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# Ugh! It's Budget Approval Time

Whoever first decided to link performance measurement to budgets may have done more damage to business effectiveness than anyone else in history.

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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 appears to be a straightforward numerical planning and accounting 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 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 budget 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 budget. The lower the budgeted profit, the easier it is to beat the budget and earn a bonus.

At any reasonable level of performance, having a lower profit budget will make the bonus higher. So we are, in effect, encouraging managers to budget low. 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.

OPINION

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 process and management culture with more transparency, cooperation, innovation, initiative, accountability and results.

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