

STRATEGY |

BUDGETING REVISITED

BY MARCO OTTI, FMVA, AND HESSEL BROUWER, CMA, CSCA

May 1, 2021

Modern budgeting methods like better budgeting, advanced budgeting, zero-based budgeting, activity-based budgeting, or beyond budgeting received considerable attention in the early 2000s. They struck a chord as both finance and business leaders were frustrated with the rigidity, time intensity, and limited benefits of the traditional budgeting approach.

Yet two decades later, many companies still employ traditional budgeting. At the same time, many of these organizations identify agility as a core tenet of their strategy. Yet traditional budgeting doesn't support agility well.

During the coronavirus crisis, for example, most 2020 budgets were irrelevant by the end of the first quarter. Once more, it became obvious that traditional budgeting doesn't add much value in a VUCA (volatile, uncertain, complex, and ambiguous) world.

We reached out to CFOs and academics in Switzerland to see how they perceive the value of traditional budgeting and to learn from their experiences of improving the process and moving to more modern and agile budgeting techniques.

THERE SHOULD BE ANOTHER WAY

Two of the individuals we spoke with are Martin Zwyssig and Marc Matthijs. Zwyssig is the CFO of REHAU, a polymer processing company, and was named "CFO of the Year 2018" by the CFO Forum Switzerland during his time at Autoneum, a global automotive supplier. Matthijs has held positions as global finance director at Dow Chemical Company and VP of finance and CFO EMEA at Zimmer Biomet. His current position is CFO at TRI Dental Implants, a Swiss manufacturer of dental implant systems.

SF: What is your experience with the traditional budgeting approach?

Zwyssig: In continental Europe, we're more used to a control culture, which has contributed to the success of many companies. There's some value to having an annual discussion with cost centers to control costs, especially during a turnaround. Why change? Usually, the complaints come from the finance organization that manages and executes the budgeting process. The main point for me has always been the amount of work in relation to the benefit. For example, you can use comparisons to previous years with target improvements of 2% or 3% without having such a burdensome process.



“I have frequent interactions with other CFOs about budgeting. Most of them are still doing traditional budgeting while everyone agrees there should be another way.” —Martin Zwysig

The budget serves as a reference point for performance. But three months into the fiscal year, you stop focusing on the budget and the attention shifts to the monthly forecast. Toward the end of the year, the focus is again on the budget in order to meet targets. I have frequent interactions with other CFOs about budgeting. Most of them are still doing traditional budgeting while everyone agrees there should be another way. The traditional view can't survive in a fast-moving world where you need a more agile organization.

SF: Have you tried to move to a different approach such as beyond budgeting?

Zwysig: Yes. The pushback around beyond budgeting was from the business units, even though most of the work was originally on their shoulders. We already had a quality six-month rolling forecast in place; we wanted to extend that forecast to 18 months with fewer P&L [profit and loss] and balance sheet items and have it forecast quarterly instead of monthly. Forecasts should reflect the best estimate and be decoupled from target discussions.

We wanted to discontinue the budgeting process and adjust the bonus plan. It needs the involvement of all levels in the organization and has to start with the management and the board of directors. The biggest challenge in abandoning traditional budgets is establishing a new approach to performance management and compensation.

SF: What existing or new elements of the planning and budgeting approach work well?

Zwysig: At Autoneum, we ended up making the process leaner. It started with cutting the number of meetings and discussions, as it isn't necessary to present detailed cost-center budgets. Another element was to make the

process shorter and lighter, and to have fewer iterations. We also downsized the reporting requirements and gave more guidance up front. We only entered into a detailed discussion if a business unit couldn't meet a certain target. Overall, it takes two to three years to see the positive effects of such process improvements.

In addition, the strategic alignment was important. The annual strategic planning was a complete bottom-up process by the business with guidance, steering, and consolidation from the group finance organization. The strategic planning involved all business units and functions, which ended with a workshop in the strategy committee. There were high-level strategic target instructions for some markets. We also created a P&L, balance sheet, and cash flow statement supporting the strategic planning, which were the starting points for the annual budget.

SF: What is the function and strategic relevance of budgeting?

Matthijs: Budgeting is about resource allocation and starts with developing and validating the company's strategy. Markets or products are treated either as investments for growth or cash cows where cash flows have to be optimized with less resources. A finance business partner, whether CFO or analyst, needs a thorough understanding of the market and the company's competitive position to challenge assumptions and to ask the right questions. The milestones to be achieved to meet the overall targets need to be clearly articulated and agreed upon by the business leadership.



“As a finance professional, you need to challenge assumptions. It isn't necessarily about being smarter but agreeing on realistic targets that can be delivered.”—Marc Matthijs

Another important aspect is the speed of change. The competitive environment changes fast, and external shocks can happen quickly. The coronavirus crisis is a good example, but it could be other changes like

government measures with a large impact. This means that when doing the planning between September and November for the next fiscal year, we don't know how valid that plan will actually be. Therefore, scenario planning can be very useful.

SF: How do you successfully apply scenario planning?

Matthijs: Well-thought-through scenario planning supports the budgeting process. Key assumptions are collected by the leadership team, and the top three to five risks and opportunities are determined for the next year. From the list of assumptions, a couple of scenarios can be prepared in a model; the scenarios don't need to be complex and can be high-level. Most importantly, the focus is on the relative difference between each scenario as opposed to the absolute values. This is where the strategy aligns with the budget.

SF: How do you make traditional budgeting more efficient and effective?

Matthijs: The budget is an organizational tool to help line managers control their resources. We should not discount the value of an operational budget for manufacturing, selling, and administrative expenses, such as training, travel, or marketing. The main point is this: You can have all the details on cost-center level and still have an ineffective budget process if you don't get the high-level process right. A simple metric to look at is the overtime spent by the finance organization during the budgeting process. For example, at both Dow and Zimmer Biomet, we made sure that systems like SAP, Hyperion Financial Management, and Tableau were integrated with each other to make the process less burdensome.

I am also a firm believer in process improvement. If it takes up to three months or longer to complete a budget, then the process is broken. Methods like Lean and Six Sigma help to make administrative processes more efficient. In my previous role, we applied this method to the budgeting process over several years: a strong understanding of the strategy across the different

business units, well-aligned assumptions between stakeholders, and a clear agenda so that everyone has the time to do their part. This helped us to finalize the annual budget after just one or two iterations.

SF: Are compensation and bonuses linked to budget targets?

Matthijs: In most management positions, bonuses were related to sales, profit, and cash flow targets. Of course, there's always the risk of gaming the system. Therefore, it's important that the annual plan does fit the right strategy. For example, when the company wants to grow in a developing market, the related investments should be reflected in the targets. Sometimes I had to commit to a range where there was room for adjustments during the year. The metrics used for compensation, for example—internal total shareholder return (iTSR)—are largely linked to the performance as a publicly traded company.

A SHIFT TO INNOVATIVE BUDGETING

Hilti, a global Swiss manufacturer of products for the construction industry, is a case study of moving to beyond budgeting. To learn more, we interviewed Felix Hess, Hilti's current global finance director, and Franz Wirnsperger, the company's global head of finance from 2003 to 2013. Wirnsperger is now managing director of the Hilti Lab for Integrated Performance Management at the University of St. Gallen in Switzerland, supporting organizations in their transformation of performance management systems. Figures 1 and 2 show the elements of Hilti's innovative approach to corporate performance management.

FIGURE 1: HILTI'S MOVE TO FLEXIBLE PLANNING

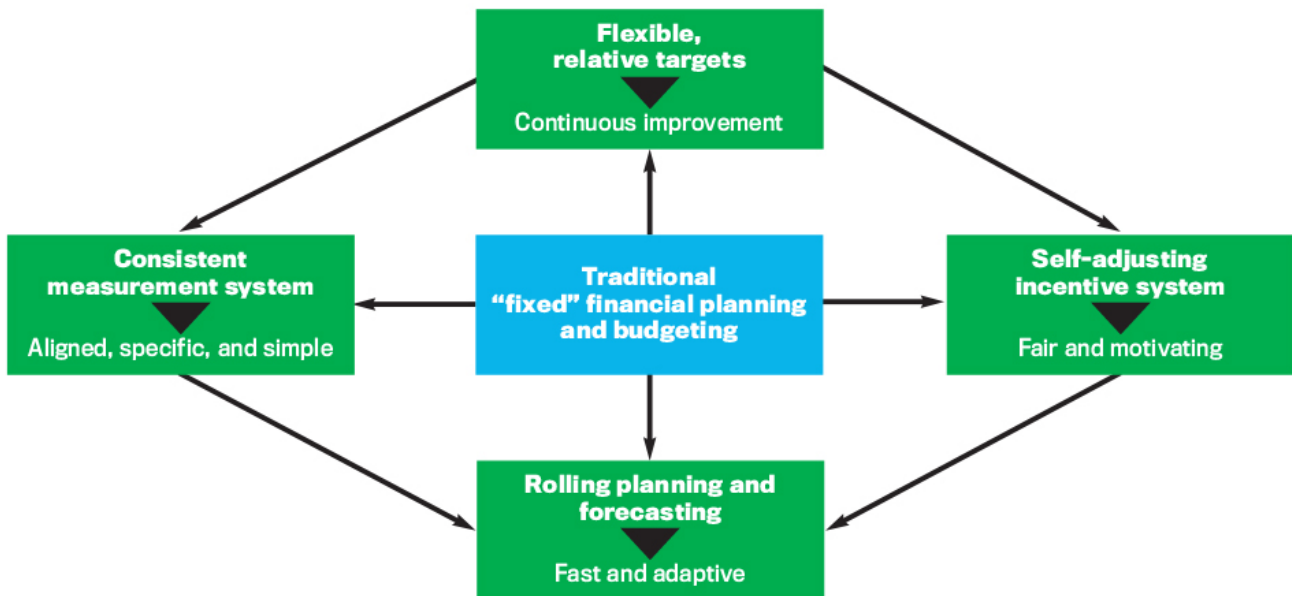
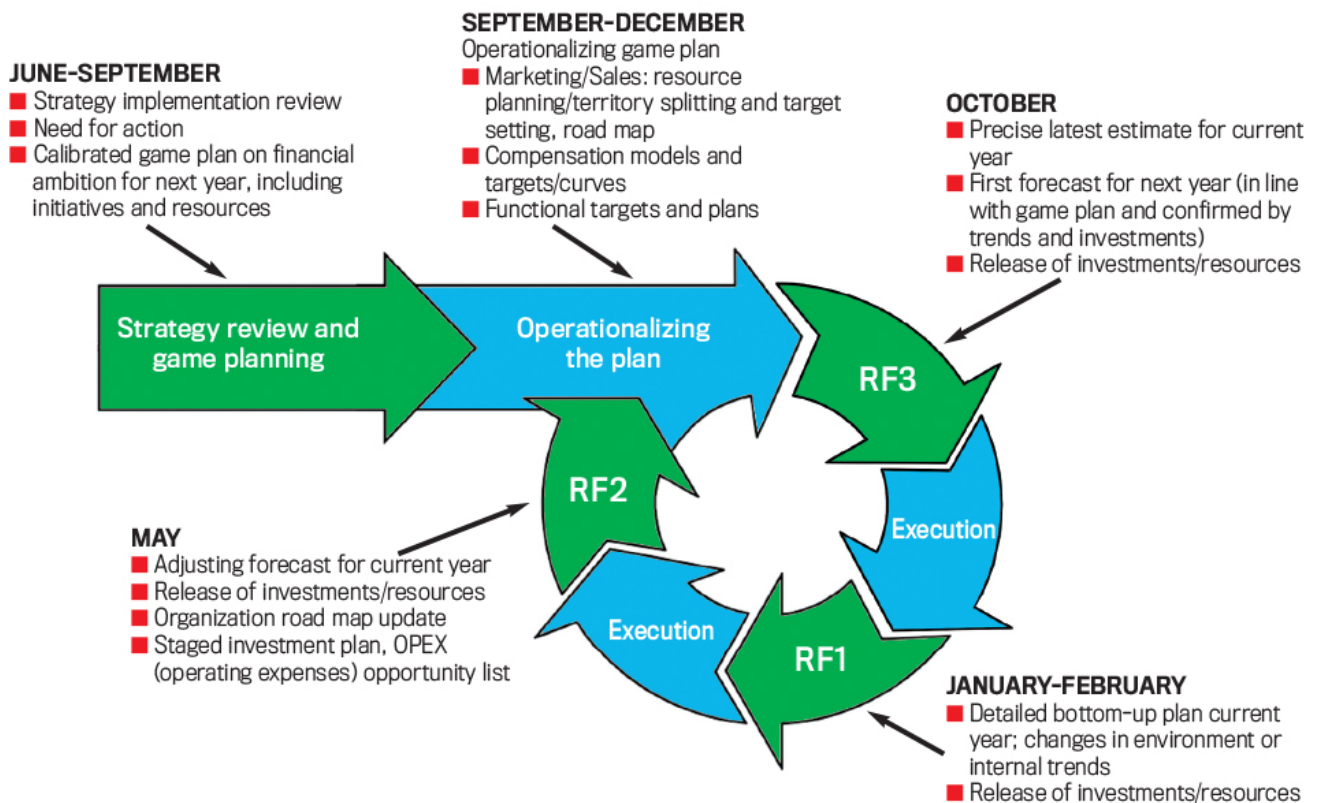


FIGURE 2: ROLLING FORECASTS AT HILTI



Click to enlarge.

SF: Are there new concepts in budgeting and performance management in the last 10 years?

Wirnsperger: I don't see major developments since the emergence of beyond budgeting. What we introduced at Hilti was based on similar ideas as beyond budgeting but also differed, especially with respect to the focus on leading with strategic targets. Both approaches involve a major change in the steering system. Being able to adapt quickly as an organization has become a competitive advantage in today's environment, and planning remains important to coordinate activities. You can't simply abandon the functions of budgets. The best way to start is with changing the target setting. This requires a comprehensive approach that reflects on how leadership and governance can work beyond command and control.

SF: How do you adjust the target setting and manage costs?

Wirnsperger: Mainly by using relative instead of absolute targets and becoming strategic in setting targets. If we look at the value chain, financial results are the outcomes of activities. Costs are activities that create outcomes that are measured with output and outcome key performance indicators (KPIs) – the input-process-output-outcome framework.



“At Hilti, we started to measure the distance to our strategic target instead of deviations to short-term budgets.” —*Franz Wirnsperger*

The first step is to define a simple financial output and outcome KPI structure that fits your business model. Ambitions should be derived directly from the strategy to give the organization a long-term, top-down orientation and to keep the system lean and flexible. Costs are an input factor to achieve those strategic targets and need to be managed on a continuous basis and decentralized using a rolling forecast process.

To transform strategic goals into activities on the department or team level, agile goal-setting frameworks like objectives and key results (OKRs) can be used to define and track objectives and outcomes. Setting few relative

strategic “north star” targets and delegating decisions and trusting your employees while ensuring a high level of transparency on progress creates a culture of performance.

SF: What were the motivations for change at Hilti?

Wirnsperger: We noticed that the financial steering system was working against Hilti’s company culture. So we decided to change the target setting and realigned our bonus system, linking it to the company’s progress toward strategic targets instead of linking it to short-term budget targets and individual targets. With the implementation of a rolling forecast, we were able to replace the annual budgeting process as our measurement switched from budget-to-actual comparisons to monitoring actual-to-actual trends. Essentially, we started to measure the distance to our strategic target instead of deviations to short-term budgets.

In the process, we completely reshaped the setup of the finance organization. Finance was in charge of performance management, and the rolling forecast process and resources were reallocated in favor of business partnering. The effect was that we got closer to operations and moved away from a pure control function.

SF: Does the CFO mainly drive the implementation, and what is the role of Hilti Lab?

Wirnsperger: Ideally, the entire leadership team is driving the change. The budget is often such a key element that educating the top management and the board of directors remains a challenge. Thus, it needs a strong and committed CFO to convince the management and the board. In some cases, the management is ready while the board isn’t, as one of their functions is to approve the annual budget (i.e., the principal-agent problem). In reality, not much changes for the board. Instead of approving the budget, the board approves the new target-setting system.

Hilti Lab combines the learnings from the Hilti case with scientific research. So far, we have accumulated more than 10 use cases. The Lab provides guidance during the implementation as we learn from different business models to enhance our approach. Depending on the size of the organization, it's possible to change the system and approach within a year. Change usually is evolutionary, starting high-level with the financial steering concept and then moving further down until the team level. Whether a system can or should be changed depends on the environment, business model, and cultural readiness of the organization.

SF: What are the benefits of Hilti's performance management approach?

Hess: It supports the transformation to become more agile. When the top management initiates changes, the performance management changes with it. Agility is the biggest challenge for companies operating with traditional budgets. Our financial steering starts with the annual strategy review we call "game planning." Then the cycle of the flexible planning follows with three rolling forecasts per year. We don't wait for the next budgeting process to start to calibrate our planning.

As the coronavirus crisis hit, it was impossible to plan for the next quarter while having to act and respond quickly. Management had to decide whether to implement short-term measures or structural adjustments. To guide our actions, we used an updated rolling forecast as a pulse check. Our beyond budgeting, bottom-up approach empowers the regional markets to make the decisions. This self-steering mechanism helps us to take the best actions tailored to each market.



"The flexible planning with three rolling forecasts per year has made us more adaptive and agile."

—Felix Hess

Beyond budgeting is based on continuous incremental—and in Hilti's case, relative—improvements year over year. A key success factor is that the variable compensation of the management is fully linked to the year-over-year company improvement. The risk with this approach is that the past may not be challenged enough. We try to overcome this with a structured functional review during the annual game-planning process.

SF: Is the finance team able to free up time and focus on more value-added tasks?

Hess: Whereas many organizations have 500 reporting line items for the budget, we limit it to 100 line items in the rolling forecast. Moreover, we connect business decisions to the forecast. This avoids unnecessary adjustments and reduces the effort. The freed-up time is used to develop our finance business partner roles.

It isn't just about transparency, but actively engaging and moderating the decision-making process of the management teams. At Hilti, the finance function is involved at the outset of the strategy review, and we take part in business discussions. This improves the overall alignment within the organization.

SF: Were there updates to your flexible planning?

Hess: With what we called Steering 2.0, we improved the strategy review process to better align the financial and business planning between the regions and headquarters. For instance, we encourage our regional markets to spend time on calibrating their own strategy review for the next year, which then flows into the next rolling forecast. Other adjustments include fine-tuning target expectations, such as cascading strategic targets during the game planning.

SF: What advice would you give CFOs who decide to abandon traditional budgeting?

Hess: I see three key success factors in order to be successful: It needs to be an integrated approach, be fully aligned with the compensation and bonus system, and fit the company's culture. If you have an existing budgeting culture, I would only adopt such a new steering system if you're willing to address the culture aspect first. I would say that changing how we manage performance has strengthened our company culture.

In addition, I would advise any CFO to be very clear on the objectives of implementing a new approach and to get the full support from the executive management and the board of directors. Even though Hilti is a privately owned company, I am convinced that stock-listed companies can explain the benefits of an agile performance management system to their investors.

TIME TO RETHINK PLANNING

Hilti's decision wasn't against budgeting, but rather challenging the assumptions of how performance was measured and looking for a comprehensive approach that's in line with the company's culture. In the process, traditional budgets became obsolete.

The main idea is to incentivize the organization to achieve long-term targets and measure the progress by continuously improving toward those targets. Success ultimately depends on how well such high-level target setting is aligned between top management, the department, and the team level by using agile methods. Combined with a rigorous scenario or game planning, frequently updated and much lighter rolling forecasts support the decision-making process between cycles.

All CFOs we spoke to conveyed a new urgency to change the budgeting process. But the approach to be taken largely depends on the business environment. For any CFO, it comes down to a fundamental decision whether

to make incremental changes to their budgeting practices to lower the burden on the finance organization, or, alternatively, to reassess everything and try innovative budgeting.

INNOVATIVE BUDGETING: 6 THINGS TO CONSIDER



Corporate culture: Make sure your approach is aligned with the business model, industry environment, and company culture. Get buy-in from top management and board of directors. Start top-down.



Comprehensive approach: Go with an integrated performance management system for your planning and budgeting approach.



Strategy and scenario planning: Conduct rigorous scenario or game planning to review the strategy and include the finance function in the process.



Relative target setting: Use relative instead of absolute targets for key output KPIs combined with long-term financial targets.



Compensation system: Adjust your compensation and bonus system to share the company's success. Replace individual bonuses with team bonuses.



Flexible planning: Implement flexible planning with frequently updated rolling forecasts that are decoupled from targets.

Click to enlarge.

The key question to answer is not only how well your present planning and budgeting approach fits the business environment but also how committed the company is about transforming to agile ways of working. If the decision is to transform your finance organization, begin with the lessons learned from our interviews (see “Innovative Budgeting: 6 Things to Consider”). The CFOs were also clear about the need for finance professionals to take the lead and become true business partners. It’s time to bring your organization’s budgeting process into the 21st Century.

Marco Ottl, FMVA, is a group controller for Autoneum. He's also a member of IMA's Europe Board and IMA's Switzerland Chapter. You can reach Marco at marco.ottl@autoneum.com or follow him on LinkedIn.

Hessel Brouwer, CMA, CSCA, is a member of IMA's Switzerland Chapter. You can reach Hessel at hessel.brouwer@imaswitzerland.ch.

0

No Comments

SF MAGAZINE

CURRENT ISSUE
PAST ISSUES
PAST ISSUES ARCHIVE

BLOGS

IMA MOMENTS
IMA PULSE
SF TECHNOTES

TOPICS

CARL MENCONI CASE WRITING
COMPETITION
ETHICS
GOVERNANCE
IMA
IMA PULSE
ABOUT SF
ABOUT IMA
SF EDITORIAL GUIDELINES &
SUBMISSIONS
CONTACT US
SUBSCRIBE

TOPICS

LEADERSHIP & CAREERS
MANAGEMENT
MEASUREMENT
REPORTING
SMALL BUSINESS

MEDIA KIT FOR ADVERTISERS
IMA COOKIE POLICY
IMA PRIVACY POLICY
IMA TERMS AND CONDITIONS