rest of the year | | • Get managers away from their year-end focus, which helps to balance short- and mid-term thinking |
| • In case of change in market conditions, businesses have limited choices: stay within budget or spend beyond expected and cut later on | | • As conditions change, companies can seize opportunities or shore up resources |

### 5. Use relative targets to motivate people

Meeting fixed budgets can create behaviour that is not in the company's interest. Therefore, companies should assess manager performance against relative, self-adjusting performance measures. Following the same idea of rolling budgets, relative targets help managers shift their focus away from solely hitting the desired numbers. They also help people:

- Realise and seize growth opportunities without the boundaries set by fixed targets
- Better manage their capacity so as to beat external competition instead of competing internally for resource allocation

As it is a good practice to include non-financial performance indicators in the company's budget, managers should be rewarded for achieving non-financial objectives as well.

### 6. Focus on processes instead of on departmental and organisational unit performance

Following the above practice, companies should focus on cross-functional core processes, e.g., streamlining operational efficiencies, instead of complying with the requirements of isolated departments. Management can then focus on major cost drivers instead of single cost figures. Again, this will help managers better align budgeting with organisational strategy and foster collaboration enterprise-wide.

## The role of corporate budgeting software

When it comes to budgeting, the traditional method used is spreadsheets. However, over the years, spreadsheets have demonstrated themselves to be insufficient to handle budgeting in the ever changing business world. Hence, dedicated corporate budgeting solutions were born to deliver the accuracy, agility and responsiveness that companies so desire. A powerful budgeting solution should help businesses adopt the best practices of budgeting, such as:

### Linking the budget to corporate strategy

Corporate budgeting software helps businesses align their budgets with corporate goals by allowing the enforcement of budget rules and timelines. To allow leaders/managers to oversee how budgeting activities impact the overall objective, budgeting software should:

- Allow data retrieval anywhere anytime
- Create exception alerts and send them to the right people

### Incorporating non-financial information

A powerful budgeting solution should allow non-financial information as well as financial data. This is demonstrated through the ability of a solution to indicate whether a number should be treated as financial or non-financial.

### Consolidating budgets

Having a central database in a budgeting solution helps in consolidating the numbers submitted from different sources. Decentralised managers can then access everything they need in one place.

### Revising the budget

Advanced budgeting systems should always allow budget phasing over a specified time period as well as budget modifications when conditions change. Moreover, such changes should be reliably and quickly updated throughout the system.

### Enhancing internal collaboration

Collective efforts can happen if there are tools and procedures to foster them. Corporate budgeting software can help with:

- Establishing a central communication portal to educate system users across the company
- Guided workflow capabilities to ensure no one is treading on one another's path

### Streamlining the budgeting process

With the right tools, enterprises can beat complexity with speed and accuracy at the same time. A budgeting solution should be able to:

- Handle automatic cost allocation no matter how complex the rules
- Eliminate version control problems by giving users a single version of truth
- Handle electronic budget submission and the approval process

Last but not least, creating an advanced budgeting system takes more than implementing the right budgeting software. Companies should know that the real payoff is "achieved only when the time saved is directed toward better analysis of the budget and greater coordination of objectives and resources both within and across business units" (Ventana Research, 2003).

## An advanced budgeting solution: the best choice

**Infor CPM - Planning and Budgeting** helps organisations test various combinations of targets, forecasts, key business drivers and organisational structures within minutes to create useful, realistic, financial and operational plans. The software performs all the calculations, enabling businesses to see instantly how a change in one variable affects other variables.

**Infor CPM - Planning and Budgeting** also enables organisations to transform budgeting into a collaborative and meaningful process that reflects their real-world needs. With this software, companies can design any number of zero-based, historical-based and rolling budgets and plans.

Incorporating a Microsoft Excel interface on top of a central database, Infor Corporate performance management's budgeting functionality lets companies retain the familiar look and feel of spreadsheets while eliminating the drawbacks and ensuring a single version of the truth.

When a business change occurs, businesses can easily adjust the budget and save it to the database, relying on the system to automatically update numbers and reports affected by the change.

**Infor CPM - Planning and Budgeting** not only helps companies improve the quality of plans and significantly reduce budgeting cycle time, but also enables them to access accurate data and reports on demand to support business analysis and decision making.

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