

# Wass Consulting Group, Inc.

## *Management Insight*

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## Strategy-Based Budgeting

### A focused approach to allocating resources

#### Summary

At most companies, compiling the annual budget ranks up there with going to the dentist. No one argues with the need, but no one looks forward to doing it either. It is doubly unfortunate then, that after spending the considerable time, talent, and money to develop the annual budget, it all too often fails to meet the needs for which it was developed. Sparked by both external and internal forces, the airline industry recently developed a new tool to address this situation, Strategic-Based Budgeting. While developing the budget using SBB may still be no more fun than going to the dentist, at least the benefits to be obtained suggest that the trip will be worth it.

- Bottoms-up: “Here’s what everyone says they need, now let’s sort it out”
- Historical: “Last year’s budget plus or minus x%, let’s see if it flies”
- Zero-based: “Justify everything from scratch, every year.”

The impact on the organization of the budgeting process is often chaotic and sometimes counter-productive, as the world seems to stand still while managers struggle to finalize their numbers. Just ask any supplier or customer who tries to place a phone call to you during “Budget Week.” In the end, all of these approaches can produce reasonable results - but reasonable results are not always sufficient for executives in today’s operating environment.

#### The Budget Blues

Regardless of your fiscal year, every manager in your organization participates to some extent in the annual budgeting process by providing his or her initial inputs. And if you are on the receiving end of all these inputs, you are inevitably involved for a number of weeks with iterations, negotiations and general gnashing of teeth until the final numbers are agreed upon and established.

Traditionally, both operating and capital budgets are established in one of four different ways, including:

- Top-down: “Here’s what we have to work with, now let’s divide it up”

#### Lessons from Another Industry

In the 1990’s, the worldwide airline industry faced a series of crises related to spiraling costs, regulation, and asset management and customer relations difficulties. Costs continued to rise, but revenues were declining - and in some cases were constrained by regulation. At the same time, the industry as a whole needed to expand capacity and embark on heavy capital investments. Customers were becoming more sophisticated and put more demands on the providers for service and support. The more savvy companies looked 5-7 years out and saw serious challenges to profitability and returns.

To address these challenges, companies looked for new ways to conduct their businesses, and to new tools and techniques to help them do so. One new tool these companies developed and subsequently applied was Strategy-Based Budgeting (SBB). SBB enabled some of these companies to focus and refine the budgeting process - and also provided a foundation for streamlining costs and operations. It is noteworthy that the two most profitable foreign airlines led the way in implementing SBB.

While there are several differences, there are also a number of similarities between the airline industry and the energy industry, including:

- A high degree of cost-sensitivity
- Large asset bases and capital investments
- High public profile
- Regulatory constraints

So how can this tool be applied to our industry and what are the lessons that can be learned?

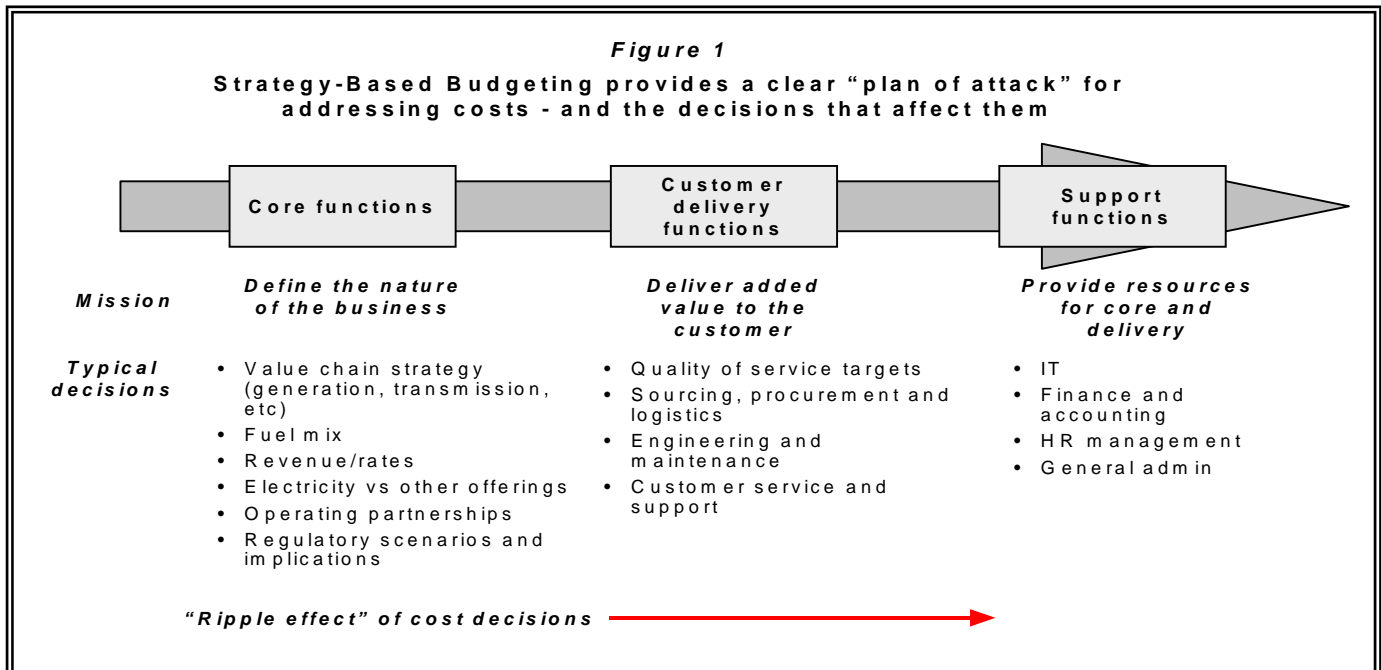
**SBB in a Nutshell**

As shown below in Figure 1, Strategy-Based Budgeting (SBB) is a formal process that recognizes three basic principles and applies them to the budgeting process:

- Some decisions are more important than others (“first things first”)
- Most decisions depend on the outcome of others (the “ripple effect”)
- Recognize leverage (“apply the 80/20 rule”)

Specifically, SBB divides the company’s functions (and budgetary entities) into three categories, including:

- **Core functions**, which define the nature of the business. The decisions at this level are strategic. In the airline industry, they involve routes (where to fly), revenues (how to configure and price passenger load), and fleet (what kind of aircraft). In a utility, these decisions could include:
  - Value chain strategy (e.g., generation versus transmission versus distribution, or the relative mix of each)
  - Electricity versus other offerings (e.g., energy-efficient products, Powerline technology applications, etc.)
  - Revenue scenarios (considering rates, regulatory constraints, fuel mix/availability, etc.)
  - Operating partnerships (contractual, virtual, short- and long-term, etc.)



- **Customer delivery functions**, which deliver added value to the customer. In the airline case, these functions included reservations, sales and marketing, cabin and ground crew, food and beverage operations, and engineering and maintenance - all services that help define the customer experience. In a utility, delivery targets typically begin with Quality of Service (QOS) targets, many of which will have direct impact on the nature and extent of operations, procurement, maintenance, engineering, and customer service activities.
- **Support functions**, which provide resources to core and customer delivery functions. In any company, these functions (and resources) include IT (systems and infrastructure), HR (staffing), and Finance/Accounting (capital), among others.

### Precondition for SBB

SBB presumes that a dynamic strategy (i.e., one that considers change) already exists. If the strategy is static, much of the reasoning behind the budget could be irrelevant by mid-year. This is an important consideration, and a specific tool, **Scenario Planning**, can be applied to ensure the fundamental strategy has evaluated the potential effects of variables such as regulatory change, technology development, and market forces. Scenario planning will be the subject of a future *Management Insight* article.

### SBB in Practice

The SBB process recognizes that the budget decisions at the core (top) level have the largest financial impact, since they typically involve the bulk of the capital base. Decisions at the next (customer delivery) level depend on the core decisions. Since they drive the support decisions, the customer delivery decisions as a group have the second largest financial impact, and so on.

The SBB framework also recognizes that strategic decisions made at the core (top) level have a “ripple effect” on operating decisions made at the

customer delivery level. Similarly, customer delivery decisions have an impact on support-level decisions. This is an important departure from traditional budgeting processes. It means, for example, that you should never see an IT budget until 1) the core decisions and targets have been set, and 2) the delivery targets and budgets have been set. Then, and only then, should IT submit a budget - because the IT budget should specifically support the core and delivery goals. This helps to eliminate the familiar cash sinkhole created by “technology for technology’s sake.”

There are thus three steps in the SBB process - but step 2 (delivery targets and budgets) doesn’t begin until the results of step 1 (core targets and budgets) are finalized. Similarly, step 3 (support targets and budgets) are never formulated until step 2 is complete. The result: better focus, less waste, and a budget that is driven by strategy - not by subjective haggling.

Once the strategic decisions have been made, the operating budget decisions can be prioritized by their cost impact. Here the Pareto Principle comes into play - typically, 80% of the cost is driven by 20% of the possible factors. In the airline example, the two biggest operating cost factors after the planes themselves are fuel and people. Since routes were already determined, fuel budgeting decisions focused on differentials in price due to location, and the amount of discretionary uplift used by the pilots. People decisions focused on operating work rules and rostering practices that in turn governed the total number of cabin crew, cockpit crew and ground crew needed.

As the cost drivers are analyzed, opportunities for reducing and controlling budget are directly linked to revisions and improvements in operating policies, practices and processes. Thus the entire budgeting process is no longer a paper exercise, but a deeper examination of how and where the business itself can be streamlined and optimized.

## Keys to Implementing SBB - Easier Said Than Done

As SBB is implemented, the senior management team typically becomes more cross-functional in outlook - vertically as well as horizontally. Operating managers must now understand the strategic direction of the company to be able to develop meaningful customer delivery budgets. Similarly, support managers can no longer operate in a vacuum, but must see more clearly the linkage between their efforts and the operating targets they must help meet.

One factor that is often overlooked in implementing a new process concept such as SBB is the internal organizational threat to “the way we’ve always done things.” This is a very real impediment to achieving meaningful results. Working through this obstacle requires change - first in mindset, and then in behavior. First and foremost is the need to instill a sense of urgency. This requires a well-managed employee communications program. The airlines that successfully implemented SBB made it abundantly clear to the rank-and-file that cost cutbacks were inevitable - the only open issues were what, why, and how they would be implemented. They very wisely formed cross-functional teams of employees, mixing both staff and line personnel, and charged these teams with the task of making the first budget proposals. Because they involved the employees in the process, they avoided potential labor problems with them.

SBB teams, of course, need to be trained or coached to use the basket of tools they need to perform the process. One approach to this is usually to pick an initial team to do a “pilot run” of the process in a certain area. After the pilot is complete, this core team disperses - with each team member becoming a team leader for a subsequent round. This cycle can be repeated as often as necessary in order to develop the critical mass of people needed to complete the SBB process. The greatest indirect benefit from this approach is that it is not a top-down mandate - the

more people participate in the SBB process, the more they understand it, the more they embrace the right mindset, and the less they resist the inevitable operational and organizational changes.

## Where SBB Can Lead You

SBB taken alone is a process improvement, but it can also be the tip of the iceberg for much deeper changes within the organization. The senior management team will obviously benefit from the increased alignment of operating goals to strategic decisions, but the larger potential benefit is the “ripple effect” that occurs as operating goals are re-examined in terms of departmental and individual goals. This cascading will touch upon individual incentives, and those companies that use Balanced Scorecard approaches to individual performance evaluation will be profoundly affected. The cost-management aspects of Strategy-Based Budgeting can also lead to a strategic approach to asset management, using similar tools and analytical skills.

Finally, because SBB is a regularly-scheduled activity, it can be one of the key tools to foster an organizational mindset of continuous improvement. This mindset is an important part of any company’s operating philosophy, similar to the Japanese concept of *kaizen*, or to the Western six-sigma quality concept. Supporting it requires a careful look at recruitment, hiring, and training activities, (as well as performance monitoring, evaluation, and incentive systems) to ensure they send the appropriate, enduring “messages” throughout the organization.

At the end of the day, the key word underlying SBB is *alignment*. The process both provides and becomes a central focal point for aligning operations to strategy, and ultimately can align individual actions more coherently to operating targets.

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