

Chapter 21

Operating without a Budget

Introduction

It can be quite time-consuming to create a budget, and you may then find that it is not especially useful, especially if the company does not take well to the command and control style of management that typically accompanies a budget. If you would prefer to avoid a budget, consider the alternative outlined in this chapter. If you are willing to modify the reporting system, decision making, and organizational structure of the business, it is entirely possible to not only operate without a budget, but to thrive while doing so. Operating without a budget is particularly useful in the following environments:

- *Rapid change.* When the business environment is rapidly changing, a business may need to reposition itself and head off in new directions within a short period of time. In this case, long-term planning is useless, and the emphasis is instead on rapidly testing new business models.
- *Rapid innovation.* When the rate of innovation in an industry is high, a business must constantly fund a portfolio of experiments. If an experiment succeeds, the company must pursue it with great vigor, which would result in the scrapping of any existing budget on short notice.

This chapter discusses the reporting systems, goal setting, management roles, compensation issues, and other changes needed to operate without a budget.

Related Podcast Episode: Episode 131 of the Accounting Best Practices Podcast discusses how to operate without a budget. You can listen to it at: accounting-tools.com/podcasts or iTunes

Alternatives to the Budget

We have spent most of this book describing how to construct a budget. However, as noted in the first chapter, there are so many downsides to the entire concept of a budget that you may not want to have one at all. If so, how do you operate without one? It is quite possible to do so if you are willing to change several systems and the corporate approach to managing employees. We will briefly address both issues in this section, and then expand on the concepts in the following sections.

In order to have a properly functioning organization that operates without a budget, it is necessary to alter three systems. They are:

- *Forecast.* The forecast is a rolling forecast that is updated at frequent intervals, and especially when there is a significant event that changes the

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competitive environment of the business. The forecast is simply the expected outcome of the business in the near term, and is intended to be an early warning indicator of both threats and opportunities. It is completely detached from any compensation plans. The rolling forecast is covered in the next chapter.

- *Capital budgeting.* Requests for funds to buy fixed assets are accepted at all times of the year. Funding allocations are based on expected results and the needs of the requesting business unit. There is no longer a formal once-a-year capital budgeting review.
- *Goal setting.* Employees jointly set targets that are relative to the performance of other business units within the company, and against other benchmark organizations. If there is a bonus plan, it is based on these relative results.

A key point is that the forecast and capital budget are not related to targets. By separating these processes from any corporate targets, there is no incentive for employees to fudge their forecasts or fixed asset funding applications in order to earn bonuses.

From the management perspective, it is critical that senior managers step away from the traditional budget based command and control system and replace it with a great deal of local autonomy. This means that local managers can make their own decisions as long as they stay within general guidelines imposed by senior management. The focus of the organization changes from short-term budgets to medium-term to long-term financial results. There is no emphasis on budget variances, since there is no budget.

Also, senior management must trust its employees to spend money wisely. The expectation is that an employee is more likely to question the need for any expenditure, instead of automatically spending all funds granted under a budget allocation.

From a more general perspective, if a company abandons budgeting, how does it maintain any sort of direction? The answer depends upon the structure of the business and the environment within which it operates. Here are several examples of how to maintain a sense of direction:

- *Margin focus.* If a business has a relatively consistent market share, but its product mix fluctuates over time, it may be easier to focus the attention of managers on the margins generated by the business, rather than on how they achieve those margins. This eliminates the structural rigidity of a budget, instead allowing managers to obtain revenues and incur expenses as they see fit, as long as they earn the net profit margin mandated by senior management.
- *Key value drivers.* If senior management believes that the company will succeed if it closely adheres to specific value drivers, then it should have the company focus its attention on those specific items, and not hold managers to overly-precise revenue or profit goals. For example, the key to success in

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an industry may be an overwhelming amount of customer support; if so, focus the entire company on maximizing that one competitive advantage.

- *Few products and very competitive environment.* If a business relies upon only a small number of products and is under constant competitive pressure, then decisions to change direction must be made quickly, and the organization must be capable of reorienting its direction in short order. This calls for a centralized management environment where a small team uses the latest information to reach decisions and rapidly drive change through the organization. In this case, a budget is not only unnecessary, but would interfere with making rapid changes. Thus, keeping employees focused on the operational direction given by senior management is vastly more important than meeting revenue or expense targets; taken to an extreme, employees may never even see the financial results of their areas of responsibility, because the focus is on operations, not financial results.

We have described in general terms how to operate without a budget. In the following sections, we will address various aspects of the no-budget environment in more detail.

Forecasting without a Budget

A good replacement for a budget is the rolling forecast. This is a simple forecast that contains information only at an aggregate level, such as:

- Revenues by product line
- Expenses aggregated into a few line items
- Customer order backlog
- Cash flow

The intent is to create a system that is easily updated, and which gives the organization a reasonable view of what the future looks like for at least the next few months. A key reason for having a rolling forecast is to bring up issues as soon as possible, so that a company can initiate corrective actions to deal with them. Thus, the goal of a rolling forecast is not to attain a specific target, but rather to provide early notice of problems and opportunities.

Employees should update their parts of the rolling forecast about once a month, and should only spend a short time doing so – a fine level of detail is not expected. Since the forecast is updated regularly, it does not have a great deal of impact on the organization if the forecast proves to be incorrect – after all, a new version will replace it shortly, so there is very little time during which a bad forecast can impact the business.

While it is customary to update a forecast at fixed periodic intervals, an alternative approach is to update it whenever there is a significant event that impacts the business. There may be events that trigger a forecast update only for a local business unit, and not for the entire company, while other events may be so significant that they warrant a complete review of the forecast. Such events should

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be rare, but should trigger an immediate response from the company, so that employees know what to expect.

Given the extremely short time line and minimal time allocated to updating a forecast, it rarely makes sense to derive multiple forecasts that also address best case and worst case scenarios. Instead, since the time period covered is so short, there should be minimal divergence from the best case scenario, so you can avoid creating extra forecasts.

The time period covered by the rolling forecast depends upon the ability of a company to project its activities into the future. If there are many long-term contracts, it may be entirely reasonable to compile a rolling forecast that extends more than a year into the future. However, if the company has a bad history of projecting results, then do not waste time doing so excessively far into the future. Instead, only forecast for the period where you have a reasonable expectation of achieving a prediction. If this means that the forecast period is only a few months, then that is sufficient – generating a longer-term forecast is a waste of time.

Another way of formulating the correct period for a rolling forecast is to estimate the amount of warning that employees need to trigger ongoing business activities, such as altering product prices, and launching new products and related promotions.

Tip: There may be situations where it is of some importance to make the best possible guess concerning a forecast. If so, consider setting up an internal prediction market, where large numbers of employees are encouraged to submit a best guess. Since many people may have access to information that can contribute to the forecast, the result can be unusually prescient.

The rolling forecast is accompanied by a rough work plan that is adjusted as frequently as the forecast. No one has to submit the work plan to a higher authority for approval. Instead, employees formulate their direction, document it in the work plan, and adjust it to compensate for both current and expected future events.

The rolling forecast is covered in more detail in the Rolling Forecast chapter.

Capital Budgeting

As noted in the Capital Budgeting chapter, the process of reviewing and approving capital expenditures can be lengthy and complex. How does this mesh with an environment in which there is no formal budget? Even if there is no budget, there should still be a rolling forecast. Given the presence of a rolling forecast, three prospects for dealing with capital expenditures suggest themselves:

- *Fast track approvals.* Many capital budgeting proposals are positioned at the lower end of the range of possible dollar amounts, and so require both fewer funds and less analysis. For these items, senior management should maintain a pool of funds at all times, and fast track the review process for any capital budget proposals submitted. This process is designed to support the bulk of all capital expenditures needed by front-line teams.

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- *Near-term projections.* The treasury staff should maintain a short-term forecast of available cash flow, so that managers can see if cash will be available for capital budget requests. If the forecast indicates a cash flow problem, then projects can be delayed until more funds are available.
- *Long-term projections.* Senior management should maintain a rolling five-year forecast. This can be quite a brief document, showing general estimates of where the market will be, and the company's position within it. Based on this forecast, the company can determine its long-term capital expenditure plans for high-cost items.

Those capital expenditures designated as fast track approvals require no attention from senior management, since the funds involved are not large. However, the largest expenditures should be labeled as strategic commitments, and therefore fall within the responsibility of senior management.

If a business has cash constraints that do not allow it to give appropriate funding to all capital projects, then senior management will likely have to become involved in more approvals. If so, they should use the following criteria when making funding choices:

1. *Legal requirements.* If the company is required to make a capital investment in order to comply with a legal or regulatory requirement, then fund it.
2. *Strategic direction.* If a lack of funding will prevent a profit center from completing a key activity that meshes with the corporate strategic direction, then fund it.
3. *Throughput.* If the overall throughput of a system can be increased by making a capital investment, and there is sufficient demand to use the extra capacity, then fund it.
4. *Return on investment.* Once all projects falling under the preceding categories have been funded, allocate funding to the remaining projects based on their returns on investment.

A good way to limit profit centers from demanding an excessive amount of funds for capital projects is to designate them as investment centers and charge them the corporate cost of capital for all invested funds. This arrangement should keep them from requesting funds for projects whose returns are below the cost of capital. If the availability of funds to the company as a whole becomes restricted, you can increase the cost of capital, which should reduce the flow of capital budgeting requests.

When you eliminate the annual budget, this also means that the annual review of existing projects is eliminated. Instead, it is far better to engage in more frequent reviews of project status. Doing so will reveal problem areas where it makes sense to terminate a project entirely, thereby making more funds available for use in other capital projects. These more frequent reviews should not be excessively detailed, or else they will consume too much time. Instead, there should be a brief review of the time to completion in comparison to the original estimate, as well as of the funds expended to date in comparison to the original projection. If either of these metrics reveals a significant negative variance, then more analysis is called for.

Goal Setting without a Budget

The senior management team typically integrates its corporate goals into the budget – so what happens to the goals when the budget is terminated? As we pointed out in the first chapter, creating fixed targets can cause a variety of behavioral problems that are highly counterproductive. But if there are no goals, how do employees know what to do?

The answer is to use continual improvement goals that will place the company in the top quartile of those companies or internal profit centers against which it measures itself. For example, a retail chain can measure the profitability of its stores, and have the lowest-performing stores attempt to match the performance already reported by the top 25 percent of stores. Further, the same company can benchmark the performance of other “best in class” companies and have its top-ranking stores attempt to attain benchmarked performance levels.

For large companies having many similar profit centers, tracking performance against peers within the company can be the best basis for such goal setting, for several reasons:

- *Internal support.* Everyone works for the same company, so employees of the top-performing profit centers should be willing to assist other profit centers to improve their performance.
- *Similar environment.* The various profit centers presumably work within the same industry, and deal with similar customers and suppliers, so their results should not only be quite comparable with each other, but their business practices should be readily transferable to other profit centers.
- *Been done.* Employees may balk at the idea of being measured against the performance of another company that may not even operate in the same industry; but this objection does not apply if the benchmark originates within the company – the benchmark has already “been done,” and within the same industry.

The tracking of internal peer performance can result in an extensive reporting system where employees can readily access the results of profit centers by geographical region, or store size, or product line, or customer. The result can be an exceptional internal database that reveals who conducts business the best, and how to contact them for advice.

EXAMPLE

Mr. Dennis Houlihan has just opened a new branch of the Second Base sports bar in Boston. As a new branch, the results of the Boston branch will likely initially rank among the worst of the 150 sports bars operated by the company. Mr. Houlihan consults the company’s internal database of profit centers to find comparable locations, and finds that the New York and Atlanta branches perform exceptionally well. He contacts their managers for advice regarding how to improve the performance of his operations.

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The trick to goal setting in this environment is to not make such goals appear to be fixed targets that are agreed upon in advance, but rather goals to aspire to achieve, with compensation being paid on the extent to which they *are* achieved.

Strategy without a Budget

The traditional approach to budgeting is that strategy is finalized before the beginning of the budget year, and is not revised until the same period in the following year. Also, strategy is debated and settled among the top management team, perhaps allowing for some input from others lower in the corporate hierarchy. This approach may be suitable in a monopolistic industry, such as electrical power generation. However, most industries experience a vastly more robust amount of competition, and so would benefit from two key changes in the formulation of strategy, which are:

- *Timing.* When the competitive environment changes constantly, then corporate strategy needs to change at the same pace. This may require minor tweaks to the strategy every few months, and possibly a major change as soon as a structural shift in the industry becomes apparent. Thus, strategy development must change from an annual event to an ongoing process.
- *Formulation authority.* Senior management still needs to ultimately manage the overall direction of the company. However, this must truly be at a strategic level, not tactical. Lower-level managers and teams must focus on how the strategy is to be implemented at a tactical level and on a continuous basis, and give feedback to senior management regarding the practicality of the plan. There should also be a clear set of decision authorizations that allow profit centers to make most decisions with no further interference from senior management; however, clear divergences from the corporate strategy should require the approval of senior management.

EXAMPLE

Latham Lumber has lumber yards in 30 states, all under local management. Latham's senior management team has adopted a decentralized management structure, under which local managers are allowed to make all operational decisions as long as they follow these guidelines:

- Annual cash flow is above the median for a peer group of competitors
- Capital purchases are pre-authorized up to \$3 million per year
- The business is focused on serving the needs of independent contractors

The staff of the Albuquerque branch of Latham Lumber sees an opportunity to open a new location near a vast subdivision that has just sold out. The investment will be under \$3 million, but the focus of the location would be on homeowners, rather than independent contractors, so this decision is bumped up to senior management for resolution.

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Both of the proposed changes in strategy development are necessary offshoots from the concept of shifting responsibility as far down in the organization as possible. Thus, if you shift expenditure authority down to employees, then you need to shift some elements of strategy down as well.

In short, when there is no budget, it does not mean that there is no strategy. On the contrary, senior management must still formulate it, and lower levels of the organization must interpret their key objectives and performance indicators based on that strategy. Ultimately, a company must have a system where everyone is clear about the overall direction of the business, as well as their roles in it.

Management Guidelines

Managers throughout a no-budget business must have a clear understanding of the company's overall strategy, and how they are expected to implement it within their areas of responsibility. Further, they must understand how decisions are made within the company, including:

- Which decisions they are expected to make
- Which decisions must be shifted to senior management
- The extent to which they can re-direct the activities of their areas of responsibility without the approval of senior management
- When they should give feedback to management regarding how local conditions are impacting the corporate strategy

When decisions are being forcefully shifted down into the corporate hierarchy, employees must know the answers to these questions in order to succeed in their jobs.

The Role of Senior Management

If decision making is being pushed deep into the ranks of an organization, what role remains for the members of senior management? They no longer have a budget to control, so what is their role?

First, there will be fewer senior managers, simply because there is almost no "command" work left. The elimination of the budget will likely thin the ranks of management considerably, especially those positioned in the middle of the corporate hierarchy who were most involved in monitoring performance. For those that remain, the role will encompass the following responsibilities:

- *Monitor performance.* It is still necessary to monitor the performance of the company, though senior managers should only interfere in an operation when its results are clearly falling well below expectations.
- *Exception detection.* An offshoot of the preceding point is that senior management should review all types of information to see if there are any changes in trends or other unusual patterns that could signal a need for a change in strategic direction. These changes may be too subtle to be noticed by a front-line employee, and can only be seen when viewed at a more ag-

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gregate level. Spotting these issues early can be critical to the long-term health of a business, and so is an appropriate task for senior managers.

- *Strategy*. The high-level strategy of the company remains under the control of the senior management team. They set the general direction of the company, and then let the rest of the company work on the tactical aspects of implementing it.
- *Financial analysis*. Senior managers, or at least the corporate staff, can assist profit center employees with a variety of issues to help them obtain better performance. The people providing this assistance essentially become in-house consultants. Examples of some analyses that they might be engaged in are:
 - Which products and services create the largest and smallest profit?
 - Should we drop a product or product line?
 - Should we drop a customer?
 - Can we increase prices?
 - Should any functional areas be outsourced?
- *Acquisitions*. The purchase of another company or its assets is a highly specialized activity that is best handled by a core team of experts. Even if an acquisition is requested from lower down in the corporate hierarchy, the actual transaction will likely be handled by corporate management.
- *Acquisition integration*. The senior management team can be involved in some coordination of the acquisition integration process, but most of the integration team will be drawn from the more high-performing profit centers. These people are best able to transfer knowledge to the employees of the acquiree. Still, there may be a need for a coordinator from senior management to ensure that adequate resources are allocated to the acquiree.
- *Coaching*. Especially during the early years of a conversion to a no-budget environment, senior managers must be deeply involved in training the rest of the organization to take on the roles and responsibilities once held by senior managers. This is a gradual process, as senior managers provide training, hand off selected functions, evaluate the results, and decide when to push more responsibility down into the organization.
- *Rapid response*. The reduced number of senior managers will likely create an extremely broad span of control (if any). This means that in the rare cases where a decision must be escalated to senior management, it can reach the apex of the company almost immediately and be sent back with a decision within a very short period of time.

Since senior managers are accustomed to much more direct action than the preceding list of activities implies, it will be necessary to completely restructure not only their job descriptions, but also the job descriptions of everyone else in the company to formally shift responsibilities downward in the organization.

Further, it is entirely possible that senior managers accustomed to the command style will not be able to switch to the mode of management needed for a “no budget”

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environment. They will continually attempt to interfere in the affairs of local profit centers with an ongoing stream of directives. If so, the chief executive officer should initiate the departure of these managers, with their replacements being more comfortable with enabling employees to run the business.

A further issue is that the “no budget” system is a rare one that might be derailed by the arrival of a new CEO from outside the organization. Consequently, this type of organization should be especially careful to promote from within when hiring for senior positions.

Corporate Staff Roles

The corporate staff is usually deeply involved in the development and subsequent monitoring of the budget, as well as associated performance plans and bonus payments. So what happens to them when the command and control structure goes away? There are several possible changes:

- *Consulting.* Quite a few of the corporate staff will change roles, from focusing on controlling the business to assisting businesses with whatever problems they may have. For example, the corporate staff can provide lease or buy analyses to profit centers, or investigate possible market opportunities, or explore the tax impact of opening a storefront in a new location. This is a fundamental role shift, where a person essentially becomes an in-house consultant. This can be a rewarding change, but may be difficult for some people to handle.
- *Perception.* Because of the just-noted switch to consulting activities, the rest of the company should experience a substantial improvement in its reckoning of the value of the corporate staff. They are now sought-after assets who can provide valuable assistance. This is a substantial improvement over the command and control environment, where most employees try to avoid contact with the corporate staff.
- *Headcount.* A decentralized environment requires far fewer corporate staff. Thus, though some people will become effective in-house consultants, there will be no need for many others. These people may shift into the company’s new profit centers, or find work with other companies.

Board Approvals

It is customary in many organizations for the board of directors to formally approve the annual budget. If there is no budget, then the board can (and should) approve a statement of the overall strategic direction of the company, and may become involved in the larger capital budget purchasing decisions. Further, it is customary for the board to review the financial statements of the firm at many of its meetings. Thus, the absence of a budget does not prevent the board of directors from reviewing the direction of the company; it merely focuses on other aspects of operations.

Compensation without a Budget

If you eliminate a company's budget and along with it the traditional bonus contract, then how do you compensate employees? Here are the key issues to consider when designing a new method of compensation:

- *Baseline.* The foundation for the traditional bonus contract is the baseline from which performance during the measurement period is to be tracked. This number is usually a negotiated figure, which means that it is subject to a great deal of politicking. An excellent alternative is to use one of the following options as a replacement baseline:
 - *Historical trend line.* If the actual performance from the last year is used as the baseline for future performance, there is no way to create a less-effective negotiated baseline. However, if earlier performance was substandard, employees may be overly compensated for achievements that are better than the prior year, but not necessarily at the level of the competition. Also, if the company needs to reorient its business, focusing on improvements from the last year may not be sufficient.
 - *Peer group performance.* The company can benchmark its performance against other "best in class" companies, and compensate employees based on their performance against this "gold standard." Another option is to divide the company into a multitude of profit centers, and use the performance of the best profit centers as the baseline. This latter approach may work best, since performance is derived from the company's specific competitive situation, rather than from the performance of another company that may operate in a different market.
- *Unit of measure.* The unit of measure for a traditional bonus plan is probably profitability, but that does not have to apply to a situation where you want to focus the attention of employees on other key success factors. For example, in a rapidly-expanding market, the most important issue may be revenue growth, even if there are no profits. Or, if a company has gone through a leveraged buyout, debt reduction (and therefore cash flow) may be the most important concern. Or, a niche strategy may mandate a high level of customer support. The central point in the selection of the unit of measure is that it provides a measure of progress toward the company's strategic objectives.
- *Team basis.* The traditional model favors bonuses for individuals. However, when longer-term goals are paramount, it requires the ongoing efforts of a large team to achieve above-average performance. Thus, it makes more sense to eliminate individual bonus plans in favor of group-based bonuses. Ideally, there should be one bonus plan, and it should include *every* person in the company. With one bonus plan, every employee has an incentive to help everyone else to optimize their performance. Conversely, if there were to be localized bonus plans, it is more likely that employees in different

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bonus plans would not assist each other, since they would have no economic reason for doing so. The worst situation is to only have individual bonuses for a small number of managers, since the rest of the company has no reason to work hard so that someone else can earn a large bonus.

- *Bonus calculation.* The calculation of a bonus can be a nefariously difficult and arcane formula under a traditional budget plan which sometimes results in no bonus at all, despite the best efforts of an employee, or an inordinately large bonus because the circumstances were just right. In a no-budget situation, it makes more sense to not establish a detailed compensation plan in advance. Instead, use one of the options just noted to create a baseline for measurement, and pay out an appropriate amount based on changes from that baseline. In general, this approach means limiting bonus payments to a certain percentage of profits or cash flow, so that the company is not crippled by inordinately large payments. Also, paying all bonuses from existing profits or cash flow means that compensation will always be supportable, since the company has already earned the money.
- *Nature of the bonus.* A company that wants to *really* focus the attention of its employees on long-term performance should consider *not* immediately paying out the bonuses that it grants to employees. A better alternative is to pay all or a portion of the bonus into a fund, which in turn invests at least some of the money in the company's shares. The fund then pays out both the accumulated bonuses and any earnings to employees when they retire. By taking this approach, a company is ensuring that employees have a significant interest in the performance of the company's stock, which in turn is driven by their ability to improve its earnings and cash flow over time.
- *Comprehensive evaluation.* A traditional bonus contract focuses on the achievement of very few targets – perhaps just profits – in order to trigger a bonus. This can lead to considerable “gaming” to twist the system to achieve only the specified targets, perhaps to the long-term detriment of the business. A better approach is to establish a large group of performance factors that an evaluation committee can use to ascertain the improvement (or decline) of the business during the measurement period. Such a comprehensive system may start with profitability, but then go on to measure (for example) backlog, customer turnover, employee turnover, absentee levels, average accounts receivable outstanding, the debt level, and new product launches to obtain a more well-rounded view of how the organization has changed.

EXAMPLE

Mr. Jones is a traditional manager who is accustomed to moving heaven and earth to meet his profit target and earn a bonus. For the past year, he made the designated profit bonus, but ignored the company's move to a more comprehensive evaluation system. The committee discovered that he only achieved the budget by eliminating training and maintenance expenditures, which seriously impact staff knowledge and machine downtime. The committee therefore awarded Mr. Jones a minimal bonus for the year.

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Compensation under this system should be based on *relative* improvement, rather than performance against a fixed target. This is a key concept, for it does not tie employees to a number or other metric that may be increasingly irrelevant over time. Thus, if there is a steep economic decline, it may still be quite reasonable to issue a bonus to the members of a profit center even if their profits dropped, because the profit decline was less than the median rate of decline for other parts of the company. Conversely, if the market is expanding rapidly, it may not make sense to issue bonuses to the members of a profit center that earned fewer profits than the median rate of profit increase for the company.

It is extremely useful to base all bonus compensation on a single company-wide profit sharing pool. By doing so, the members of the various profit centers will have a strong incentive to work together to create more profits. If the employees in profit centers were to instead be paid just on their own performance, then they would be far less likely to assist other parts of the company. Another effect of this arrangement is that a poorly-performing profit center may even receive unsolicited offers of help from other profit centers, because its poor performance is adversely affecting the compensation of other employees.

One type of compensation that has no place in a no-budget company is the stock option. A stock option generates a return for its holder if the price of the underlying stock increases. However, there is not necessarily a relationship between the price of the stock and the actual performance of the company. A stock price may go up due to general price volatility, speculation regarding a takeover, or simply because the valuation of the entire stock market is increasing due to an improvement in general economic conditions. None of these scenarios are impacted by the performance of the person to whom a stock option is granted. Indeed, the reverse can be the case – a person could engender phenomenal company performance, while a variety of factors *decrease* the value of his or her stock options. Consequently, it is better to use compensation devices that only provide increased pay if the company performs better than its peer group.

Controls without a Budget

The budget and the command and control system are both considered to be robust types of controls, since they ensure that someone is examining actual results against a standard, and tracking down variances. However, is this really the case?

The budget and the command and control system are both designed to be *detective* controls, which mean that they find control breaches after they have already occurred and funds have already been lost. While useful, this type of control is not especially robust. A better type of control is the *preventive* control, which keeps control breaches from ever occurring in the first place.

In a “no budget” scenario where responsibility is pushed down in the organization, there are more people involved in running the business, more people whose compensation is tied to its success, and therefore more people who are interested in having stronger controls. Thus, even in the absence of a budget, it is entirely likely that employees will demand a strong control system simply to ensure their own

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success. The system of controls may develop in a decentralized manner, as the corporate staff assists the profit centers with the controls most applicable to them, but this does not mean that the system will not be a robust one.

Further, a decentralized system calls for an extremely broad-based sharing of financial and operational information. Such a transparent environment can be a very effective control, for there is nowhere for someone to hide inappropriate expenditures of any size.

Behavioral Norms

Senior managers may point to specific individuals within a company who might take advantage of the situation if a tight budgeting system were not imposed; however, this justification is based on the concept of imposing a command and control system on an entire company in order to prevent possible deleterious activities by just a few people. It would certainly be easier to only restrict the behavior of those few people, or even encourage them to work elsewhere, rather than impose a repressive level of control on the entire company. Thus, a reasonable alternative to the command and control system is to imbue the organization with a strong sense of ethics and limits to acceptable behavior, and then act decisively when one of the few miscreants in the company breaks those boundaries.

Another argument by senior management in favor of strong controls over expenditures is that there are always a few employees who add improper expenditures to their expense reports, which only detailed cost reviews will find. This certainly does happen from time to time, but only few employees engage in this sort of behavior. In most cases, it seems odd that a company will entrust its employees with expensive assets, design products, and deal with important customers, and yet assume that they will run a few unwarranted expenses through their expense reports. In reality, nearly all employees can be trusted within a framework of a modest number of controls. Instead, it is certainly worth considering the use of well-defined behavioral norms, and coming down hard on any employees who step outside of those norms. Doing so means that the company is acting forcefully against a small number of employees, while not punishing all other employees with an oppressive set of controls.

Profit Knowledge

If there is to be no budget, then the entire organization requires more knowledge of how the company makes money, so that they can contribute to making more of it. This calls for company-wide education by the accounting staff of how the company earns money, where it loses money, and the profit that the company earns from specific transactions. Thus, the sales and marketing staff should know how much profit the company makes on each product, so that it can increase sales of those items. Similarly, the engineering staff must be encouraged to use target costing to create products that generate acceptable returns. Target costing is the process of projecting the costs expected to be incurred to create a new product and how this

will impact product profitability levels. Further, the customer service department must know which customers generate the most profit for the company, so they will pay particular attention to them.

Ultimately, the amount of information transparency should be so great that it is nearly impossible for someone to hide an inappropriate expenditure.

Information Exchange

A great deal of responsibility is shifted down to the front lines of a business when there is no budget. In this situation, employees need to discuss alternatives with each other for how to run their profit centers, as well as where to find solutions to their problems, and cast around for ideas regarding how to improve their operations. None of these requirements can be met in the work silos that are part of a traditional organization. Instead, employees need new ways to communicate with each other. This may involve company-sponsored blogs, newsletters, more formal gatherings, and so forth, with the goal of creating a massive number of connections amongst employees. This approach is completely at odds with the traditional view of restricting information to a select few within each department, and so can be a wrenching change for those employees who used to control all of the corporate information.

Hiring, Promotions, and Continuity

As has been noted in this chapter, operating without a budget calls for an entirely different way of doing business – and one that is not widely practiced. Thus, a company that wants to follow this path must do so by training employees internally in how the system operates, and providing them with ongoing coaching for many years. This scenario has the following impacts on hiring, promotions and employee continuity:

- *Hiring.* The hiring process requires even more interviews than usual to pick out those candidates who seem most able to take on responsibility and operate well in a profit center environment.
- *Promotions.* There should be a system for locating those employees most comfortable with the new system, who are willing to coach others in how the system works, and who have the potential to become part of the management team. Conversely, no one should be promoted who might want to convert back to the command and control system, or even adopt some elements of that system.
- *Continuity.* Given the rarity of people trained in the no-budget system, it is imperative that a company using this system retain its employees for the maximum amount of time. Otherwise, it will spend inordinate amounts to train replacement employees. Long continuity calls for the creation of an unusually employee-friendly environment, but only for those who are clearly willing to work with the system. Those employees who resist the system

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should be encouraged to work elsewhere in firms that are managed in a more traditional manner.

The worst mistake that a no-budget company can make is to hire a senior executive team from the outside, since these people are quite capable of rooting out the entire system and reverting to a command and control environment. Instead, it is much better to promote people from within the company to the executive ranks, for they understand the system and are committed to continuing it.

Customer Ownership

Under the no-budget system, it makes considerable sense to drive responsibility as far down into the organization as possible, which in turn suggests that there should be many profit centers. However, if there are many profit centers servicing the same customer, who “owns” each customer? Generally, each customer should be assigned to a single profit center, even though a customer may deal with multiple profit centers. The reasons for doing so are:

- *Responsibility.* There must be one profit center that is ultimately responsible for each customer. Otherwise, there is a risk that a customer with a problem will be shunted among multiple profit centers before a resolution is achieved; this delay does not constitute good customer service.
- *Poaching.* If the various profit centers are allowed to poach customers from each other, this will likely be achieved through price reductions, which reduces the profitability of the company as a whole.

It may appear that a profit center that is established earlier than another profit center will have captured a larger group of customers, and so will always own the financial results associated with those customers. However, senior management can become involved in the matter from time to time and transfer ownership to a new profit center if it becomes apparent that the new profit center is generating most of the products and services for the customer.

Service Center Pricing

Under a traditional accounting system, such internal service centers as the maintenance department or trucking department are allocated operational funds. Under a more decentralized system, there is no central budgeting authority to assign funds to these service centers. Instead, each service center must negotiate the prices it can charge to the other departments for its services, and those other departments can go outside the company if they can achieve a better deal by doing so. This approach effectively creates a budget for each service center which is based upon the market price for similar services. Taking this approach ensures that the service centers have lean operations.

Service centers should charge their costs to users. This does not mean that they should have a zero expenditure level by the end of the year, with all costs incurred

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having been passed along to users. Such a condition would only arise if a service center were 100% utilized throughout the year. In reality, a service center only charges for actual usage, and its services will probably not be completely utilized throughout the period. This is the same condition that a freestanding business would experience – it is rarely in a situation where its services are totally consumed.

These service center issues do not necessarily mean that all support services be handled locally by each profit center. On the contrary, it may be quite cost-effective to handle a number of issues from a central location, such as information systems, tax planning, and financing. Thus, it is possible to have a decentralized decision-making system while still providing the entire business with centralized services.

Accounting Reports

When responsibility is shifted into the depths of an organization, information needs to flow along with it. This means that the accounting staff must create and issue reports at great speed to the entire organization, thereby creating a rapid feedback loop from which the company can take corrective action.

The information provided by the accounting staff may encompass more than financial information. Indeed, such information may be downplayed if senior management wants to encourage employees to focus on other key performance indicators.

EXAMPLE

The management information systems manager of Quest Adventure Gear is creating feedback reports for various people within the company. His reports include the following:

<u>Title</u>	<u>Information Provided</u>
Customer service manager	Customers gained; customers lost
Engineering manager	Engineering change orders; warranty claims
Maintenance manager	Downtime at bottleneck operation
Sales manager	Sales discounts granted; Days sales outstanding

A more balanced approach is to issue a complete package of financial and operating information throughout the company, which usually includes the following:

- *Rolling forecast.* This is a general-level forecast that requires little time to update, and may cover a period of as little as three months. See the Rolling Forecast chapter for more information.
- *Leading indicators.* This is a very limited set of leading indicators that strongly indicate the direction of the market in which the company operates.
- *Performance comparisons.* This is the operational and financial performance of the various profit centers, and is presented only for the key information that the company is most interested in. The various profit centers use this information to compare their results. It is intended to be both a spur for more

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action and the source document for the eventual payment of performance-based bonuses.

- *Benchmark comparisons.* If the company chooses to benchmark performance against that of one or more outside companies, it can compare the recent performance of the company against that of the benchmark. This information can be used to calculate performance-based bonuses.
- *Financial results.* This information should be issued at the level of responsibility of the recipient, and should be formatted to show the results for each of the last 12 months in order to present a trend line, and preferably aggregated so that readers are not overwhelmed with detail. There are several ways to present financial information. A general format follows.

Sample Presentation of Financial Results

<u>Cost Center</u>	<u>Current Month</u>	<u>Same Month Last Year</u>	<u>Current Y-T-D</u>	<u>12-Month Average/Month</u>	<u>Quarterly % Change</u>
Accounting department	\$50,000	\$58,000	\$163,000	\$52,500	-4%
Engineering department	125,000	137,000	490,000	131,000	-3%
Maintenance department	72,000	55,000	160,000	60,000	+11%
Power plant	150,000	147,000	440,000	153,000	+1%

The preceding report shows that the accounting and engineering departments appear to be successfully pruning their costs, while the maintenance department has experienced a significant expense surge that is worthy of further investigation.

A variation on the trend line report is to include a percentage change line, which may be more useful to report users. Whether you use this feature is entirely up to recipients. Some people find that a percentage change number provides better information than the raw numbers upon which it is based.

There are a few reports that may still be needed by senior management, and which the rest of the company does not need to see. For example, there may be cash flow forecasts needed by the treasurer to anticipate cash borrowing and investments. There may also be transfer pricing reports needed by the tax manager to predict future tax payments. Generally, these are reports intended for specialists, and so are of no interest to the rest of the company.

Transfer Pricing

A transfer price is the price at which one part of an entity sells a product or service to another part of the same entity. There are a number of transfer pricing methods, such as using the market price, or a negotiated price, or cost plus a margin. Transfer pricing is used to avoid paying income taxes in high-tax regions, and so is a significant focus of government auditing activities.

When there is no budget, the flow of costs through a company must be as transparent as possible, which means that there can be no transfer prices built into the reports seen by employees. Instead, only the actual cost of a product that is transferred between departments should be shown.

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If transfer prices must be used for tax recognition purposes, then they should be included in a separate set of reports that are only used for tax reporting purposes.

Investor Relations

When the investment community is accustomed to receiving budget information from a publicly-held company, withdrawing the budget is essentially reducing the amount of information that they receive. In the absence of this information, investors and analysts may be somewhat more inclined to take their business elsewhere, or at least will be increasingly uncertain of the future direction of the company.

You can alleviate this problem by replacing budget information with other types of more relevant information. For example, the investor relations officer could issue a rolling three-month forecast once every three months. This gives recipients a fairly accurate portrayal of what the next quarterly financial statements will contain. In addition, there may be a general projection covering the next year, but which does not contain quarterly targets. The company can also release information about key performance indicators, such as backlog, market share, and customer retention; this information can provide a solid foundation for the analysis work of an outside analyst.

Releasing this different mix of information to the investment community may even limit the impact of short sellers, since there will be so much information in the marketplace that the current stock price will likely be very realistically valued, with minimal price volatility. This leaves little room in which a short seller can earn a profit.

Implementation of the No-Budget Environment

The changes noted in this chapter make it clear that operating effectively without a budget essentially requires a retooling of the entire system of running a company. Employees are accustomed to the command and control environment (even if they do not like it), and so will require substantial re-education into a decidedly different system that they have never seen or heard of before.

The implementation process for this change is a slow one. Even if senior management is willing to adopt the new concept at once, the rest of the company will require time to become accustomed to it. The new approach calls for the development of entirely new systems of governance, new reports, and new policies and procedures. Further, employees must believe that senior management is really turning over a broad range of responsibilities to them, and will not interfere in their decisions – and it takes time for this belief to grow in response to the actions of senior managers.

For these reasons, the best approach to a no-budget environment is a gradual one, where senior management and employees jointly develop the new system over time, perhaps through pilot projects in some parts of the company, or through a broader rollout. The correct implementation requires a company to keep the business

running properly despite any problems arising during the transition, so expect a number of years to pass before the transition has been completed.

Summary

Once a company commits to the “no budget” environment and spends several years transitioning to it, what does the environment look like? The following can be expected:

- *Use it or lose it.* There is no longer a mentality of “use it or lose it” in the company. Instead, actual costs incurred are tracked on a historical trend line, with ongoing peer pressure to reduce costs. Thus, the negotiation of a cost budget and subsequent use of it near the end of the year are gone.
- *Forecast integration.* Instead of creating a full-year budget and then forgetting about it until the next year, the company updates a forecast every month. Given the immediate relevance of this information, managers are more likely to use it to plan their profit center activities over the near term.
- *Profit knowledge.* Every employee who deals with customers knows the profit associated with each transaction, which they can use to influence sales to customers.
- *Compensation based on relative performance.* There is no longer a negotiated fixed target to reach each year. Instead, employees do their best to improve their performance against that of an internal peer group or an external benchmarked organization, and they are paid based on their relative performance. This means that there is no false amplification or reduction of revenue forecasts, since forecasts are now divorced from the calculation of compensation.
- *Feedback loop.* In order for the entire organization to operate without a budget, there is an extraordinarily fast feedback loop for all types of information, so that employees see the results of all key financial and operating information as soon as possible. Further, the reports are “sliced and diced” so that only the information relevant to an individual is reported to him.
- *Customer service.* The attentiveness of employees to the needs of customers will have increased noticeably, since nearly all decisions relating to customers can be made at once, rather than being sent up to a higher level for approval.
- *Training.* Since it is impossible to shift responsibility down in an organization without giving employees sufficient knowledge to handle it, there is an ongoing training program, coupled with a regularly-scheduled needs assessment for every employee. The funds allocated to training are substantial.
- *Employee turnover.* There has been an initial spike in employee turnover, as those not accustomed to the new system leave for other companies who still use a traditional command and control system. After this one-time surge, employee turnover has plunged, since the quality of work has substantially increased.

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In general, the no-budget environment is a simpler one than the more traditional command and control system. This may not be immediately apparent, given the large effort needed to transition to the no-budget environment. However, consider the situation from a cost perspective – there are fewer people involved in a no-budget company, since many of the corporate staff and mid-level managers who used to maintain the command and control environment are gone. Certainly, there is a higher degree of information sharing and interaction among profit centers, but the *complexity* of the system has declined. Further, those people still with the company who used to monitor expenditures and demand explanations for variances are now employed more usefully, providing information to more employees and assisting them with a variety of internal consulting projects.

Chapter 22

The Rolling Forecast

Introduction

Reality diverges from your budget extremely quickly, especially if the sales backlog is only large enough to support operations for the next few months. If so, sales could change so fast that the budget will look like science fiction by the second quarter of the year, and not even bear a slight resemblance to actual results by the end of the year. The solution may be a rolling forecast. In this chapter, we discuss how to create a rolling forecast, and a variation on the concept, called continuous budgeting.

The Rolling Forecast Process

A rolling forecast is a recasting of a company's financial prospects on a frequent basis. The frequency of forecasting means that the forecast could potentially occupy a central role in a company's planning activities. In this and the following section we address several aspects of that role – the timing of updates, the updating method, the time period covered, and the format of the forecast.

Ideally, a rolling forecast could be created as soon as a company issues its financial statements for the most recent reporting period. By doing so, management can update the existing forecast based in part on the information contained in the most recent financial statements. You may want to update the forecast on a monthly basis, but do so only if the resulting information is useful to management – which is usually only the case in a volatile market. In most situations, a quarterly update to the forecast is sufficient, and is not looked upon as quite so much of a chore by the management team. An alternative view of when to update a forecast is whenever there is a significant triggering event. This may be a change in the business environment, the release of a new product, the loss of a key employee, and so forth. If you are updating only after a triggering event, the revision of a rolling forecast may be quite sporadic.

The rolling forecast is usually considered to be a much more frequent creation than the annual budget, so you need a revision process that minimizes the amount of updating effort. Here are several ways to construct a rolling forecast, beginning with the simplest approach:

1. *Adjust recent results.* Copy forward the company's most recent actual financial results, and then adjust revenues and expenses based on any changed expectations for the forecasting period. This method is essentially based on historical results. It requires the input of very few people, and can be created very quickly.
2. *Block revision.* Only forecast at a very high level, where there is essentially a single line item block for the expenses of an entire department. There may

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be somewhat more detail for the revenue portion of the forecast, since this is the most critical area. This information will likely be extracted from the most recent historical results, but may be subject to more revision than the method just discussed. This approach can also be constructed quickly, with input from just a few people.

3. *Detailed revision.* Forecast every line item in the financial statements “from scratch.” This approach takes substantially more time and requires broad-based input. Few companies are willing to expend the time needed for this level of forecasting.

Of the preceding methods, either the first or second should work well, because they require little time to create. When forecasting requires little time, it is more likely to be accepted on a long-term basis by employees. Ideally, it should take no more than one day to update a rolling forecast.

Another issue with the rolling forecast is the time period to be covered by it. There is no universally correct period. Instead, the time period covered depends on the nature of the business. Here are several examples of situations calling for different forecast periods:

- *Software development.* A business creates software and launches it through the Internet. Its investment in fixed assets is low. Competing products can appear at any time, and the market can pivot in a new direction at a moment’s notice. In this case, management probably does not need a forecast that extends more than three months into the future.
- *Market leading manufacturer.* A business is the dominant low-cost provider of industrial goods in its market niche, thanks to its heavy investment in fixed assets and production technology. The market is probably steady and changes little, so management can get by with a quarterly forecast update that extends over a two-year period.
- *Government contractor.* A company has a backlog of long-term contracts with the federal government. Its cost structure is easily predicted, and revenues are based largely on contracts that are already in hand. Management probably only needs a quarterly forecast update, with particular emphasis on the revenues generated by specific contracts. The forecast duration should match the duration of key contracts.
- *Retail business.* A company sells highly fashion-oriented retail goods from multiple stores. Sales levels are highly variable, so management probably needs a monthly forecast that has a particular emphasis on sales by product line and by store.

Another way to view the duration of the forecast period is whether extending it further into the future will alter any management decision making. If not, there is no point in creating the extended forecast. A good way to determine the correct duration is to start with a rolling 12-month forecast and adjust the duration after a few months to more closely fit the needs of management. It is quite common to have a forecast duration of at least one year, and rarely more than two years.

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In summary, you generally want to update a rolling forecast on a fairly frequent basis, do so at an aggregated level, and for a period that can be as little as a few months and extending up to two years.

The Rolling Forecast Format

What should a rolling forecast look like? As just noted, keep it relatively short in order to make the updating task as easy as possible. However, this does not mean that the entire forecast should be encompassed within just a few lines. Instead, consider structuring the forecast to address the key variables in the business, so that managers focus on changes in just those areas that will make a difference to the business.

The following sample format is designed for a manufacturing business that produces roughly the same items every year and in predictable quantities. There is a focus on the cost of commodities and managing the bottleneck operation, which leads to more detail on those specific items.

Sample Rolling Forecast for Manufacturing Operation

	<u>Quarter 1</u>	<u>Quarter 2</u>	<u>Quarter 3</u>	<u>Quarter 4</u>
Sales	\$8,200,000	\$8,225,000	\$8,290,000	\$8,320,000
Cost of goods sold	<u>5,330,000</u>	<u>5,593,000</u>	<u>5,720,000</u>	<u>5,741,000</u>
Gross margin	\$2,870,000	\$2,632,000	\$2,570,000	\$2,579,000
Gross margin percentage	35%	32%	31%	31%
Other expenses	<u>2,510,000</u>	<u>2,535,000</u>	<u>2,550,000</u>	<u>2,565,000</u>
Net profit or loss	<u>\$360,000</u>	<u>\$97,000</u>	<u>\$20,000</u>	<u>\$14,000</u>
Bottleneck utilization	92%	98%	105%	108%
Platinum cost/pound	\$1,700	\$1,750	\$1,775	\$1,775
Palladium cost/pound	\$700	\$705	\$710	\$715

The rolling forecast for the manufacturing operation reveals a decline in gross margins and net profits over time, which appears to be caused by an increase in the cost of platinum, which is listed on the report as a key commodity. Also, note that the forecast is in quarters, not months – the company has a sufficiently stable product line and marketplace that it does not need to update its forecast every month. Finally, the forecast reveals that there is a growing problem with the overutilization of the company’s bottleneck operation, which management needs to address.

What about if a company has minimal fixed costs and is located in a highly volatile marketplace – such as software development for smart phone apps? In this environment, a product may have a short life span or highly variable revenues, so the focus tends to be more on detailed revenue information and the rollout dates for new products. The following sample format could be applied to such a situation:

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Sample Rolling Forecast for a Software Developer

	<u>January</u>	<u>February</u>	<u>March</u>	<u>April</u>
Revenue:				
App – Geolocator	\$80,000	\$75,000	\$60,000	\$45,000
App – Find my car	55,000	65,000	65,000	40,000
App – Family tracker	<u>160,000</u>	<u>160,000</u>	<u>100,000</u>	<u>80,000</u>
Total revenue	\$295,000	\$300,000	\$225,000	\$165,000
Expenses				
	<u>165,000</u>	<u>175,000</u>	<u>175,000</u>	<u>180,000</u>
Net profit or loss	<u>\$130,000</u>	<u>\$125,000</u>	<u>\$50,000</u>	<u>-\$15,000</u>
Product release dates:				
App – Backcountry locator	1/21/xx			
App – Wildlife tagger			3/5/xx	
App – Urban locator				4/4/xx

The rolling forecast for the software developer makes it clear that revenues decline rapidly, so revenues must be the key focus of the organization. There is also considerable emphasis on the release dates of new products, which will hopefully drive renewed revenue growth. Note that the preceding example format is expressed in months, rather than quarters. In a volatile marketplace, a quarterly update may be far too long an interval to show the rapid changes in sales that will likely occur.

What about a situation where a company relies upon a number of large contracts with its customers? In this case, the key focus must be on the revenue stream associated with each contract, as well as on the dates when contracts will terminate. The following sample format could be applied to such a situation:

Sample Rolling Forecast for a Contractor

	<u>Quarter 1</u>	<u>Quarter 2</u>	<u>Quarter 3</u>	<u>Quarter 4</u>
Revenue:				
Air Force contract	\$1,700,000	\$1,720,000	\$1,690,000	\$850,000
Marine Corp contract	2,400,000	2,350,000	130,000	0
USGS contract	<u>850,000</u>	<u>875,000</u>	<u>430,000</u>	<u>0</u>
Total revenue	\$4,950,000	\$4,945,000	\$2,250,000	\$850,000
Expenses				
	<u>4,300,000</u>	<u>4,290,000</u>	<u>1,950,000</u>	<u>830,000</u>
Net profit or loss	<u>\$650,000</u>	<u>\$655,000</u>	<u>\$300,000</u>	<u>\$20,000</u>
Contract terminations:				
Air Force contract				11/20/xx
Marine Corps contract			7/11/xx	
USGS contract			8/15/xx	

The rolling forecast for the contractor is driven entirely by revenues. The company can easily cut back on staffing when there is no work, so its expenses are not a

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concern. The non-financial information in the forecast keeps management aware of the truly critical item – when customer contracts are scheduled to expire.

What about a situation where certain elements of the forecast are more volatile than other elements? If so, construct an update table that specifies how frequently information should be reviewed, and adjust the model as indicated by the table. The following table shows how updating frequencies might be specified for a clothing retailer:

Sample Forecasting Frequency for a Retailer

<u>Line Item</u>	<u>Volatility</u>	<u>Update Frequency</u>	<u>Comments</u>
Revenue	High	Daily	Shifts in fashion occur at lightning speed, so management must be aware of sales by stock keeping unit on a daily basis
Labor costs	Medium	Monthly	Shifts in the local labor market may require that the company boost its pay at regular intervals
Merchandise costs	Medium	Monthly	The company exercises reasonable control over its purchases of merchandise through bulk purchasing arrangements, so costs do not change that frequently
Facility rent	Low	Quarterly	Facility rentals are long term and not subject to change
Other expenses	Low	Quarterly	There is little volatility in all other costs

Continuous Budgeting

A variation on the rolling forecast is continuous budgeting. Continuous budgeting is the process of continually adding one more month to the end of a multi-period budget as each month goes by. This approach has the advantage of having someone constantly attend to the budget model and revise budget assumptions for the last incremental period of the budget. The downside of this approach is that it may not yield a budget that is more achievable than the traditional annual budget, since the budget periods prior to the incremental month just added are not revised. We do not revise these budget periods for two reasons:

- *Accounting software updates.* The budget is loaded into the accounting software for budget-versus-actual reporting analysis, and would be time-consuming to change if the budget were to be continually revised.
- *Budgeting labor.* It is much less labor intensive to only add one budget period than it is to revise the entire remaining portion of a budget.

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The continuous budgeting concept is usually applied to a twelve-month budget, so there is always a full-year budget in place. However, the period of this budget may not correspond to a company's fiscal year. For example, a company uses the period January through December as its fiscal year. After it completes January, the company adds January of the following year to its continuous budget, and drops the January just completed.

Continuous budgeting calls for considerably more management attention than is the case when a company produces a one-year static budget, since some budgeting activities must now be repeated every month. In addition, if a company obtains the input of many employees to create its budgets on a continuous basis, then the total employee time used over the course of a year is substantial. Consequently, it is best to adopt a leaner approach to continuous budgeting, with fewer people involved in the process.

It is generally easier to use a rolling forecast than a continuous budget, since a continuous budget requires the review of all of the revenue and expense line items that are usually included in a full-year budget. A rolling forecast concentrates attention on only a few of the more crucial elements of a full budget, and so is easier to update.

Summary

The rolling forecast is an ideal way to give employees the best possible estimate of what will probably occur in the near future. The forecasting process is specifically designed not to be elaborate, on the grounds that a simple update is more likely to be accepted by a company than a lengthy, bureaucratic budgeting production. And by keeping the model simple, you can focus on the key drivers of success, rather than being bogged down in the details.

It is possible to run a rolling forecast in conjunction with an annual budgeting process, but many companies find that the higher accuracy level of a rolling forecast makes it sufficient for their needs, and so dispense with the annual budget entirely.