



A Closer Look at Rolling Budgets

BY MARC P. LYNN, PH.D., AND ROLAND L. MADISON, PH.D., CPA

THE CHALLENGES ASSOCIATED WITH AN EFFECTIVE IMPLEMENTATION OF ROLLING BUDGETS ARE MANAGEMENT CHALLENGES, AND SOFTWARE TECHNOLOGY CAN ONLY BECOME PART OF THE SOLUTION WHEN MANAGERS ARE READY TO USE IT TO ENHANCE THEIR DECISION MAKING.

Businesses are increasingly using *rolling budgets*. Also called *continuous budgeting*, rolling budgets always involve maintaining a plan for a specified time period in the future. To implement rolling budgets, many advocate leveraging new technological resources, which means software. It must be understood that the technology (e.g., bolt-on software packages) is not the solution. It is a tool by which and an environment in which management can have the opportunity to develop solution sets.

Published surveys of financial officers of the largest industrial companies in the United States, Australia, Holland, Japan, and the United Kingdom show a number of interesting similarities as well as differences in budgeting practices across countries.¹ First, the use of master budgets is very widespread in all of these countries. Another significant finding is that financial managers in many countries distinguish between cost behavior patterns—variable versus fixed costs—for a common reason: They want to prepare more meaningful budgets by building flexibility into the model.

How do these facts impact the concept of rolling

budgets? Rolling budgets always involve maintaining a plan for a specified time period in the future. This result is achieved by adding a new time period in the future as the current time period that ended is dropped. Large companies, such as Electrolux and General Electric, prepare strategic plans and then integrate annual operating budgets that are divided into four-quarter rolling budgets, and smaller high-tech public companies, such as Keithley Instruments in Solon, Ohio, follow a similar pattern of planning.

The annual operating budgets are prepared based upon best estimates of what management expects to occur and wants to achieve during the coming year. Flexibility is built into the process by considering how costs and revenues will change if different levels of activity occur (e.g., flexible budgeting), and each quarter's changes are made to reflect changes in the economic and financial environment—things such as what the competition is doing, how the economy is spending for capital goods, and any planned changes in their product mix (adding or dropping a product line). In short, sound managers operate an entity with one eye always on the horizon, and a well-prepared business

plan as reflected in a “*flexible* rolling budget” can be one of the financial managers’ best tools to assist them in their role of planning and controlling the operations of this company.

In his article “Budgets on a Roll,” Randy Myers identified a number of problems with annual static budgets.² A closer look, however, reveals that these problems were really management or human resource problems, where the proper development and use of budgets as just described was simply not understood. One example cited was that of an “account director” who would land several large clients “early in the year and make his annual budget” and then “coast” the rest of the year. This is not a problem with the budgeting process. It is a prime example of inept management and human resource functions that do not know how to plan and develop proper incentive systems.

COSTLY SOFTWARE CANNOT HELP POOR MANAGEMENT

The implementation of costly software based upon fixed algorithms that merely permit one to roll the budget forward on a monthly basis without looking at the big picture is not a solution for poor planning or for a lackluster management team. If the management of any company allows its sales force to play such games in the planning process, shareholders likely would not value the financial expenditure for software that merely accelerates the game. Maybe heads should roll before the budget rolls.

Electronic spreadsheets such as Microsoft’s Excel may be widely used for supporting the budgeting process, but if the data to populate the spreadsheets does not come from the corporate database directly, maintaining data integrity is a real problem. The use of other software packages that are more directly integrated into the corporate database certainly eases this problem, but it must be remembered and understood that budgeting is not a piece of software nor simply a mindless algorithm. It is a management process, and software is merely a tool to help facilitate this process.

It has been said that “Implementing rolling budgets doesn’t necessarily require any fundamental change in the way a company has been doing its budgets—except, of course, it no longer does the job just once a

year.”³ But maybe one should take a closer look at Eden before hunting for apples. Assume that a company that has been constrained by limitations imposed by static budgets suddenly finds itself able to roll them monthly with ease. Does the company now reevaluate salaries and bonuses on a monthly basis? If so, how is this done? If not, then what expectations might the company have to alleviate problems posed by employees who get lucky and meet their quotas early? Who will make such decisions, and how will they get implemented? Are the company’s managers really ready to identify, let alone deal with, all the associated issues at the clerical and tactical levels? While a new budgeting system might be ready to roll, how prepared is the company’s human resource (HR) system?

This is where integrated information systems, especially well-implemented enterprise software, can be very helpful. One may not be ready to answer all of the key questions or even know all of the questions that need to be asked, but at least management would have a good chance of finding out whether and how its technology can respond to the challenge. But the technology (e.g., bolt-on software packages) is not the solution. To use an analogy, if your grandfather is having trouble driving, putting him behind the wheel of a faster, more powerful automobile isn’t the correct solution to the problem. Although you may have really great maintenance and support for the powerful new car, your grandfather isn’t the only one who has to drive it, even though he may be the one who determines where to go, when, how, and why. Now, if your grandfather is actually the CEO of the company, and the “new car” is really a rolling budget, everyone in management had better look out because you don’t know whom the grandfather will crash into with the new high-powered toy!

Reports generated from the company’s main information systems will not coincide with data in the spreadsheet unless the spreadsheet uses the main systems as its data source. Unless one coordinates and manages this effectively, the data transfer might be in a precarious position. It is a major challenge, but such problems are usually solvable. What is *not* always solvable easily is reflecting things done outside the main corporate database system (for example, in spreadsheets) and bringing them back into the main system’s environment. This

Practical Example: Static Budget vs. Rolling Budgets

When one of the authors was on a business trip, he met a young account manager for a large consulting firm. The account manager was essentially a salesperson who sold expert consulting services. The manager was about 28 years old, held a college degree in marketing, had worked for the same firm for six years, and was evaluated based upon meeting the sales goals in a master static budget. The manager received a modest base salary but could earn a 5% bonus if he achieved \$1.5 million in consulting sales for the year.

The manager said he had never failed to meet the annual goal and had always met it by Labor Day. When asked what he did for the rest of the year, he said, "I coast and spend more time with my girlfriend." I asked if there were any incentive to make \$2 million in sales versus meeting the annual budget number. His reply was: "Not really—the bonus rate jumps to 6% on the extra half-million in sales, another \$30,000. I already make over a hundred grand and my girlfriend earns about \$85,000—so why kill myself?"

After five years of experience, it should be obvious to top management that the annual goal the manager was given at the start of the year was well within his ability to achieve—and long before the end of the year—and the additional 1% bump in commission was not an adequate incentive to motivate the manager to generate the additional revenue.

If compensation is the primary motivator for sales managers, then there are a variety of incentive alternatives available without spending substantial money on

purchasing an ERP system and buying expensive software to convert to a rolling budget model. A simple change in the incremental bonus rate may be the solution. For example, a series of constantly rising bonus rates over a more narrow range of sales may be used. There is nothing wrong with the static budget, but top management does not have to tell the account manager what his annual sales goal is at the beginning of the year. Even if top management *does* know what they want from their personnel and the personnel are capable of making even greater sales, give them the incentive to perform.

Thus, a quarterly rolling budget with a goal of \$400,000 in sales for the first quarter is introduced, and a 4% bonus is granted for reaching that goal. Near the start of the second quarter, a budget for \$500,000 is developed with a 5% bonus. Next, based upon the results of the first two quarters and a view of the horizon of the next six months, budgets of \$600,000 with an 8% bonus for the third quarter and \$700,000 with a 10% bonus for the fourth quarter are introduced.

This rolling budget illustration removes the incentive for the account manager to hit a couple of large clients early in the year and coast for the rest of the year. If top management is satisfied with \$1.5 million in sales but wants to reach \$2 million, it must give the manager the incentive to perform for the full year to reach his potential and the higher goal. While a rolling budget may be used to accomplish this goal, it is not necessary: A simple modification in the incentive plan may help reach the sales objective.

process is not something that must always be avoided, and many functions supporting decision making are, in fact, best handled by such approaches. If management uses these "external" tools to determine policies, new bonus levels, or other incentive actions, the flexibility obtained in the new spreadsheet or financial modeling software is not necessarily *transferable* to the main system's database or processing environment.

Even if a firm can get what is needed from the exter-

nal package, can it efficiently share, capture, or update data in the main system without modification? Remember that re-keying large amounts of data and relying on coworkers to guarantee the integrity of many complex spreadsheets are issues that need to be addressed. It may be very challenging to determine what modifications are necessary, how much they will cost, and what impact such modifications may have on other system functions, such as user screens, reports, calculations, database

queries, links with other integrated products, other “bolts” being used, support agreements, warranties, and version and/or revision upgrades. When a company is using a very complex beast such as SAP or Oracle enterprise systems, nothing is going to be easy, quick, or inexpensive. If the built-in capabilities of these products can be used without modification, this solution is likely the best option to avoid the problems just identified.

One problem in trying to get users to accept the built-in capabilities without making modifications is that the Excel spreadsheets they have been using are easier and more familiar. Furthermore, users are not constrained by having to use real data from the actual corporate database. Finally, without modifications to these systems, a fair amount of training is usually required. In addition, they have probably been using spreadsheets to perform these various functions for quite a while, so why should they change now? This is when change management rears its ugly head once again, but isn't that what this is all about?

MANAGEMENT, NOT SOFTWARE, IS KEY TO SUCCESS

As previously noted, training is a major issue that must be addressed when contemplating any new software, but in this case the firm is not merely dealing with the software but also with new business processes and decision points. Training is costly, requires substantial planning, and can *only* be considered once the business process issues have been addressed. Breaking through the constraints of static budgets may provide great benefits, but not if too many necks are broken in the process. Just imagine this flying-related analogy. You are accustomed to flying a Piper Cub, which is a simple plane with *fixed landing gear* that does not retract. Suddenly you get the urge to buy a Learjet. Just because you are familiar and comfortable with the Cub, would you pull out the Cub's landing checklist, which *does not* include a “*gear down*” instruction, as you approach the airport in your Learjet? You might be enjoying the increased speed and power of the new jet, but eventually you will crash. And don't blame the Learjet or the Cub. The pilot did it all by himself!

What we mean by this analogy is: Can you do a better job of managing your company by finding ways to

make the budgeting process better? Certainly you can! Can software be a key tool? The answer is a resounding “Yes!” But software is no panacea. Like anything else in business or in life, changing a key step in a complex system is not as easy as one would like to believe. Transitioning to rolling budgets and ignoring the potential of flexible budgets based on different activity levels and cost behavior is not easy. A rolling budget is not “annual budgeting done more frequently.”

There is no doubt that management can do a better job of running the company by finding ways to make the budgeting process better, and new software can be a key tool in this improvement process. But like anything else in the business world, it is not going to be as easy to implement as the providers of these new software packages would like companies to believe. Transitioning to rolling budgets *is not* easy, and, once again, it is not annual budgeting done more frequently. If one understands and accepts this fact and wants to investigate some software approaches that could be helpful, a good place to start might be CFO.com's Budgeting and Planning Software Providers list, available at <http://www.cfo.com/chart.cfm/3036961>. But please do not stop at this point. Remember, no challenge of this nature will be overcome by a piece of software alone. ■

Marc P. Lynn, Ph.D., is associate professor of information systems and director of the Center for Teaching and Learning at John Carroll University, University Heights, Ohio. He can be contacted at mlynn@jcu.edu.

Roland L. Madison, Ph.D., CPA, is professor of accountancy at John Carroll University. He can be contacted at rmadison@jcu.edu.

- 1 Eric W. Noreen and Ray H. Garrison, *Managerial Accounting*, 10th ed., McGraw-Hill Irwin, New York, N.Y., 2003.
- 2 Randy Myers, “Budgets on a Roll,” *Journal of Accountancy*, December 2001, <http://www.aicpa.org/pubs/jofa/dec2001/myers.htm>.
- 3 *Ibid.*

FURTHER READING

Paul Hamerman, “Improving Performance—Technology Steps Up Budgeting and Financial Planning Software,” *CFO Project*, vol. 1, October 1, 2002, <http://www.cfoproject.com/document.asp?id=1478>.

Marie Leone, "Major Miners," CFO.com, May 6, 2002.

<http://www.cfo.com/article.cfm/3004532>.

Marie Leone, "Rolling Budgets, with a Twist," CFO.com, June 3, 2003. <http://www.cfo.com/article.cfm/3009422?f=insidecfo>.

Andy Neely, Mike Bourne, and Chris Adams, Cranfield School of Management, "Better Budgeting and Beyond," *CFO Project*, vol. 2, October 1, 2003, <http://www.cfoproject.com/document.asp?id=2094>.