

## **Better Budgeting and Beyond**

### **Meeting Marketing's Needs for Planning and Control**

## Agenda

- How is planning and control supposed to work to maximise profits?
- What are imperfections of variance analysis?
- What are imperfections of corrective action and profit maximisation?
- How can we do this better?

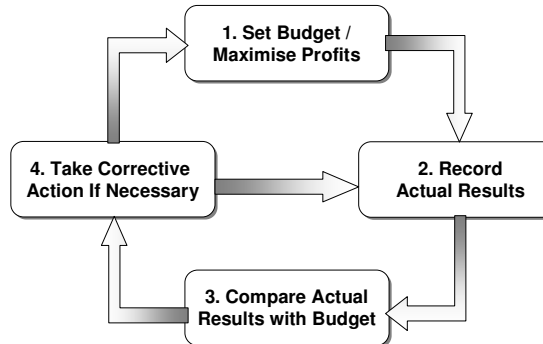
# Good processes and information are needed

## CONTROL INFORMATION

|         | Actual | Budget | VAR |
|---------|--------|--------|-----|
| Revenue | 22     | 20     | 2 F |
| Cost    | 18     | 17     | 1 U |
| Profit  | 4      | 3      | 1 F |

F = Favourable  
U = Unfavourable

## CONTROL PROCESS



Accounting reforms focus mainly on process – faster closes etc.  
Yet imperfections in control information are a major problem that is widely ignored

## Better Budgeting and Beyond – The Big Debate

- **Why Budgeting Kills Your Company**  
*Harvard Business School Working Knowledge, 11 August 2003*
- **The Case Against Budgeting**  
*Business Finance, July 2003*
- **Budgets Roll with the Times**  
*Optimize, August 2003*
- **Should You Shoot Your Budget?**  
*BetterManagement.com, 29 August 2003*
- **Is Planning a Waste of Time?**  
*CFO.com, 12 August 2003*
- **Beyond Budgeting**  
*HBS Books 2003*

# Speed is fad in Finance

- “Few organisations have yet aggressively sought to reduce their monthly closing timetable” **KPMG**
- “Reduce management time” **Accenture**
- “Month-end close cut from 10 days to 3 days”, **Oracle**
- “Workflow support for budget submission and approval process” **IBM**
- “Real-time control and accountability” **Peoplesoft**
- “Web-Based Financial Solution” **COGNOS**
- “Streamline financial data consolidation” **Hyperion**
- “Deliver management information on a more detailed basis” **Hyperion**
- “Fixed targets are a thing of the past” **SAP**
- “Budgeting abolished”, **BBRT**

...but what about **BETTER** decisions?

## 1. Setting Budgets

Spreadsheet proformas are generally circulated to all departments, showing last year's figures and blanks for budget proposals

|         | <i>LY<br/>Budget</i> | <i>This Yr<br/>F'cast</i> | <i>LY<br/>Actual</i> | Budget | VAR | %   |
|---------|----------------------|---------------------------|----------------------|--------|-----|-----|
| Revenue | 225                  | 210                       | 218                  | 240    | 22  | 10% |
| Cost    | 188                  | 175                       | 182                  | 200    | 18  | 10% |
| Profit  | 38                   | 35                        | 36                   | 40     | 4   | 10% |

# 1. Which stretch target?

Choose the most appropriate basis for comparison:

- Last year's actuals
- Last year's budget
- This year's baseline forecast

Choose the most appropriate stretch criterion - actual or %

Always set priorities for improvement: global % increases do not succeed

# 2. Recording Actual Results

Results are allocated to a time period and categorised before reporting. The mechanics of record keeping can introduce complications and anomalies into the results.

|         | Jan  | Feb  | Mar  | Apr  | May  | Jun  |
|---------|------|------|------|------|------|------|
| Revenue | 16.2 | 20.2 | 16.9 | 21.1 | 17.6 | 22.0 |
| Cost    | 13.5 | 16.9 | 14.1 | 17.6 | 14.7 | 18.3 |
| Profit  | 2.7  | 3.4  | 2.8  | 3.5  | 2.9  | 3.7  |

### 3. Comparing Actual with Budget

Imperfections in variance analysis are ignored at your peril!

|         | This Month |        |       | Year to Date |        |       |
|---------|------------|--------|-------|--------------|--------|-------|
|         | Actual     | Budget | VAR   | Actual       | Budget | VAR   |
| Revenue | 22.0       | 20.0   | 2.0 F | 114.1        | 120.0  | 5.9 U |
| Cost    | 18.3       | 16.7   | 1.6 U | 95.1         | 100.0  | 4.9 F |
| Profit  | 3.7        | 3.3    | 0.4 F | 19.0         | 20.0   | 1.0 U |

After identifying variances, important to:

- assess Causes
- find Options
- Compare Effects (what-if models)
- Decide on corrective action

### 4. Taking Corrective Actions

Balancing the budgets, using the spreadsheet as an adding machine, may not be the best decision

1. *Balanced Budget*      2. *Beat the Budget*

|         | Year to Date |              |              | <i>Rest of Year</i> |               |              | <i>Rest of Year</i> |               |              |
|---------|--------------|--------------|--------------|---------------------|---------------|--------------|---------------------|---------------|--------------|
|         | Actual       | Budget       | VAR          | <i>Actual</i>       | <i>Budget</i> | <i>VAR</i>   | <i>Actual</i>       | <i>Budget</i> | <i>VAR</i>   |
| Revenue | <b>114.1</b> | <b>120.0</b> | <b>5.9 U</b> | <i>125.9</i>        | <i>120.0</i>  | <i>5.9 F</i> | <i>128.9</i>        | <i>120.0</i>  | <i>8.9 F</i> |
| Cost    | <b>95.1</b>  | <b>100.0</b> | <b>4.9 F</b> | <i>104.9</i>        | <i>100.0</i>  | <i>4.9 U</i> | <i>106.4</i>        | <i>100.0</i>  | <i>6.4 U</i> |
| Profit  | <b>19.0</b>  | <b>20.0</b>  | <b>1.0 U</b> | <i>21.0</i>         | <i>20.0</i>   | <i>1.0 F</i> | <i>22.5</i>         | <i>20.0</i>   | <i>2.5 U</i> |

**What are the  
critical imperfections  
of variance analysis?**

## Variance Analysis

Variance Analysis is an accounting technique that permits the close examination of the differences between budgeted information and actual information. It is used to investigate the causes of differences that are deemed significant, and breaking them down into categories that are potentially meaningful for managerial action.

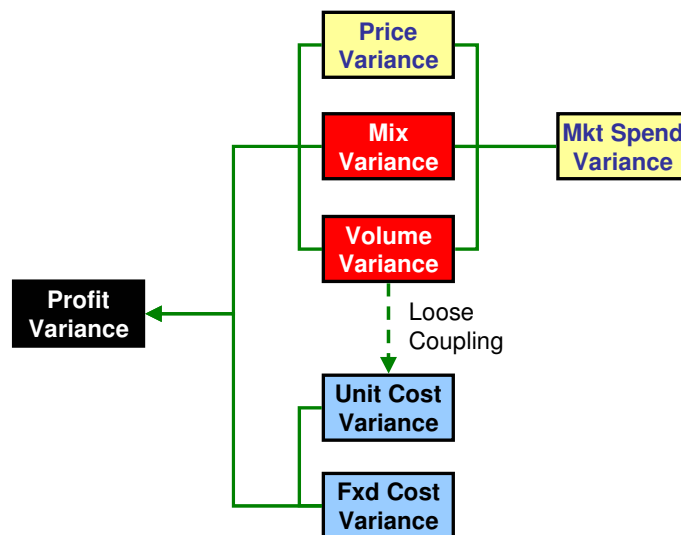
# Critical Imperfections

Ignoring the imperfections and complications of variance analysis can cause very **dysfunctional decisions**

- Additivity: variances are assumed to split into sum (or difference) of subsidiary variances
- Separability: variance can be separated into effects of different factors

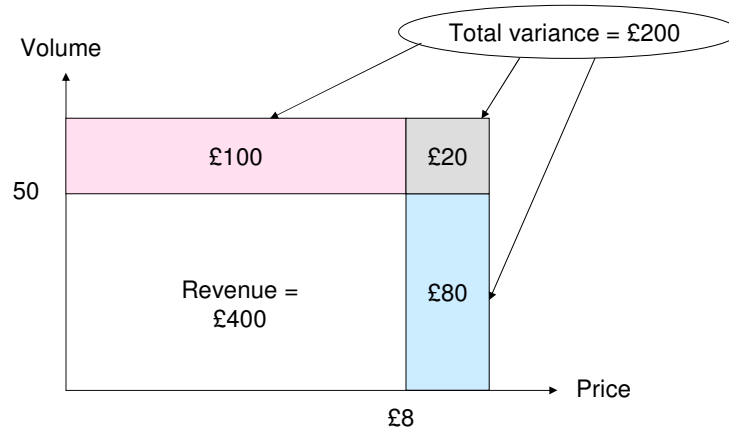
# Variance Tree

Profit variances can be separated out into two sub-models with only “loose coupling”



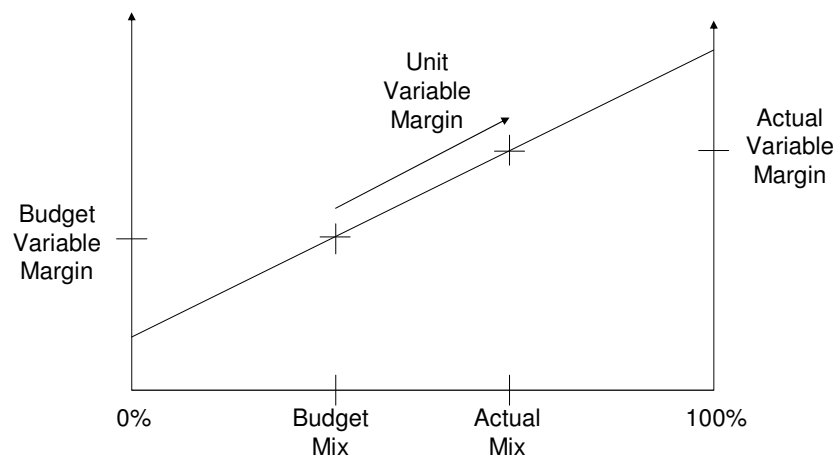
# Multiplication and the Grey Areas

All variances are not additive. Multiplicative ones are common and their effects cannot be attributed unambiguously



# Mix Variance

Mix variance arises when actual mix differs from budget, and margin is product dependent



# Volume Variance

Volume variance arises as a result of many different factors. Important for variance analysis to separate out all the different volume variances, so that controllable variances are isolated.



# Ratios and Trade-Offs

- Ratios are widely used in variance analysis
- Not all ratios are sensible to use:
  - e.g.  $\frac{\text{Advertising Expenditure}}{\text{Miles travelled by Salesmen}}$
- Efficiencies in one area often trade-off with other ratios
- Mistake to judge single efficiency ratio variances without reference to other trade-off factors

# Trade-Off Imperfections

| Department     | Wants  | Which causes          | To be less good at  |
|----------------|--|-----------------------|---|
| Marketing      | Customers to receive personalised service              | Operations            | Containing costs by spending less time with each customer         |
| Finance        | Pricing to cover short-term costs                      | Sales                 | Negotiating to secure long-term customer loyalty                  |
| Credit control | Credit limits to reflect financial risk criteria       | Sales                 | Winning business from long-term prospects                         |
| Computing      | Databases to be shared across departments              | All other departments | Reducing their overheads  |
| Manufacturing  | Standard product features                              | Product development   | Creating a competitive product range                              |
| Purchasing     | Lowest cost bids                                       | Manufacturing         | Quality control, failure and defect reduction                     |
| Sales          | Enquiries to be qualified by whoever takes the message | Operations            | Reducing cost of telephone time and effort                        |
| Advertising    | Long-term budgets to support Brand development         | All other departments | Obtaining funding for other valid investments                     |
| Operations     | Standardised service to meet ISO9000                   | Marketing             | Offering differentiated service levels to various market segments |

**What are the critical imperfections of corrective action and profit maximisation?**

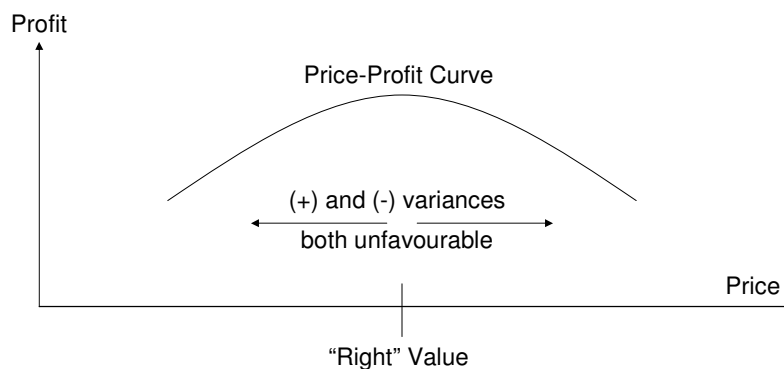
# Corrective Actions and Profits

Ignore the imperfections at your peril !

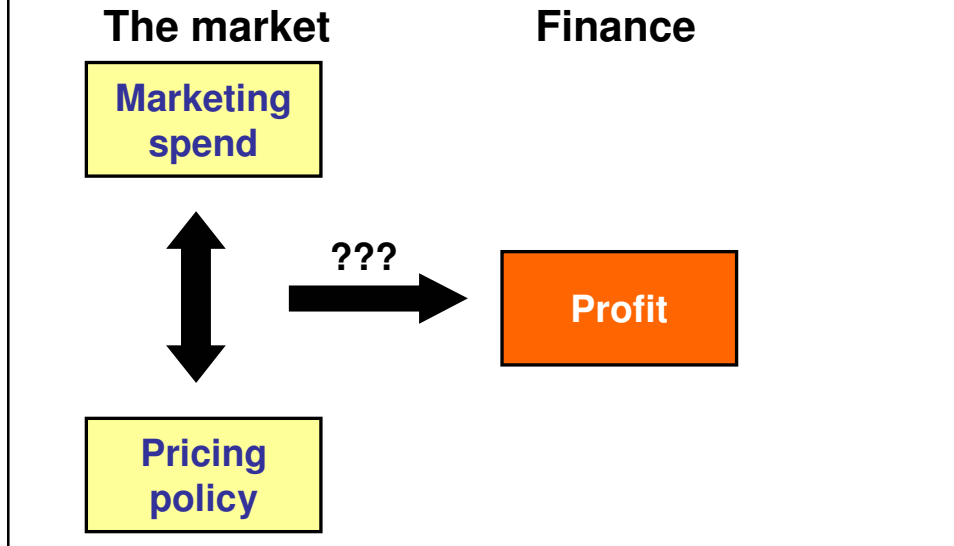
|                           | IDEAL   | IMPERFECTION  |
|---------------------------|---|---|
| PROFIT MAXIMISATION       | Follows as a consequence of correcting unfavourable variances   | Suboptimal profits are likely to result from reacting to all "unfavourable" variances |
| RESPONSIBILITY SEPARATION | Can design reports that unambiguously report the consequences of individual managers' decisions and actions | Interdependencies between departments and decisions                                   |
| HIERARCHY OF OPTIMISATION | Can optimise whole by optimising subordinate levels   | Optimisation is not hierarchical  |
| NO FALSE ALARMS           | Variances always result from genuine problems   | False alarms are common. Managers learn to ignore them.                               |
| EARLY WARNINGS            | Always sufficient time to correct problems  | Too little too late.  |
| FAIRNESS                  | Budgeting provides a fair basis for comparing the performance of different managers.                        | Management by fear.   |

# Optimisation and Rightsizing

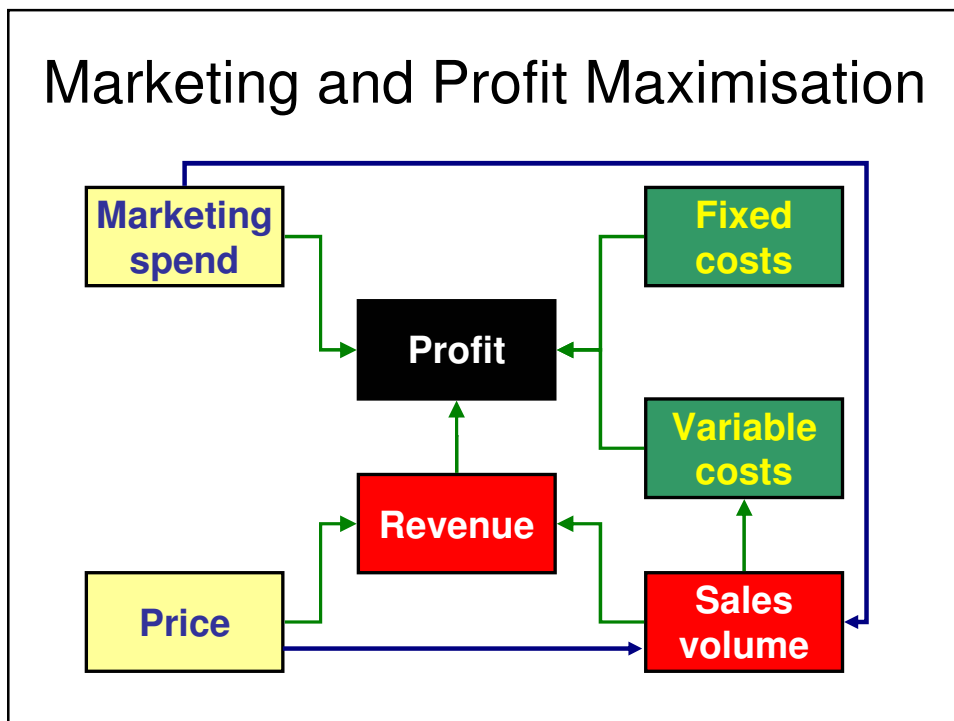
"Favourable" and "Unfavourable" variance concept may be inconsistent with the idea of "right" values



# Marketing and Profit Maximisation

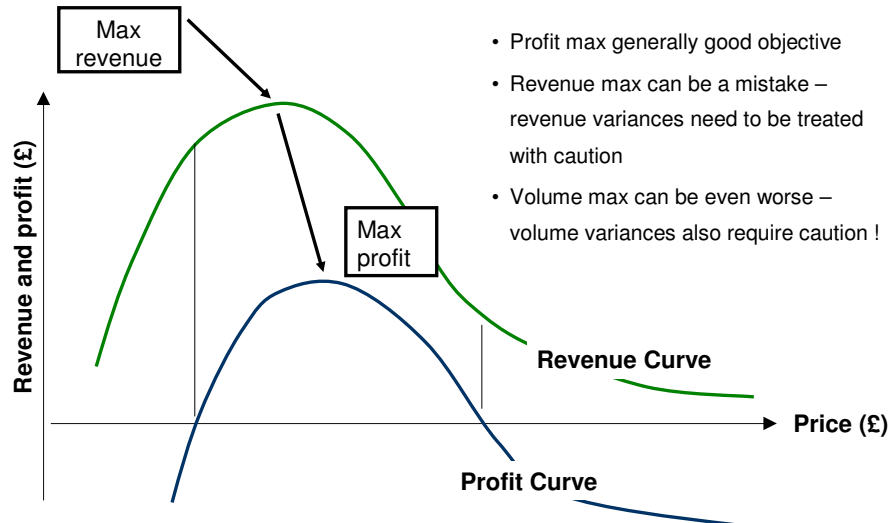


# Marketing and Profit Maximisation



# Maximise Profit, not Rev. or Vol.

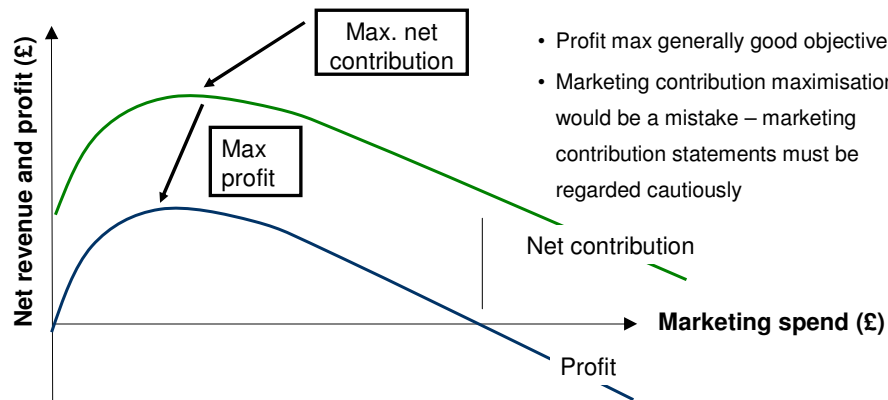
Revenue and volume are not proxy variables for profit !



# Maximise Profit, not Contribution

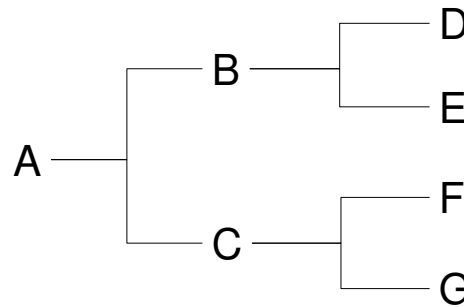
Marketing contribution is not proxy variable for profit !

$$\text{Contribution} = \text{Revenue} - \text{Marketing Spend}$$

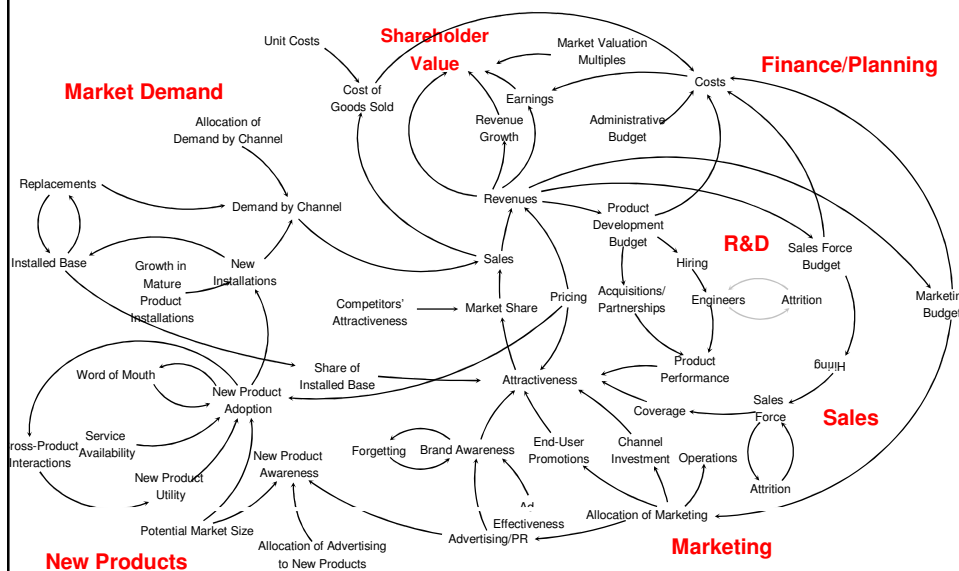


# Hierarchy Diagrams and Separability

- Our minds routinely categorise effects into hierarchies
- Delegation is a practical manifestation of this
- Mutually Exclusive, Collectively Exhaustive is our natural assumption
- Perfect MECE is rarely found in practice
- MECE imperfections have extremely important consequences and must not be ignored

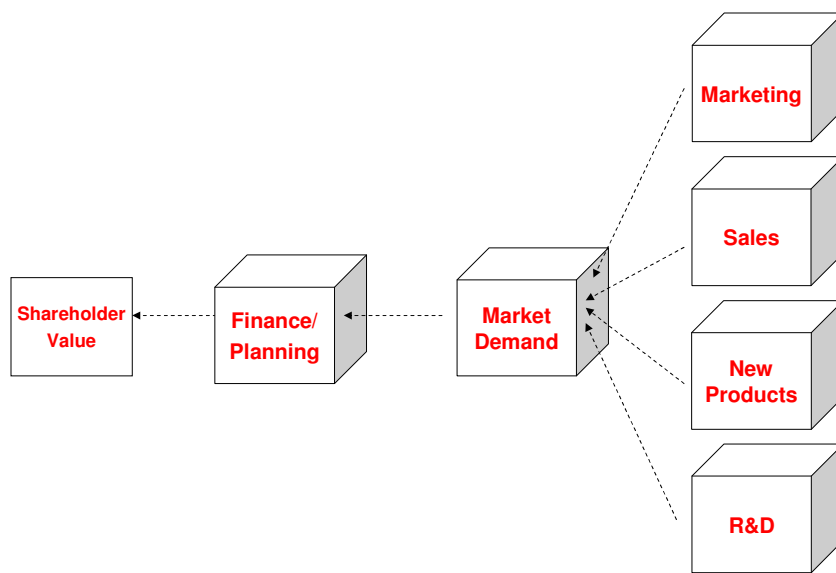


# Real Companies are Networks – cannot model accurately as whole

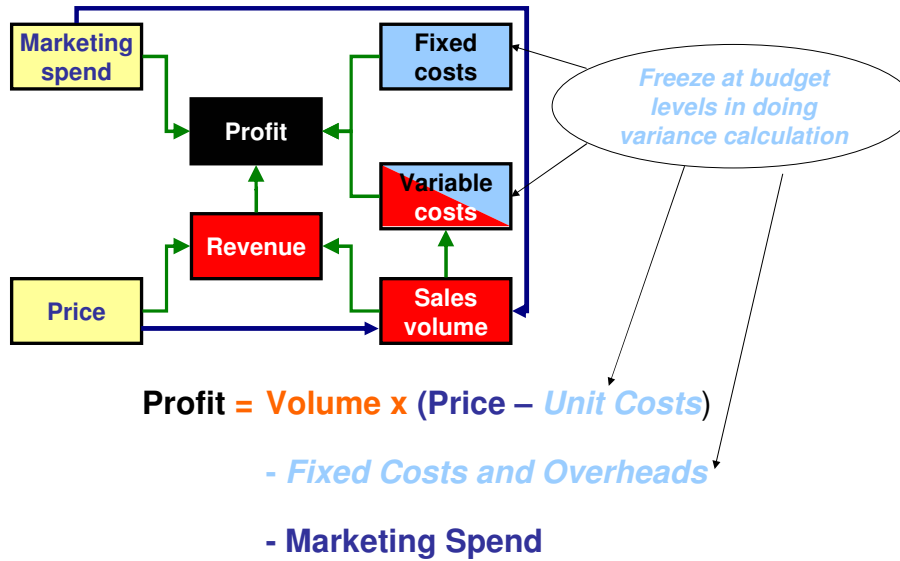


**Doing things better**

Separate into loosely coupled models

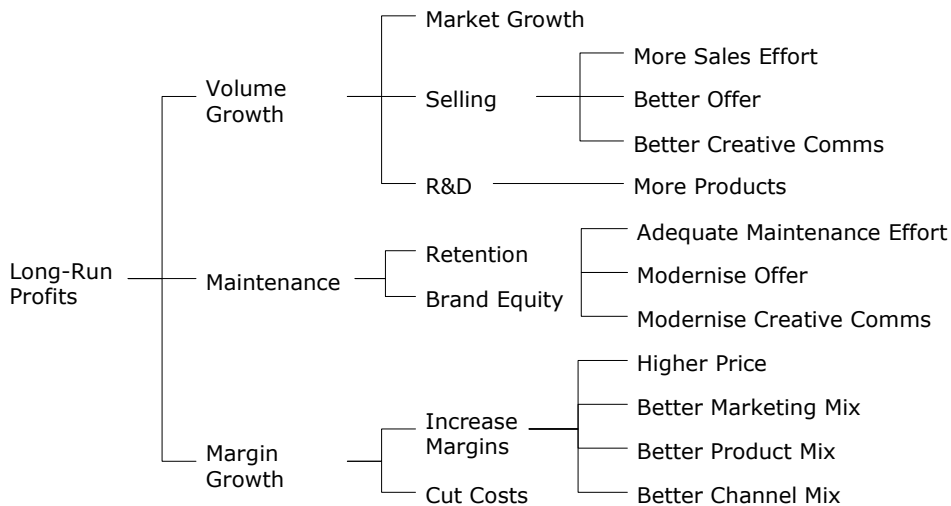


# Marketing Separation



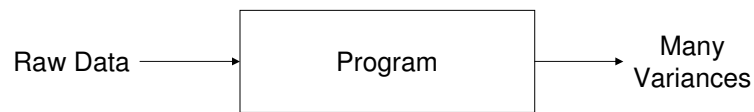
# Separate into Marketing Sub-Models

Take care to allow for MECE imperfections



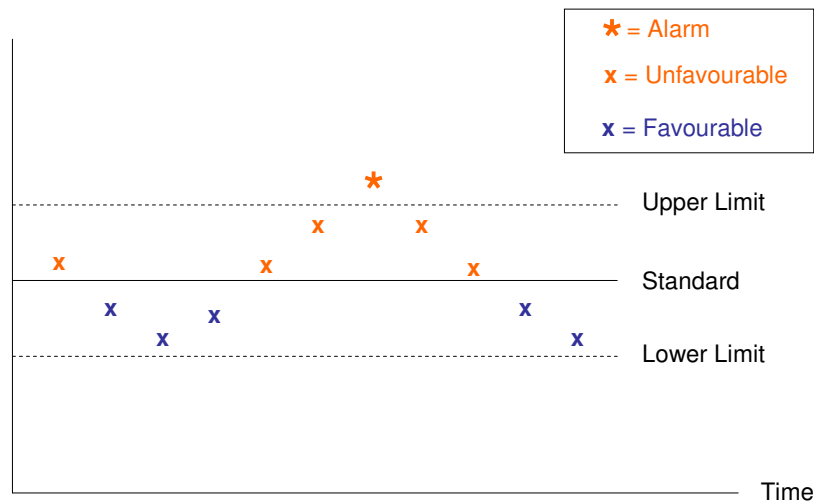
# Conventional Analysis

Good design of the program that produces variance analysis is an imperative

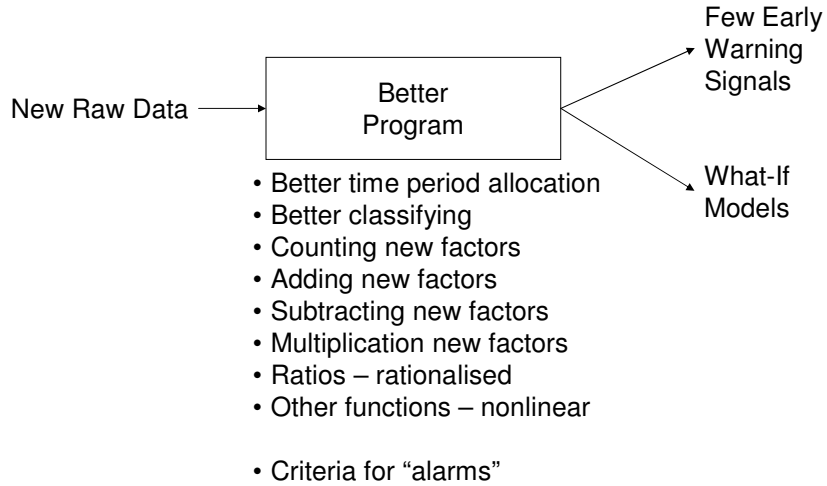


- Time period allocation
- Classifying
- Counting
- Adding
- Subtracting
- Multiplication
- Ratios

# Criteria for Alarms need Setting by Management



# Improved Analysis



# Improved Analysis

