Best Practices in Budgeting

N. Dean Meyer

Many people think that preparing an annual budget is necessary, but not particularly useful. It's a matter of projecting spending, perhaps building in a little padding for the inevitable cuts, and then negotiating a number that has little to do with the real needs of the business.

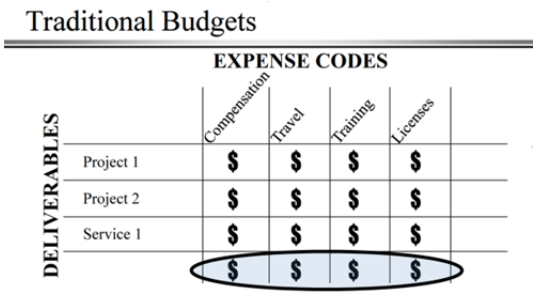
The truth is, this traditional approach to budgeting doesn't add much value. And indeed, it creates many serious problems that the organization must deal with throughout the year.

There is a better way – "investment-based budgeting" – a budget process that links funding to the needs of the business and solves many critical leadership issues.

But first, let's examine exactly what's wrong with the traditional approach to budgeting.

Traditional Approach to Budgeting

Imagine a spreadsheet, where the columns represent your general-ledger expense codes and the rows represent the projects and services ("deliverables") you plan to produce in the year ahead. Managers fill in the cells based on historic spending trends, seasoned by their knowledge of what those projects and services will require. So far, so good.



But in the traditional approach to budgeting, you then *total the columns* to calculate planned spending by expense code. Consider what happens when you submit this traditional budget….

Micro-management: Of course, your CFO and executive leadership have to manage costs. But what have you given them to talk about? Only your planned spending by expense code – compensation, travel, training, vendor licenses, consultants, etc. Of course, the CFO and executives really aren't qualified to know what you need to run your organization. But that's all you've given them, so that's what they challenge. You've set yourself up for micro-management, the wrong kind of dialog to have with your executive team.

Game playing: Perhaps no one will admit it, but managers generally build some padding into their budget proposals in anticipation of cuts. Executives inevitably demand those cuts, so the managers take some (but perhaps not all) the padding out. This goes back and forth a few times, with no reason to believe that the final outcome will be the right answer. In some cases, fat may remain. In others, cuts may go deep into the bone.

"You cut": Executives may simply force you to make cuts in your budget. You may postpone some internal investments which are necessary in the long term but not urgent. But at some point, you may have to cut some projects and services. This puts you in the awkward position of judging your clients' service requests to decide which are not worthwhile, making you clients' adversary rather than their partner. This is the opposite of customer focus and entrepreneurship.

Lost opportunities: Managers feel overwhelmed with unconstrained demand, so the last thing they want is additional work. As a result, they're unlikely to suggest innovative new projects and services, some of which might be extremely high payoff for the business. This is particularly true in IT, as we seek opportunities in a world of digital business based on technologies such as ubiquitous connectivity, social media, mobility, big-data analytics, 3-D printing, robotics, and so much more to come.

The "black hole" for money: Throughout this process, executives see your costs without clear visibility into what that money buys – the projects and services you plan to deliver. This may lead to the impression that your organization is a "black hole" for money, requiring more and more without an understanding of why, and without an appreciation of the value you deliver.

Poor decisions: Ultimately, how is your budget decided? The right way to determine your budget is to fund all the good investments, and no more. That is, funding should be based on the needs of the business and the investment opportunities at hand. But you can't calculate returns-on-investments in compensation, travel, training, etc., since these costs are not connected with any benefits. So instead, executives are forced to decide budgets based on arbitrary algorithms like last year's budget plus or minus a percentage, spending trends, industry benchmarks, and politics. This is not likely to optimize shareholder value, or the effectiveness of the enterprise or your organization.

Allocations not based on consumption: Some organizations allocate their budgeted costs to business units based on high-level drivers such as headcount or revenues. These allocations are not necessarily proportional to business units' consumption of your products and services. More complex formulas may be somewhat more accurate, but still aren't directly linked to clients' consumption, aren't controllable, and may make these "taxes" all the more opaque. But note that the budget doesn't document planned consumption, so it can't provide any data to make allocations fairer. The consequence is generally unproductive political debates and mistrust.

Unrealistic expectations: Perhaps the worst consequence of traditional budgets is that clients' expectations are not conditioned by available resources. There is no way to know which projects and services are funded in the budget. And short of fee-for-service chargebacks, to clients, everything appears free. Thus, demands far exceed available resources. Your organization is blamed when it cannot satisfy virtually unlimited demand with finite resources. And you have no basis for saying to a client, "Great idea! But that wasn't covered by our budget. So let's look for incremental funding."

The Only Thing Worse: Trend-based Budgets

The only thing worse than the traditional approach – totaling the columns – is a budget based strictly on projections of past spending.

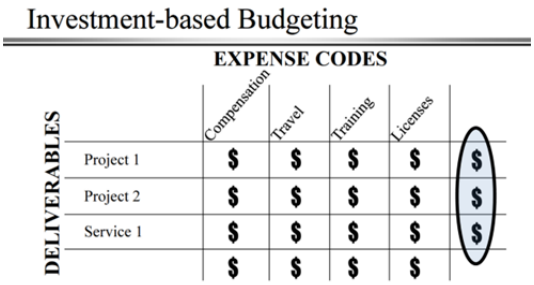
Using historic data to project next year's spending, with minimal input from your management team, completely ignores trend-breaking events such as changes in business, vendor pricing discontinuities, new projects, new services or service levels, and critical investments in infrastructure and innovation.

Even if trend-lines are adjusted a few percentage points based on some high-level drivers, budgets based on past spending have little to do with next year's business realities.

Best Practices: Investment-based Budgeting

Of course, the right answer is to *total the rows*, not just the columns. An investment-based budget forecasts the costs of what you plan to deliver – the project and services anticipated in the year ahead.

The goal is to negotiate your budget based on the rows, that is, on which deliverables the business plans to "buy" from your organization. Once that's agreed, you can total the columns to submit the budget to enterprise financial systems in the familiar format (expense codes by cost center).



Investment-based budgeting has many benefits:

- The budget dialog shifts from micro-managing your costs to managing demand – a businesslike discussion of where spending pays off. It's more like investment portfolio management than haggling over costs.
- The game-playing stops. Since the budget represents the true, full cost to the enterprise of next year's projects and services, the only way to cut costs is to reduce demand.
- You are not forced to judge clients' requests to decide which are to be cut; cost management becomes a collaborative demand-management decision.
- Managers are free to propose new investment opportunities, knowing that new deliverables bring with them incremental funding. Some of these innovative ideas may have significant payoffs to the business.
- Everybody understands the value which can be expected for different levels of funding. And with all your funding associated with the costs of deliverables, transparency builds trust.
- Clients naturally defend your budget by defending their needs for the projects and services which benefit them.
- Budget decisions can be based on the needs of the business and the returns on new investment opportunities.
- Resources are aligned with business strategies, since only those products and services with the best returns are included in the budget.

- Teamwork is enhanced, since entire project and service-delivery teams are funded as a single deliverable (rather than negotiating each manager's budget independently); thus, a manager needing help from peers won't find them too busy to do their share.
- Once the budget is decided, it's clear which projects and services are funded (and which are not). This aligns clients' expectations with available resources, and provides a sound basis for demand management throughout the year.
- Allocations can be based on the cost of deliverables planned for each business unit, a fair algorithm based on their consumption of the organization's projects and services.
- Relationships improve when your organization is not the obstacle, and when youhave the resources, and hence can be relied on, to deliver what the business needs.

In short, investment-based budgeting ensures improves shareholder value; it enables greater organizational effectiveness; and it improves relationships with business clients.

How to Implement Investment-based Budgeting

Developing an investment-based budget is as much a business planning process as a financial process.

Each managerial group is considered a basic entrepreneurial unit. The plan is developed at that level of granularity – a plan and budget for each group – and then aggregated into the organization's plan.

Investment-based budgeting consists of the following steps:

1. Each group defines, or refines, its catalog of products and services. This catalog includes products and services delivered to other groups within the organization as well as to clients outside the organization.
2. Each group forecasts demand, both "keep the lights on" and discretionary deliverables. In addition to these "sales" to clients, this demand forecast includes internal sales to peers. For example, infrastructure engineers sell repairs, enhancements, and new capacity to infrastructure service-delivery managers. The demand forecast also includes requests for funding for infrastructure and significant innovation projects for the organization's own benefit (akin to loans from the bank).
3. When teams are to produce a deliverable, each group forecasts its own share of the work; then, their respective rows are linked through a coding scheme.
4. Each group develops a staffing strategy, including the kinds of skills needed and requirements for staff-augmentation contractors. It analyzes the appropriate "billable-time ratios" for each type of staff, setting aside time for necessary sustenance activities like time off, professional development, process improvements, innovation, and relationship building. This results in a cost per billable hour within each group.
5. Each group estimates the billable hours required for each deliverable.
6. Each group forecasts vendor costs, including direct costs associated with individual deliverables (such as project-specific vendor costs) and indirect costs which will be apportioned to multiple

deliverables (such as infrastructure costs). Indirect costs are assigned to one or more catalog items, or to a set of specific deliverables.

7. The management team discusses and approves (or not) deliverables sold to one another. This creates costs within the internal buyer's budget, which are assigned to one or more catalog items, or to a set of specific deliverables. (This step is essential to cost modeling, even if the engineers and service-delivery managers are mixed in the same group.)
8. Each group tags deliverables with a source of revenues, e.g., direct budget, allocations, or fee-for-service chargebacks.
9. The organization's executive then scrutinizes the entire plan to ensure that managers have been realistic and frugal (no fat).
10. Then, the organization is ready to review the plan with clients, adding or subtracting deliverables based on their needs.
11. With clients' support, the organization submits its budget for executive decision making.
12. Once the budget is negotiated and agreed, the columns (expense codes by cost center) are tallied and uploaded to enterprise financial systems.

While You're At It, Rates

A nice by-product of investment-based budgeting is a product/service catalog with rates (unit costs).

Rates provide the best basis for benchmarking; you can use them to ask the question, "Can I buy this particular product/service for less elsewhere?"

Rates are also used for demand management. During the year, *published* rates are applied to *actual* utilization to create invoices for products and services delivered. Beyond just the understanding this brings, these invoices explain where the budget went and how much is left for the rest of the year.

Of course, rates are published at the beginning of the year (at the same time the budget is developed). And most organizations hold them stable throughout the year (barring some major discontinuity). This creates a stable environment for business decision making.

Calculating rates does not need to be a separate analytic process. Indeed, it should not be separate. As a best practice, rates should be extracted from the same data-cube as the budget. This avoids additional effort . Perhaps more importantly, it ensures consistency. The rates charged during the year are certain to add up to the agreed budget.

The math is simple: *Budget = Rates * Volumes + Reimbursables (pass-throughs)*

Rates are just another view of the same data that produces an investment-based budget.

Practicalities

Management engagement: Managers are responsible for planning the year ahead, and then living up to that plan. By their engagement in the budget process, managers can be expected to accept accountability for its contents.

Beyond that, with investment-based budgeting, they learn to think like entrepreneurs, developing a clear understanding of their catalogs, customers, cost structures, and their interrelated accountabilities. But changing the way people think and behave requires engagement by the entire management team in the process. Managers develop their own business plans, budgets, and catalogs with rates, all with the help of a project team.

If these transformational effects aren't as important, the process may be done by a project team, with input from the managers.

Tool: Of course, the right tool is critical. You might get started with spreadsheets, but you'll quickly learn that it's not quite so simple. You'll need a tool designed for this purpose.

The tool you're looking for is not a simple cost model, like activity-based costing (although it has a cost model imbedded in it). And it's certainly not a projection of historic data. The tool handles the full detail of the demand forecast. And it supports each step of the planning process, structuring managers' inputs and producing reports for the project managers and the organization's top executive, as well as a variety of different views for audiences like clients, the CFO, and the CEO.

Documented process: Equally important is a well-structured, carefully documented, repeatable process. This should be more than a "cookbook" describing each step of the process – each workshop and each managerial homework assignment. You'll need principles and guidelines to make the right decisions at each step of the process.

The Bottom Line

While it takes an investment to implement investment-based budgeting, the cost is far less than revamping accounting systems to produce invoices and dashboards. And the benefits are far greater. It's not just a matter of after-the-fact financial analysis. Investment-based budgeting is a change in the way your organization relates to its internal clients and manages its business.

With its relatively low cost and far-reaching benefits, investment-based budgeting may be one of the best investments an organization can make.

Dean Meyer is author of Internal Market Economics, and a pioneer in apply principles of market economics inside organizations to design effective budgeting and resource-governance processes. He's a consultant, executive coach on organizational issues, and author of seven books. Find more on investment-based budgeting – including case studies, white papers, and tools – at www.FullCost.com.