

The End of Traditional Budgeting

By Gregory J. Nolan

Bank management generally considers the annual budgeting process to be the least rewarding endeavor of the year. And yet it ultimately forms the basis for the bank's earnings per share goal. This earnings per share goal is shared externally with shareholders and analysts. The achievement of the goal also forms the basis for many of the incentive compensation plans within the bank. So why is it that many senior and executive managers don't believe the budget and hate the process they go through each year in preparing it?

Senior executives want relief from a process they believe is ineffective and doesn't represent the plans they would have created, if they had been allowed to do so. Chief executive officers want a process that gets senior managers more involved but still represents the goals that shareholders and analysts expect of them. Finance managers want out from under the burden. They work incredibly hard preparing the plan and don't believe their efforts are appreciated. The problem is not with line-of-business management or finance management. The problem is a process that has evolved over the decades to become an outmoded, disruptive, annual intrusion into the day-to-day management of the bank.

This article will expose the weaknesses of the traditional annual budget process and present alternatives designed to provide management with a consistent rolling view of eighteen to twenty-four months of real profitability without the need for the onerous, annual budget process.

Weaknesses of Traditional Budgeting

Traditional Annual Process

The best way to describe the traditional annual budgeting process in commercial banks is painful. The annual process is a headache to every manager that gets involved with it.

Short-Term Focus

Many business experts have written and spoken out against the American focus on current period earnings and the lack of long-term vision. This is especially evident in the capital markets when you see the pressure on annual earnings and current quarter results. Banking has focused on this pressure so much over the years that their annual budgeting efforts have evolved to center uniquely on this pressure.

Consider the typical bank budgeting and forecasting scenario. The managers who get involved in budgeting do so once a year and the process only goes out to the end of the following year. For example, in most banks around the country the process started in

August and will conclude in December. The budget developed will be for 2005. During 2005 forecasts will be made to supplement the budget information. But the forecasts will only go through December 2005. So forecasts made in April will be for only nine months; in July the forecast is for only six months; and in October for only three months. The forecasts are always concentrating on the achievement of the current year's earnings per share goal.

Unfortunately, this budget process acts as if 2006 doesn't exist. Instead of a seamless transition from one year (2005) to the next (2006), 2006 doesn't exist, until it gets serious attention at the beginning of the next budget cycle.

Pain of Bottom-up and Top-down

What's more painful, bottom-up or top-down? Bottom-up is the process that begins the budgeting at the center level and asks managers to create their budgets for the next fiscal year. These detailed plans are then summarized up the organization to see the overall budget for the company. Top-down is the process where a senior executive, such as the CEO, establishes the overall goals for the company and then managers are asked to incorporate these planned results into their budgets. Financial institutions vary on how far down the organization budgets are prepared.

Bottom-up is tedious and rarely summarizes to the plan the CEO wants. Top-down is less painful to develop and more painful to deliver upon. I asked a line-of-business executive at a \$30+ billion bank about his feelings on the annual budgeting process. He said, "This past year the process wasn't so bad. We changed to top-down so there wasn't much work to do. They told us our number and we entered it. Of course, who knows if we can meet our target, it's not like we were involved in setting it."

"The year before was really painful. We did a bottom-up plan. So we worked really hard to figure out what we could deliver the following year. We started summarizing the plan up the organization and then the CEO and CFO started pushing back. Increase this and that; deliver more; iteration after iteration. Finally they told us the numbers they wanted us to use and we plugged them in. This year we eliminated the pain and wound up in the same place. Except it's still not our plan!"

G/L Budgeting

Another major problem is that traditional budgeting is based on the general ledger (G/L). The G/L is the storehouse for the basic financial information of the company. That basic information is specifically direct revenue, direct expense and balance sheet amounts by center. Many managers who get involved in the budget process generally only budget these amounts for the areas of their responsibility. Many of these managers have major profitability responsibility but never get to budget profitability.

I spoke with the head of Commercial Banking at a \$70+ billion bank about this issue. He said, "We don't budget all direct revenue and expense. We budget outstanding balances,

salary, and travel and entertainment. Finance adds benefits, occupancy, etc. for us. While we are doing this, back office is budgeting their numbers. Finance ultimately adds in these back office allocations to our budgets. We don't understand or believe the allocations, and they play no part in the management of the business." This is a major disconnect since the profit centers are the ones that generate the work that gets processed in the back office. How can the front office and back office planning efforts be unrelated if their businesses are so closely related?

Another problem occurs in the back office. Since they don't integrate their efforts with profit center planning, they are forced to go it alone. The typical scenario is for an operations manager to budget direct expense, such as salary expense, based on last year's amounts. The typical effort begins by estimating the increase that is required and then increasing it in anticipation of push back. For example, managers who believe that a 5% increase is required often budget 10%. Then in the budget review sessions they argue vigorously as they get reduced to 7%. They exit the session feeling pretty good about the extra 2%. In reality, no one knows if the 5% was correct, the 7% or the 10%. All they can hope for is that when they get into the year; they have enough resource on hand to meet the demands created by the profit centers.

Fixing the Measurement of Profitability

If banks are going to effectively plan profitability, they must first clean up the calculation of actual profitability. If general ledgers supplied sufficient financial information to support management, then profitability systems wouldn't be required. The fact that financial institutions are spending millions of dollars on profitability systems is evidence that G/L's don't supply enough financial information to support management's decision making. The typical profitability system runs after the G/L closes. Profitability systems normally take the G/L information as input along with other information such as volume statistics from application systems. The objective of profitability systems is to properly align revenue and expense to show net income within the company. That is by profit center, product, and/or customer.

Many banks have made significant strides in improving profitability calculations. Internal funds accounting has improved significantly with the adoption of matched maturity marginal rate funding. Risk adjustments and equity accounting have also improved significantly. The last important area to be improved is non-interest expense accounting. Many banks employ an antiquated methodology known as expense allocations to account for non-interest expenses. However, business line managers hate expense allocations because it degrades the profitability calculation and inhibits management decision making. If management hates expense allocations so much, why do banks employ them in calculating profitability?

Expense Allocations

Expense allocations are designed to move the expense of the back office to the front office where the revenue is booked. Profit center managers, product managers, and customer relationship managers in banks that use expense allocations are frustrated with the profitability information they receive. They do not believe the expense amounts allocated to their P&L's and cannot understand the validity of the allocations. In addition, they can't really articulate the problem with their P&L's or understand the amounts they should have been charged. As a result they usually wind up blaming back office managers for overspending and bickering with finance managers over the allocation rules.

To better understand the problem with expense allocations, we will use a business as an example where it's easier to relate to the amounts. Imagine you buy into that business so you really have a net income focus. You put up your capital and buy a Porsche dealership. That feels pretty good, owning a company. Now you wait for sales. A lot of people come in to look at the cars, but no one's buying. Finally someone buys a car for \$100,000. You get to the end of the month and it was the only car sold. Now you turn on the typical bank profitability system, and it reports that you sold a \$700,000 Porsche for \$100,000. Now what do you do? Do you try to figure out how to sell Porsches for \$800,000? Or do you get out of the business because the product is unprofitable?

Obviously the car didn't cost \$700,000. And yet the profitability system allocated 100% of the actual expenses of the dealership to the product. Management needs to know that the Porsche only cost \$80,000 and there's a great margin on the product (product profitability). Management also needs to know that the customer that purchased the car is also very profitable (customer profitability).

Before improvements can be made to planning and budgeting, banks must first fix the measurement of actual profitability and this means replacing expense allocations with a more meaningful calculation.

Linking Measurements to the Operation

For profitability systems to be embraced and utilized by business managers, the measurements in the system must link to the operations being measured. Operations today are truly dynamic. Banks are offering new alternative delivery channels and exciting new products. And the good news is that customers are taking advantage of these new offers. The bad news is they don't announce their transaction intentions. They decide at will whether to visit the branch, call the telephone center, use a debit card or write fifty checks. As a result the utilization of the various channels can fluctuate dramatically over time and the measures within the profitability system must reflect these realities. It is no longer adequate to allocate 100% of a channel's resources regardless of whether or not the customers utilized those resources.

The True Nature of Operating Expenses

Operating expenses, for the most part, are incurred in the positioning of resources. What is the expense of positioning resources? It's the salaries and benefits of the employees who do the work, the expense of the space they occupy, the expense of the machinery they utilize, the expense of heat, light, and power, etc. It is also the expense of positioning computing resources.

These valuable resources are the employees and the computers of the bank that process the work, interact with customers, and handle all of the day-to-day activities that keep the bank operational. Allocating 100% of these expenses to revenue each period, without consideration for what they did or how much they did, creates false pictures of the business and leads to bad decision making.

The Role of Activity Based Costing

Activity based costing comes in two flavors. The first is where activity measurements are used to allocate 100% of expenses of the back office to the front office. Despite using the name "activity based costing" this method results in the same old problems that business managers hate.

The second is where activity based costing follows the concepts of full capacity costing and as a result provides true insights into the nature of profitability, how capacity is positioned and utilized, and the impact of customer behavior on net income. Banks that use this method of activity based costing are creating usage-based charges to profitability statements with channel identity. Activity based unit costs multiplied by the volumes processed measure the usage, and the amounts appearing in the profitability statements actually reflect the amount of resources consumed by customers as they purchase products and services from the bank. And if capacity goes unused it's reported as unused capacity.

The key to creating this information is double entry bookkeeping. Most profitability systems are created with the design emphasis on the debit side of the calculation. This is because of the emphasis on 100% allocation from back office to front office. However, profitability systems that have been designed to take advantage of the power of activity based costing have placed design emphasis on both the debit and credit side of the calculations. This allows for a charge to the P&L with channel and product identity and a credit to the center that did the work with channel and product identity. Creating information on both sides of the transaction is what links P&L's with channel utilization reporting.

Integrating Profitability Information

Another advantage of usage based charges is they allow for the integration of profitability information. Since activity based costs identify the activity performed, these activities can be linked to the transactions processed. The resulting charges to the profitability

statements have product identity and can form the basis for integrating the multiple views of profitability. That is, show profit center profitability by product; or product profitability across profit centers; or customer profitability by product. Using activity based costs in this way also allows for channel usage to be identified.

These four integrated views provide management with the financial information they need to manage the business: profit center profitability, product profitability, customer profitability, and resource utilization reporting. When all of this reporting identifies the channels utilized by customers, then the measures within the financials truly link to the measures within the business. This allows for business managers to plan profitability results instead of just some of the direct revenues and expenses. It also allows for operations managers to base their plans on the front office plans, with product transaction volumes being the linkage.

Budgeting Profitability

Before eliminating budgeting we first have to improve it so it links with the measures of actual profitability. It's a tremendous step forward to have managers budget profitability. Profitability is the ultimate objective of the planning process and the critical goal for which banks should hold managers accountable.

What's required to budget profitability? Banks that have improved the measurement of profitability using activity based costs are in a unique position to budget profitability. To accomplish this they must project transaction volumes. Using budgeted transaction volumes allows the planned activity based costs to be extended by planned volumes to create planned channel usage amounts for inclusion in the budgeted P&L's. This approach to budgeting also supports the creation of integrated budget profitability; that is, budgeted profitability by profit center by product, etc.

Linking Front Office-Back Office

Budgeting transaction volumes also links front office and back office budgeting efforts. Since front office managers are predicting volumes of product to be sold, back office managers can use these amounts to budget the levels of resources required to process the work. When budgeted transaction volumes are used within a profitability system which contains volume budgeting functionality, the double entry bookkeeping creates planned charges to the P&L's and planned credits to the centers that will process the work. Operations managers can use these planned credit amounts to budget levels of resources that are required to process the work. This also becomes the basis to discuss budget variances. If volumes rise above the budgeted levels, the operations managers can make cogent arguments to get resources increased.

This process integrates the planning efforts across the bank. It leads to more interactive dialogue across the organization and truly links plans for market penetration with resource planning. Budgeting profitability should be more than an administrative chore.

It should be an integrated effort to make the best projection possible on how net income and revenue growth are going to be achieved in the future.

Replacing Budgeting with Forecasting

Now that a clear view of actual and budgeted profitability exists, we can take the next step, which is to eliminate the painful annual budgeting process. The logic behind this step is based on the assumption that if there is value in projecting future results then it must make sense to project future results more than once a year.

As mentioned earlier, the budget projection typically goes out fifteen months into the future. This time frame results from some budgeting efforts starting as early as July of the preceding year. During the year when the budget is in force, forecasts are made through end of fiscal year. Why not forecast results consistently throughout the year always projecting eighteen to twenty-four months into the future?

If the recommendations in this article are adopted, then the process can be much less painful than currently experienced in most banks. Consider the insights into the business arising out of integrated profitability results showing channel utilization. Now consider having twelve to twenty-four months of history on this information. This history can be the basis for volume forecasts that drive the integrated forecasts of profitability.

Using Automation to Develop Forecasts

Our research shows that the single biggest obstacle to planning volumes is the business manager's reluctance to get involved with that level of detail. This obstacle can be overcome by utilizing automated systems that create the forecasts using historical data in conjunction with statistical trending packages. This puts the manager into edit mode rather than creation mode. It's much easier to edit a projection than to create one. Another major improvement would be to ask the manager to only interact with key volumes rather than all of them. The system can create the remainder of the required volumes based on key historical relationships among the volumes.

These improvements would result in a rolling eighteen to twenty-four month continuous forecast of profitability and channel usage. Every fall management simply has to review the forecast for the next fiscal year and, when satisfied simply populate the budget for the next fiscal year with those forecast numbers. The pain associated with this process would be minimal since management would be very familiar with the numbers and experienced in working with them.

How Frequently to Reforecast

We believe quarterly updates to forecast would be sufficient. While some may believe monthly updates are required, we believe the quantity of information created and the work required reviewing it is not cost-justifiable.

We also believe twenty-four months of forecast to be most beneficial. Using history as a starting point the creation of twenty-four months of forecast profitability would be very straightforward. Management would not have to edit every number, only the trend lines. In this way, forecasts prepared in January 2004 would have included all of 2005 and 2006. Forecasts prepared in April 2004 would forecast through end of first quarter 2006.

The Future of Financial Planning

The future of financial planning is painless, not painful. Managers, who have unique knowledge and insight into the business, will be reviewing rolling forecasts on desktop screens to edit the future projections and finalize the forecast. The linkage of profit centers to operations will be dynamic. When profit center managers plan to proactively motivate customers out of one channel and into less expensive channels, the forecast will show the impact of that migration. The impact will be reflected in profit center and product profitability forecasts and in channel resource and utilization forecasts.

Likewise when customer behavior changes due to outside influences such as competition, technology advances, or new offers from other industries, the trend lines will show the migration. As senior and executive management develops plans to respond to these realities, the results of those plans will be shown in the new forecasts with integrated views showing the cascading effect through the company of projected change.

Most importantly, management will be focused on real operating results without the credibility issues and internal bickering associated with expense allocations. They will also be focused on the future, not just the future through end of the fiscal year but a future that extends through eight fiscal quarters.

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