Rethinking budgeting process in times of uncertainty

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Abstract

Even in good times, most businesses find budgeting difficult. The process is frequently inefficient, with managers wasting too much time trying to stick to a budget that has been imposed on them. Creating one consistent budget to coordinate business units and track performance for a complete fiscal year is difficult when economic forecasts alter on a weekly or even daily basis. Following the standard budgeting procedure will almost certainly be ineffective. The objective of this study is to: first, it identifies the primary drivers of uncertainty that necessitate the rethinking of budgeting models. Second, it describes many budgeting models and tactics that have been advocated as being the most effective during volatile periods.

Keywords: Budgeting, minimized budgeting, relative targeting, rolling forecast

Introduction

In today's world, the future is growing increasingly unpredictable. When we use the terms "unpredictable" or ‘’uncertain’’ or "volatile," we're implying that the process for forecasting the future is flawed. Things transpired that were not anticipated or had a different influence on the plan than envisaged. Some of these factors are outside of an organization's control. We observe a rival adjusting their rates, a company developing a disruptive technology, the effect of natural phenomena such as weather, a change in government policy, a big change in the regional economy, or a combination of these factors (Spender 2014) . Despite these issues, senior executives are nevertheless expected to lead their firms through all of these problems in order to ensure that limited resources are directed to the most profitable goods and services. For them, planning entails establishing a rationale for when, where, and how the company expects to achieve its long-term strategic objectives. Today's business environment, on the other hand, is troublesome, and there are a number of big challenges to overcome

To foresee the future, many CEOs rely largely on their years of industry expertise. To build and validate future strategies, finance directors frequently rely on previous trends and economic data. However, at this unusual time, historical tendencies may no longer be relevant.

Uncertainty manifests itself in many ways. It could take the form of a natural disaster, the depreciation of a foreign currency in which a company operates, geopolitical shifts, a competitor merger or acquisition, or a global epidemic (McGrath and MacMillan 2009). Uncertainty, in whatever form it takes, reveals a truth: businesses must be flexible in their planning, budgeting, and forecasting in order to deal with changing business conditions.

Setting targets to inspire and reward performance; coordinating resources by forecasting midterm financial results and preparing accordingly; and exerting control by setting cost boundaries and centrally controlling cost allocation are the three basic aims of any budgeting effort.

Any of these objectives will be extremely difficult to attain due to the increased unpredictability and volatility. Unforeseen market headwinds or windfalls make absolute budget targets less and less meaningful. Actual results are no longer a reliable indicator of manager performance when compared against budgets. Moreover, predicting results in great detail and over extended time horizons has gotten increasingly challenging. Single-point estimations will nearly always be incorrect in many circumstances. Managers must be able to respond swiftly to changing conditions in unpredictable times. This frequently necessitates going over or under budget for quite reasonable reasons. The use of strict budget constraints to maintain control has shown to be ineffective.

These concerns add to all of the well-known, long-standing budgeting challenges: a great deal of effort and complexity, deliberately gloomy or unattainable aims, swiftly obsolete assumptions, and so on. Setting comprehensive, strict budgets a year or more in advance is, in short, becoming increasingly pointless.

For many major businesses, precise forecasting remains a difficulty even in the best of economic times. During unpredictable times, it is even more critical for businesses to be able to plan their operations as precisely as possible.

Fundamental sources of business uncertainty

A) The Increasing Speed of Business and Globalization

The speed of business is maybe the most difficult task. It was difficult for a company to enter a new market, develop a new product or service, or change its business strategy in the 1980s. The main issue was a lack of communication (Scherer et al. 2009).

To reach potential customers, a dependable way must be available to contact them, explain how the product or service might benefit them, and allow them to respond and ask questions. These approaches (for example, direct mail, TV, or newspaper advertising) were slow and difficult to target ideal customers before the Internet era. It also required a local presence to oversee any responses, which was expensive in terms of time, energy, and cost incurred on recruiting and training salespeople. This has all changed thanks to the Internet and the rise of e-commerce. To begin with, geographical barriers are gone, and technology allows both real and virtual businesses to be founded and connect successfully with clients in a fraction of the time it took in earlier years (Passaris 2006). Not only can the medium combine text, voice, images, and video, but it may also be interactive and answer individual client inquiries automatically. The Internet's reach is far more sophisticated than prior marketing methods, and it is more adaptive, targeted, and significantly less expensive.

Organizations no longer need to maintain a local presence; product promotion is available around the clock, and social media sites allow others to advertise products without the supplier's involvement or cost (Daniels et al. 2002). The time needed for new business to enter has been lowered from years to months, if not weeks, because to this capacity. Existing vendors have changed their business models in response to this threat. Once again, Internet-based technology has enabled them to do so at a breakneck pace. In response to a rival, companies may make changes to product specs and pricing situations in minutes, when in the past, months of planning were required, as well as the cost of rewriting product literature and retraining employees (Payonk et al. 2015). The Internet has drastically changed the corporate scene by making everything considerably faster than it was previously.

B) The Increasing Complexity of Business

The second issue that firms face is the increased complexity of business as a result of technological advancements. Organizations were traditionally connected with specified markets where they delivered mass-produced items and services twenty years ago (Massa et al. 2018). There was little other option for gathering input but to conduct labor-intensive surveys by hand. Organizations can now obtain a competitive advantage by selling specialized products directly to individuals due to the improved communication.

Similarly, more flexible production techniques and ‘just in time' inventory management systems have been enabled by better and quicker information, lowering stock levels and associated costs (Vasconcelos and Ramirez 2011). Intermediaries can now operate and customize products to meet specific demands thanks to the Internet. They don't require much capital to run the business this way, yet they may nevertheless give the impression of being a large, stable company. Another phenomenon affecting businesses is ‘people power,' which manifests itself in the form of social media complaints or endorsements that have a substantial impact on client purchases. These types of remarks, which frequently have little to do with the product or service being supplied, are more about social views about business responsibility, but they can be just as damaging as failing to keep up with rapidly changing fashions.

C) The Decreasing Planning Time Horizon

As a direct result of the increased speed and complexity of business, the planning time horizon has shrunk dramatically (that is, the ability to predict future time periods with any degree of accuracy). Annual budgeting, quarterly forecasting, and monthly reporting were acceptable management methods in the past since market fluctuations could be accommodated within the set planned timescale.

Budgeting models and strategies in uncertain times

1. Relative targeting model

In an unpredictable world, there are few absolutes. Rather than developing extremely exact, absolute budget targets, companies should focus on more aggregate and relative targets that allow for the necessary flexibility. Detailed cost breakdowns are preferred to margin or "cost per ton" targets and total-cost envelopes. Predicting overall sales at the regional level, for example, will almost certainly prove to be more accurate—and hence more useful—than attempting to narrow down exact sales data for each country or, worse, each product line within a country.

External comparisons, such as market share, return on capital used relative to the competition, or relative total shareholder return, should be used wherever possible, but internal benchmarks, such as each site's operating margin relative to others, can also be valuable.

Changing targets and the incentives that result will almost certainly be a very political activity. This can be avoided, as one industrial goods company discovered, by encouraging the board to select a few targets from the present set and then deferring the fundamental reworking until later (Balve et al. 2019) .

2. Minimized budgeting scope model.

Companies should assess key performance indicators at a time when the business environment is continuously changing (KPIs). The focus on cash and spending management in the short term necessitates a reevaluation of the business metrics. In uncertain times, prioritizing KPIs that focus on liquidity and working capital, rather than sales and growth measures, may be a good idea (Shahin and Mahbod 2007).

A mechanical profit-and-loss and balance sheet approach to budgeting is still used by many businesses. Developing value driver trees, which focus the budgeting activity on the measures that truly matter, is a better option. It also aids in distinguishing between drivers that can be anticipated with certainty and those that are yet unknown (Barrett 2007).

Furthermore, businesses should reconsider and most likely shorten their budgeting horizons. A two-year budget sounds not necessary when even the next quarter's outcomes are uncertain. Companies should confine themselves to the relevant time frame and data relevant to the choice at hand, even in circumstances where product development decisions demand predictions beyond the next year (Jaques et al. 2001).

Finally, budget at a higher level of abstraction. Attempting to foresee long-term events at the product or legal-entity level yields little benefit. Planning at the divisional or regional level will provide for sufficient flexibility. If specific legal entities require planning—for example, to undertake fair-value testing in accounting—it should be done mechanically at the end of the close process. It should not influence managerial decisions in any way.

3. **Shortened budgeting process model.** According to BCG's CFO Excellence database, top-quartile finance operations complete budgeting in just four weeks, which is less than half the duration as it takes the average organization (Chief Financial Officer (CFO)). Furthermore, commencing the process in November rather than July will provide companies with a clearer picture of what the future year would entail.

The finance department should search for ways to shorten the budgeting and planning process so that more time can be spent on company management. A more collaborative approach can reduce the number of budget changes and provide a better understanding of cost factors for all parties involved.

The budgeting procedure must be completed in the correct order to be successful. Budgeting should follow the basic W pattern. It begins with top-down strategic direction and financial aspirations, followed by middle-up financial cornerstone validation. After the cornerstones have been agreed upon, the organization can start filling in the details from the bottom up until final approval. To prevent developing several, overly detailed versions along the road, it's critical to hold off on adding details for as long as feasible.

Companies should anticipate the need to change or amend plans on a monthly or quarterly basis, with a focus on real-time evaluation and decision-making. As a result, the reforecast process cannot take weeks to complete; instead, it must be structured to be finished quickly and performed without requiring considerable manual work. To avoid underestimating the influence of external events, a forecasting tool that can swiftly change assumptions and examine a variety of scenarios is required.

4. Scenario modeling.

Single-point forecasts of revenue or the cost of specific materials will almost certainly prove to be incorrect for companies operating in dynamic marketplaces. These businesses should instead consider scenarios that reflect the underlying volatility (Costa and Paixão 2010).

The budget process is frequently a consensus-building exercise in more stable times. Some businesses may also make contingency plans for "worst-case" scenarios. Companies might speculate on many unfavorable scenarios and put together a budget or strategy to address these eventualities. This system isn't flexible enough to respond to rapid or unexpected economic developments. It's more of a "what-if'' scenario than anything that's currently happening (Palermo and Van der Stede 2011). A corporation is still left with a yearly budget at the end of the day. They simply have a variety of possibilities from which to choose.

Many firms demand their employees to create numerous risk and opportunity scenarios and stress test them against a baseline forecast. Businesses must be prepared for drastically varied revenue levels due to the uncertainty, the restoration of consumer and commercial spending habits, and changes in supplier networks (Coveney and Cokins 2017). It's not enough to establish a baseline strategy with X% up and Y% down assumptions. The difference in revenue levels could be significant enough that G&A and operating cost structures would need to adjust in different scenarios. The "revenue ramp" and predictions about the timing for returning to a more regular operating environment will be one of the main areas of focus. Businesses should be pragmatic, creating simplified budgets for each of the three standard high, medium, and low scenarios. Value driver trees are highly recommended since they make the activity much easier by allowing alternative assumptions to be changed in and out. The company should write out major initiatives in the center, "anticipated" scenarios, and then create key variations based on whether things go better or worse. The correct software can make the process go more smoothly.

Although the value of scenarios for budgeting may appear clear, but few finance departments employ them. In the end, scenario-based budgeting is meant to aid the firm in thinking through conceivable deviations and preparing accordingly, not to anticipate specific results or to strain thinking beyond what's likely.

5. Zero-Based budgeting

Understanding where the company is now, as well as taking an objective look at previous performance and near-term projections, is crucial to the budgeting process. For many firms, rolling back to a previous year may not be a viable option, and a zero-based approach might better match annual costs to business demands. In today's world, consistent performance trends could last anywhere from six to twelve weeks. To generate realistic budget assumptions and key performance metrics, these short-term patterns will be compared to known or existing long-term trends (Pyhrr 2015).

Many current budgets are based on previous ones, with minor adjustments made to account for inflation or changing business patterns. Prioritizing operating and capital expenses and aligning them with the company's strategy is the first step in zero-based budgeting. It should only be employed in regions where the potential savings are the greatest (e.g., capital spending and costs such as procurement). Identifying the organization's top costs and determining which of them may be realistically decreased is beneficial. Employee costs and real estate costs may be inflexible and difficult to modify. Other expenses, such as marketing and capital expenditures, can be reset at the start of each year.

6. Rolling Forecasts

On a monthly or quarterly basis, companies frequently generate informal projections. Members of the financial department are frequently responsible for this. Forecasts may or may not be linked to current organizational decisions (Dworski 2005). Frequently, they are simply updated year-end estimates. A corporation should establish a procedure where they review a 12- to 18-month rolling forecast with a focus on the most critical financial variables to get the most out of a rolling forecast. This method improves trend visibility and aids in the detection of deviations between forecast and actuals (Lorain 2010). This sort of budgeting can make managers more accountable because performance is compared to forecasts on a regular basis. If the CFO can engage the CEO and other senior executives to identify gaps and discuss how to fix them, this type of budgeting can make management more accountable.

7. Quarterly Budgeting and Forecasting

In times of great uncertainty, some businesses abandon long-term ambitions in favor of focusing on the next three months. Companies under such stress, particularly those through a turnaround, should consider ditching annual budgets in favor of quarterly budgeting (Zeller and Metzger 2013). These businesses should concentrate on cost-cutting and managing their working capital for immediate demands. Because the horizon is much narrower, this short-term approach allows organizations to allocate resources in real time and generate better forecasts (Neely et al. 2003). It's also simpler to assess their performance and determine what works and what does not.

8. Transparency

The sales and operations leaders who must deliver the results have always had to take ownership of projection assumptions. The planning process must now, more than ever, be a joint endeavor between finance, sales, and operations. The operating departments must develop and drive the plan's assumptions, with finance evaluating the assumptions through comparisons to trends, industry stats, and other data points (Sarma Danturthi 2016) . Finance must work hard to ensure that corporate executives come up with smart and realistic strategies in a year when product mixes are changing drastically and supply chains are being rethought. Furthermore, the business planning process will necessitate input and insight from functions that may not have previously been involved or have just supplied simple cost roll-forwards (Krajewski 1990). Following the creation of the budget, the various roles involved in its creation must maintain ownership and track continuing performance. To do so, the budget structure must be aligned with reporting and KPI frameworks, so that frequent flash and KPI reports can show whether the plan is on track or if re-planning is required (Pan and Wei 2012; Bauer 2004). Employees can grasp the operating assumptions that underpin the statistics in order to support and back the budget. This is particularly true for resources who are compensated based on their financial performance. Otherwise, budget-driven performance targets will fail to provide enough incentive.

9. Budgeting and Forecasting Tools and Infrastructure

The technology used to collect and aggregate budget and forecast data is an important part of sustaining a forecast in real time. While Excel is a popular and widely used tool among finance and accounting teams, it has limits when it comes to reliably and efficiently updating data. Spreadsheets could be saved in many locations; a lack of version control could mean executives aren't looking at the most up-to-date figures; and formula errors could result in time spent looking for problems when the numbers do not add up (Subbotina and Субботина 2014). Organizations need a solution that can be accessed from any distant location with an internet connection as the remote workforce grows. The capacity to efficiently construct and present a budget is dependent on the choice of a cloud-based planning, budgeting, and forecasting solution, as well as the integration of these capabilities with business intelligence and business process management systems (Lueg and Lu 2013).

Conclusion

Rather than developing extremely exact, absolute budget targets, companies should focus on more aggregate and relative targets that allow for the necessary flexibility. Margin or "cost per ton" targets and total-cost envelopes are favored over detailed cost breakdowns. When even the following quarter's results are uncertain, a two-year budget seems unnecessary. In the short term, the focus on cash and spending management involves a reevaluation of company indicators. The finance department should look for ways to streamline the budgeting and planning process so that it can devote more time to corporate management.

Companies should plan on changing or amending plans on a monthly or quarterly basis, with an emphasis on real-time evaluation and decision-making. A more collaborative approach can reduce the number of budget modifications and give all parties involved a better grasp of cost factors. Due to the unpredictability, the restoration of consumer and commercial spending habits, and changes in supplier networks, businesses must be prepared for radically varying revenue levels. Many current budgets are based on prior ones, with slight tweaks to account for inflation or shifting economic habits. The organization should write significant projects in the center, "expected" scenarios, and then key variants dependent on whether things go well or badly.

In a year when product mixes are changing dramatically and supply networks are being rethought, finance must work hard to guarantee that corporate executives come up with wise and realistic solutions. Companies with a lot of unpredictability might consider switching to quarterly budgeting instead of annual budgeting. More than ever, the planning process must be a collaborative effort across finance, sales, and operations. The system that collects and aggregates budget and forecast data is critical to maintaining a real-time forecast. As the remote workforce develops, businesses need a solution that can be accessible from any location with an internet connection. The ability to create and present a budget efficiently is determined by the cloud-based planning, budgeting, and forecasting system selected.

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