CFO

miagen Adaptive Insights

Making the Shift

Four Secrets Behind Great Budgeting and Planning

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FOREWORD: FROM OBSTACLE TO OPPORTUNITY

CFOs are being asked to take on more responsibilities than ever before, but one of their essential tasks continues to cause frustration: budgeting and planning. The exercise of effectively and successfully setting targets, allocating resources, and providing incentives for employees to achieve certain goals.

Today's senior finance executive has a lot on his or her plate. As companies move forward, focusing more on top-line growth while keeping a close eye on their bottom line, they are facing immense pressures—from strict regulations and economic volatility to evolution in consumer behaviors. The pace of change has only increased. In addition to these changes, finance has taken on additional, more-strategic roles within the organization. Yet with all these pressures and responsibilities, the budget continues to rank as one of their biggest hurdles.

With so many advances in technology, it is a wonder that organizations have not yet found a solution to make the budgeting process simpler, less time-consuming, and more aligned with targets. How does an exercise that requires so much time and resources yield so little concrete value to the organization? Budgets have traditionally been a hurdle for finance due to the time and costs associated with them. What's worse is that even after sinking resources into their budgets, the end product is less than satisfying. Many companies find their budgets are outdated by the time they're created, leaving finance in a tough position.

But instead of considering the budgeting process a painful exercise or an operational hurdle, it can become an opportunity. For those companies that are able to successfully transform their budget, they can take advantage of commercial opportunities, boost visibility into their business, and better manage their bottom line.

So how can you make the shift your budgeting process to realize these benefits? By taking advantage of the new tools and methodologies available to you today. CFOs should take the lead in analyzing and adopting the methodologies that will enable this transformation.

SECRET #1: CHALLENGE THE STATUS QUO.

Remember your last budget meeting? If you're like many CFOs, it was a long, exhausting process that was not particularly effective. As the presenters showed you their plans, you probably challenged every number and explored every assumption. In the end, you may have changed the numbers a little, but if you're honest, you have to admit that each unit's final budget for next year looked a lot like the one its managers proposed at the beginning of the budget process — which in turn wasn't much different from the latest forecast for this year or from last year's numbers.

We hear variations of this story time and again at companies across industries and geographies, and executives wonder why the process unfolds like this and what they could change about it. The short answer, in many cases, is that you've been anchored. Anchoring is a well-known psychological bias whereby one piece of information sticks in your mind and influences your interpretation of subsequent information, even if you're unaware of it. In the case of budgeting, getting stuck in the same numbers from year to year is almost unavoidable. But there are ways to orient the process to challenge the status quo or default allocation — and they work with other target-setting or resource-allocation processes as well.

Many studies have shown that even obviously irrelevant numbers influence estimates. In one, for example, respondents were asked to estimate the age of Mahatma Gandhi at death. Before they had to answer, half were asked if Gandhi was younger or older than 9 when he died; the other half were asked if he was younger or older than 140. Both questions are absurd and their answers obvious, so you'd think the respondents would have disregarded them entirely. Yet the first group, on average, gave estimates of Gandhi's age at death that were 17 years younger than the second group. If people can be anchored by such obviously irrelevant inputs, imagine the gravitational attraction of highly relevant numbers in the budgeting process, such as this year's outcomes when discussing next year's targets.

Many management techniques attempt to overcome this challenge. Zero-based budgeting is one, but the process is time-consuming and unrealistic on an annual basis. Another is the "what would it take" exercise, where the CFO quizzes managers on, for example, what it would take for them to double their assumed rate of growth or to achieve the same results with half the resources. When used sparingly, these are useful challenges that can get teams to rethink their assumptions.

But they can also lead to ineffective budget conversations if they become too familiar, as presenters learn to expect the challenge and sharpen their arguments for a given budget number or performance target. Most such techniques are still susceptible to the influence of past performance. In fact, we've found anchors to be so powerful that only another anchor can dislodge them. Re-anchoring combats the anchor of history and convention with another anchor, grounded in a different set of facts. For example, consider just one aspect of a budget discussion in which you agree on sales targets for a number of regions. To re-anchor the discussion, you would need to take three steps.

Identify what will determine performance. Set fact-based criteria that define what's possible with respect to sales, such as market size, current market share and sales-force head count relative to competitors. Don't try to include every driver that affects sales; the criteria need to be plausible, not exhaustive. It's important to make sure that objective data can be found for those you do choose. This year's targets (or results) should not be a factor — they already have enough weight as an anchor. Alternatively, data from competitor benchmarking can be quite useful in this context. For instance, one consumer-products company built such a model using just four criteria: current market size, projected market growth (in absolute dollar value, not percentage terms), current competitive position and a composite metric for competitive intensity.

Estimate sales potential. This should not require a massive effort. The aim here is to set next year's sales targets as if you didn't know this year's, relying only on the criteria you defined. Many modeling techniques do this, but the simplest — a statistical regression based on your criteria — is usually sufficient because this isn't intended to be a predictive model.

To calibrate your model, you need to check that it is directionally consistent with sales of the past few years, yielding plausible outputs in a majority of cases. It's probably precise enough if the model output is within 10 percent of the historical numbers in two-thirds of sales territories. If that's not the case and model results are extremely different from your existing plans in the vast majority of cases, it could be because the criteria or the data used in the model are wrong. But if you confirm that the criteria and data are right, your historical numbers may be entirely arbitrary. In such circumstances, you'll need a more fundamental rethink than reanchoring can provide.

Position the model as a second anchor. With a well-built model in hand, you can use its output to challenge the status quo and change the dynamics of the discussion. For instance, instead of starting a budget meeting by saying, "You're on track to sell 100 units this year, and you're aiming for 103 next year. I think you can do better," you can change the conversation into something more concrete: "You're aiming for 103 units next year, but the model tells me you have the potential to aim for 120."

Of course, this will require a longer discussion. Fortunately, such conversations are seldom necessary for more than a third of a company's sales territories. For the rest, the proposed targets will be close to the model's estimate, so discussions can be moved through more quickly.

Companies that apply this kind of approach find that it focuses debate where it's needed and reduces the inertia that anchoring induces. It is not a panacea: at the end of the day, you will still have to make tough decisions. But re-anchoring will help make difficult conversations considerably more productive.

CFO Summary

- Getting stuck with the same budget numbers every year can be hard to escape.
- It's critical to orient the budgeting process to challenge the status quo.
- Create a new model that you can use to question stale numbers and reinvigorate budget discussions.

SECRET #2: SET TARGETS FOR CONTINUOUS IMPROVEMENT.

Most companies use the calendar year as their fiscal year and have recently been through an often tortuous, bottoms-up internal budgeting process. Management is now preparing to seek approval from the board of directors. Ugh!

From the outside, budgeting and planning appears to be a straightforward numerical task. But for many it is a nerve-wracking negotiation, replete with extensive and repetitive posturing, suspicion, defiance, stubbornness and bravado. For a few it is a game filled with excitement and thrills, while most simply view it as the nastiest season of the year.

Despite the game-like atmosphere, budgeting and planning is tremendously important. At stake are the plans for important business decisions on matters such as marketing initiatives, capital investments and new employee hiring. These critical facets of business planning require careful thoughts and judgments about market-demand trends, industry capacity, competitor strategies, technologies and a whole host of other critical inputs and projections.

But overshadowing that is the regrettable reality that for most companies the plans will be used during the year as a benchmark against which to measure performance. This comparison will determine bonuses, so managers have a vested interest in negotiating an attainable plan. The lower the plan, the easier it is to beat the plan and earn a bonus.

At any reasonable level of performance, having a lower profit goal will make the bonus higher. So we are, in effect, encouraging managers to plan low, or budget high. That is, we are paying them to plan for mediocrity. It is hard to excel in business, sports or any competitive activity when one aims to perform to as low a standard as possible.

Every manager has a boss and indeed even the chief executive officer has the board. Those bosses understand the game, so when the manager submits a budget for the coming year, the boss naturally expects that the manager has biased that budget toward lower revenue and higher cost so the profit budget is more achievable.

The manager's biases can be conscious decisions. But in many cases, they can be subconscious too. We all have a natural preference for risk reduction, so we overstate bad things (costs) and understate good things (revenue) even when we think we are being balanced. Layer on top a desire to earn as much as one can, and it is easy to see how the low-profit budget materializes. The technical finance term for this is "sandbagging."

Since the boss knows all about sandbagging (the boss is, in fact, probably even better at it) the response is: "How can you put forth this plan with a straight face? Where are all the growth initiatives? Why do you expect prices to decline so much? Where is all this extra cost coming from?"

This goes back and forth as the parties attempt to narrow the gap toward a budget they both accept. Discussions are anything but transparent, since both parties have an interest in holding the information they have confidential to help their own side's negotiation. The budget process creates an incentive to withhold information from superiors and subordinates.

Some managers seem to be better than others at this budget negotiation game, and they wind up getting easier budgets and often earn higher bonuses as a result. At many companies, a careful analysis over time shows no correlation at all between pay and true performance, because the ease or difficulty of budgets can end up mattering more than the results. Tying bonuses to budgets reduces the emphasis on actually improving performance as long as targets can be negotiated.

The boss is put in a precarious position. Adopt an accommodating approach, and the manager won't set her sights high enough. But take too tough a stance, and the manager may no longer consider the budget as his own. If the business underperforms, the manager will likely say "I told you that budget was unrealistic." Managers don't take ownership of the budget when the bar is raised by the boss.

These are some pretty serious problems, but what else can be done? How can we set targets any other way? Don't we need to address uncertainty by setting targets as close to when the year starts as possible so we know what is reasonable? And how do we make sure rewards aren't too high in cases in which the manager is simply lucky that the industry is doing well?

Many companies focus on continuous improvement, always measuring performance against the prior year. Thus the budget process can be the true planning process it was intended to be, one in which managers and bosses sit on the same side of the table sharing insights and ideas and trying to find ways to improve performance. If performance improves, both parties win.

Although many companies recognize the benefits of a continuous improvement focus, many don't see how to make this work in a dynamic business environment. Many companies face commodity cycles and competitive volatility, making it hard to let go of the budget-based targets and look to continuous improvement.

There are two requirements to make a continuous improvement incentive succeed. The first is a "complete" measure of performance that takes into account revenue growth, margin improvement and asset efficiency. Well-known measures of economic profit and others based on cash flow can be used to make sure an improvement in the performance measure only happens when all aspects of performance are collectively moving in the right direction.

The second requirement is to make sure the incentive plan is not too sensitive to the up-and-down volatility of the business. The more volatile a business is, the less sensitive bonuses should be to the swings above or below target. With the proper sensitivity, a good portion of performance cyclicality can be dampened and the resulting reward program can be more effective.

To be sure, determining the right complete performance measure and properly calibrating incentives for cyclical performance are difficult tasks. But the reward for embracing such ideas is a budgeting and planning process and management culture with more transparency, cooperation, innovation, initiative, accountability and results.

CFO Summary

- Budgeting is a critical exercise that requires careful consideration and strong judgment.
- There can be a subconscious tendency to submit budgets with lower revenues and higher costs so that profit is more achievable.
- When done right, focusing on continuous improvement can yield significant benefits—transforming the budget process into the planning process it was intended to be.

SECRET #3: FINANCE'S WORK IS NEVER DONE.

Setting plans and budgets is only half the battle; the other half is keeping them top of mind all year. As we approach mid-year, teams run the risk of losing their focus on annual plans set "way back" in December. As new opportunities and distractions crop up, teams may focus on the immediate rather than the important.

In many companies, the CFO monitors the budget for overspending. Exceeding budget is a problem, but it's not the only one. Under-spending can imply that some budgeted work not is not getting done — potentially, a larger problem.

In small and midsize businesses, the chief executive officer generally is responsible for hitting plan, but many CEOs are distractible. Others simply lack the interest or discipline to keep their top team's eyes on the plan. As an example, one of my clients is the founder and CEO of a $36 million IT company. He is an industry visionary, always focused on the more distant future, and he finds execution mundane. His company implemented annual planning, but the CEO held three monthly plan review meetings and then abandoned them. His attention was captured by new ideas, and driving the current plan was not fun.

Soon, it was worthless.

CFOs should play a critical role in developing a culture of management discipline that goes far beyond budgeting. They can begin by operating three levers: communication around performance; the formal mid-year plan update; and organizational pressure on the leadership team.

1. Shine a light on performance

A business plan hidden in a desk drawer is worthless. Each member of the leadership team must have a set of key performance indicators that should be part of the annual planning process.

Each month, companies should hold plan review meetings that allow leaders to present their results to their peers and superiors. In smaller firms, that could be a single monthly meeting. Firms with over $20 million revenue might benefit from monthly meetings in each department (with the VP and direct reports) as well as a top-level monthly plan review meeting with the CEO and each VP. Firms over $300 million may have three or more levels of plan review meetings.

Review meetings highlight each leader's performance (or lack thereof) — a big motivation for staying on plan and hitting both group and individual targets. Moreover, review meetings can identify problems early, enabling management to adjust course and stay on plan.

CFOs have every reason to drop in on plan review meetings from time to time, or as a regular attendee. Their presence alone can raise the performance bar. If such meetings aren't happening, it may fall to finance chiefs to plan them. They may need the CEO's ongoing support, since many executives in mid-market firms have not yet learned the benefits of formally monitoring plan progress.

2. Don't be afraid to change course

Growth companies often inhabit high-change niches with less than a year's visibility into their customers, competition, finances, and sometimes even their own products and services. After six months' time, that annual plan can feel old, with an increasing number of initiatives needing to be tweaked or replaced. So rather than fighting any change to the annual plan, or letting any shiny new initiative consume it, it may make sense to update it. Resources (time, talent, and money) can be reallocated in an orderly, formal (but not cumbersome) process, which the CFO can facilitate.

3. Control the pressure

Pressure in the workplace is a useful tool for shaping performance. Too much pressure is a bad thing, but so is too little. Consider the highest performance environments in the world: the Olympics, the Navy Seals, and the World Chess Championship. All high pressure, yet people choose to put themselves into those situations. Some stay, and some leave (which is as it should be).

CFOs who more narrowly restrict their role to finance can still maintain pressure on the entire team by making sure it's clear what each leader is expected to do. This makes pressure productive because the path to success is transparent. Pressure without clarity makes people crazy. In fact, most CFOs possess tools such as dashboards and internal reports that act as windows into the performance of individuals and teams.

With the support of their CEOs, CFOs can help maintain the level of productive pressure within the work environment by reminding each member of the team how meaningful their work is. CFOs can also help create incentive programs and other rewards for high performance and establish consequences for under-performance.

Staying on plan is hard work, but CFOs sit in an excellent spot to deliver strategic value by helping the entire leadership team stay focused on the plan all year. By setting the drumbeat for plan review meetings, by formally readdressing the plan at mid-year, and by helping to keep the pressure on, CFOs can drive both top and bottom lines.

CFO Summary

- Once the budget's in place, it's only the beginning.
- While overspending can cause problems, underspending can be a red flag for even bigger issues.
- CFOs can lead improvements in budgeting and planning by shining a light on performance, deciding whether to change course, and controlling pressure.

SECRET #4: ROLLING FORECASTS CAN GET YOU OUT OF YOUR FP&A RUT.

It's a tough time to be leading finance. Current levels of business uncertainty—whether driven by hard-to-predict customer demand, new government regulations, or weird weather patterns—is complicating the task of managing financial performance. Meanwhile, private equity firms looking to cash out of acquisitions made during the recessions are pressing CFOs to create smooth glide paths for landing to their IPOs. In another corner, activist investors are demanding double-digit growth from publicly traded companies.

Unfortunately, new research by APQC shows that only 40% of 130 finance executives from very large organizations rated their financial planning and analysis (FP&A) capabilities as effective. Responses to several other survey questions underscore that FP&A at many companies is not very far up on the maturity ladder. What's going on? Two thirds of survey participants said their finance teams are always swamped by basic financial management duties such as periodic forecasting of how performance is trending versus annual budget targets. They have little time for, say, investigating cost drivers or testing the probable outcomes of bundling and pricing options.

What is really sad is that 20 years ago CFO magazine was writing about the need for improvement in this area. The message was: to be relevant in the pursuit of strategic objectives, finance teams had to become stronger business partners and generate analyses that help decision makers increase economic profit. Today, a lot of work remains untouched. The research shows that most CFOs are willing to invest in better financial systems and data models, but they are not necessarily inclined to develop analytical talent or polish their FP&A process models. Indeed, only half of the survey takers reported that the business entities they serve are committed to expanding the mission of finance so that it adds more value to decision-making.

Nonetheless, there is one brighter spot on the horizon. Survey respondents indicated the move to rolling forecasts is well underway. When an organization conducts a rolling forecast of revenues and operating margins, it is anticipating and dissecting emerging trends that will impact the business four-to-eight months into the future. Coupled with regimens such as driver-based planning, rolling forecasts can help an organization be more agile in the face of fast-moving marketplace trends.

The APQC survey showed that organizations that do use rolling forecasts are better aligned with unfolding business strategy, are more effective at business analysis, derive greater value from their budgeting and planning processes, and have more reliable forecasts than those who do not use them. For example, 94 % of businesses that use rolling forecasts described their business analysis as effective. Only 50 % of those who do not use rolling forecasts described their analysis that way. Arguably, the move to rolling forecasts is a first step to take in building stronger FP&A capabilities. Still, it is good to see that the static annual budget is being augmented by a planning technique that can provide the business with a continually refreshed view of opportunities and challenges.

When it comes to the use of other relatively advanced planning techniques, the survey found that FP&A organizations that engage in scenario analysis or predictive analysis felt they are better aligned with unfolding strategy. It's a decent bet that over the next 12 to 18 months, more finance teams will be looking at doing projects along these lines. But many will surely face a cross-road: "should we get started with these techniques and learn how to demonstrate their value to the business?" Or "should we wait until we're asked by the business side to get up to speed? Surely, progress will evolve in stages. In all, this may be a good opportunity for CFOs to engage their planning teams in some soul-searching.

CFO Summary

- Uncertainty has made managing financial performance more complicated than ever before.
- Most finance executives do not rate their current financial planning and analysis capabilities as effective.
- With finance tied up in management duties like comparing performance against targets, they have less time to devote to truly understanding the driving forces behind these issues.
- Rolling forecasts allow organizations to better align with their strategy, perform more-effective business analysis, and derive greater value from their budgeting and planning processes.

CONCLUSION: INVESTIGATING OPPORTUNITIES

If your budget isn't all that it can be, you're not alone. Take this as an opportunity to investigate the technologies and strategies that will transform your budget from a strain to strength.

By making changes to the status quo, your organization can more easily adapt budgets and forecasts to respond to opportunities and threats. Instead of planning based on oldated information, look at how your plan can work at a higher level by focusing on key drivers. When you have more-solid inputs from business line managers, you can more quickly and easily get the numbers to put together a budget that is more accurate than ever before. By reevaluating your budgeting process, you can implement strategies and tools like rolling forecasts to get more from all the time your organization devotes to budgeting. This can help you to achieve the results your company is looking for—freeing up time and resources for more-strategic activities.

Finance functions are in a unique position to lead these changes. By working with the C-suite, as well as your colleagues in sales and operations, you can gain buy in for these changes. Understand what's available to your company through these improvements, and you can better make the case for investment. With a smarter budget, finance can focus on providing insights to drive the right business conversations for the future.

SPONSOR'S PERSPECTIVE: LEVERAGING ADVANCED ANALYTICS FOR PLANNING AND FORECASTING

If plans don't really reflect the business, then why plan at all? Is this something you simply have to do because it's what's expected of finance, or is it actually helping improve business performance—by helping managers define goals and spend more effectively and deliberately?

According to BPM Partners, a leading analyst firm who studies FP&A processes, the number one complaint from finance departments (and business managers) is the planning process takes too long. The number two? The process is simply too labor intensive. When a process takes too long and too much effort, the results are almost always subpar.

The fact is the days when ineffective planning was tolerated have faded. A dusty set of spreadsheets, with suspect numbers that everyone forgets about, just doesn't cut it any more.

First, planning and goal setting have risen in importance. More organizations are conducting goal reviews across every part of the organization—measuring business functions against their revenue, units, conversion, or spend commits—from corporate to finance, sales, and marketing. Simply, organizations are managing by metrics more than ever before. It's because data is increasingly the driver behind decisions, and is increasingly available, yet historical data without measurement against a plan makes performance impossible to measure and accountability hard to assign.

The second is that the role of the CFO is changing. It used to be that the number one goal of the CFO was to close the books and report financial results. But according to Accenture, 70% of CFOs have seen their strategic influence increase over the past few years. It means more time planning, and less time stuck in the details. Yet to make the move to strategy, plans have to reach beyond finance and connect to the models and plans that each business function needs to be successful. It's time to reframe the discussion: Instead of obsessing over line items, focus on the key metrics that matter to business owners, and use that information as the starting point for building a complete model. Talk to managers about their business initiatives, what's going on in the market and with competitors, and why they'll do better or worse. Focus on how they're going to make money, and the factors that influence it, to take your plans to the next level.

Finally, everything is moving faster than before. While that dusty plan may have stood the test of time for six to nine months before, you'll be lucky if it represents reality by the time it's one to two months in. The reason is organizations can now launch products faster, respond to competitors faster, and the overall global economy moves faster. It means your plan has to be flexible and account for change, your forecasts have to be accurate enough and account for more drivers, and you need to be

agile enough to re-plan and re-forecast frequently. It's about leveraging advanced analytics to identify the business performance metrics that drive growth and profitability, continuously fine tuning KPIs, and incorporating external factors into your forecasts. If you're not doing this, you're going to be left behind.

This means that spreadsheets just aren't enough anymore. Because the fact is, the only way plans and forecasts work—meaning, when they are accurate, timely, and relevant—is if managers are engaged to work with them. The only way they can be agile is if they have the latest data in them, and the only way they can be trusted and aligned is if everyone is making decisions and planning using the same set of rules.

And this is very hard to do when your finance team is juggling hundreds of spreadsheets, going back and forth over email with managers—because that creates errors, discourages engagement, and reduces planning and forecasting frequency.

There's some good news here though. Technology has kept pace with the challenge. Data is now more accessible than it was before, so the big obstacle to having plans based on the accurate data, and re-forecasting based on the latest data, is less costly to overcome than it used to be. Data can be extracted from ERP and CRM systems and more easily combined in the cloud—without expensive infrastructure and tools.

Also, managers and FP&A teams can collaborate in the cloud too, so everyone is working against the same data, the same calculations, and the same reports. By getting rid of calculations and data tucked away in multiple spreadsheet tabs and versions, plans can be more responsive and you'll feel confident in the numbers.

Finally, so with planning's rising importance, it really is time to reinvigorate that process. By using technology, rethinking your planning process, and getting people on the same page, you can finally convert that dusty, old plan into a living, breathing playbook for your business.

About Adaptive Insights

Adaptive Insights has helped more than 3,000 finance organizations in more than 85 countries streamline the budgeting and forecasting process so it's more collaborative, agile, and flexible, enabling finance to manage constant change. With the cloud-based Adaptive Suite, Adaptive Insights customers are planning, reporting, and analyzing faster and more efficiently than ever before. Enterprise and midsize organizations can see business performance in real time and update plans and forecasts to adjust. Better yet, everyone is using the same version of the truth. The result is that Adaptive Insights customers can use that freed-up time on strategy, planning, and improved decision-making to drive change.

About Miagen

Miagen was established in 2003 with the mission of enabling better decision making in large organisations through the application of advanced modelling, cutting edge technology and specialist expertise. Today, thanks mostly to our outstanding team and huge technology advances, we are making a significant contribution to some of the world's largest, most dynamic companies. We have a unwavering focus on service quality and client satisfaction. We are the largest Adaptive Insights partner in EMEA and have been 'EMEA Partner of the Year' for four years running. We operate from offices in Dublin, London and Abu Dhabi and our work spans the globe.

Learn more about how Adaptive Insights can help you by viewing a demo at
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