

# Reality-Based Budgeting

Improved budgeting, planning & forecasting can take wishful thinking out of the bottom line

By David F. Giannetto



Does your organization's budget reflect reality, not a best-case scenario of what senior management would like to see happen, but what is actually likely to happen? Once the organization's budget has been established, does it live and breathe with your organization? Does management know where it stands on a daily basis and, more importantly, where it will end up, long before the end of that budgeting cycle?

If you answered "no" to these questions, if these are not characteristics of the budgeting environment within your organization, then your organization isn't budgeting reality. And you are not alone; most other organizations also lack these superior performance-producing characteristics.

Consider every organization that declared bankruptcy last year. How many of them do you believe budgeted for bankruptcy producing negative growth? These organizations clearly were not budgeting reality, but before the end of their last budget cycle, they found themselves dealing with a rather painful reality.

## The Best Intentions

Many of the problems that prevent organizations from creating realistic budgets are inherent in the very nature of how they are managed, and the environment that is therefore created within them. Even with the best intentions, it isn't easy to create a budget that realistically reflects what the organization can actually achieve in the next year because a host of organizational behaviors make it nearly impossible.

Most budget processes are labeled top-down or bottom-up, but what actually happens in most organizations is a blended version of the two. Typically, as the year's end approaches, the organization's finance department produces a series of spreadsheets that provide line-of-business managers with financial information about prior performance, where the current year is likely to end and, in better organizations, a statistical projection of what could happen next year. These spreadsheets are distributed down to the cost center management level and, thus, multiply exponentially and grow in complexity. Along the way, individual line managers attempting to validate or glean useful information from these purely financial statistics often add disparate operational information. Excel-mania runs

rampant.

These line managers have the right idea. They are attempting to relate the financial results they will achieve this year with the effort it took to generate them, and then use that as a foundation for predicting what is possible next year. Their daily responsibilities focus on the efficiency and effectiveness of the processes they manage; their compensation is most often tied to these operational metrics, not the financial results they produce.

Typical operations-oriented managers do not focus on revenue or profitability; from a financial perspective, they focus on, and are most often held accountable for, managing expense. But what they truly care about is the operational performance of their segment of the business. They know that they must not commit to a budget for the next year that they cannot realistically achieve (i.e., a workload that cannot realistically be completed), nor financial goals that cannot realistically be achieved.

For the most part, these lower-level or operations-oriented managers, regardless of their level on the organization's hierarchy, are attempting to budget reality. But the budget process itself is not asking managers for the operational workload that can realistically be achieved; it is asking for the financial results they will achieve.

These managers must translate their operational effort into financial results, and here the process breaks down. These managers often do not have information that clearly shows the cause-and-effect, or action-result, relationship between operational performance and financial results. Lacking this factual information, they simply do the best they can. They make the best assumptions they can and derive the best guess for the future.

### **Their Own Best Interests**

Extensive psychological studies have shown that almost every person, when forced to make decisions in an uncertain situation, will make the most conservative decision possible. This basic human dynamic, combined with typical incentive programs that compensate for performance exceeding budgetary goals, cause nearly every lower-level manager to budget at or below goals they know they can achieve. They are simply looking out for their own best interests. The average budgeting process itself offers or demands nothing more from them. The spreadsheets they are using are flexible enough to derive any projection that suits their needs.

It is generally expected that as this "bottom-up" budget moves from lower-level managers back up through the executive ranks, the process itself, and the more informed perspective of an executive, takes additional information into account, and therefore the budget takes "reality" into account. But the reality of what is happening is that the budget is transforming from the "operational" perspective it has at the lower levels back into the financial perspective that the budgeting process demands. Every subsequently higher manager adjusts budget goals based on their personal perspective, their take on the business and what is most closely aligned with their best interests.

It is true that most executives will have more information about the long-term financial needs of the organization; they may even have more insight into the marketplace. But they, too, are forced to work in the same environment, an environment that typically does not tie together operational performance and financial results. In reality, they are left to make the best decision they can; they too rarely know.

Are these organization-wide behaviors the problem, or merely the symptoms of a larger problem? The theory of traditional change management has led companies to spend considerable resources debating this issue. The bottom line is that the answer to this question doesn't matter. The answer doesn't change anything; the answer doesn't improve financial or even operational performance.

### **Protecting Reality**

The true answer lies in creating a process that in and of itself overcomes these basic organization-wide flaws and the human behaviors that prevent management from seeing the organization from a realistic perspective. The budget process itself must force management to focus on reality, and make fact-based decisions about what is and is not realistically achievable. The process itself must prevent personal perspectives, agendas or compensation plans from distorting reality.

For organizations that are struggling to distribute, collect and consolidate data, and then transform this data into meaningful information via increasingly more complex spreadsheets, this may seem like a utopian dream state. Although spreadsheets have done a good job of bringing data analysis to the masses, they, too, are part of the problem. Spreadsheets lack built-in controls to guide or mandate that users follow a methodical budgeting process. They are easily edited, manipulated and sometimes distorted, knowingly or unknowingly, by users seeking to turn data into meaningful information. This freedom, which makes them such powerful analysis tools, makes them poorly suited to serve as the centerpiece of a process that can force an organization to change its old habits. A process needs structure, surrounded by adequate controls, to perform in a consistent manner.

Organizations that have overcome these traditional barriers to budgeting reality share certain characteristics. They utilize one central database, typically related directly to their general ledger application, which stores past and current actual data (data that reflects actual past performance). This actual data is available to the organization via one or two core budgeting applications designed for this purpose; they share information in a relatively real-time basis, and allow management to understand where they stand relative to their budget throughout the year. The organization's general ledger application cannot fill this role. The budgeting process itself is controlled by the budgeting application, not via a series of interrelated spreadsheets. The budgeting application provides both the structure and the controls needed to create and maintain a consistent budget process.

The budgeting application provides enhanced management information. This information utilizes past, actual data to project performance into the future, and takes into account known, future spending patterns and budget plans to tell management where it is going and when it is not going to meet budget, before it actually happens. This ability allows the organization to proactively manage its performance relative to agreed-upon budgets. Management is more focused on preventing failure and realizing opportunity that would otherwise have been missed. Under these circumstances, the yearly budget cycle itself becomes less critical. It is replaced by an ongoing budgeting process that focuses constant attention on performance, even if it is limited to information that is financial in nature. Once the pain and difficulties associated with generating and reporting the yearly budget have been removed, the organization will naturally begin to focus on the processes and procedures that are truly driving its success. At the lower levels within the organization, this allows management to focus on greater execution, while executives focus their time and attention on an even bigger reality" how well the

organization needs to perform to stay competitive and grow in its market space.

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David F. Giannetto is CEO of The Telos Group, co-author of *The Performance Power Grid, The Proven Method to Create and Sustain Superior Organizational Performance* (J Wiley & Sons, 2006) and a professor in the Executive MBA program of Rutgers University. He can be reached at [dgiannetto@telosconsulting.com](mailto:dgiannetto@telosconsulting.com).