While most budget processes succeed at setting spending limits, they do little to assure the proper allocation of resources. This white paper examines the shortcomings of traditional budget approaches, and suggests a powerful new format for budget submissions and negotiations—termed "Investment-based Budgeting"—in which departments plan the costs of their products and services.

**Traditional Budget Approaches**

What's wrong with the way most enterprises plan their budgets each year? Consider how the process works. Managers forecast their expenditures in each of the major general-ledger expense categories—planned costs of compensation, travel, training, vendor services, etc. They know their proposed budgets are likely to be cut, so they build in "fat."

Of course, the CFO and top executives of the enterprise know that they do this; so they feel comfortable requiring managers to cut their budgets without any concomitant reduction in their deliverables—the "do more with less" demand. Unfortunately, the number that's finally agreed to usually has little to do with what's really needed to run the business.

While this process may successfully limit spending to available funds, the annual game is contentious, unproductive, and may actually diminish
shareholder value. It's no wonder that many managers are cynical about the entire process.

It's important to take a detailed look at the specific problems created by budgeting to expense codes.

**Poor Allocation of Scarce Resources**

Traditional budget processes do an extremely poor job of allocating precious resources in an optimal manner.

What is the optimal budget for a given department? In technical terms, each department should be funded to the point where the marginal internal rate of return on the next best investment drops to the weighted-average, risk-adjusted cost of capital. In simple terms, each department should be given the amount of money needed to fund all the good investments, and no more.

But of course one cannot calculate the ROI on expenses like travel and training. ROI can only be judged in the context of value, which requires an understanding of what the enterprise gets for its money as well as the cost of each of these deliverables.

For lack of any data on the ROI of specific investments, or even any sense of what won't get done if a department's budget is cut, CFOs and enterprise executives have no choice but to base budgets on arbitrary numbers like "last year plus/minus X percent."

Clearly, this has nothing to do with the investment opportunities available in the coming year.

On one hand, this may miss opportunities for sensible frugality by funding some departments to keep on doing most of what they've been doing, whether there's value in it or not.

On the other hand, high-return (even strategic) investment opportunities may be foregone for lack of proper funding.

The sad thing is, with the data they're given in traditional budget processes, executives have no way of knowing what they're missing. In other words, traditional budget processes do not permit CFOs to fulfill their fiduciary responsibilities to their shareholders, taxpayers, or donors.

**Undermines Strategic Alignment**

Another serious problem is that traditional budgeting processes do nothing for strategic alignment.

Strategies typically engage many internal departments, working in concert to deliver something new like an innovative product, penetration of a new market, or an acquisition.

With traditional budgets, there's no way to consider the costs of a strategic initiative across the entire enterprise. Each internal department is budgeted independently. As a result, one department may be funded to pursue a strategy, but the internal support functions on which it depends may not have the resources they need to participate.

At worst, this can cause strategies to fail. At a minimum, traditional budgeting does not consider the enterprise-wide cost of a strategy, nor does it align all departments with the enterprise's strategies.

**False Expectations of Productivity Gains**

The annual budget game leads executives to confuse budget negotiations with performance management. It's obvious that organizations don't magically become more productive just because executives demand that they "do more with less." But many executives cynically presume that managers won't improve their organizations unless they're pressured to do so.

Budgeting is a poor venue for executive review of managers' performance-improvement objectives. Performance management should occur continually, not just once per year; and it's the job of leadership, not the budget process. It's naive to think that squeezing the budget is a fair substitute for ongoing performance management, or that doing so will lead to deliberate and well-planned process improvements.

Even if budget pressures could force productivity improvements, there's no reason to believe that this pressure will produce exactly the amount of savings required to meet the budget. That would be pure chance! Budget cuts are generally arbitrary percentages, rarely based on facts like the estimated productivity gains to be expected from specific investments in the organization—facts which can only be revealed by an investment-driven budget process.
As a result, budget pressures often make organizations less, not more, productive. When departments struggle to meet unrealistic expectations, they rob Peter to pay Paul and become unreliable. They may cut back on training, process improvements, and innovation—the so-called "discretionary" expenditures that are the first to be sacrificed. In doing so, their productivity, responsiveness, quality, and reliability suffer.

When some departments lack the resources to reliably deliver on all their promises, others who depend on them also become unreliable. Cutting budgets without consciously deciding what not to do causes things to fail randomly in various departments throughout the enterprise. Ultimately, the entire enterprise becomes less capable of delivering even the important things, both operations and strategic initiatives.

A healthy budget process focuses strictly on allocating scarce enterprise resources in an optimal manner—a matter of deciding what activities to fund and what not to do—not on performance management.

**Inappropriate Micro-management**

Traditional budget processes also have an insidious effect on enterprise culture. They invite micro-management, where CFOs and top executives attempt to tell leaders how much they should spend on travel, training, consulting, etc.

Top executives are not equipped to make such decisions. Individual managers are in the best position to know what they need to spend to deliver their internal and external products and services.

Micro-management leads to false economies. Artificial constraints on travel or consulting may get in the way of key organizational objectives, often forcing managers to use higher-cost alternatives (like buying from a vendor when internal staff could do it better and cheaper). They may even destroy the department's ability to deliver some of its internal products and services.

Beyond that, micro-management is the antithesis of empowerment. Managers are held accountable for their departments' business results; but with one hand tied behind their backs, they may not have the authority they need to manage their organizations. Accountability without authority sets people up to fail. It turns leaders into victims and scapegoats.

An empowered culture holds leaders completely responsible for the performance of their organizations, and matches accountability with authority. In an empowered culture, people are managed based on their deliverables, not how they produce them. Leaders are not subject to arbitrary constraints on expense codes, but rather are held accountable for delivering agreed results at a fair cost.

**The Alternative: Investment-based Budgeting**

A healthy budget process requires managers to forecast their costs (as usual), but then they **attach all costs to deliverables**—the products and services their departments "sell" to other departments within the enterprise or to external customers.

This is not a matter of chargebacks. It's simply an alternative format for budget proposals. Simple versions of this concept were called "activity-based budgeting." In the US Federal government, it's called "program-based budgeting."

Each department's budget submission appears as a list of products and services, and the full cost to the enterprise of each. "Full cost" includes not only direct costs, but a fair share of all indirect costs. Thus, prices are comparable to outsourcing.

Of course, this budget proposal must be transparent and subject to audit to ensure that there's no "fat" built into the numbers. But any fat is driven out by scrutiny before budget decisions are made, simply a matter of checking the facts on the inputs to the cost model.

Then, the budget decision-process can focus on which internal products and services the enterprise chooses to buy. Straightforward, businesslike discussions of costs and the ROI of the proposed deliverables replace emotion, politics, and unrealistic "do more with less" demands.

Budget decisions become **investment decisions**, hence the term "Investment-based Budgeting."

As an added benefit, the budget data can also be used to determine rates for internal products and services. Rates can be used to estimate new projects during the year. They also provide the best basis for outsourcing comparisons. And of course they're fundamental to governance processes such as demand-management and chargebacks.
The Benefits

Why is it important to plan budgets based on the full cost of products and services in every department throughout an enterprise? Here are the top ten benefits of Investment-based Budgeting.

1. Save money by inducing frugality—not just in indirect costs within a department, but also in the services that departments buy from one another.
2. Ensure reliable delivery of chosen products and services by funding all the needed resources and support services.
3. Enhance shareholder value by optimizing resource allocation decisions based on ROI.
4. Improve enterprisewide strategic alignment.
5. Enhance organizational flexibility and response time.
6. Set prices based on a clear understanding of full costs.
7. Calculate accurate business-unit profits.
8. Manage your business for sustainability, with appropriate set-asides for training, innovation, process improvements, client relations, and infrastructure.
9. Enhance internal teamwork by funding entire enterprisewide project teams.

Implementing Investment-based Budgeting

CFOs and Budget Directors can do so much more than hounding business leaders into budget reductions. An Investment-based Budgeting process leaves the legacy of a fiscally sound, fact-based, sustainable business process that enhances shareholder value year after year.

Executives interested in Investment-based Budgeting can find all the details on how to prepare budgets showing the full cost of each department’s products and services in the Full-cost Maturity Model (FMM). It defines the calculations that go into costing products and services, and describes an evolutionary path toward that ideal through five levels of organizational maturity.

By implementing Investment-based Budgeting, CFOs can have a far-reaching impact on leadership accountability, enterprise strategy, and shareholder value.

RESOURCES:

Full-cost Maturity Model. 2007, 2008. (report)
How to calculate the cost of an organization’s products/services, and five levels of maturity in business planning, budgeting, and costing.

Downsizing Without Destroying: how to trim what your organization does rather than destroy its ability to do anything at all. 2003, 2008. (monograph)
Why conventional approaches are destructive, and a sensible alternative based on business strategy and portfolio management.

FullCost. (software and planning process)
Software and a step-by-step business planning and budgeting process that implements investment-based budgeting.

Telephone meeting with researcher/author Dean Meyer. Complimentary; call 203-431-0029 to arrange.

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