

## **Budgeting in a Chaotic Economic Environment ... Factors Leading to Improvement**

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*Traditional budgets and budgeting processes have been identified as frustrating and inflexible. They are based on immovable targets and often lead to suboptimal attitudes and behaviors. When the budget process is performed in a chaotic economic environment, these negative aspects are exacerbated. This paper identifies and discusses actions that can be implemented to enhance the flexibility of budgets and their processes and to reduce the negative aspects involved.*

### **INTRODUCTION**

Budgets are considered to be tools for strategic business planning, providing managers with information to manage cash flows, monitor progress towards reaching goals related to critical success factors/key business indicators, and focus on how well results compare to the plans. In addition, these plans are often used to evaluate managerial performance. Within this framework, there is a great deal of frustration and dissatisfaction with budget processes. When a chaotic economic environment, such as we have been experiencing over the last few years, is added to the mix, the degree of frustration and dissatisfaction grows rapidly.

### **PROBLEM DISCUSSION**

Finance and Accounting professionals, as well as managers of other responsibility areas (such as production and product managers, marketing and sales managers, and distribution managers), register complaints about budgets and budgeting processes. Player (2006) compiled a list of complaints regarding budgets and budget processes. Some of these frustrations were identified as budgets taking too long to prepare, the process costs too much, the underlying assumptions of budgets are often incorrect, budgets cause unproductive gaming manipulations, and provide an illusion of control that doesn't exist in reality.

In 2008, the Institute of Management Accountants (IMA) reported the results of a survey conducted by Centage Corporation and the Institute of Management & Administration (IOMA) and addressed to corporate Chief Financial Officers (CFOs) and finance executives. The results indicated that CFOs and finance executives were plagued by budget headaches. They responded that budgeting was frustrating because non-finance managers weren't participating adequately in the process, they weren't taking

responsibility for their part of the overall process, many didn't understand the process, they didn't meet budget deadlines, and they tended to pad their numbers.

Also, these managers were expressing fear of the consequences of exceeding the tolerance limits for favorable and unfavorable variances from budget. As well, they were uncomfortable with the risks associated with budgets and their variances being employed as part of the performance evaluation process.

In addition, the CFOs and finance executives were unhappy with having to use Excel spreadsheets to prepare the budgets. They indicated frustration with the process being too manual, too time consuming, too prone to errors, and too inflexible. They also indicated that using the spreadsheet process made it difficult to generate good, usable reports and to move information from one area to another.

The degree of difficulties and problems associated with budgets and budget processes grows exponentially when the economic environment becomes unstable (or more so). Under these conditions, budgets are less meaningful, more inflexible, and their underlying assumptions become even more incorrect. Managers of all budget areas are more likely to take longer to gather and provide information, add more padding to their numbers, and be more reluctant to take responsibility for the information they do provide.

## **FACTORS LEADING TO IMPROVEMENT**

There are a number of practices that finance managers can implement to enhance the efficiency of the budget process and to improve the usefulness and flexibility of the budget information, especially in times of economic chaos, including:

- Upgrade the technology used for the preparation, analysis, dissemination, and management of the budgets. There are a number of budgeting software packages now available that eliminate the problems with using Excel spreadsheets. These packages tend to be much more user friendly (so managers are more likely to use them). In addition, they have the capacity to save time, add flexibility to the budget process, reduce the opportunity for errors to occur, and allow for a variety of 'what if' analyses. (Player, 2007 and Orlando, 2009)

Recent Update: For those who are still required to (or like to) use Excel for the budget process, the IMA recently published a series of six articles, in their *Strategic Finance* journal, by Porter and Stephenson (2010). The articles detailed how to create an Excel-based budget, and/or different parts of an Excel-Based budget, that can really be used and that are reasonable to create. In addition, two follow-up articles were published by Cox (2010) in the same journal that focused on the use of Access in conjunction with the Excel-based budgets.

The knowledge imparted in these articles should help to improve the flexibility and usability of Excel-based budgets for finance managers. As well, the understanding of budgets and budget processes should be enhanced for those who are non-finance managers, but also involved in the budget process.

- Expand the budget communication process by thoroughly explaining the process, emphasizing time factors, assumptions to be used, and the responsibilities of each party involved. Emphasis should also be made on how important the process is to the meeting of strategic and operational goals, as well as the importance of maintaining and growing the company's financial health/position. (Orlando, 2009)

- Maintain the open lines of communication continuously throughout the budget process and into the implementation and assessment stages. Keep the participants involved in all aspects of the budget process and touch base with them frequently. This represents an opportunity to enhance motivation and provide guidance and periodic updates. (Orlando, 2009)
- Maintain well-developed, up-to-date strategies and make sure they are connected to the operational plans. Make sure that all budget participants are knowledgeable about the strategic plans and how they connect to current (and future) operations. In addition, ensuring that the strategic and operational plans, and their linkages, are visible throughout the organization enhances the opportunity for all members of the organization to work towards the common goals. (Chen and Jones, 2007 and Croake and Peterson, 2005)
- Provide, on-going and continuous (as needed), training and education to all employees involved in the budget process, to ensure that they have the knowledge needed to build their budgets and have them integrated into the entire budget package. In addition, make sure that all budget participants know how to use the technology and other tools provided to build their budgets. (Williams, 2008)
- If manager compensation packages include evaluation of budget results, it must be clear and ensured that participants understand the process and are knowledgeable about the need to meet operational goals. Because that which gets measured is what becomes important to managers, the compensation plan must be well thought out and dynamic enough to factor in the effects of changes in economic conditions that are outside managerial control. (Orlando, 2009)
- Implement a process of rolling forecasts, which continuously takes the forecasts and corresponding budgets into the next budgeting period (with the budget periods becoming shorter, such as quarterly rather than semi-annually or annually). The most currently available information is used, taking into consideration the movement of leading business indicators and the company's critical success factors. This allows the company to respond more quickly to changing economic conditions. It also provides the firm with the ability to become more proactive when negative trends and/or positive developments occur. The focus is on improved analysis, with more frequent updates, increased continuous planning, and reduced cycle time. (Player, 2006 and Croake and Peterson, 2005)
- Organizations, or parts thereof, that use Activity-Based Costing (ABC) should use Activity-Based Budgeting. Budgeting through this process allows managers to implement plans for continuous improvement, emphasize cost and activity management, and foster improvement in the efficiency of necessary activities. (Hansen and Mowen, 2008)
- The next step, beyond the use of Activity-Based Budgeting, is to incorporate a driver-based approach to the budget process. This approach requires managers to understand the cause-and-effect relationships within the organization and to understand the key factors that drive the business. Once the drivers for the key factors or activities are identified, they can be linked with operations to present an integrated view of the business. Incremental improvements of the drivers, rather than budgeted targets, become the focus of the process. While financial performance is clearly important, that performance rests on the ability of managers to accomplish the incremental improvements of the drivers of the business (not the other way around). (Player, 2007 and McVay and Cooke, 2006)

This process allows managers to better understand all parts of the business and how they all fit together. It also allows the organization to better adapt to a changing economic environment, such that targets can be adjusted as more current economic information becomes known. The process fits very well with the concept of rolling forecasts.

## CONCLUSIONS

Implementing some or all of these factors may well eliminate many of the negative aspects of budget processes, especially in times of great economic uncertainty. Actions taken have the ability to enhance the flexibility of the budget process and improve the overall usefulness of the budgets themselves.

Indeed, some of the actions, including implementing rolling forecasts and driver-based budgeting, may lead the organization to the concept of Beyond Budgeting (Player, 2007). This perspective virtually eliminates the formal budget and budget processes and takes an approach that utilizes continuous planning and constant adaptation to changing economic conditions. The focus goes beyond the annual budget period, into medium-term goals, with strategy planning becoming a continuous process and pushed down to lower, front-line levels. Continuously creating value using the key drivers of the business is encouraged and implemented, integration across the organization is fostered, and adaptability to changing conditions is strongly encouraged. Many of the principles of traditional budgeting are no longer useful and, in some cases, are counterproductive to successfully driving the business.

A number of companies are pursuing all or some parts of this concept and many are pleased with their improved ability to manage their businesses, especially in times of economic chaos. The future holds a great deal of interesting and, perhaps frustrating, challenges as budgets, budgeting processes, and other planning mechanisms are adapted to meet the ever-changing needs of business.

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