

New era budgeting

The downturn has rendered budgets agreed last year largely irrelevant. PwC's **Nick Jarman** and **Sanjay Bibekar** offer some thoughts on the way forward

As we all know, the business environment has become increasingly hostile and volatile. In April 2008, one major FTSE 100 company declared a pre-tax profit of almost £1bn, with revenue growth for 2009 forecast at 4%. By February 2009, the same company had reported a loss of almost £100m for the nine months ending in December 2008, with expected losses of £150m for the full year. Indeed, in most sectors, the slowdown has been so dramatic that the budgets agreed last year have become irrelevant.

In light of this deepening downturn and increase in economic volatility, is it still sensible for companies to budget for 12 months? And does the annual budget still serve its purpose, given the significant time and resources needed to produce it?

The cost of budgeting

A PricewaterhouseCoopers (PwC) survey conducted in February 2009 offers some stark facts about the real price of budgeting and forecasting.

- * On average, companies devote an equivalent of five full-time staff to strategy and planning activities, and eight full-time staff to budgeting and forecasting, for every £1bn of company revenue.
- * The median process cost, as a percentage of revenue, is 0.06% for strategy and planning activities and 0.05% for budgeting and forecasting.
- * The median time taken to complete a budget is 100 days with some taking significantly longer.

What are budgets for?

The cost may be high for the budgeting process, but let's not forget they serve a

wide range of purposes. Budgets are used as the basis to communicate revenue and profit growth forecasts to external stakeholders including analysts, banks and rating agencies. They can provide performance targets for executives and employees – with their bonuses often based on achieving them – as the starting point for workforce and recruitment planning and as the planning basis for the procurement of materials and services. Finally, budgets are also used to forecast cashflows and foreign exchange exposure, which in turn are used to make funding and hedging decisions.

Budget shortfalls

If companies are putting so much time and effort into the budgeting process, why does experience tell us that budgets often fail to deliver their intended benefits? A PwC survey conducted during 2007 highlights the following:

- * Companies tend to take more than three months to agree a 12-month budget, which means that the budget is out-of-date by the end of the first quarter.
- * The reliability of budgets is also an issue, with more than 40% of survey respondents expressing a desire to see budgeting accuracy improved.

* The budgeting process itself is often inefficient, with 25% of time spent on data gathering and consolidation. Indeed, some companies fall into the trap of using their enterprise resource planning (ERP) software for preparing their budgets. Such inappropriate use of tools can create additional costs and reduce the effectiveness of the planning process.

Fixing the budgeting problem

Given the difficulty with forecasting revenues beyond the next quarter, a number of companies are considering moving to rolling forecasts, as either a replacement for, or supplementary to, the annual budget.

So what does a quarterly rolling forecast look like? Companies that budget for 12 months usually start in August of the previous year and update their budgets every quarter once actual data is known. In contrast, a rolling forecast would be prepared for 12 months. Once the actuals for one quarter become available, the next three quarter forecasts would be updated, and the fourth quarter budgeted afresh. Therefore, there is no artificial '31 December – end of year' to spend budgeted funds.

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Annual budgeting process

YEAR 1				
	Q1	Q2	Q3	Q4
Budget	Budget	Budget	Budget	Budget
Forecast Q1	Actual	Forecast 1	Forecast 1	Forecast 1
Forecast Q2	Actual	Actual	Forecast 2	Forecast 2
Forecast Q3	Actual	Actual	Actual	Forecast 3

Rolling forecast process

YEAR 1				
	Q1	Q2	Q3	Q4
Forecast 1	Forecast 1	Forecast 1	Forecast 1	Forecast 1
Forecast 2	Actual	Forecast 2	Forecast 2	Forecast 2
Forecast 3		Actual	Forecast 3	Forecast 3
Forecast 4			Actual	Forecast 4

YEAR 2			
	Q1	Q2	Q3
Forecast 1			
Forecast 2	Forecast 2		
Forecast 3	Forecast 3	Forecast 3	
Forecast 4	Forecast 4	Forecast 4	Forecast 4

Rolling forecasts are not a panacea for every business, as the planning horizon over which budgets can be realistically prepared varies according to levels of revenue volatility. So, for example, utilities may forecast revenues with a relatively high level of accuracy, and can therefore continue to employ an annual budgeting process. In contrast, many companies, including banks, airlines and high street retailers have seen greater volatility in demand, so might consider adopting a rolling forecast.

The move to rolling forecasts can carry setup costs. The cycle time for effective rolling forecasts needs to be about two weeks, rather than the three

months traditionally required for annual budgets. Achieving this means investing in the technology needed to speedily and accurately process, approve and consolidate financial and operational data from across the business.

Putting rolling forecasts into practice

The move from annual budgeting to rolling forecasts is a five-step journey. First, companies need to align their organisational strategy, long-term planning, metrics and targets with the budgeting process.

Second, the budgeting process needs to be simplified by reducing the number

of budget iterations, budgeted lines and versions as well as the time taken to budget. Assumptions, business drivers and overhead allocations should be standardised across the company.

Once the process and the data models have been simplified, the next step is to automate the budgeting process. A number of the latest budgeting software applications on the market have sophisticated workflow approval functions, robust security measures and a Microsoft Excel-style interface, which reduces the need to train employees to use the system.

With an automated system up and running, the company will be ready to introduce rolling forecasts. The company may ultimately consider eliminating the annual budget once the rolling forecast process is fully established. Additional future options include the introduction of indirect cashflow forecasting, foreign exchange exposure forecasting and balance sheet budgeting.

This looks simple when contained within four short paragraphs, but implies changes to working practices, culture and potentially the organisational structure – and will take time to hone.

Demand forecasting, the final ingredient

Rolling forecasts may not suit all, but where appropriate, can provide value and benefit to those who can make it work. The increasingly asked question, which would further reinforce the value of rolling forecasts, is what is the true signal of demand? That, however, is a much longer debate.

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