

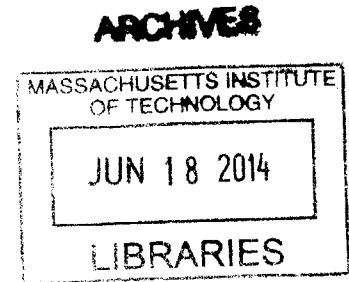
**Corporate Budgeting In Practice:
Driving Strategic Focus and Performance**

by

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Masters of Science, Marketing

The Johns Hopkins University, 2005



Submitted to the MIT Sloan School of Management
in Partial Fulfillment of the Requirements for the Degree of
Master of Business Administration
at the
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Abstract

This paper identifies insights and methods used in practice to address two weaknesses in the traditional corporate budgeting process. One point of failure is the weak linkage between organizational strategy and budgeting – resulting in the proliferation of activities that do not support strategic priorities. The second point of failure is a strong linkage between budgeting and performance evaluation and incentives that leads to behavioral dysfunctions among employees. Together, these challenges create significant barriers to successful strategy execution in organizations. This paper defines the intended role of budgeting, details the challenges that resulted from the two points of failure, and offers a sample of thought-provoking approaches to support practitioners' use of corporate budgeting to help execute organizational strategies more effectively.

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Acknowledgements

Over the course of my career I have gravitated toward the strategic, preferring to examine problems and to devise solutions for connecting disparate “dots”. As I traversed between Public Relations, Marketing Management, Product Development, Innovations and even my experience in the start-up world, the common thread has been strategy. What is the best approach to building awareness or a brand for a product/service, or firm? Which method is ideal for conveying key value propositions to customers or employees? What is the optimal product design for addressing customers’ needs? Which path is best to take to bring about an organizational turn-around? How should a firm position itself and grow its customer base? These are all questions I have enjoyed answering throughout my career and I do so with a tenacious curiosity about problems and relentless pursuit of sustainable solutions. One of parents’ favorite tales is the case of my encounter with a puppy with four broken legs (the problem) as an elementary school-aged kid. My solution was to fashion homemade splints for all four legs and ensure he had a consistent supply of food and water. A remarkable feat given my age and the fact that I probably saw something similar once on TV. As a problem-solver, the sense of elation I felt to see that puppy begin to walk is the same sensation I feel when I have my ‘ah-hah’ moment while facing a problem today. And the euphoria I feel when I recognize my solution or strategy has begun to work.

It is in that same spirit that I pursued this thesis topic. The problem I observed was the difficulty my organization, the U.S. Postal Service, and many organizations have executing some of its best strategies. Despite well-conceived plans, motivated employees and lots of energy involved in many activities, execution falls short. As a problem-solver and disciplined strategist, I wanted to examine the role that corporate budgeting should and could play to help organizations execute better.

Given that I possess no domain expertise in finance, the development of this thesis was the result of many people sharing their time, expertise and resources to aid my learning. They include: Xavier Giroud (my MIT academic advisor), Joseph Corbett (CFO of USPS); Cynthia Sanchez-Hernandez (USPS VP of Pricing); Anil Kurian, Daryl Kinnard, Eugene Sutch and Kelly Dougherty (USPS Corporate Finance); Steve Monteith, Tom Foti and Elke Reuning-Elliott (USPS Product Management) and Sebastian Castaneda (Finance executive at Ecopetrol) and Andre Barros (former CFO of Ferrous Resources).

I would also like to thank my family and friends for their moral support and putting up with my frequent exit line, “Gotta go! I must work on my thesis!”

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Notes

The terms 'firm', 'organization' and 'business' are used interchangeably throughout this document. The topic is explored at a fundamental level, and it is believed that, at this level, the principles outline within apply broadly to organizations regardless of their structure: corporation, non-profit or government agency.

Chapter 1

Introduction

Most multi-billion dollar organizations develop strategic plans every year to convey how they will generate returns to meet the expectations of their stakeholders. A robust portfolio of initiatives is maintained, and a flurry of activities ensues each year in an attempt to achieve the goal of exceeding costs with revenues. Senior executives face critical questions while seeking to sustain and increase organizational growth: a) which initiatives should be pursued to actualize its strategy, b) how many initiatives are sufficient for a firm's portfolio to support its strategy, and c) how best to resource activities to achieve the desired results? In other words, how might we successfully execute our chosen strategy to actualize returns?

While corporate budgeting has many functions, the process is one method firms use to formally evaluate initiatives and select those that hold potential to assist in reaching their objectives. "A budget is defined as the formal expression of plans, goals and objectives of management that covers all aspects of operations for a designated time period. [It]...focus[es] on the importance of evaluating alternative actions before decisions actually are implemented. [It also] ... allocates funds to achieve desired outcomes" (Shim & Siegel, 2009). Budgeting is one of the tools senior executives have at their disposal to drive

focus on and alignment with their strategies as well as bolster the organization's performance in pursuit of its mission.

Nearly all organizations have a formal budgeting process yet many lament the inability of the process to ensure the proper strategic focus and performance yields needed to achieve its goals. In recent study conducted by CFO Research Services of finance executives in large companies with annual revenues greater than \$2Billion, the firm found that there is pervasive “[d]issatisfaction with financial planning ... across the organization from executives who can’t trust the accuracy and outputs from the process to the front line managers who question the amount of time spent on activities supporting the analysis...” (CFO Research Services, 2011). Despite the key role financial planning plays in driving business performance, the process is deemed limited in value due in part to “financial drivers and metrics that don’t align with strategies” (CFO Research Services, 2011).

The reasons are manifold. In fact according to David Norton of the Balanced Scorecard Collaborative, “... no management system has a greater impact on performance... [than budgeting]. [Yet there is a]... basic structural incompatibility of the strategic planning and the budgeting processes ... mak[ing] it difficult to link the long-term process (strategy) and the short-term process (budgeting) (Norton, 2006). Organizations are replete with examples of what occurs when budgeting does not function as the critical filter that it should be.

Consider one example common to firms: “project overload” in which too many concurrent projects are allotted budgets, resulting in diluted human resources and reduced organizational effectiveness.

Despite possessing the very strategic task of (a) ensuring organization-wide focus on the firm's strategy and (b) providing performance motivation, there is a growing chorus of academics and practitioners that proclaim that corporate budgeting is broken and incapable of delivering on these responsibilities. A recent CFO Research Services study revealed that senior financial executives believe that the budgeting process is so time-consuming and inflexible that “the final budgets often fall out of step with quickly evolving business conditions”, rendering them outdated and stale by the time they are complete (CFO Research Services, 2011). Despite spending 25,000 person days each year on the budgeting process (Gary, 2003), according to a recent Balanced Scorecard research, 60% of firms do not link their budgets to their strategies (Norton, 2006). Without proper alignment between budgeting and strategy, the process is reduced to an annual rubber stamping exercise sanctioning ‘business as usual’. These findings lend credence to the suggestion that there are structural inadequacies in the budgeting process rendering it ineffective at functioning as the strategic tool it should be.

Even when conscientious management pursues best practice techniques, processes and technology to manage corporate budgeting, shortfalls continue to

occur due to the human factors necessary in driving organizational performance. Leadership, culture and employee motivation are critical success factors for a firm in general, and that has particular implications for the enterprise performance management discipline, as well. In other words, people are at the heart of this corporate budgeting challenge. This fact is acknowledged by the emergence of behavioral finance which studies how psychology, the basis for human desires, goals and motivations, and its impact on financial behavior of practitioners (Shefrin, 2002). "In behavioral finance, it is acknowledged that the psychology of employees has influence on the decisions they make and on their work motivation" (van Moorselaar, 2011).

Academics and practitioners agree that corporate budgeting as employed today embeds incentives that motivate people to act in their personal best interest not the best interest of the firm. In fact "the [flawed] budgeting process is so deeply embedded in corporate life that the attendant lies and games are simply accepted as business as usual, no matter how destructive they are" (Jensen, 2001). "A common criticism of the traditional budgeting process is that it results in negotiated targets that provide incentives to minimize goals to more easily reach incentive bonuses. The conflict of interest between goal setting and individual rewards often results in dysfunctional behavior that can destroy an organization. Fixed targets are negotiated in a game of liar's poker where managers are incented to minimize goals and projections. As a result, the various levels of the organization regularly try to minimize expectations instead of

stretching to achieve maximum results” (Player & IBM, 2009). This misalignment of incentives and goals is one root cause of firms not actualizing their real potential in the marketplace.

The two inadequacies examined in this thesis include a) the weak link between strategy and budgeting, and the strong link between budgeting and performance evaluation and incentives. Despite the observed flaws in corporate budgeting theory and practice, and the dysfunctional human behaviors that have grown up around the process, some organizations stand out for having devised ways to overcome these limitations.

Objective of Thesis

The intent of this thesis is to examine the insights and practices of those best in class firms to answer a few questions regarding corporate budgeting: If the role of the budgeting process is to “...give financial expression to strategy” or to be the “tool by which an organization transforms its strategy into action” (Infor Corporation, 2009), how then could the budgeting process drive organization-wide focus on its key strategies? What best practices link budgeting to strategy to in order achieve the proper focus? How might the budgeting process be used to effectively identify the best initiatives that support the firm’s strategy and filter out projects that distract from strategic focus? What human capital-focused practices are leveraged by organizations to drive desired performance? How might the

budgeting process be used to properly motivate employees to perform in line with the firm's best interests?

At the heart of the question posed by this thesis is the discipline of execution. In other words, it seeks to document how corporate budgeting can be used to help organizations execute their strategies more effectively. It is designed to stimulate thinking on how to better use a core business process (corporate budgeting) to increase organization's competency at executing its strategy. It is an important question because the failure to execute is the biggest reason CEOs fail (Charan & Colvin, 1999). This is true whether the organizational type is corporation, non-profit or government. Those working in the corporate world may experience the consequences of failed execution more immediately but all organizational types will eventually suffer the same fate – removal of senior executives and/or the eclipse of the organization by a competitor that is better able to deliver results in the marketplace. An inability to perform leads to obsolescence.

Scope of Thesis

The aim of this thesis is to highlight theory but to focus primarily on what has been explored in practice among organizations. Section two expounds on **the role of budgeting in the firm and its relevant challenges**. Section three highlights best practices for **linking budgeting to a firm's strategy** in order to achieve organization-wide focus on priorities. Section four examines the human

factors inherent in enterprise performance management and how leading organizations manage **employee motivation, incentives, and behavior to achieve the firm's desired objectives**. Section five concludes the work with additional considerations on the subject.

Methodology

This thesis has been produced through a review of academic and business literature. It should be noted that relatively few numbers of works have been generated within the academic community on this topic. Hansen, Otley and Van De Stede acknowledged the lack of research on this topic by stating “[there are]... practitioners’ concerns with budgeting problems that the scholarly literature has largely ignored while focusing instead on more traditional issues like participative budgeting.” The team wrote *Practice Developments in Budgeting: An Overview and Research Perspective* “to demonstrate the level of concern with budgeting among practitioners, to suggest potential for continued scholarly research and to raise academics’ awareness of the disconnects between budgeting practice and research” (Hansen, Otley, & Van der Stede, 2003). Therefore by design (the desire to analyze strategies and tactics that have worked in practice) and literature availability, this thesis relies heavily upon business research and practitioner literature. The content was also derived from a series of interviews within the sponsoring organization of the thesis writer (U.S. Postal Service) and select firms from diverse industries.

Chapter 2

The Role of Budgeting

Corporate budgeting has been employed as a means to managing organizational cash for much of business history. Modern finance has its origins in 1950s. The function has experienced an expansion in its role since then including the introduction of performance management into budgeting by linking financial targets and employee incentives to reach those targets. "Formal budgeting using modern budgeting disciplines emerged in the 1950s as the numerical underpinning of corporate planning". "Budgeting has evolved into a tool of control and compensation. Because of its importance and complexity, it should be managed with skill and care" ("Budgets and Budgeting," n.d.).

A survey of academic and business literature establishes that there are many functions that the budgeting process can serve (Wyatt, 2012) (Shim & Siegel, 2009). One of the most important roles is expressing the corporate strategy in financial terms. A budget is simply a different, more detailed view of the corporate strategy. "The budget can act as a plan to help us to achieve our objectives. In fact, in many US organizations, the budget is often referred to as the annual operating plan. ...[It] is a costed version of what we are going to do over the year" (Wyatt, 2012). To achieve its goals, a business must express its strategy in a measurable way. Organizations do this by identifying revenue-

generating projects that support its strategy and provide a means for the organization to achieve its goals.

If constructed and managed properly, budgeting should be a natural outflow of the strategy planning process. Stated differently, it should be a continuation of the strategic planning process that gives financial expression to senior managers' strategic intentions. "Budgets are necessary to highlight the financial implications of plans, to define the resources required to achieve these plans and to provide a means of measuring, viewing and controlling the obtained results, in comparison with the plans" (Ioana-Diana, 2013).

At the same time, budgets also act as a monitoring and controlling mechanism, an employee motivation device and performance planning tool. Budgets are considered to be "a major feature of most management control systems. When administered intelligently, budgets compel planning, provide performance criteria, and promote communication and coordination within the organization" (Horngren et al., 1994)(Wyatt, 2012).

Given these two functions, budgeting provides two important check points that could help ensure an organization is executing its strategic priorities. As illustrated in Figure 1, if the budgeting process works as it is intended, proposed organizational activities will be filtered during the budgeting cycle. (By filter we mean evaluated for its alignment with strategic priorities, among other things).

This budgeting filter should theoretically allow (filter in) only those activities that support strategic priorities into the corporate work stream. Performance evaluation should motivate employees to focus and place effort on executing the same strategic priorities that have been introduced into the work stream. It should help filter out behavior that is misaligned with strategy and support decisions to filter out activities that do not perform in line with strategy. If used properly, the two check points act as strategy reinforcing opportunities (force multiplier) ensuring only strategy focused activities and behavior are maintained in the corporate work stream. This is the act of executing strategy – identifying proper activities, resourcing the activities and motivating behavior that actualizes best results.

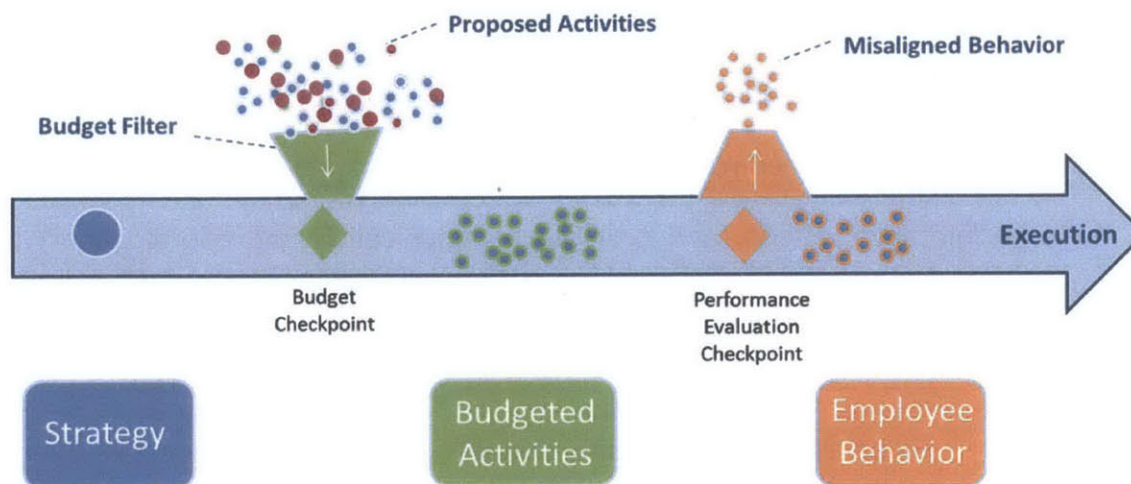


Figure 1 – Strategy-Budget Linkage Drives Execution

If the budgeting process works as it is intended, it acts as a force multiplier. Organizational activities will be filtered during the budgeting cycle to allow only those activities that support strategic priorities to enter workflow. Performance evaluation multiplies the force even more by establishes the proper motivation among employees that bolsters their focus and effort on executing the same strategic priorities.

These two roles place the finance unit in a position of vital importance within an organization. It should not merely exist as a support service (doling out funding for pet projects) or internal compliance (halting activities that have no remaining funding) branch as many firms have relegated this function. Rather, it is elevated to the most strategic of functions within the organization, one that helps express the very reasons for a firm's existence. This strategic purpose of finance has been 'rediscovered' as of late and can be substantiated by an increase in the number of organizations looking to finance executives to help them achieve high performance (Schulman & Axson, 2014) (Ernst & Young, 2011). Finance executives are now being thrown into the center of activity as key participants in corporate strategy and leadership. In fact in a recent Accenture study of 200 organizations in the public and private sectors, it has found that there is a strong correlation between firms that have invested in developing high performance finance units and those that exceed in overall business performance (Boulanger & Stewart, 2006). And the fallout from the 2008 financial crisis helped bolster the case for assigning a more strategic significance to finance.

"The empirical evidence suggests that the best finance organizations contribute directly to the manner in which the organization as a whole maximizes its value in its industry. Such value is not measured simply as earnings per share. In the marketplace, stock price is based on expectations of future cash flows adjusted for risk, not on traditional accounting metrics. So finance

executives must be able to discern what drives current and future value, and then help make the essential linkages between financial capabilities and long-term performance. In this way, the finance organization helps decision makers understand strategic, tactical and operational levers in economic terms. This is crucial to maximizing shareholder return—and it enables the finance organization to help the enterprise respond more effectively to changing business conditions” (Boulanger & Stewart, 2006).

Criticisms and Challenges of Corporate Budgeting

Despite the near universal use of corporate budgeting, criticisms of the traditional process are pervasive and highlight a variety of points of failure in the process. Quoting Jack Welch, former CEO GE, “Not to beat around the bush, but the budgeting process at most companies has to be the most ineffective practice in management (The Economist Newspaper Limited, 2009).

The specific complaints run the gamut from its lengthy process that generates a stale document out of synch with rapidly changing business environment to its encouragement of employee behavior that’s misaligned with corporate interests. For the purposes of this thesis, the two important areas of note include criticism around a) the strategy and budgeting linkage and b) the budgeting and performance management linkage. The two components are related, and they require deeper probing. The lack of a proper connection

between the initiatives approved through the budgeting process and the strategies initially formulated by senior management will result in an organization not delivering on its most important goals. Organizational resources have instead been diverted to activities that may appear as important to front line managers despite their misalignment with senior management. In a similar way, tethering performance evaluation to budgeting exacerbates the misalignment between strategy and targeted action. This is driven by short-sighted activities that aim to meet self-imposed performance targets which may not be in the organization's best interests. The net result of failures at both points in the budgeting process is the emergence of a strategy – performance gap that renders the organization unable to effectively execute its strategy. Unlike an optimally functioning budgeting process that acts as a force multiplier, a poorly functioning budgeting process fosters force dispersal.

Challenges Linking Strategy and Budget

The Challenge

Norton notes in “Linking Strategy and Planning to Budgets” (Norton, 2006) that “[a]ccording to Balanced Scorecard Collaborative research, 60% of organizations do not link their strategies to their budgets”. The absence of this strategy-budget link is the reason “most organizations cannot execute their strategies”. Norton goes on to explain that the nature of strategic planning is

long-term, future-oriented while the nature of the budgeting process is short-term, present and backward-oriented. The two have distinct purposes that should be managed separately, but synchronized. However, this synchronization largely goes unaccomplished.

This lack of alignment is not lost on employees and organizational stakeholders. A 2007 study by Price Waterhouse Coopers, noted that “executives and other stakeholders have long vilified the budgeting and planning processes.” This resentment stems from the perception that the process is not aligned with actual performance and the observation that budgeting needs to be better aligned with the corporate strategy. The study explains that the resulting irrelevance of the budgeting and planning processes is demonstrated by the extent to which “analysts and shareholders largely ignore performance against budget in favor of other performance metrics” (Price Waterhouse Coopers, 2010).

Sources of the Problem

The top-down process originating from senior management typically reflects the strategic objectives of organizational leadership. The bottom-up budgeting process captures project level details that are summarized in the top-line view of the final budget. This top-line view impedes senior executives’ visibility into the activities and resources allocated to line manager activities. The

muddy nature of the traditional budgeting processes makes it difficult for senior managers to decipher low value from high value activities. In response to the opaqueness of the process, management typically engages in "... across-the-board [cuts or increases]—even though [they]... know that this approach penalizes the high-performing units and props up the underperforming ones. The result is a decoupling of the company's resource allocation process from the highest-value strategic opportunities" (Gary, 2003).

Organizational resources thus are diverted to activities selected by front line managers who may lack proper insight into strategic objectives - generating misalignment with organizational priorities. The problem is exacerbated by the annual practice of allocating financial resources via a "budget plus or minus" calculation. Plus or minus allocation method does not allow for critical evaluation of organizational activities but rather allocates the same funding plus or minus a flat percentage across the board. This practice has the result of allowing a category of initiatives to be set adrift, coasting sometimes for years unsynchronized with strategy. "...Budgetary controls often impede the pursuit of strategic goals by supporting such mechanical practices as last-year-plus budget setting and across-the-board cuts. Furthermore, the budget's exclusive focus on annual financial performance causes a mismatch with operational and strategic decisions that emphasize nonfinancial goals and cut across the annual planning cycle, leading to budget games involving skillful timing of revenues, expenditures, and investments" (Hansen et al., 2003).

If this scenario plays out within an organization, the de facto strategy is comprised of the initiatives that are driven by front line managers, and that appear in the approved budgeted, not the strategy envisioned by senior executives. "Budgeting and performance are typically overseen by the finance department... whereas planning is coordinated by a strategy department. Often, the two processes aren't well integrated, resulting in strategies that are often dictated by the budget process instead of vice versa" (Gary, 2003). In this case, the strategy is what employees do – not what is written on paper. In other words, to know a firm's true strategy, do not look to the official strategy document but look to its budget instead.

Outcomes of the Strategy Gap

The net result of this pervasive misalignment over years within an organization leads to a pronounced inability to execute in the marketplace. The failure to execute is the biggest reason CEOs fail (Charan & Colvin, 1999). Charan and Colvin explain that based on their research, failure is rarely due to intelligence or an inability to devise great strategies and objectives. Rather, the inability to make those strategies happen is the most significant reason for failure. The pair cites Kodak as an example. "When Kodak ousted Kay Whitmore, conventional wisdom said it was because he hadn't answered the big strategic questions about Kodak's role in a digital world. In fact, Kodak had created,

though not publicized, a remarkably aggressive plan to remake itself as a digital imaging company. Whitmore reportedly embraced it. But he couldn't even begin to make it happen" (Charan & Colvin, 1999).

The mechanism to link strategy and budget is an important component of the organizational axle enabling it to actually navigate properly. An inability to execute ultimately leads to obsolescence. Whether the organization type is corporation, non-profit or government, the principle is the same – its ability or inability to execute is factor (in part) of the strategy-budget link.

Challenges Linking Budgeting to Performance Evaluation

The Challenge

Much has been written about the susceptibility of the budgeting process to "gaming and dysfunctional behavior" (Hansen et al., 2003). According to a 2007 PwC Budget and Forecasting Study, "over 53% listed the annual budget as a primary driver of compensation plans, rewarding and enforcing behaviors that are not always in line with the company's best interests" (Price Waterhouse Coopers, 2010).

Tethering budget targets to performance-based compensation has led to a category of myopic budget-driven behavior by employees. Gary cites the Beyond

Budgeting movement's source of the problem – the “fixed-performance contracts”. They believe that the phrase “fixed-performance contract” reflects the fact that targets spelled out in the budget act as an implicit fixed contract between the organization and employee (Gary, 2003). He states, “A recent Hackett survey found between 60% and 90% of the top 2,000 global companies have this sort of contract. And there are usually financial incentives attached: Career prospects and bonuses ride on this contract—incentives for hitting the targets amount to as much as 97% of a U.S. manager's annual salary” (Gary, 2003). He believes this is the most significant flaw in the budgeting process.

The most prevalent of the “games” played by employees include a) “padding” budget requests with inflated costs to ensure their budgets survive the negotiation period (also known as the “cutting rounds”) with what he/she believes is a reasonable budget¹, b) securing easily attainable targets (also known as “sandbagging” or “lowballing”) to ensure they meet or exceed “expectations”, c) manipulating budget reports to appear to achieve targets, and d) spending needlessly to maintain existing budget levels in subsequent years. “Those who earn the best performance ratings are often the most skilled in negotiating easily achievable budget targets for themselves. Even more damaging, many will manipulate numbers in their budget reports to inflate results and artificially achieve short-term targets. And others will spend money wastefully so as not to see a reduction in next year's budget allocation” (Merchant, n.d.).

Beyond the rigging, the dysfunction extends to the working relationships between employees. “It sets colleague against colleague, creating distrust and ill will” (Jensen, 2001). It reinforces the natural silos that exist in organizations and acts as a disincentive to collaborate across divisional lines because budget dollars are subject to an annual competition for silo-oriented projects. The performance targets further bolsters this divide by providing silo-oriented feedback and rewards. What’s more “[b]udget targets are also typically financial in nature ignoring the non-financial that help drive focus on strategic objectives (van Moorselaar, 2011).

Sources of the Problem

Pay for performance and other incentive programs encourage gaming because they trigger an increase in compensation (typically in the form of a bonus) when budget targets are met. Employees, as a result, may take steps to make those targets as easily achievable as possible or manipulate results (e.g. spreading the results across multiple years, channel stuffing, etc.) to avoid suffering their organizational “penalty” for not meeting those targets. The human tendency is to adopt creative methods to meet performance targets in order to avoid penalties and earn rewards.

Also at the heart of this problem is the issue of establishing budget targets with little to “no reference to a credible (outside) source” and the fact that targets

are locked in for the entire year (Hansen et al., 2003). In most organizations, the front line managers are expected to be experts in their respective business areas because they are closest to the customer, products/services and issues. As a result, budget targets are not aggressively challenged. Instead organizations use “across the board” tactics during the negotiation phase to bring the final budget under the organizational ceiling for that year.

The Outcomes of Performance Dysfunction

Consider if the organizational carrot (promise of rewards) and stick (consequences of missed targets) inherit in the budgeting-performance mechanism encourages every front line manager to fudge numbers ‘just a little’. Taken across an entire organization, typically with hundreds of budgeted initiatives, the sum of this behavior leads to a real problem in a given year. Taken over years, this behavior will undermine the organization.

At the individual level, employees become reward-obsessed and thus short-sighted with little incentive to act in the firm’s best interests or the best interest of its customers if those interests do not align first with employees’ interests. It also leads to internal competition among employees and/or departments who engage in protectionism to maintain turf and power which are conveyed through sizable budgets. (Hansen et al., 2003)(van Moorselaar, 2011).

Such budget-driven competitiveness threatens cross departmental collaboration necessary to execute organization wide strategies.

Over time, the organizational culture becomes corrupt. "[S]henanigans ... become so common that they're almost invisible. The budgeting process is so deeply embedded in corporate life that the attendant lies and games are simply accepted as business as usual, no matter how destructive they are". "Moreover, since managers are well aware that everyone is attempting to game the system for personal reasons, you create an organization rife with cynicism, suspicion, and mistrust" (Jensen, 2001).

In aggregate, this behavior entangles the organization in a web of distortion which misleads decision making firm-wide. Top-down initial budgets may establish a ceiling on spending but the performance-derived budgets lock in a cost floor that artificially sets it higher than it actually is (Gary, 2003). Having created a culture rife with the sharing of distorted data, decision making from cubicle to the board room will potentially direct the organization further from its true objectives. Coupled with the sub-optimized operating plan that has established mediocre performance targets relative to competitive performance, distorted data will eventually undermine the organization (Jensen, 2001).

The traditional link between budgeting targets and compensation drives an organization to become insular as each person's motivations are shaped by

individualistic incentives in which each player retains control over the “goal” line. The net result is an organization that is quite literally competing with itself instead of competing with its true opponents in the marketplace. A certain amount of performance atrophy sets in as the firm loses its ability to perform on par with real competitive benchmarks because the focus is instead on winning internal budget wars and clearing the wrong performance hurdles.

Adding together the net effect of (a) the misalignment that results from the a weak or absent strategy budgeting link and (b) the misalignment that results from the strong link between budgeting and performance incentives, it is clear how and why executing strategies remains a challenge in organizations. Instead of acting as a force multiplier as shown in Figure 1, the combined improper linkages fosters force dispersal (Figure 2). In other words, if there is a weak or absent link between strategy and budget, the budgeting process does not properly filter out activities that do not support strategic priorities. Activities, instead, pull the organization’s resources in different directions, away from its intended target. A strong link between budget targets and performance incentives has the same effect of diverting resources away from the intended goal and diminishing profitability. This is a result of employees being driven by rewards and / or punishments have them act in their personal interests instead of the firm’s. Lower than required resources are thus allocated to activities that are aligned with strategy and provide execution momentum.

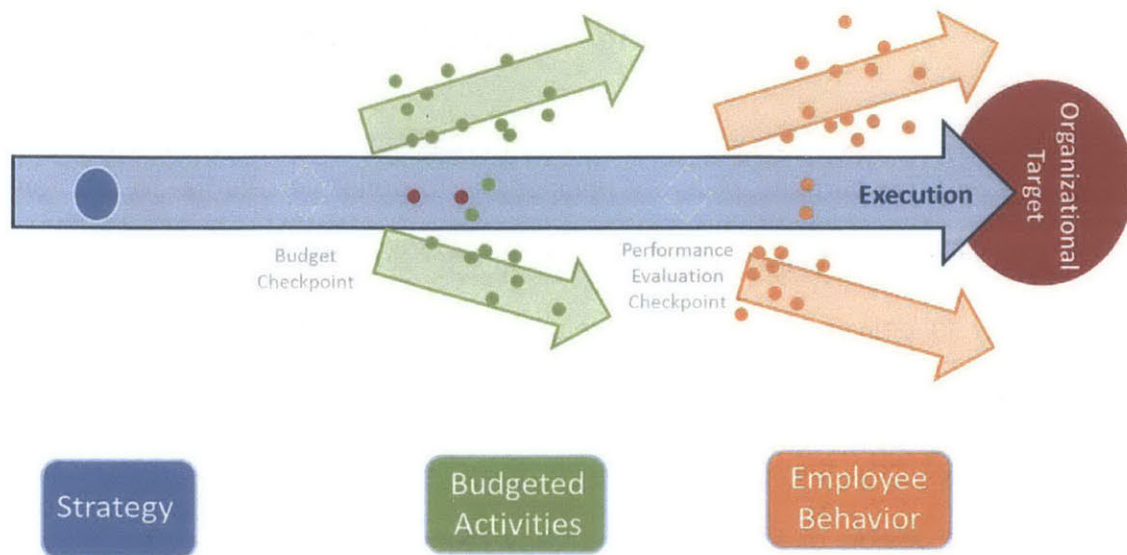


Figure 2 - Poor Linkages between Strategy, Budgeting and Performance

If budgeting is not used properly, it fosters force dispersal. A weak or absent link between strategy and budget results in a budgeting process that does not properly filter out activities that do not support strategic priorities. Activities, instead, pull the organization's resources in different directions, away from its intended target. A strong link between budget targets and performance incentives can have the same effect of diverting resources away from the intended goal and diminishing profitability if performance planning is distorted with myopic motives. Lower than required resources remain to support strategy focused activities.

The first point of failure at the budgeting filter allows organizational resources to be dispersed across a wide variety of disparate activities with little returns for the actual strategy. The second point of failure compounds those results with a distortion of the reality in which the organization operates.

Chapter 3

Linking Strategy to Budgeting

The purpose of every business is to generate returns. In fact, even non-profit organizations and governmental agencies are created and structured in a way to deliver some type of return for their stakeholders. Regardless of their form, organizations engage in strategic planning to devise a roadmap that outlines how they plan to achieve the desired returns. "A strategic plan is the grand design of the firm and clearly identifies the business the firm is in and where it intends to position itself in the future. Strategic planning translates the firm's corporate goal into specific policies and directions, sets priorities, specifies the structural, strategic and tactical areas of business development, and guides the planning process in the pursuit of solid objectives" (Dayananda, Irons, Harrison, Herbohn, & Rowland, 2002).

Once strategic plans are developed, it is the role of the budgeting process to support the build out of operational plans that give expression to the organizational strategy. "Budgets are necessary to highlight the financial implications of plans, to define the resources required to achieve these plans and to provide a means of measuring, viewing and controlling the obtained results, in comparison with the plans" (Ioana-Diana, 2013). In other words, budgeting adds the tactical, quantitative dimensions to the organizations roadmap such that it can be executed by its employees. "The budget is supposed to be the tool by

which an organization transforms its strategy into action (Infor Corporation, 2009). “In essence, the budget is the instrument with which the manager underlies and implements decisions, takes responsibility for the efficient use of resources and controls the income level, expenses and profit” (Ioana-Diana, 2013).

Yet, as previously noted, “... only 40% of organizations link their strategies to their budgets” making it understandable that most organizations cannot execute their strategies (Norton, 2006). The absence of this connection between the organizational strategy and budget is the first point of deviation away from the most important priorities. And as a result, resources will be allocated instead to activities that have not been validated as driving the value internal and external stakeholders seek. “[I]f a budget is designed without reference to the strategies it is supposed to support and the resources available, the corporation will not move towards its desired goals” (Infor Corporation, 2009).

Drs. David Norton and Robert Kaplan have worked nearly twenty years to understand and apply a framework that helps organizations execute their strategies. Norton explains from his work at the Balanced Scorecard Collaborative that without an explicit strategy-budget link, strategic and operational activities are indistinguishable. As a result, the latter (shorter-term actions, tactics) will preempt the former (long-term actions, strategies). This tendency will have the organization “sacrifice [its] long-term viability” (Norton,

2006). In Norton's opinion, no function within an organization has a greater impact on performance than budgeting.

Methods in Practice

Despite the absence of the important strategy-budgeting link in many organizations, leading firms are implementing tactics to bridge this chasm. The methods being employed by practitioners to link budgeting to strategy as observed through the literature review process can be grouped into three categories: process integration, resource re-allocation and project visibility.

Process Integration

Process integration tactics leveraged by organizations point to the separation of strategy from budgeting (through distinct processes) as the source of misalignment. The working theory is that strategy, planning and budgeting are successive stages of a singular organizational process flow. This theory thus calls for one overarching organizational process that acts as a focusing agent linking budgets to strategy by enforcing a waterfall style process in which each successive step builds upon the previous.

Gary in his piece entitled, "Breaking the Budget Impasse" (Gary, 2003) quotes a principal of Marakon Associates, Mike Baxter, highlighting this

organizational structure challenge, “Budgeting and performance are typically overseen by the finance department whereas planning is coordinated by a strategy department. Often, the two processes aren’t well integrated, resulting in strategies that are often dictated by the budget process instead of vice versa”. Baxter goes on to suggest that an all-in-one process be created with the CEO setting all the strategic goals across units, reviewing alternatives and linking resources to high value-creating activity.

Infor Corporation suggests the following simple process flow, for example, to ensure budget is linked to strategy:

“Senior Management (Corporate) Activities

1. Define key objectives.
2. Identify strategies and impact.
3. Document assumptions.

Operational Management Activities

4. Develop tactics and high-level operational budgets.

Management Review Activities

5. Assess and mitigate risks.
6. Check the plan for completeness and finalize it” (Infor Corporation, 2009)

The literature review identified at least three approaches that have been formulated to address the challenge of process integration.

- *Strategy Management System*

A common mechanism used among organizations is to leverage a 'strategy management system' – a formal process to formulate and implement strategy systematically throughout the organization – to naturally align budgeting (as well as other business activities) with strategy. The most notable of such systems is the Balanced Scorecard (BSC) and its variants. The modern-day form of the Balanced Scorecard was developed by Drs. Robert Kaplan (Harvard Business School) and David Norton (Figure 3). The intent was to evolve the organization's strategic plan from a 'passive document' to one that provided clarity needed to execute the strategic objectives throughout the organization. It is both a management and measurement system that enables strategy to be translated into action, but also helps the organizations understand what needs to be measured. It uses four lenses – finance, people (learning and growth), customer, and operation (internal process) – through which to measure performance thereby balancing the perspectives to which senior executives are exposed. "It provides [holistic] feedback around both the internal business processes and external outcomes in order to continuously improve strategic performance and results" (Balance Scorecard Institute, n.d.).

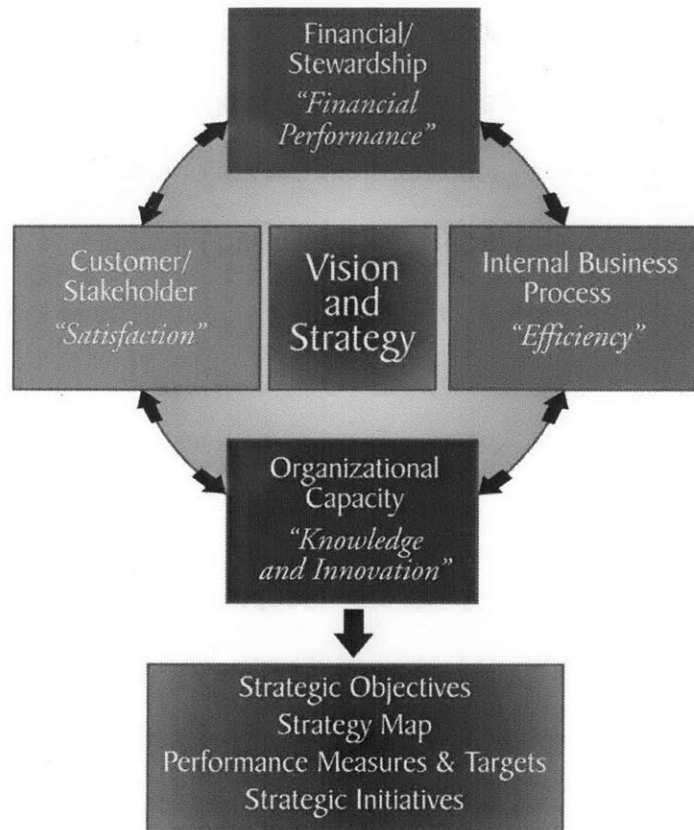


Figure 3 - Balanced Scorecard as a Strategic Management System

One of the important contributions of the Balanced Scorecard is the introduction of non-financial performance measures. The belief is that financial measures are backward looking— providing insufficient guidance for what should be done in the future to meet strategic objectives. The customer, operation and people measures are believed to be predictive of future success (Shim & Siegel, 2009).

The Balanced Scorecard and its variants enable one important practice – the identification of strategic measures with KPIs and the “cascading” of those metrics down through the organization. Budget management then becomes a

case of managing costs but also delivering on the KPIs for strategic priorities. “The Balanced Scorecard methodology considers the integration between budgeting and the [scorecard] as the major pillar in the management principles of a strategy focused organization: making strategy a continuous process” (Shim & Siegel, 2009). It forces the allocation of resources to the most strategic initiatives.

- *Organizational Structure*

Among the practices adopted as a remedy for strategy-budget misalignment is an organizational redesign, either at the firm-level or the finance unit level, to help achieve better synchronization. Gary (2003) offers that experts believe “hous[ing] strategy planning and budgeting in the same office” is the best method of alignment.

McKinsey and Company conducted a survey of Finance and C-level executives and found that while 43% (as high as 49% in some industries) use finance as a strategic tool to support value creation by identifying opportunities, few make structural changes to enable this (Broer, Kiefer, Melwani, & McKinsey & Company, 2009). Yet there is a segment of firms that have leveraged organizational structure as a bridge.

Kaplan and Norton noted that companies have achieved “performance breakthroughs” by implementing strategy management systems because they

Kaplan and Norton noted that companies have achieved “performance breakthroughs” by implementing strategy management systems because they align key management processes with strategy. A key success factor for sustaining their performance, they allege, is the creation of a corporate-level “Office of Strategy Management”. Taken more broadly, the general principle of establishing an office to guide and coordinate the siloed strategy execution activities that occur across an organization is worth noting as a best practice.

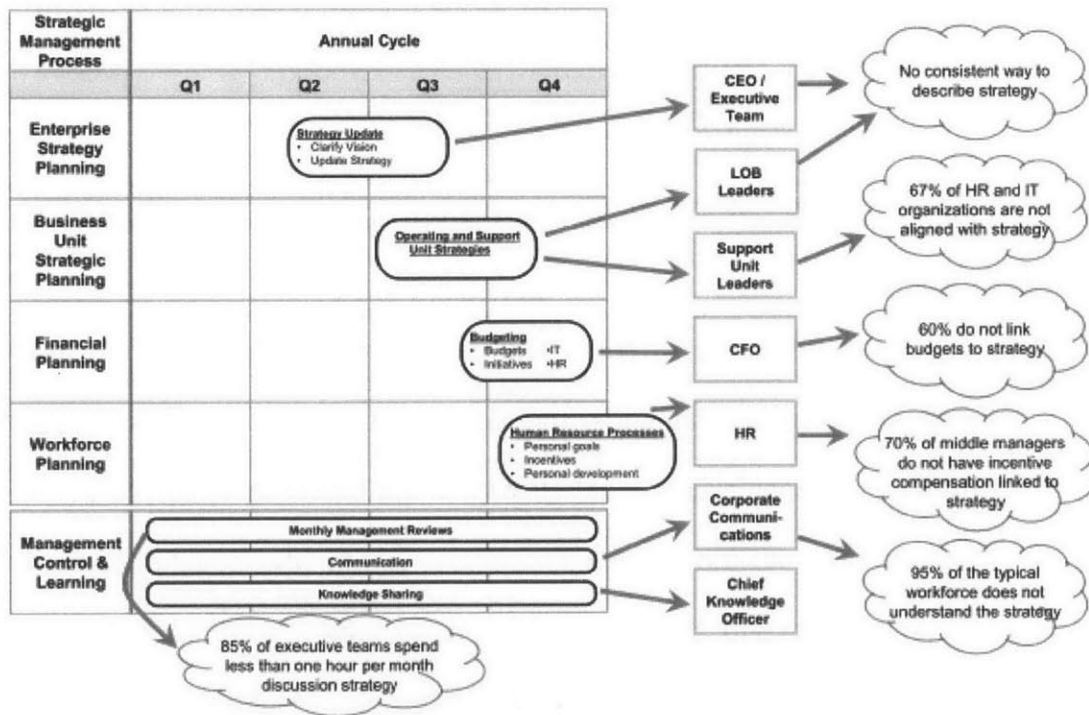


Figure 4 - Uncoordinated Management Processes (Kaplan & Norton, 2005)

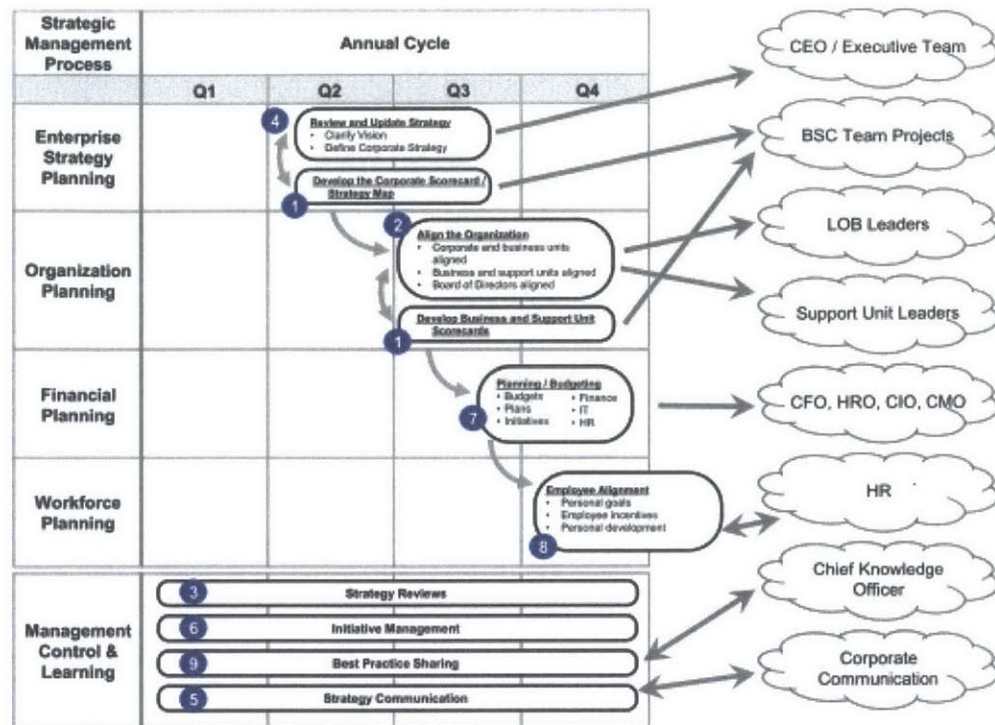


Figure 5 -Strategy Office Ensures Strategic Alignment (Kaplan & Norton, 2005)

At a minimum, such an office synchronizes the planning windows of key functions (strategic planning – midyear; Finance – third and fourth quarters, etc.) (Figure 4) to ensure functional strategies are informed by the corporate strategy. Most importantly, the office ultimately drives for the development of functional strategy plans and their execution in alignment with the corporate strategy (Figure 5). Two of the nine roles the office plays include strategic planning and budgeting. In the firms Kaplan and Norton observed, the office drove strategy development and ensured the proper coordination with budgeting to make certain targets are consistent with the strategy. It also ensures proper resource allocation to support strategy. Finally Kaplan and Norton propose that successful firms elevate this office to the level of other senior offices. Of the four proposed

reporting structures for the office, three are organized under the CFO (Figure 6) (Kaplan & Norton, 2005).

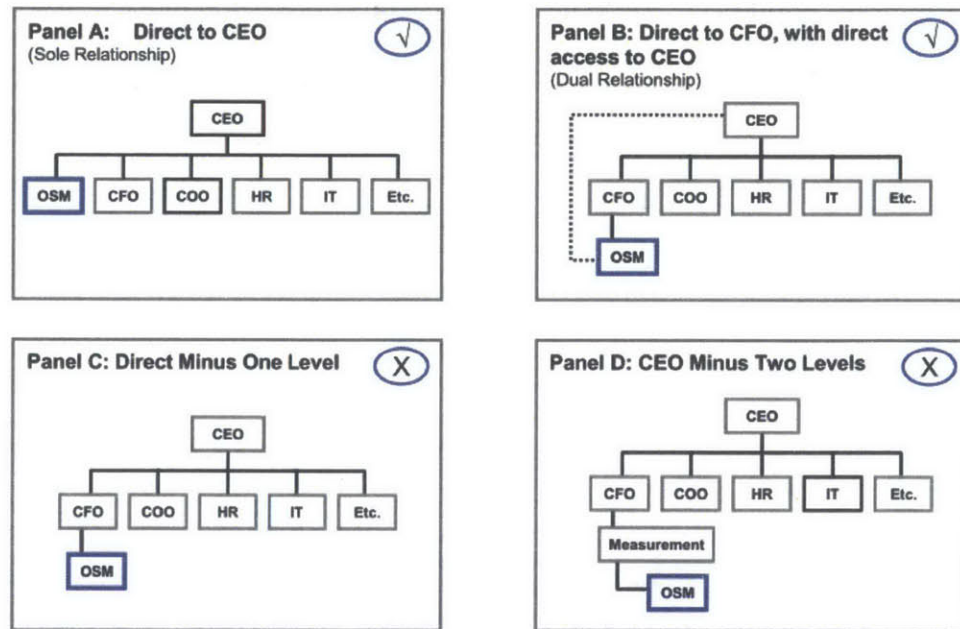


Figure 6 - Reporting Options for Strategy Office (Kaplan & Norton, 2005)

- *Corporate Center Reorganization*

Although not extensively adopted, another concept that has come to be advocated by practitioners is the restructuring of the corporate center around value-creating activities, as opposed to a traditional organization of the corporate center around support functions. Kontes (2004) argues that organizational silos concentrate expertise and create an inherent challenge with coordination (Figure 7). He recounts his observation, over years working with corporate clients, of how poor strategic planning efforts are as defined within firms. He notes that

important aspects are either missing or are so disconnected that the function is rendered ineffective. Similarly, performance objectives created via the budgeting process are typically the purview of finance which traditionally is too far removed from markets, competitors and business economics needed to connect performance objectives with business objectives. Kontes suggest that these functions cannot be effectively realigned within the traditional siloed structure (Kontes, 2004). Rather, the entire corporate center should be re-organized (Figure 8).

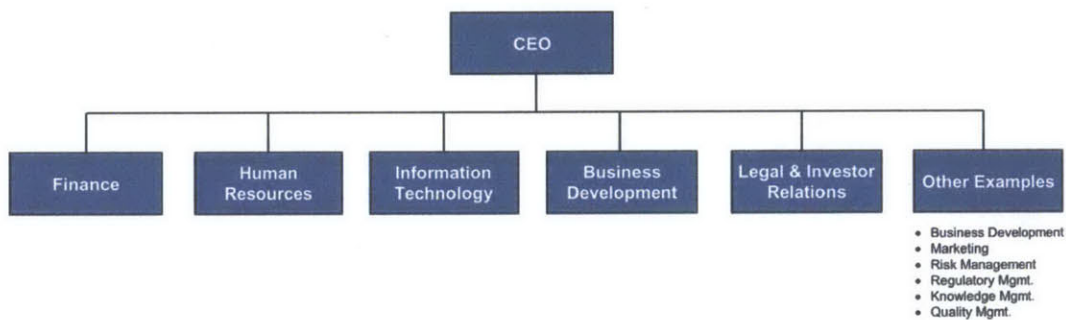


Figure 7 - Typical Corporate Center Model (Kontes, 2004)



Figure 8 - Alternative Corporate Center Model (Kontes, 2004)

Resource Re-Allocation

Resource Re-Allocation mechanisms leveraged by firms focus on another key problem: the tendency for organizations to maintain historic resource allocations levels despite changes in strategic direction. Some practitioners believe that the inability or unwillingness of firms to shift their allocation of financial, human and other resources to support key strategies creates an inertia that is at the heart of the strategy-budget chasm. Front line employees have come to know that if an effort is not supported with resources, it is not truly supported or prioritized by senior management. The theory supposed by practitioners in this case is that resource “re-allocation” can be used as a tool to realize strategic goals. It can also serve to combat the ‘business as usual’ inertia that limits performance. Developing a competency in shifting resources enables senior executives to forge a link between strategy and all categories of resources (including budget) deliberately. Re-allocation thus can enable effective execution of strategy. Such re-allocation requires that firms develop ‘resource agility’ to combat politics and other structural limitations that have organizations repeat the same approaches year after year with limited performance improvements.

McKinsey and Company has conducted research on this topic and studied 1,600 US firms between the years of 1990 and 2005. They found that those firms that “continually evaluate the performance of business units, acquires and

divests assets, and adjusts resource allocations based on each division's relative market opportunities...after 15 years, ... will be worth an average of 40 percent more than...firms that merely allocate capital, talent and research dollars in the same investment patterns" (Hall, Lovallo, & Musters, 2012). Despite the correlation between asset re-allocation and performance and the time spent building strategies, most firms resort to relatively the same allocations year after year resulting in "inertia" (Figure 9).

Capital allocations were essentially fixed for roughly one-third of the business units in our sample.

Correlation index of business units' capital expenditures,
year-over-year change, 1990–2005

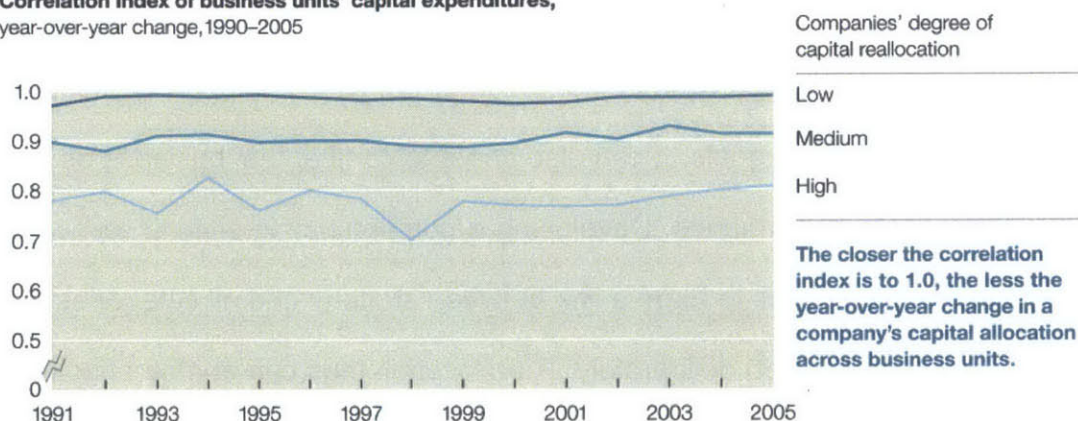


Figure 9 - Inertia in Capital Allocations (Hall et al., 2012)

"Companies that reallocated more resources—the top third of our sample, shifted an average of 56 percent of capital across business units over the entire 15-year period—earned, on average, 30 percent higher total returns to shareholders (TRS) annually than companies in the bottom third of the sample (Figure 10). This result was surprisingly consistent across all sectors of the

economy. It seems that when companies disproportionately invest in value-creating businesses, they generate a mutually reinforcing cycle of growth and further investment options” (Hall et al., 2012).

Companies with higher levels of capital reallocation experienced higher average shareholder returns.

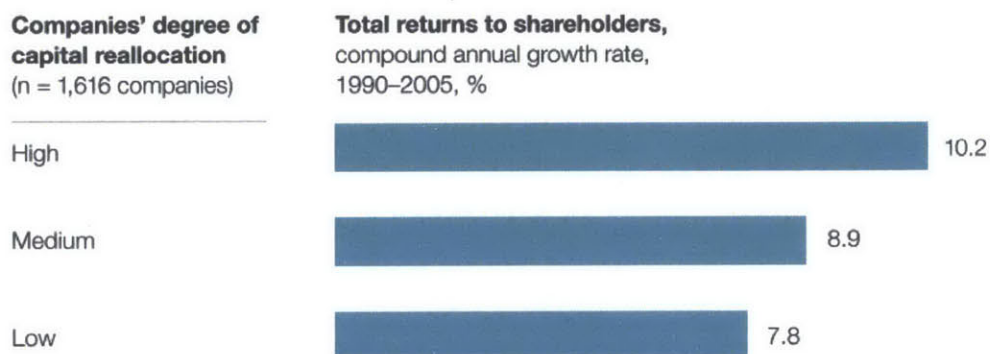


Figure 10 - Capital Reallocation Drives Higher Returns (Hall et al., 2012)

Stephen Hall (2012) is careful to note that this should be viewed as a long-term strategy. “The goal isn’t to make dramatic changes every year but to reallocate resources consistently over the medium to long term in service of a clear corporate strategy” (Hall et al., 2012). Hall also notes that some particular situation calls for the firm to maintain allocation levels in order to actualize potential, and this too requires senior management judgment.

Again, choice samples of how this concept has been approached in practice follow to provoke thought about to characterize and solve the challenge.

- *Portfolio with Hard Targets and Rules*

As Hall (2012) established, inertia weakens the connection between strategy and budgeting because it enables 'resource vampires' to drain resources regardless of their alignment with strategy. Organizations can strengthen the link by developing a target portfolio – a collection of targets that gives senior executives a basis for periodically revisiting and reevaluating resource allocation. Senior executives' active engagement with its portfolio of strategic targets during an established periodic review forces the conversation about the proper resource allocation. This clears the way for corporate budgeting to approve or deny funding in accordance with the strategic priorities.

Other iterations of this concept include organizing initiatives or businesses into logical allocation categories (e.g. 'seed, nurture, prune, and harvest') and/or in investment categories (e.g. 'grow, maintain, and dispose'), and then apply simple decision rules to define an allocation percentage for each annually. Such mechanisms help alleviate political or historic biases from the resource allocation decision process and systematize active post investment reviews that drive strategy-budget alignment. A good example was the effort Google CEO Larry Page undertook to prune out many initiatives generating through the firm's seeding initiatives but that failed to meet strategic targets / hurdles. He

implemented simple rules to prune out under-performing, non-strategic initiatives to free up resources for more important activities (Hall et al., 2012).

This high-touch approach requires a global view of the organization's resources to ensure senior executives can make the best decisions about aligning them with strategy. The next section expounds on how firms are creating this sort of visibility to ensure budgets are synchronized with strategy.

Project Visibility

Project Visibility mechanisms leveraged by firms recognize that “bad” initiatives “hide” inside organizations, drain resources and are maintained at the expense of more strategically important initiatives. At the heart of the problem is the tendency to report activities up to senior executives in a summarized, top-level manner. This practice obscures senior executive view and limits their ability to identify value-creating opportunities. Allocating resources in chunks to business units and divisions empowers front line managers to average resource allocation across their portfolios without the proper accountability for each initiative. The theory espoused by practitioners who have developed means to respond to this issue is that management needs improved visibility across the enterprise in order to make better strategic investment decisions. Improved visibility necessitates the introduction of new mechanisms to delineate and categorize “all” budget-consuming initiatives in the organization. Authors

Goedhart, Smit and Veldhuijzen (2013) are careful to note, “It’s also crucial to develop a strong understanding of the reasons those activities perform as they do and of the alignment between their potential for value creation and corporate investment priorities”. It is only when this visibility is achieved can the link between strategy and budget can be forged and/or strengthened (Goedhart, Smit, & Veldhuijzen, 2013). Why this is possible through a visibility-enabling process is that senior executives are provided a basis for allocating budget to value-creating activity identified therein.

Once again, three examples have been extracted from business practice to demonstrate how organizations may dissect the portfolio of initiatives (at the division, unit and/or activity levels) to obtain a “finer”, enhanced view of activities to help fill the strategy gap.

- *Corporate-Wide Resource Map*

The resource map captures activities within a firm at a granular level to know where resources are deployed and see how each activity is performing (Figure 11). The detailed view empowers management with insight into where value is created and destroyed across the firm. It also arms them with a basis for shifting resources, in this case the budgets, to strategically relevant activities. This level of visibility also aids the corporate budgeting group to conduct proper filtering of initiatives and subsequent budget approvals and denials.

Visibility is important for accountability. Authors Goedhart, Smit and Veldhuijzen (2013) noted that not all organizations have the requisite details or are able to access the level of details on each activity necessary to develop such a map. However, if a firm is serious about uncovering the opportunities and hindrances to improved performance, enabling visibility should be a priority. Armed with insight enabled by a more granular view of activities, executives can “selectively evaluate the underlying strategic rationale for each, determine whether its business plan was grounded in concrete, viable initiatives, and assess whether it had sufficient corporate resources to be successful” (Goedhart et al., 2013).

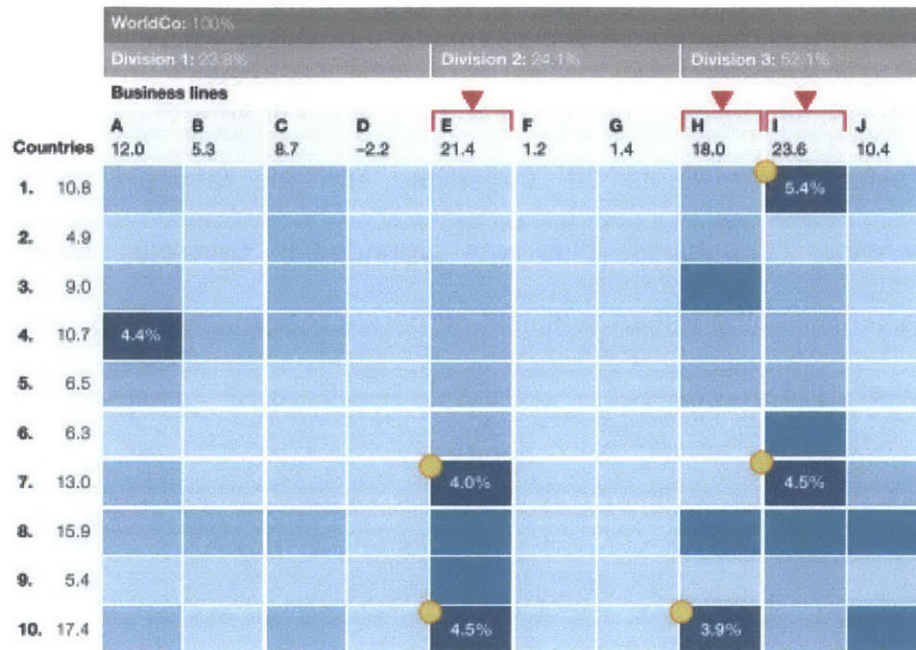
Among 100 business segments in one industrial company, a handful represented the greatest opportunity for value improvement.

% of total value-improvement potential¹

■ <0.9% ■ 0.9–2.3% ■ 2.4–3.7% ■ >3.7%

▼ 3 of 10 business lines represent >60% of the total value-improvement opportunity ...

● ... and within those business lines, 5 segments combined represented >20% of the total opportunity



¹Total value-improvement potential is defined as business-plan value divided by base-case (business-as-usual) value minus one. Numbers are rounded.

Figure 11 - Sample Detailed Portfolio Analysis (Goedhart et al., 2013)

- *Strategic Budget Category*

In a similar vein, David Norton in “Linking Strategy and Planning to Budgets” (2006) advocates for the creation of a new budget category much like capital expenses (CAPEX) and operating expenses (OPEX) entitled strategy expenditures (STRATEX). It represents an interesting solution. The category would separate strategic activities and their investments from operational

activities and their investments (Figure 12). “Executing strategy is based on executing the initiatives tied to strategic objectives. The method for funding these initiatives thus becomes the link between strategy and budgeting” (Norton, 2006). Traditional budgeting processes do not typically isolate the two and as have been established earlier, strategic activities become lost among non-performing activities.

In practice, STRATEX involves strategic change management and is used to fund initiatives associated with firm strategy. The same investment discipline seen in CAPEX investments are employed in the STRATEX model.

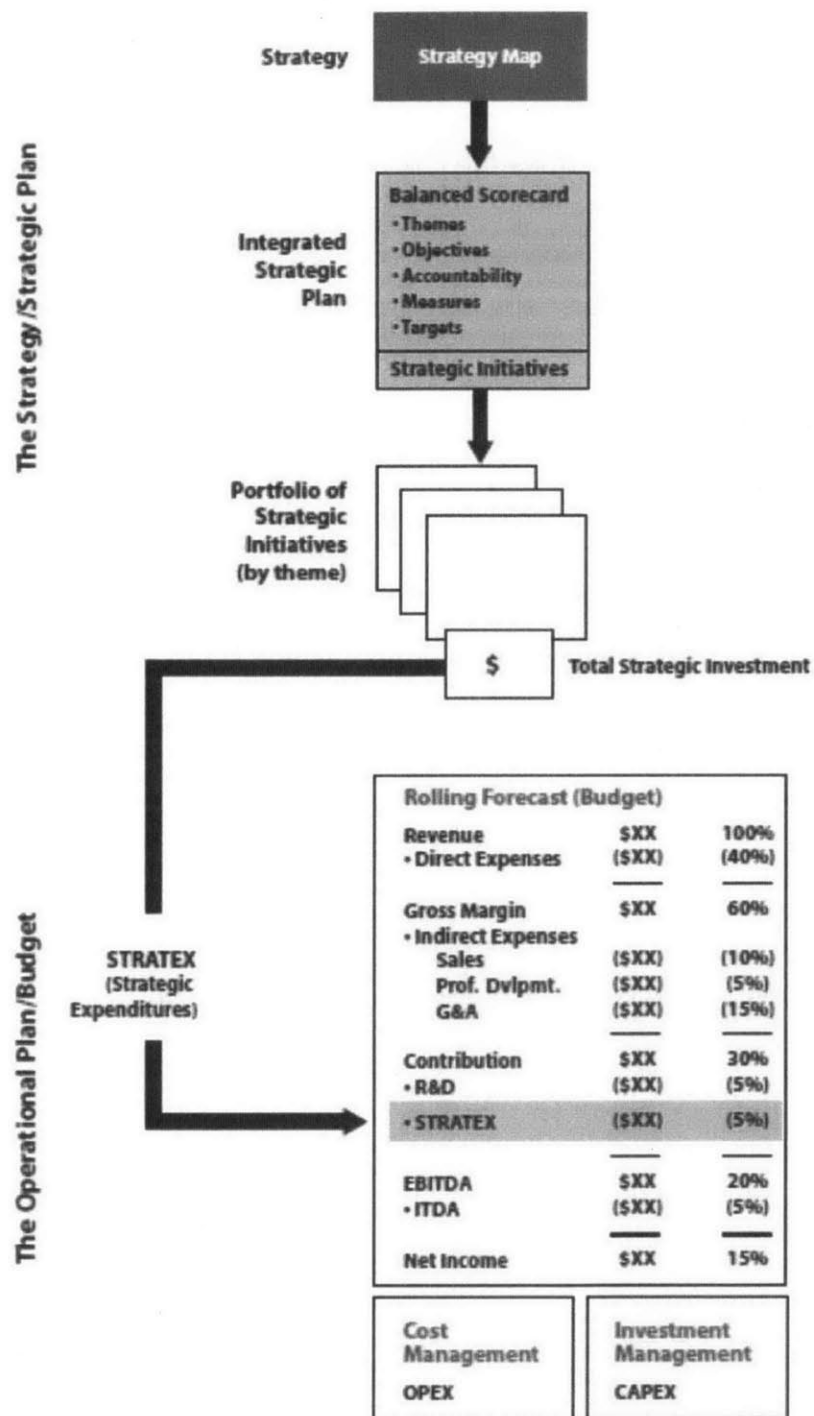


Figure 12 - STRATEX Budget Category (Norton, 2006)

- *Alternative Budgeting Model*

A segment of the practitioner community (including the likes of Boeing, Emerson Electric, and the U.S. Marine Corps) advocates for the use of an alternative form of budgeting to increase its effectiveness. This method, Activity-Based Budgeting (ABB), “focuses on generating a budget from an activity-based model of the organization, as opposed to the traditional product-market, responsibility center, or departmental focus” (Hansen et al., 2003). Proponents believe that budgeting should primarily serve a planning function (Hansen et al., 2003).

The concept of ABB applies activity-based and capacity planning to budget. It promotes the identification of a set of planned activities for the organization first, and then the conversion of that plan into a cost based budget of those activities. Typically budgets are designed around functions and departments. ABB focuses on activities, and consequently the associated budgets would cut across departments (Wyatt, 2012).

The closed-loop model (Figure 13) is the core of ABB. “Stage 1, the operational loop, uses activity-based concepts to convert the estimated demand for products and services into activity requirements using activity consumption rates, and then translates activity requirements into resource requirements using resource consumption rates”. “Stage 2, the financial loop, develops a financial

plan based on the operational plan. Financial balance is achieved when the financial plan meets a predetermined financial target. Once the organization knows the demands, activities, and resources, it determines the cost of resources, traces them to activities, and then to products/services. The projected financial results can be viewed in the aggregate, or can be broken down into information by resources, activities, processes, products, or other cost objects” (Hansen et al., 2003).

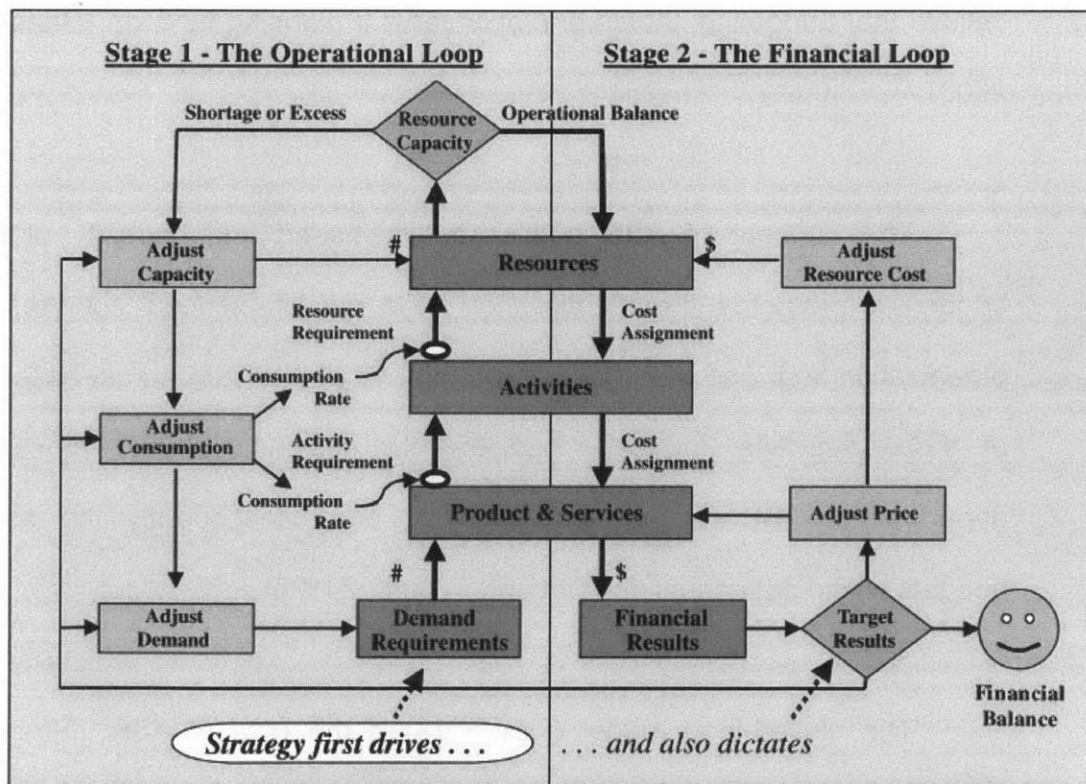


Figure 13 - Activity-Based Budgeting Closed Loop Process

Proponents cite many benefits of this approach. But for our purposes, understanding how best to link strategy and budgeting, this approach is anchored plan with a view of the organizational strategy (operational loop) and works down to a formal budget (financial loop). ABB enables funding to flow from the organizational strategy

Chapter 4

Linking Budgeting to Performance Management

Another central role budgeting traditionally has played within organizations is that of a performance planning and evaluation tool. In a traditional control function in which budgeting is used for “managerial motivation and as a standard for performance evaluation” (Libby & Lindsey, 2010), many agree with Wyatt that “We may use budgets to judge the performance of individual units within the organization and to judge the performance of managers” (Wyatt, 2012).

And it is still widely used among firms in North America. Consider Libby and Lindsey's (2010) recent work in which 80% of their Canadian sample and 77% of their American sample acknowledged using budgeting as a control mechanism within their organizations (Figure 14). Of the respondents, 94% plan to continue the practice while 6% are either considering or have plans to abandon the practice of using budgeting as a managerial motivation and performance evaluation tool (Libby & Lindsey, 2010). Firms are looking; however, to improve the process – 88% of US respondents agreed “the problems with budgeting has more to do with how they are used and some of the roles they are asked to play; budgets have the potential to be extremely useful if used appropriately” (Libby & Lindsey, 2010).

Use of budgets for control*.

	Canada		US		Total	
	Freq	%	Freq	%	Freq	%
Are budgets used for control?						
Yes	277	80%	163	77%	440	79%
No	69	20%	49	23%	118	21%
Total	346	100%	212	100	558	100%
If use budgets for control:						
Do you plan to abandon the use of budgets for control?						
Yes	2	1%	2	1%	4	1%
Possibly	18	6%	4	2%	22	5%
No	257	93%	157	97%	414	94%
Total	277	100%	163	100	440	100%

Figure 14 - Budgeting as a Control Mechanism (Libby & Lindsey, 2010)

Why the budget performance incentive linkage?

The success of any organization is largely dependent on its employees' ability to carry out the mission. "In behavioral finance, it is acknowledged that the psychology of employees has influence on the decisions they make and on their work motivation. It is believed that motivated employees in general will increase their work effort and thereby their work performance" (van Moorselaar, 2011). Such thinking was the impetus for introducing incentives into the budgeting process.

Modern-day finance espouses the belief that "An organization is more likely to succeed when its employees are held accountable for their actions. When employees are held accountable, they are going to work harder to achieve

their goals because their compensation and / or job security are on the line” (Jan, White, & Castellina, 2011). As previously stated, it is evidenced by the pervasive use of budgeting as the basis for performance evaluation.

But others like Hope and Fraser refer to the practice of linking performance evaluation to budgeting as the “annual performance trap”. “This trap involves dysfunctional behaviors that stem from evaluating front line managers vis-a-vis budget targets that are set without reference to a credible (outside) source, and that remain fixed for the next budget year” (Hansen et al., 2003). Libby and Lindsey (2010) disagree with Hope and Frasier (2003) that firms make use of “fixed” performance contracts but rather have found that many firms use subjectivity and make allowances for uncontrollable circumstances (Libby & Lindsey, 2010). They do agree, however, that the gaming behaviors that have seeped into the performance planning process are not only prevalent but are detrimental to organizational performance. The pair also found that in order to reap higher benefits from the budgeting process, firms need to take gaming seriously and prevent this dysfunctional behavior (Libby & Lindsey, 2010). This begs the question, what is being done to repair the budgeting and performance management link?

Methods in Practice

Before delving into the specific approaches found during the research, it would be important to note why employees engage in antics in the first place. With that understanding, the techniques that follow will have a proper context.

While most of the literature recount the dysfunctions related to performance evaluation as sinister schemes to gain incentives (bonuses, raises or promotions), Steele and Albright (2004) identified four motivations for gaming:

Deficiencies in knowledge, skill and/or abilities – In this case, front line managers may lack the analytical skills necessary to value investment options or lack the skill to accurately predict (forecast) relevant variables for their business cases. This also extends to a lack of knowledge of the marketplace and pertinent benchmarks that could support the budget planning process. As a result, they make guesses. The guessing game does not reflect the realities of the business opportunities and threats however.

Machiavellian-Myopic behavior – In some cases employees are fully aware that they are manipulating numbers purely for their gain, or as a result of weak / non-existing personal motivation. Those who are motivated thus may develop elaborate systems for their gaming.

Lack clarity on performance goals and expectations – In other cases, the behavior is motivated by the disconnect that has developed between senior management and mid-level management about what is truly expected and the time-frame for achieving results. Front-line managers in response to their perception of expectations engage in “tap-dancing” and game playing to manage the expectations. They also may build in performance slack to allow themselves a buffer in case of some unforeseen event that may cause them to miss the budget. Oftentimes employees are setting targets well below what is achievable as a result.

Organizational environment – the final category of behavior is motivated by the organizational culture, incentives and values. If an organization rewards “hard-charging” employees that achieve by any means necessary, others will follow that model to reap the rewards bestowed upon this performance poster-child. As a matter of fact, if the organization has a practice of rewarding (bonuses, etc.) or punishing (shaming, etc.) employees based upon poorly derived performance targets, the dysfunctional behavior will spread throughout the organization (Steele & Albright, 2004).

The literature review uncovered a number of insights and methods used by organizations to minimize or eliminate destructive behavior. Using the motivation categories identified by Steel & Albright as a filter, much of the literature advocates **re-anchoring** performance evaluation which will be detailed

below. The two motivations relatively easier to address will be detailed first: a) Deficiencies in skill, knowledge and abilities and b) Lack of clarity about performance goals and expectations

Best-in-class organizations are addressing the deficiencies in skill, knowledge and abilities through training a larger portion of their front line managers in analytical skills. The Aberdeen Group has conducted research to examine the use, experience and intentions of finance executives with regard to performance management. They found that one of the key success factors in developing performance-driven organization is more pervasive competencies in analytical skills across the organization, not just in the finance department. In their recent work, "Culture, Collaboration and Coordination: Driving High Performance with EPM" (White & Castellina, 2013), 41% of leading organizations have front line managers already trained in these skills and 38% plan to build and nurture them.

Addressing the behavior that results from unclear expectations is somewhat straightforward as well. At the heart of this issue is insufficient communications or more specifically the absence of a common language that all stakeholders across the organization share. "Sharing knowledge across the organization ensures that everyone is working from the same data, standards are enforced, definitions are shared enterprise wide, and the organization is being run to the best of its ability. Having a library of standardized metrics and KPIs

allows employees to know which key performance indicators are most important to the success of the organization and how they are measured. Equally important, a standardized library of metrics and KPI's ensures that performance is calibrated and measured consistently both within and across business units. Without agreed standards, different business units might measure KPIs in different ways" (Jan et al., 2011).

The more challenging issues and their associated dysfunctions are related to the Machiavellian-Myopic Behavior and Organizational Environment categories identified by Steele and Albright (2004). Approaches in practice that address the dysfunction which arise from these motivations can be grouped into the following categories: **relative targets**, **contribution based compensation**, and **broader metrics**.

Relative Targets

During a traditional budgeting process, hard targets are negotiated and established for each unit of an organization. With target-setting power, front line managers have the opportunity to establish targets that are more in line with personal rather than corporate goals. Empowering the front line with this level of input is reasonable because of their proximity to the market and its business. Best-in-class organizations; however, use relative targets instead of the traditional fixed targets. "Relative indicators include comparison to historical

performance data such as prior-year results, internal peer group performance comparisons, external evaluations to direct competitors, and external benchmarks against world-class performers” (Player & IBM, 2009). Hope and Fraser (2003) add that the rewards should be team-based versus being based on individual targets. “Instead, emphasis is placed on performance in relation to the competition and on creating additional shareholder value. This process transforms goals from arbitrary financial numbers to more operational objectives. Relative measures are closer to how the organization is viewed in relation to the marketplace, which places the emphasis on factual competitive measures rather than an arbitrary fixed number” (Player & IBM, 2009).

This re-anchoring approach is also advocated by others (Hope and Fraser) (Merchant) as a way to separate performance evaluations from budget planning. The rationale is that because budget targets are comprised of static assumptions in most cases, using them as evaluation targets is a flawed practice given the rapidly changing environment in which organization operate. Again because front line managers are closest to the market, customer and products, they possess information asymmetry that can be leveraged during the target negotiation phases of the budgeting process. This solution eliminates the temptation to game the targets by eliminating front line managers’ sole ownership of the data that informs the targets. Hope and Fraser (2003) capture this idea in principles 1 and 2 of their ‘six principles of managing with adaptive process’ framework which is at the heart of the Beyond Budgeting movement.

Hansen, Otley and Van der Stede (2003) point out that while there has been work done to affirm the advantages of this approach, the actual implementation in practice is quite difficult. Merchant continues that “[i]f no such [competitive] peers or [peer data] exists, come up with a standard based on historical performance, adjusted for changes in economic conditions, size of market, interest rates, price of oil and other key factors” (Merchant, n.d.). Player provides more insight into how this method is carried out by leading organizations, “Best-in-class organizations set relative targets based on high-level key performance indicators (KPIs) such as return-on-equity, free cash flows, or cost-to-income ratios. Stretch goals are then set and aimed at maximizing profit potential and creating value, both in the short- and long-term. Managers can then be evaluated and ranked using a range of relative indicators rather than managers’ own numbers. Such indicators provide a much more adaptive method of determining a manager’s contribution to the organization. These relative indicators include comparison to historical performance data such as prior-year results, internal peer group performance comparisons, external evaluations to direct competitors, and external benchmarks against world- class performers. Relative targets are self-adjusting, in that environmental fluctuations automatically impact everyone’s performance” (Player & IBM, 2009).

Contribution-Based Compensation

In traditional budgeting processes, budget targets are established with a floor (hurdle target) above which employee incentives kick in and a ceiling that caps those incentives (Figure 15). This practice creates the right conditions for gaming to occur. “When performance approaches the hurdle target, a manager has a strong incentive to accelerate the realization of revenue and profit. When performance hits the cap, the manager has a strong incentive to push revenue and profit into the next year” (Jensen, 2001).

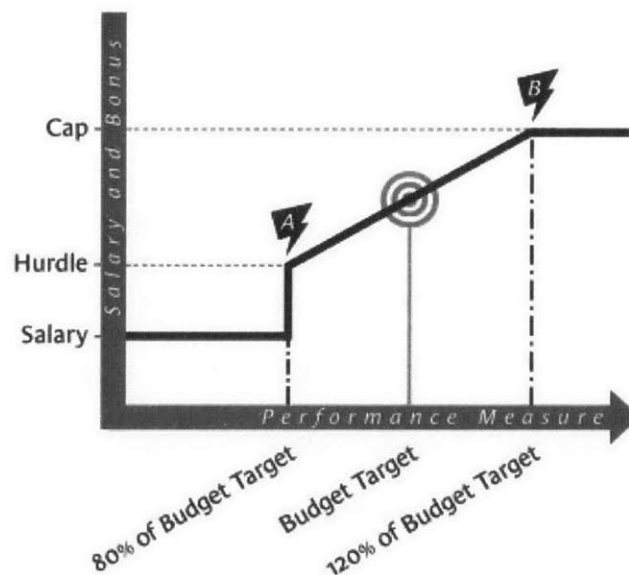


Figure 15 - Typical Executive Compensation Plan (Jensen, 2001)

The solution proposed and adopted in practice is to compensate employees based on actual contributions not budget targets. Jensen (2001) advocates for a “linear compensation plan” (Figure 16) in which front line managers are compensated for “what they actually do, not for what they do relative to what they say they can do” (Jensen, 2001). Others (Merchant, n.d.)

(Player & IBM, 2009) (IBM, 2009) point to similar tactics as a means to decouple incentives from the budgeting process and instead offer rewards based on 'measured performance', 'value created' or 'contribution to the bottom-line' rather than how they perform against budget. Hope and Fraser (2003) propose that not only should the evaluation include a peer-review but that it also should benefit from hindsight. In other words, the evaluation considers the internal and external climates' impact on performance. Regardless of the specific tactic, the temptation to sandbag budget targets is eliminated because it is no longer a basis for performance evaluation. As a result, managers are encouraged to input estimates that reflect reality.

Jensen (2001) acknowledges the criticism and evidence that targets motivates high performance, "Empirical evidence shows that tying goals to rewards does enhance performance. A recent study of more than 500 studies, for example, indicates that performance increases by an average of approximately 16% in companies that establish targets". He retorts; however, that there is no documented evidence that proves the ascribed "high performance" is a result of actual accomplishments or whether that performance too is a product of gaming.

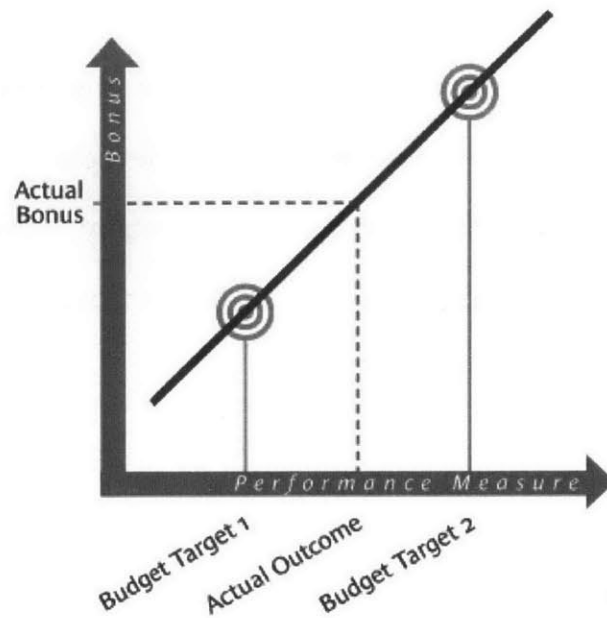


Figure 16 - Linear Compensation Plan (Jensen, 2001)

Broader Performance Metrics

Traditional budget targets, used for performance evaluation, focus on financial metrics. Such short-term targets nurture short-term thinking inside the organization. Organizations may begin to broaden the point of view of its employees from a short-term focus to long-term by adding non-financial and long-term targets. Employees, as a result, will better align behavior with long-term strategies and away from short-term benefits. In this case, non-financial targets are used as leading indicators of future financial performance. (Hansen et al., 2003) (Merchant, n.d.).

“Since the ultimate performance of the organization is tied to the performance of its employees, 63% of the best in class are establishing a performance-driven culture to drive accountability. Accountability leads to greater engagement, making participants in the process more active, educated, and enthusiastic” (Jan et al., 2011).

Chapter 5

Conclusion

Corporate budgeting should play a far more strategic role in organizations. It can serve as an important force multiplier for organizations all of which need focus to execute in the increasingly competitive and fast changing business environment. Unlike any other function within organizations, it focuses activities, facilitates resource management, influences employee engagement and performance. Two critical points of failure render this important role of finance ineffective in many organizations. In fact, it is not apparent to many organizations the impact of these subtle yet significant oversights. Corporate budgeting is a continuation of the strategic planning process and extension of the strategic plan. Without a proper link between strategic and budgeting, a significant misalignment occurs. Over time, the budgeting process loses its meaning and is not used properly within an organization. When that occurs, entrenched behaviors that have developed around the process protect the ineffective model of budgeting that is pervasive in organizations. Many firms have adopted balanced scorecard solutions and technology solutions to bridge this gap without making necessary changes in employee motivation and engagement. Driving focus and performance requires significant treatment of the human factors involved. Becoming a best in class firm able to chart a course and deliver the associated returns requires a recoupling (strengthening) of the

strategy-budget link and a decoupling (loosening) of the budgeting-performance evaluation link.

Well intentioned organizations that looked to the methods highlighted in this thesis and others not covered by this work should recognize the important role that leadership and culture plays in the success of such change management. Without them, it will be difficult to implement any of the approaches described. It should also be noted that while this thesis emphasized dysfunctional behavior, there are well meaning motivations at play among employees as well. It is important to understand the motivation and address those versus blindly attempting to wipe out dysfunctional behavior assuming all intentions are impure.

This thesis examined two points of failure in the corporate budgeting process with the goal of providing insights for how organizations might execute their strategies better. While the literature review was broad, this work is not an exhaustive treatment of the topic or the methods that could potentially serve as useful solutions to these budgeting weaknesses. Nor did it highlight the flaws or criticisms of the methods. It instead provided a survey of the types of solutions being explored to solve challenges of effective enterprise management. Given the importance of corporate budgeting, it would appear that further exploration of theories and methods to improve corporate execution of strategy is in order.

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