Re-inventing the Budget Process

The Cost of Success

BY KAREN TERESE O'LEARY

"It does not do to leave a live dragon out of your calculations, if you live near him," the writer J. R. R. Tolkien advises.

Contributing to corporate strategy, investing in your staff's future, and satisfying customers with excellent service. . . it's easy to agree on which business objectives are really important. Yet conventional budgeting processes routinely fail to fund them.

In doing so, traditional approaches to budgeting (the dragon) can sabotage the success of an organization before the fiscal year even begins. They lead to poorly allocated resources; overburdened, ineffective, and demotivated staff; and internal clients who don't get the services they need.

Interviews with executives demonstrate what can go wrong and how they fixed the problem.

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How Budgeting Goes Wrong

In conventional budget processes, staff request funding for various cost factors: compensation, travel, training, etc. Then, corporate executives either debate whether staff really need to be trained, or force staff to trim their budgets to arbitrary targets such as last year's level plus or minus a certain percentage.

Neither approach is healthy, according to Dean Meyer, president of NDMA Inc., a consulting firm that researches tools and methods to enhance the performance of

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organizations. "The conventional approach to budgeting is based on politics and salesmanship. It's more like horse trading than investing," says Meyer.

When isolated expense items -- such as travel and training -- are slashed, the performance of an organization can be severely compromised. As skills become obsolete, staff are demoralized, productivity falls, and turnover rises.

The other approach, forcing staff to cut their budget to targets, isn't any better. "Predetermined caps and across-the-board cuts are arbitrary and uninformed," according to Meyer. "They're blind to good investment opportunities."

Either way, ongoing operational activities generally survive, but key strategic initiatives may go unfunded. That reduces shareholder value and can threaten the viability of the entire company.

Unbridled Expectations

The trouble doesn't stop once the numbers are decided. The aftermath of traditional approaches to budgeting plague staff and the corporation throughout the fiscal year.

Conventional budget processes don't clarify which deliverables are funded and which are not. As a result, clients throughout the corporation expect staff to do absolutely anything they ask for free, then blame staff when their resources are lacking.

FullCost calculates the cost of the products and services clients buy

This can severely damage staff's morale, their reputation, and their careers. "Sometimes these poor people are so burdened with clients' unrealistic expectations that they spend every minute trying to do the impossible, and take no time for sustenance tasks like training or returning clients' calls," Meyer says. "But if you don't invest in your future, you'll soon be obsolete and out of business."

A Fresh Approach

When Meyer realized how many organizations were suffering the symptoms of ineffective budgeting processes, he set out to find a better way. After ten years of research, NDMA released a method and tool-kit called FullCost®

Instead of submitting budgets for compensation and training, for instance, Meyer helps staff portray their budget as a set of deliverables (products and services), each of which carries a price that represents its fully-burdened cost.

FullCost was developed in the context of what Meyer calls the "internal economy" of a corporation. Every department is viewed as a business within a business, "selling" its products and services to a market comprising everyone else in the company (whether or not money actually changes hands).

At first glance, the FullCost spreadsheet looks familiar. Budget items such as salaries, training, travel, equipment, and licenses are identified across the top; and projects and services are listed down the left side.

"The mistake most organizations make is totaling the columns of costs instead of the rows of deliverables," says Meyer. "Adding up a column of travel expenses, for example, without tying them to projects that are essential to the business, leaves them vulnerable to getting slashed."

The FullCost software totals the rows—calculating the cost of the products and services clients buy, spreading fixed and indirect costs across an organization's many deliverables.

While it sounds simple, the spreadsheets include complex formulas and behind-the-scenes software that automate every step in the budget-preparation process.

The conceptual challenges are significant. Most activity-based costing studies don't treat internal support groups as entrepreneurships that also sell products and services within the department. Figuring out how to do just that is, perhaps, the more important contribution of Meyer's research.

Fact-based Budget Decisions

When a budget documents the true costs of the many products and services clients want, the debate in the budgeting process is raised to a higher level. Rather than demanding that staff do more with less, executives make budget decisions based on returns on investments and on the impact of specific projects on corporate strategy.

Meyer calls this "Investment-based Budgeting."

The result is that executives invest in worthwhile projects. "We have literally hundreds of projects and services that we deliver to keep things running well and to track patients, students and treatments," explained **Dr. Joyce Mitchell**, CIO and associate dean at the University of Missouri Health Services.

"If we didn't get our projects funded properly, the hospital would be chaos. But when I added the number of people I needed for these projects to what I needed just to keep the place going, it was a large budget. Senior management said, 'We're just going to give you last year's budget.' And I said, 'Then I can't afford to do anything new.'"

Senior management recognized that the projects which would be sacrificed were not optional. They needed to replace a mainframe application that does patient accounting and tracks clinical work at the hospital. Also, at that time, projects had to be done for the hospital to be Y2K compliant.

As a result of Mitchell's FullCost budget, hospital management understood the investments they had to make. "My budget has probably doubled," Mitchell reports.

Mitchell's experience may be dramatic, but it's not unique. **Lew Davison**, director of information systems at the Missouri Department of Transportation, reports similar results.

"We'd become weary of the fight every year at budget time to justify how much we were spending," says Davison. "We were looking for a way to approach management that would let us keep our proposed budget for worthwhile projects.

"The traditional way of cutting costs was to slash everything by X percent," says Davison. "Without the FullCost process, management would not have known about the specific opportunities that would deliver high ROI. Our budget, I'm sure, would have been slashed with the rest of them.

"But with FullCost, we were able to present opportunities, and we clearly showed that an across-the-board cut wouldn't work," says Davison. In fact, in the first year of using the FullCost process, while the rest of the budgets in the DoT were shrinking, Davison's IT budget went up.

Meyer says, "Budgeting shifts from being a burdensome, bureaucratic struggle into fact-based, businesslike discussion... a way to build corporate consensus on investments and priorities."

FullCost makes budgeting a businesslike discussion of investments

Reliable Delivery

FullCost also improves an organization's reputation for on-time delivery.

Conventional budgets don't document what's included and what's not, so clients expect more than staff's resources permit. Staff are then blamed when they can't deliver.

A dramatic case example occurred at Dean Foods, a large Chicago-based supplier of dairy, pickle, and specialty-food products. A vice president in one of their divisions sent a memo to **Gary Rietz**, CIO, (with copies to the Chairman, CEO, and President) criticizing IT for a systems problem that threatened a big piece of their business.

Upon investigation, Rietz found that the "systems problem" was nothing more than an enhancement that the executive team had cut from his budget. Instead of blaming IT for the problem, the CEO placed the responsibility squarely on the client to justify the project to corporate executives.

The moral of the story: Understanding what's included in the budget (and what isn't) is essential to businesslike relationships between staff and their clients.

It gives staff the resources they need to accomplish approved projects and services. This ensures that critical projects will, in fact, get done.

It also avoids putting staff in the untenable situation of facing demands that far outstrip their supply. "Staff are no longer given inadequate budget and simultaneously asked to achieve the impossible," says Meyer.

This improves the quality of staff's work. "When projects are approved and the resources allocated in advance, you know you can do them well, instead of cutting corners or robbing Peter to pay Paul," Meyer explains.

Furthermore, it ensures that staff reserve some time for training, product research, and business improvements – all critical to quality. "Time and resources for rejuvenation activities are key to the long-term viability of an organization," notes Meyer. "But when staff are overburdened with unfunded demands, the first thing to go is training."

"NDMA's budgeting system has helped with job satisfaction and motivation," says Mitchell of the University of Missouri. "It's also helped people realize that my group follows through on their promises and gets the job done."

Entrepreneurial Culture

Meyer's focus is on training staff, not doing the analyses for them. The handbook that comes with NDMA's tool-kit reads like a cookbook, with each step described in detail.

Some of the steps in the process are: defining the product/service catalog (at just the right level of detail), categorizing projects by source of revenues (eg, client services versus "venture funding"), determining "billable-time" ratios that balance client work with sustenance tasks, forecasting hours and expenses, amortizing group-level and organizationwide overhead, aggregating costs from the various groups working together on a project, formatting the spreadsheets to support budget negotiations, and finally producing rate sheets.

Investing time and effort in learning the new business and budget planning process is a critical cornerstone of the system's success. It might take six to ten months to implement FullCost, most of which is spent training managers to think like entrepreneurs and plan their businesses. But in the process, managers clearly define their products and services, their customers, their suppliers, and their accountabilities.

FullCost helped align our resources with the strategic goals of the company

"The cultural impact is huge," says Meyer. "FullCost builds an understanding of the business, an entrepreneurial spirit, and customer focus. And it encourages teamwork, since peers are recognized as customers."

Business Alignment

When Minnesota-based St. Mary's Hospital merged with the Duluth Clinic, their challenges included setting up a common infrastructure for the medical clinics and hospitals, and integrating enterprisewide operations such as patient scheduling, registration, and records. This led to a tremendous demand for information systems, says **Robert Bender,** CIO of the merged SMDC Health System.

"No question about it, the perception was that IT resources were free," reported Bender. "The demand was virtually infinite, and we were expected to be able to respond. Period." Meanwhile, Bender was struggling to unite two very different IT groups.

Bender looked at Meyer's company as well as a big-five consulting firm for help in establishing a healthy, integrated IT function. "Meyer's process was more encompassing," said Bender. "I saw more thoroughness, more concepts pertaining to what we wanted to do, so we went with NDMA."

Budgeting for their products and services was just one step in Bender's comprehensive organizational design program.

"When we started the budgeting this year, senior management said, 'Here's the target. Here's what to set your budget at for this next fiscal year.' So we went back and listed all of the things we could and couldn't do based on the target," reports Bender. "Then we told the senior executives the things our internal customers wanted that couldn't be done."

The end of the story is a happy one. "As a result, we had over half a million dollars put back into the IT budget," Bender reports.

Beyond funding critical initiatives, Bender says the new budget process improved client relationships. "We were able to identify for clients the resources that were actually available. That realization didn't exist before; everybody just thought our time is unlimited.

"People responded positively to this. Our customers are really stepping up to the plate and telling us what they want to have done. And they're willing to pay for them."

Davison found a similar benefit. "Clients took an active role in defending their particular projects," he reports. This allowed executives to verify that clients care enough to fight for the projects they want. Plus, client involvement gives executives better information about the benefits of projects, and improves the odds that key projects get funded.

Fixing an ineffective budgeting process comes at a price. "FullCost is not easy," reports Mitchell. "But it's worth the work."

Perhaps Bender sums it up best when he says, "I really believe that FullCost helped align our resources with the strategic goals of the company." ❑

Know your cost of services with FullCost®

FullCost includes both software and a step-by-step planning process in which an organization develops its product and service catalog, operating plan, budget, allocations, and rates.

For more information, visit: www.FullCost.com.

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