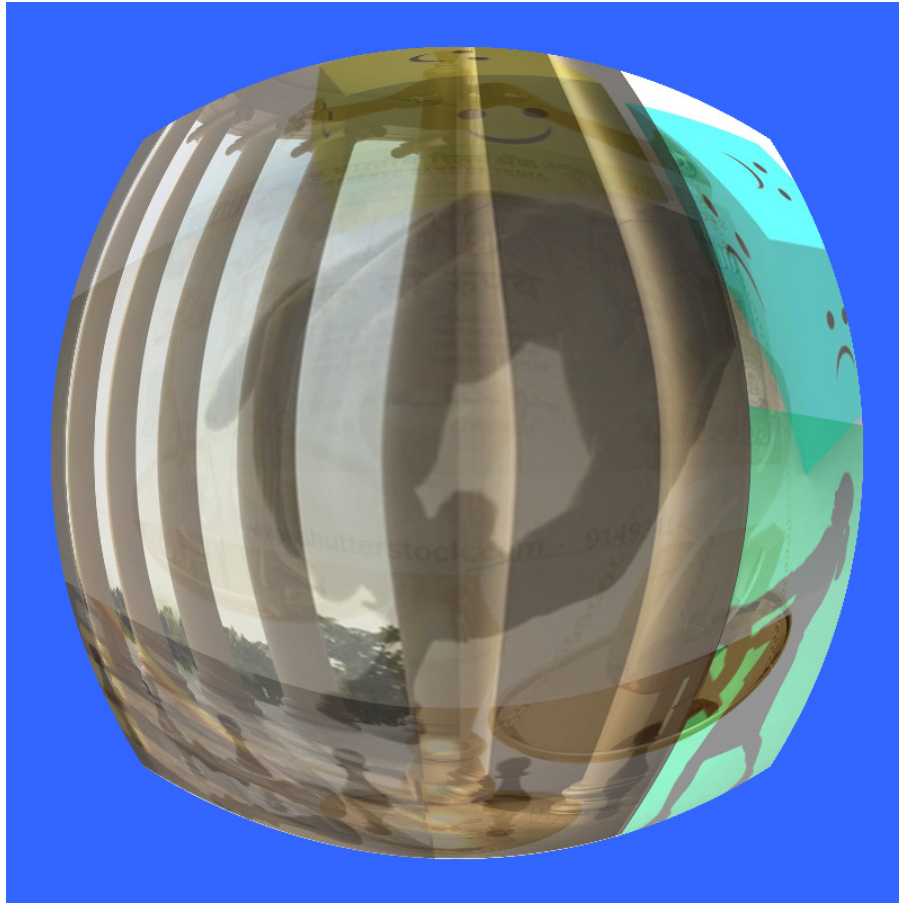
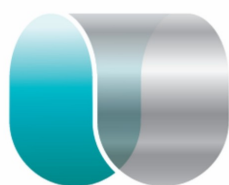


# **4 Key Reasons why a Budget cannot be Your Strategy**

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***Many small and medium organizations are still using "BUDGET" as the main management tool and believe it to work as a strategy. This paper explains the limitations of the Budget" and why it is now increasingly important to switch over to the Balanced Score Card as THE management tool.***



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## 4 Key reasons why your budget cannot be your strategy



### Do you have a strategy?

Many small and medium size organizations, when asked if they have a formal written down strategy, would say "YES". When we ask it to be shown to help us understand their thinking, they simply produce a work-sheet which essentially reflects the budget! Some have the possible receivables in the same sheet and it looks like a cash-flow statement. We have found it happening in many organizations. It is very hard to stress the importance of a formal "Strategy" document—after a position has been taken by the person with whom discussions take place.

Steve Player (February 8th, 2010) in his blog ([Reference 1](#)) entitled "What Budgeting and Old Furniture Have in Common" writes "In our rapidly changing business world, the traditional budgeting process qualifies as a piece of old furniture. Getting rid of it creates valuable space and more opportunity to invest our limited time in ventures that deliver greater success."

*This paper discusses why the budget can not and should not replace a formal "Strategy Document".* We would start by discussing first about budget and strategy and then give some key reasons why a budget / cash-flow statement can not replace the formal "Strategy" document.

**The budget is dead. There is no doubt whatsoever about that. It is as dead as a doornail. This must be distinctly understood, or nothing wonderful can come of industry's 20th-century management model that seemingly grows more dysfunctional with every quarter. Jack Sweeney ([Ref 2](#))**

### What is a Budget?

A budget is a plan that includes the money the organization would spend and when would it spend it. It may include, in addition to expenses, possible income and use it also a cash-flow plan. This management model was first developed in 1920's to help financial managers control costs in the organizations. Many large organizations like General Motors, Siemens etc. have used it till 1960'70 as a management tool and it did work well during those days.

In the present turbulent times, few organizations have the capability to plan ahead. Yet, we see that organizations remain locked into this habit of managing by budget—an annual event of stretched negotia-

## 4 Key reasons why your budget cannot be your strategy



tions assuming that not much different would happen— continue to produce and clients would buy!

Budgets when produced based on last year's budget figures (Incremental Budgeting) is quick and simple. Persons responsible would merely add say 10% to last year's budgets if the big-boss wants an increase of 10% in turn-over. Life remains simple and no one minds the hassle. In progressive organizations, "Zero-based" budgeting is required. But then management should draw out a formal document listing strategic objectives for the budgeted year. Since the concerned people are supposed to justify their budgets, this becomes a better from of budget. Some advantages of Budgeting are listed in Table 1.

**Table 1—Some advantages of Budgeting Process**

- Encourages managers to take financial responsibilities.
- Allows first order planning and allocation of funds.
- Communicated important financial numbers to managers.
- Clarifies what needs to be achieved and what is to be done next year!
- Forces a review of the plans by managers, every time the budget is monitored.

Controlling budgets in the present dynamic situation requires front line managers to be given discretion rather than being bound by constraints of the budget—if that be the only management tool! If the budget process over-powers other performance review and evaluation processes within the organization, it can lead to bureaucracy, lack of quick decisions and wastage of time to justify, even when the situation required exceeding budget. The processes should be enabler of change rather than it's barrier to mental and systemic changes required in the organization. So are we saying that budgeting is useless? No—the process is very educative and necessary to make people n the organization aware of ground realities—but beyond that—the flexibility in approach is necessary.

### What is a strategy?

Strategy is a planned course of actions which an organization proposes to take to achieve its aims and objectives. So, essentially it is not just budget and control of expenses. It is thinking about it's growth, about talent and many other aspects. The strategy development process is very enriching and enables the leadership team to understand—jontly—what must be done to take the organization

## 4 Key reasons why your budget cannot be your strategy



further on all fronts. This is the base to produce the budget document and ensure allocation of resources when needed. The definition of strategy makes it clear that it is the first level document and is not the budget—which just considers the financial aspects of operations.

### Dangers of Sticking to Budget like an accountant!

The management of the organization should be more concerned with strategy implementation and not just with the budget—which is a tool—more like a vehicle taking the organization to its destination—but not the destination by it-self. If the strategic objectives require changes to the budget, same should be ordered rather than changing the strategic intent. Sticking to the budget and not the strategic intent can derail the organization from its well thought-out path and achievement goals.

### Four key reasons why budget can not replace strategy:

#### 1. Budget does not cover all concerns about clients:

Clients continuously require *better, cheaper and quality products and services—quickly*. Your competitor is continuously striving hard, includes more frills and improves quality to attract your clients. Budget would generally contain financial figures to control marketing and sales expenses including salaries etc. of the staff. However we have yet to see a budget which talks about other important elements which concern clients. Some of these are described below.

#### **Need for new products and features**

Organizations might be losing orders since the clients might be purchasing from your rivals who supply complete range of products / services. The need to add more products / services and continuously look for such trends is vital element in the game of remaining ahead. Allocating marketing budget and then spending it – does not ensure that this activity / study is being done effectively within the organization.



## 4 Key reasons why your budget cannot be your strategy



### **Need to diversify into new geographic markets**

Gathering relevant data to evaluate an organization's market share—maintenance and improvement—is a good way to keep competition at bay. Budget would allocate expense for marketing – but would not be effective to control this aspect. The data required for keeping an eye on the market share continuously can be assured by allocating appropriate budgets, but actions to maintain the leadership position would need quick decisions. Budgets can be de-motivating – and your staff might take the easy way out and justify inaction pointing to lack of budget. Your competitive position can be at stake—unless other performance evaluations are given more weightage than the budget! Frequent review of market share with powers to exceed or manipulate budgets can allow quick additions to products and services or expand and open additional geographic boundaries. Such modus-operandi requires enough flexibilities and empowerment – which a budget is supposed to not allow!

### **Need to educate client**

Making clients aware about the key advantages of products an organization sells is an important activity of the marketing department. You have to make the client aware about your products so that he wants to buy them. Budget would allocate the expenses to do it! But how does one control the outcome and its effectiveness? If organization does not have a system to review the outcome and merely controls the budget, desired results can not be guaranteed.



### **Need to improve client satisfaction and reduce complaints**



Every organization has its own share of disgruntled clients and complaints. Handling these issues is very important for the organization. Budget would normally like to control expenses on this account. Measures to improve client satisfaction and reduce the complaints go beyond budgetary constraints. Factors like (a) how important is the client for the organization? (b) what can be the consequences of dissatisfied clients can not be relegated to budgetary con-

## 4 Key reasons why your budget cannot be your strategy



trols and operational managers would need flexibility to handle clients. To improve client satisfaction, organizations normally convene separate meetings at regular intervals and not have these linked to the budget control meeting.

### 2. Concern about Operations and Processes:

Organizations need to continuously improve and operate efficiently. It requires data generated during process execution to make real-time decisions—which can not be so accurately planned. Whereas budgets can allocate funds for specific improvements like automation, adding new capital equipment etc. – it would fail to monitor progress of these measures if the discussions only hover around financial aspects. We know of many instances of reduced machinery maintenance due to budget constraints which eventually reflect on production capability and loss of turn-over. It is no point saving on expenses or cutting costs which impact long-range health of the assets. Some of the issues which normal budgets would not be able to properly monitor are:



- Emergency shut-downs and machine failures.
- Force-Majeure type conditions—terrorism, strikes, power-cuts etc.
- Acts of terrorism.
- Sudden increased loss of talent due to market volatility

### 3. Budget cannot control innovation and Learning

All organizations must continuously develop and improve on the value which it adds and provides to the clients. This would require continuous developments and training / competency development of it's human resource. Budget would generally allocate enough funds on Training of employees. However, as we all know, provision of funds does not guarantee their being spent judiciously and effectively. Most of the government departments and public institutions

## 4 Key reasons why your budget cannot be your strategy



wake-up to the development needs at fag end of the budget period when they see the danger of it being left un-spent and then hurriedly try to consume the budget. If we monitor the expense pattern of the various budget allocations on a quarterly basis, we can identify the budget items which are late starters! Many good organizations would re-adjust the budget continuously and allocate more funds to activities which need to consume more funds than planned. Rater than waiting till the end of the budget period, they would cut down budgets for activities which lagged behind. Thus well thought-of activities get stifled—merely due to the concerned managers waking up late. Cutting / reducing budgets etc. clearly demonstrate the dangers which can result in lack of strategic thinking in the powerful budget process! The accounting and the finance heads take charge of running the organizations – many times overlooking the importance of empowering the strategic initiatives.



### **R&D and Product development**

A budget can easily control R&D / new product development expenses. But, is it enough to spend the money? What is important is whether we could achieve sales attributable to these expenses. It is therefore necessary to keep an eye on the ratio of Sales achieved from new products and thereby the effectiveness of the R&D budgets.

### **Change Management**

Innovation and development are projects essentially requiring change management. These projects would normally face resistance – unless they are laboratory based innovations. Changing people and their attitude is some thing which can not be



## 4 Key reasons why your budget cannot be your strategy



controlled looking at budget performance and needs supplementary management tools. Thus, if we need to introduce organization to a new quality tool—like six sigma, the flexibility required would be enormous. Though some budget planning would be necessary—unless detailed plans are made and monitored, budget reviews would not be much help.

### **Sustainability**

Budget generally does not cover many aspects of sustainability. Talking about sustainability, the “Corporate Knights” (Reference 3)—the magazine for Clean Capitalism in its media release of Jan 27, 2010 announced its sixth annual Global 100 list of the most sustainable large corporations in the world. It described many metrics like Sales per unit energy consumption (US\$/Giga Joule); Sales per unit CO2 emitted (US\$/tons of CO2 emitted), Sales per unit of water used (US\$/Cu. Meter), Sales per unit of waste produced (US\$/ton of waste), % of women in Board of Directors, CEO to average worker pay for last three years and many others. The budget process obviously is not concerned about these measures—which are strategic initiatives and need to be monitored separately.



### 4. Concern about diverse financial matters

Budget is great tool for working capital management – period. It is no more than that!. Thus pricing of products depending on the market demand and changes in external environment can not be left merely to budgets. These need considerations beyond the realm of Budgets. Day to day management of stores, introducing discount sales and other promotions which are an essential element of strategy do not get reflected into a budget.

## 4 Key reasons why your budget cannot be your strategy



### Productivity

Budgets do not directly reflect on the status of Productivity in an organization. Organizational strategy normally would target productivity improvements as a key financial measure. The cost of goods produced and the expenses incurred to produce them, is a good measure to watch. Budget alone can not provide this data for management review. Again, a strategy would normally declare the goals and results expected – in the short and long range. Merely controlling costs without an eye on results would not provide sufficient reasons to discuss productivity. Similarly, the operational cost is controlled via budget. But, what is more relevant is to control the ratio of actual production to cost of production.

### Receivable management

Most of the budgets are related to expenses whereas the “Food Pipe” of the organization is concerned with “receivables management”. It is like controlling the exhaust of air from ventilated buildings without worrying about quality of air in the space and amount of fresh-intake. An impor-



tant aspect of receivable management is the aging of accounts. All organizations should regularly monitor how much is to be received and how much has been delayed and by whom! Budget in the normal course would not help review the situation resulting in ground-level actions.

### Conclusion

Budgets have their role in all organizations—but the budget process should start only after the strategic intent of the organization has been made clear to all participants. Detailed plans for meeting the strategic goals, their time-lines and resource requirements are prerequisite to making a budget. Budget review should be done every month—but means to measures progress on all other strategic measures need to be also in place. Balanced Score card ([Reference 4](#)) is a good tool to implement in all organizations to ensure that

## 4 Key reasons why your budget cannot be your strategy



management has the right information and focus to ensure that it is implementing it's strategy. Balanced Score Card should be looked at as an essential tool since "Budgetary Controls" or management by "Budget" alone is not adequate in the 21st Century.

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