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Just-in-time budgeting
for a volatile economy

A volatile economy makes traditional budgets obsolete before they're even completed. Here's how companies can adapt more quickly.

Mahmut Akten, Massimo Giordano, and Mari A. Scheiffele

Most companies find budgeting a formidable challenge even under stable conditions. Managers often spend significant amounts of time on it, only to be dismayed by how little value comes from four to six months' effort. Under volatile conditions, when economic forecasts change from week to week, developing one reliable budget to coordinate business units and track performance for an entire fiscal year is very difficult. Following the traditional budget process may even be unproductive.

There's no easy fix, particularly for very large corporations, and companies that have tried to solve the problem don't have much of a track record. Executives can, however, take several measures to make the process more effective: for instance, scenario planning, zero-based budgeting, rolling forecasts, and quarterly budgeting. Central to all of them is a substantial increase in the CFO's role and a radical speeding up of the budgeting process.

New approaches

For many companies, allocating or withholding resources quickly and efficiently may be the only way to navigate today's very tough environment. A completely new approach to the budget process is often needed. The list that follows isn't exhaustive, nor are the activities on it mutually exclusive. In some combination—depending on the business, size, complexity, and culture of the organization involved—they can help companies improve the budget process.

1. Scenario planning with trigger events

In more stable times, the budget process is typically an exercise in consensus building—a lengthy and difficult effort to generate a single view of the future to guide a company's investments and rewards over the coming year. While many management teams speculate informally on how their businesses will evolve, few actively debate a number of scenarios or undertake the concrete short- and long-term financial analyses that would make such a debate meaningful. The process therefore isn't agile enough to respond to sudden, dramatic changes in the economy. Any revisions to the budget as the year unfolds are reactive and backward focused rather than reflecting an informed view of alternative future scenarios.

Executives at some forward-thinking companies, however, have not only formally developed concrete macroeconomic and business scenarios, including some considered extreme,[1] but also modeled the implications of each scenario for their own businesses and customers, as well as for competitors. At the end of the process, these companies adopted a single budget, but they supplemented it with concrete alternative financial statements and business plans based on plausible future scenarios. This approach lets companies build flexibility into their cost structures—for instance, through the outsourcing of services or the use of contingent purchasing contracts—so they can more easily shift from the primary budget if necessary.

Furthermore, these companies have also identified the handful of events—say, a change in the availability of short-term funding, the bankruptcy of major customers or suppliers, or a specific market share decline—that would trigger a shift from the primary scenario to an alternative. CFOs and the finance function monitor these trigger points and stand ready to alert the executive team if risk levels breach well-defined thresholds. The entire executive team would then immediately implement the predetermined contingency plans.

At one global health care products company, for example, executives monitor sales of specific premium product lines, a key indicator of the future course of revenues and profitability. When the executives saw that customers were buying fewer premium products and greater numbers of basic ones—or none at all—they shifted to a different budget and withheld part of the company's planned second-half 2009 spending until the first-quarter numbers were clear. This company is actually growing and doing quite well, but when its trigger points suggested weakness in a key indicator, executives quickly adapted their approach to resources and investments for the rest of the year.

It's important to note that the CFO need not apply contingency plans to the whole organization; changes can be limited to specific business units, while others continue to implement the current budget. Managers of the affected units must then develop and apply new budgets and incentives and reconsider hedging strategies, capital allocations, and funding.

2. Zero-based budgeting

Amid today's extreme uncertainty, most companies are cutting discretionary expenditures. The typical budget process is not, however, designed to make managers rethink their business models if the recession persists or shifts the economy in a fundamental way. On the contrary, many current budgets are anchored in past ones, with incremental changes to adjust for inflation or specific product trends.

Zero-based budgeting was developed during the inflationary environment of the mid-1970s to avoid precisely this trap.[2] It starts the process wholly from scratch, assuming different end points for different industries and businesses, such as a 30 percent smaller overall market or a modified organization or portfolio. Operating and capital expenditures are then prioritized according to their

[1] See Richard Dobbs, Massimo Giordano, and Felix Wenger, "The CFO's role in navigating the downturn," mckinseyquarterly.com, February 2009.

[2] Zero-based budgeting, first named by Peter Pyhrr in the *Harvard Business Review* (1970), gained prominence during the 1970s, particularly when President Carter introduced zero-based budgeting into the federal budget process, in 1977. See Peter A. Pyhrr, "Zero-base budgeting," *Harvard Business Review*, 1970, Volume 48, Number 6, pp. 111–21.

alignment with the company's strategy and their expected returns on investment. Breaking down the budget into such discrete funding decisions makes it easier for the CFO and other senior executives to choose among competing claims on scarce resources.

Consider, for example the telecom industry, which has changed significantly in the past decade. Most incumbent operators project lower revenues in the near future but must still invest significantly in next-generation networks to be viable in the long term. To balance these competing demands, a European telecom player recently started a zero-based budgeting process by disaggregating its expenditures into logical decision units addressing different types of expenses, such as new capital expenditures (say, building a third-generation network) or maintenance. Each decision unit's capital expenditures (such as those for meeting license requirements or growth in a targeted city) were then classified as "keep," "discuss," or "cut." Finally, executives based the priority of each capital expenditure on its financial returns and alignment with the company's strategy. After only a few iterations, the company reached its target capital expenditure level—a 20 percent reduction, which nonetheless supported investment in future growth.

Clearly, this approach can add a couple of months to an already long process. We therefore recommend zero-based budgeting only for areas promising the highest potential savings—for instance, capital expenditures, certain operating expenditures, and very focused costs, such as procurement. It's useful to identify a company's biggest expenses and which of them can realistically be cut. Some costs, such as those for employees or a branch network's real estate, are relatively inflexible and hard to change. Others, such as advertising or most capital expenditures, could be reset from scratch every year.

3. Rolling forecasts

Most companies prepare informal earnings forecasts on a monthly or quarterly basis, usually in a planning group within the finance department. These forecasts, seldom tied to active decisions about the budget's management, almost always involve nothing more than updated projections of year-end values. As a result, the company-wide process is opaque, no one is accountable for the outcome, and projections for the rest of the year are less and less valuable as it progresses. At one global Internet provider, this haphazard approach meant that some business units projected meeting their full-year earnings targets despite growing gaps between the forecasts and the actual numbers. The finance department, trying to explain the actual numbers and to propose ways of closing the gaps, found itself caught between the CEO and the chief operating officer (COO) on the one hand and the heads of business units on the other. By the time the business units acknowledged that they would miss their targets, it was too late to take compensatory action.

Some leading companies have formalized a process that involves rolling 12- to 18-month forecasts for the most important financial variables. This approach increases the visibility of the process and accountability for it so that CFOs can act when forecasts start to diverge from actual performance. In companies we've observed, the CFO manages the process, convening business leaders, the CEO, and the COO each month or quarter to identify gaps and discuss how to close them. Typically, a good, hard debate among business units examines their performance and generates a way forward.

For companies that aren't accustomed to this kind of collaboration on their budgets, it represents a big cultural change: managers are accountable for their promises and must collectively adapt to the fast-changing macroeconomic climate. At the global Internet provider, simply getting everyone into the same room to discuss the growing gaps between forecasts and performance was a challenge. The CFO had to orchestrate a mind-set shift so that the managers of different units rallied around one another to solve the problem.

4. Quarterly budgeting

In periods of extreme uncertainty, some companies may need to set aside their long-term goals and concentrate on the next three months. Companies under that much stress, especially those attempting a turnaround, ought to abandon annual budgeting and switch to a more tactical quarter-by-quarter process. These companies should focus on cutting costs and on managing their working capital and short-term financial needs, not on developing annual revenue or profit guidance. The quarterly approach allows companies to allocate their resources in real time, to make better forecasts, and to review their performance at the end of each quarter and therefore identify and address problems more quickly.

In the longer run, quarter-by-quarter budgeting can stunt growth by overemphasizing the short term. CFOs and their companies should return to focusing on the long term, with annual budgets, as soon as possible.

General improvements

Whether a company sticks to its traditional approach, implements one of the new ones described above, or combines them to meet its own needs, it should also improve the budgeting process as a whole. These improvements take time to implement, but when carried out from the top down, by the CFO and other senior executives, they can limit the amount of cumbersome work an organization must undertake at the end of each quarter.

Key metrics

At a time when priorities and, indeed, the very business environment itself are changing rapidly, companies must review their key performance indicators (KPIs). Today's focus on cash and risk management requires a reevaluation of metrics relevant to the quality, liquidity, and returns of assets and a shift away from the revenue and growth indicators emphasized in recent years. Often, the new focus just means reprioritizing performance metrics when budgets are prepared or incentive systems linked. Executives must also constantly assess the quality and health of all performance cells[3] in order to detect any deterioration in key metrics—such as the number of orders or customers or the churn rate—more quickly.

A shorter process

The time the budget process consumes must fall dramatically: it can no longer start in September and go on until February or March, as it does at many companies. They can speed up the pace sufficiently only by substantially increasing the amount of top-down guidance from the CFO, synthesizing tracked KPIs, and eliminating formal bureaucracy. In the usual approach, for example, top management introduces a budget that descends to the front line for fleshing out in detail and then returns to the top for finalizing. One way CFOs could accelerate the process would be to conduct negotiations between top managers and the divisions during the first iteration and leave the divisions to manage the budget's implementation by the front line.

[3] For a perspective on how to reorganize performance cells by implementing a value creation approach, see Massimo Giordano and Felix Wenger, "Organizing for value," mckinseyquarterly.com, July 2008.

Level of detail

If an existing budget needs updating rather than rewriting, a company doesn't have to update it at the original level of detail. Business unit managers in many companies imagine that deep specifics and full financial statements reflect greater accuracy. At the level of individual units, for any given year, it's hard to disprove that idea. Many business unit leaders produce a conservative budget, however, so that they are sure to meet or exceed expectations at the year's end. When such unit-level numbers are aggregated, the resulting company-wide numbers are wildly off the mark. Knowing that business unit managers are typically too conservative, executives may pad their forecasts, making the end product all the more unreliable. On occasion, however, individual business units are too aggressive, and that's why one global construction company, for example, missed its aggregate production targets for more than a decade. Less data can actually be more meaningful data if executives restrict the projections of business units to top-line estimates.

Incentives

Any time a budget is modified, changes to forecasts and expectations can affect management's compensation levels and bonuses. Such incentives are typically aligned with specific levels of budget line items, such as volume forecasts, that companies may have to change so they can adapt to volatile economic conditions. Those conditions can render bonuses null as a performance incentive anyway. Why strive to meet a volume target, for example, if the downturn makes it unlikely that you will?

Updating incentives when budgets change appeals to some people but may create great complexity in practice. Negotiating new targets and resetting incentives can politicize the budget process as managers maneuver to impose their own mind-sets: lowering targets to beat them comfortably. New targets and incentives also distract attention from the need to review the business plan and the allocation of resources.

A more appropriate way of structuring incentives is to start using relative targets—such as market share, cost metrics, or health indicators (say, customer satisfaction)—excluding uncontrollable variables. Such targets (for instance, the cost of an airline seat exclusive of expenses for fuel) are relatively insensitive to macro-conditions and thus motivate managers to build the business no matter which scenario comes to pass.

These times of economic volatility call for a faster budget process more closely connected to strategy through the CFO's active intervention. Despite the special challenges, companies can greatly improve their chances of coping with the uncertainty they now confront. MoF

Mahmut Akten (Mahmut_Akten@McKinsey.com) is a consultant in McKinsey's Istanbul office, **Massimo Giordano** (Massimo_Giordano@McKinsey.com) is a partner in the Milan office, and **Mari Scheiffele** (Mari_Scheiffele@McKinsey.com) is a partner in the Zurich office.