3.9 Budgets and Strategic Planning – Summary Notes

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THE ROLE OF BUDGETS ANND VARIANCES IN STRATEGIC PLANNING

A budget is a systematic method of allocating financial, physical, and human resources to achieve strategic goals. Firm develops budgets in order to monitor progress toward their goals, help control spending, and predict cash flow and profit.

The central challenge that budget developers face is mapping out the future, something that can never be done with perfect precision. The fast pace of technological change and the complexities of global competition make developing effective budgets both more difficult and more important for firms.

Best practices linking budgets with planning

Important benefits of improving the budgeting process include better companywide understanding of strategic goals, more coordinated support for those goals, and an improved ability to respond quickly to competition. A discussion of best practices used by leading companies to develop budgets follows.

- **Link budget development to corporate strategy.**

Because the budget expresses how resources will be allocated and what measures will be used to evaluate progress, budget development is more effective when linked to overall corporate strategy. Linking the two gives all managers and employees a clearer understanding of strategic goals. This understanding, in turn, leads to greater support for goals, better coordination of tactics, and, ultimately, to stronger companywide performance at firms.

But how is such a link created? Companies that apply best practices find that communication plays an important role. Top management must take the lead in developing and communicating strategic goals. But to develop those goals, top management needs information about customers, competitors, economic and technological change - information that must come from customer-contact and support units. Companies that establish effective channels for communication find it easier to set challenging yet achievable strategic goals.

Setting goals before budgeting begins makes it easier for budget developers at all levels. When this happens, budget developers at firms create from the start budgets that support strategic goals and that, therefore, need fewer revisions. Budget development then becomes not only faster and less costly but also far less frustrating.

- **Design procedures that allocate resources strategically.**

Within firms, competition for resources is inevitable. Every function and business unit needs funding for both capital and operating expenses - usually in excess of the actual resources available. This makes it critically important for firms to design procedures so that resources are allocated to support key strategies.

Best practice companies find that resource allocation is part science, part art. Fortunately, following certain best practices leads to better results. One such practice is coordinating the review of operating and capital budgets. Doing this gives managers insight into the ways in which changes in one budget affect the other. Another practice is to develop sophisticated measures for evaluating proposed budgets. The measures used tend to vary by industry, but most take into account the company's weighted average cost of capital. Many measures also assess the degree of risk involved in competing plans of action, the costs or advantages associated with deferring action, as well as factors such as expected developments in interest rates. By using such measures, and by using cross-functional teams to examine action plans, companies can better select plans whose benefits will produce desired results. Finally, by monitoring the results of allocation efforts, companies can refine and improve their procedures.

- **Tie incentives to performance measures other than meeting budget targets.**

Many companies still evaluate managers primarily on how closely they hit budget targets. While this may seem logical, in reality this type of one-dimensional evaluation tempts managers to "win" by playing games with budget targets. Such game playing isn't always in the company's best interest.

At best practice companies, meeting budget targets is secondary to other performance measures. Such companies use a balanced set of performance measures to chart progress toward strategic goals, and use the same measures in their incentive programs. This reinforces the importance of key strategies and communicates what results will be rewarded.

At many companies, business unit managers are involved in identifying the measures that are most relevant for their operations. Typically, some measures are financial, while others track progress in other efforts. For example, an appropriate nonfinancial measure for one business unit may be product defect rate; for another, speed to market for new products. Once the measures are identified, higher-level management clarifies what targets each manager is expected to meet. Managers and employees receive training on the company's incentive program so that they understand the reason behind the rewards.

- **Link cost management efforts to budgeting.**

By linking cost management efforts to budgeting, companies improve the quality of information available for managers to use in developing their budgets. Accurate cost information is fundamental to budgeting. Companies that use accurate cost management techniques and provide budget developers with ready access to cost information improve both the accuracy and the speed of their budget process.

Standardizing the cost management system companywide is an important step in improving the link between cost management and budgeting. Many companies also have found activity-based costing (ABC) helpful in identifying the real cost of producing, selling, and delivering products and services. Even small- to medium-size companies are exploring the potential of ABC, as packaged software becomes more widely available and brings down the cost of engaging in this type of analysis.

Another best practice in linking cost management to budgeting is the strategic use of variance analysis. Variance analysis is the study of differences between budgeted and actual costs, or the study of costs at one company compared with industry averages. By using variance analysis to identify weaknesses, managers can identify areas where their organization needs to improve its performance. But managers must focus on those variances that have a significant impact. Otherwise, decision making and budgeting can become bogged down in trivial detail.

- **Reduce budget complexity and cycle time.**

Best practice companies strive to reduce budget complexity and streamline budgeting procedures. Such streamlining allows management to collect budget information, make allocation decisions, and communicate final targets in less time, at lower cost, and with less disruption to the company's core activities.

By controlling the number of budgets that are needed and by standardising budgeting methods, companies take important steps toward streamlining budgeting. Another key step is to minimize the amount of detail included in the reports used to develop budgets. Also, in their effort to streamline budgeting, leading companies use information technology to automate budgeting and facilitate workflow. These companies make sure that budget developers are thoroughly trained in new technologies. This training, together with ongoing monitoring of information needs companywide, helps best practice companies deliver the right information to managers, on time and at the right cost.

- **Develop budgets that accommodate change.**

By developing budgets that accommodate change, companies can respond to competitive threats or opportunities more quickly and with greater precision. They can use resources efficiently to take advantage of the most promising opportunities. Furthermore, knowing that budgets have some flexibility frees budget developers from the need to "pad" budgets to cover a wide variety of possible developments. This leads to leaner, more realistic budgets.

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Companies typically review budgets quarterly, monthly, or even weekly. By including in these reviews reports on changes in business conditions, companies alert managers that new tactics may be called for, if they are to meet their targets for the year. While it is important that budgets not be revised to cover up for poor performance or poor planning, best practice companies choose to revise budgets rather than adhere to budgets that do not reflect current conditions. Some companies rely on "rolling" or "continuous" forecasts rather than on traditional annual budgets. The chief difference between such forecasts and traditional budgets is that the forecast is updated with actual results as the company moves through the year. Figures for three or more subsequent quarters are projected in decreasing degree of detail.

One way in which Firm can build flexibility into budgets is to prioritise according to strategic importance action plans that were rejected due to resource limitations. By doing this, the firm can act swiftly and decisively if additional resources become available.

Another way in which best practice companies develop budgets that accommodate change is to require managers to create scenarios based on a variety of assumptions about business conditions. The affordability of powerful information technology allows for the creation of many "what if" scenarios. This practice makes it possible for companies to respond more quickly and effectively if actual conditions follow the pattern of a particular scenario. Firms can also build flexibility into budgets by setting aside funds at the business-unit level to take advantage of competitive opportunities. Some companies even establish separate subsidiaries to look into promising products or technologies.