BUDGETING

An Agile Approach to Budgeting for Uncertain Times

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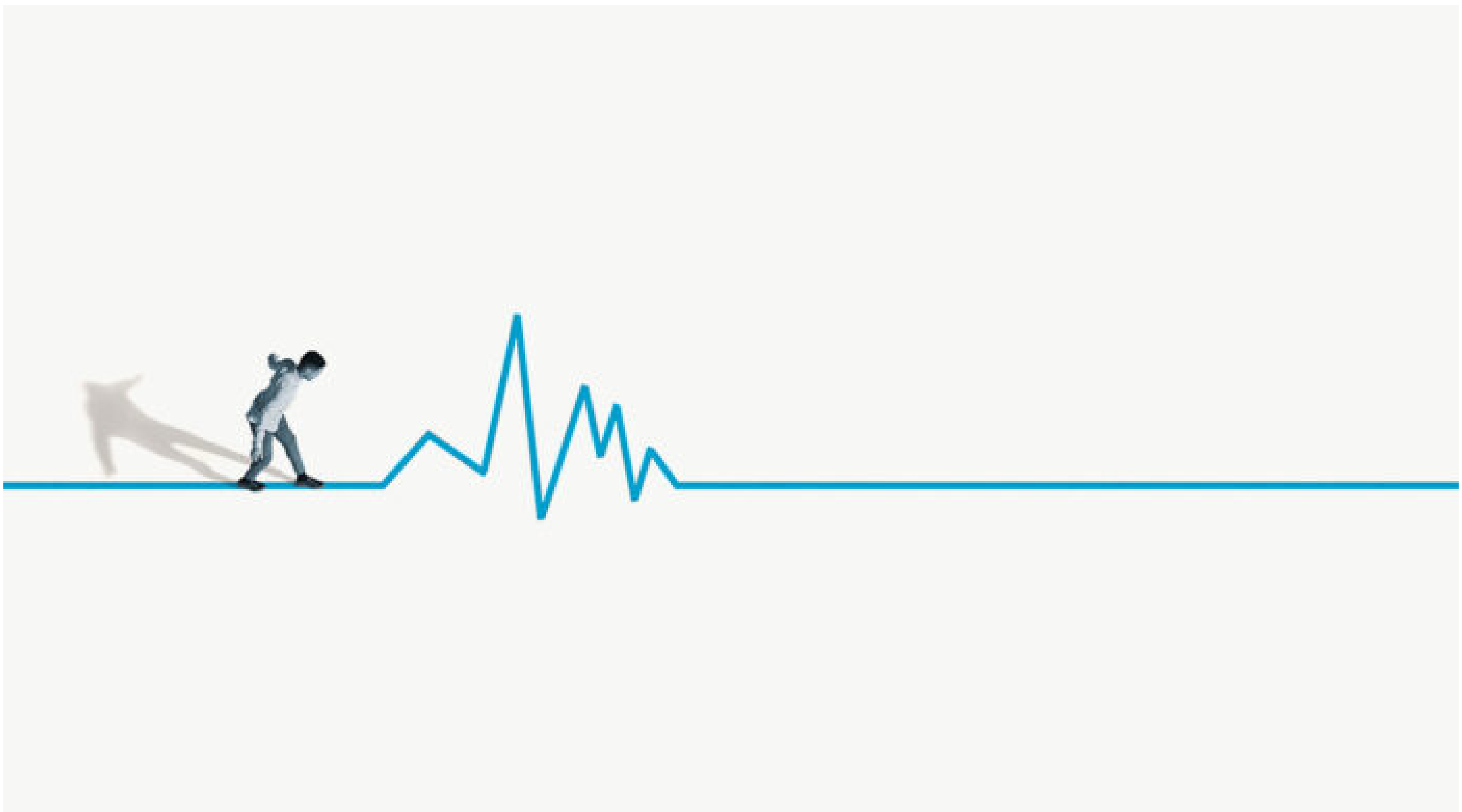

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It’s August, and you know what that means. Leadership teams are launching annual business planning and budgeting processes, all too aware that the current year’s plans went kaput sometime around March thanks to the pandemic.

2020 has been particularly chaotic, but let’s face it, even in typical times most planning and budgeting processes are frustrating. They start five or six months early with promises of visionary transformations that quickly give way to tedious templates, endless financial forecasts, haggling over targets, and battling for resources.

Companies have an opportunity to make a clean break this year, with the pandemic requiring a more agile approach. We have seen three things that work:

1. Change the purpose of planning and budgeting. Most planning and budgeting systems are designed to help senior executives predict, command, and control. Predict precisely what the company must do to deliver smooth, stable trends in earning per share (EPS). Command each siloed business unit and function to execute detailed plans that will add up to the desired total. Then rigorously control activities within each silo to make sure people conform to plans and deliver required results.

As Luke Skywalker once said: “Every word of what you just said was wrong.”

First, analyses by Bain & Company and others finds that predictable EPS trends explain only 1% of total shareholder returns. Improving performance (return on invested capital and earnings growth), on the other hand, has 30 times greater impact. It pays to plan for higher performance, not for predictable earnings.

Second, the predict, command, and control model is especially ineffective in periods of constant crises and black swan events like pandemic disease, social unrest, digital disruption, military conflict, terrorist attacks, financial shock, and environmental crisis. Historically, two-thirds of successful new businesses have had to ditch their original strategic plans to cope with unforeseen market conditions. In a world of unpredictable and accelerating change, long-term forecasts will be increasingly unreliable, and commanding people to stick to flawed plans will grow more dangerous.

Effective planning and budgeting define success as improving outcomes for customers, employees, investors, and communities — not as hitting budgets. It focuses on learning, adapting, and growing — not on trying to predict the unpredictable. It tells the truth about forecasts, making it commendable to expose honest uncertainties and potential pivot points — not pretend they are unthinkable.

2. Shift the focus from financial precision to strategic success. Typically, right around now, as the planning and budgeting season kicks off, the chief financial officer issues financial targets and spending guidelines. Later, when budget submissions finally roll in, it's not uncommon for the total to be 20% too high. At that point, the CFO does some financial analyses to prioritize investments and make painful cuts. On paper, it adds up to impressive returns. In reality, it seldom turns out that way.

A better approach is to turn the targeted outcomes developed in step one (above) into strategic portfolio guidelines that drive the budgeting and adaptation process. These guidelines force discussions that allocate resources from the strategy down, rather than from individual projects up. Here are some typical questions strategic portfolio guidelines might raise:

- What are the outcomes that will be most important for strategic success?
- In light of those priorities, where should resources go? For example, how much of our resources should go to running the business (operations) versus changing the business (innovations)?

- Within innovation, what's the right balance of resources going toward incremental innovation versus breakthroughs?
- How much should go to various customer segments?
- How much should go to different sales and distribution channels, geographies, business units, brands, or product lines?
- How much of our technology resources is properly spent on keeping current systems running versus developing new features or improving architecture?
- What hypotheses must be true for these resource allocation strategies to work, and how can we test them most quickly and efficiently?

When executives tag individual investments with these strategic classifications and add them up, they often discover surprising patterns. Their greatest growth opportunity may actually turn out to be losing market share and investing little in innovation. Ninety percent of the technology budget may be going to simply keeping the lights on and fixing legacy systems. Investment in the online channel preferred by key customers may turn out to be woefully low.

By properly aligning resources with strategic priorities, companies can better see the tough tradeoffs that should be made but aren't working — either because of neglect or because decisions are being made by the wrong people. This has only become more important in the current turbulence. Executives responsible for strategic outcomes should make the resource tradeoffs to achieve them. In agile organizations, such as NatWest Group (formerly Royal Bank of Scotland), performance units submit not only their recommended resource allocation plan but also what they could deliver with 20% more or 20% less. They anticipate what could be cut without sacrificing strategic objectives and how they should respond to unexpected events and results.

3. Plan faster and more frequently. If budgets are inflexible and a crucial forecast can't be adjusted, the person making it naturally obsesses over its accuracy. Left untouched, even small mistakes can compound over time and make a mess of plans. However, if we can adjust a long-term forecast every quarter, month, or week, we can continually improve its accuracy in far less time and with far less effort. Setting bold, challenging objectives and then adjusting plans to incorporate valuable lessons learned is the best way to improve.

Consider how the National Oceanic and Atmospheric Administration (NOAA) forecasts and tracks serious storms to save lives. Around the middle of May each year, NOAA issues a directional forecast for the upcoming hurricane season: June 1 through November 30. The purpose is to help cities, businesses, and emergency managers anticipate likely scenarios, prepare potential action plans, and allocate adequate resources. This year NOAA predicted with 70% confidence that the Atlantic area will have a 60% chance of an above-normal storm season. It forecasted 13 to 19 named storms, six to 10 hurricanes, and three to six major hurricanes.

These are broad ranges, but they clearly indicate that people should be ready to batten down the hatches. Once a hurricane develops, the NOAA accelerates its research, and develops five-day forecasts of a storm's intensity and path. This forecast has a wide margin of error, plus or minus 200 miles, but helps people rehearse scenarios and prepare contingency plans. The forecast for the next 24 hours, however, cuts the margin of error by 75% — to plus or minus 50 miles.

Like five-day hurricane paths, five-year business strategies are hard to predict. Fortunately, business planning can follow similar principles: describe an expected path, estimate the uncertainty and a reasonable range of outcomes, clarify the hypotheses behind the predictions, track the validity of those hypotheses, change those that are wrong and adapt the plans to achieve the best possible results in light of the most accurate information.

For most companies, traditional planning and budgeting has a comfortable certainty built into it. Managers like knowing what is expected of them. CEOs like the control it connotes. It's hard to give that up. But precision is not the same as accuracy, and plans that are flexible enough to focus on what truly creates value are worth the discomfort.

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