Strategic Financial Planning: A Model for Effective Budgeting

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Problem Statement and Objective

In the current business landscape, nearly all organisations engage in budgeting and annual planning processes. At one extreme, we observe small entrepreneurs who rely on intuition to estimate costs and revenues. At the opposite end, large corporations utilise sophisticated analytics to inform their forecasts. The majority of companies fall between these two methodologies.

The significance of this process cannot be overstated for a firm's strategic decision-making and its pivotal role in ensuring success. It sets the annual priorities, allocates investments across various sectors, and projects the organisation's profitability. Challenges persist not only in the planning stages but also in the governance and oversight of budgets. Our aim is to establish a robust foundation for sound budgeting practices tailored to the needs of Small and Medium Enterprises (SMEs) and startups.

Breaking Down the Basics: Revenue and Cost

To simplify, companies estimate their future revenue and costs to determine whether they will be profitable in a given period, most commonly a financial year. There are multiple approaches to perform exercises on each of the pillars.

1) **Revenue**: Essentially, companies aim to predict how much sales they will realise in the upcoming year. This can be achieved through top-down and bottom-up methods. The former also includes trend analysis and planning for business inputs. The first tool determines future results by applying past patterns to previous observations and allows one to quickly create a prediction for different business units and products. Although its simplicity is a clear advantage, it overlooks multiple variables impacting growth such as the external environment, investment levels, changes in marketing activities, and other internal factors. Modelling the business inputs helps to fill this gap, as it outlines the rules driving the firm's performance. Having determined the function, the company may make assumptions about those controllable variables and set targets to arrive at the desired sales output. We will discuss it in greater detail in the dedicated section below. Lastly, there is a bottom-up approach whereby individual business units estimate revenue predictions themselves, based on experience or one of the methods. While it allows for a greater level of detail and flexibility, it is difficult to coordinate and bears a risk of manipulating the goal setting for individual purposes. Therefore, we do not recommend it.

2) **Costs**: Many professionals find estimating costs to be more complex than forecasting revenue. This is due to the challenge of allocating the costs correctly across the business, which we are addressing now. Firstly, we advise categorising direct (related to generating revenue) and indirect expenses (unrelated to generating revenue) within the business. Some examples of direct expenses may include packaging, shipping, the cost price of goods, and customer services costs, such as returns and advertisements. Indirect costs typically include office rent, salaries of employees (excluding salespeople), and IT systems, etc. Then, as the direct costs are linked to revenue, we determine the ratio between the two, based on past months or years. This allows us to ascertain the direct costs based on the revenue prediction. In a more advanced setting, we recommend allocating the costs to a business unit or even at a product level. Lastly, we review the overhead costs and, if applicable, allocate them proportionately to the business units, so that each of them has its own profit and loss account. This should result in a budget view of a company, including predicted revenues, direct and indirect costs, and the bottom line. If the profit and loss is split into business units or product categories, it allows organisations to make investment decisions based on detailed predictions.

Modelling a Revenue Function

Determining the right input metrics is the key to understanding revenue drivers and giving organisations more control over their operations. This allows companies to make assumptions and track performance of the controllable variables that result in greater output. In this section, we describe the mechanism of creating revenue function on an e-commerce example.

We know that:
Revenue = Average Selling Price x Number of Units Sold,
where Number of Units Sold = Traffic to the product page x Conversion, so:

Revenue = Average Selling Price x Traffic x Conversion,
where Traffic is determined by level of online advertisement and organic traffic; and Conversion is affected by price discount, availability and user experience.

Therefore:
Revenue = Average Selling Price x (Ads Investment + Organic Marketing) x Availability x (Price Discount + User Experience).

This helps to breakdown the complex revenue target into six components that can be controlled on the operational level. Once we arrive at the correct inputs, we should set goals for them, based on the assumptions that those inputs would drive the targeted revenue outcome.

Although we focused on an e-commerce store example, any organisation's business model has its own revenue function. We advise for the companies to analyse what inputs drive their growth and use it to break down the sales figure. Some executives do this using their experience and knowledge of an industry, however, we recommend complementing it with a statistical analysis such as regression modelling, if historical data is available. Lastly, we remind of the importance to test the assumptions by comparing the actual results against expectations to refine which variables (and their levels) are the most indicative.

Determining the Growth Initiatives

After establishing the baseline budget and deriving a revenue function for the business model, the next step is to consider growth projects and associated investment levels. These proposals should evaluate the required headcount and infrastructure, an implementation plan and timeline, and the expected financial returns. We recommend for each small company or business unit to have three, and no more than five focus areas for each year. Each of the project should be evaluated from the following perspectives.

1) **Financial analysis:** As the minimum, the company should perform Net Present Value (NPV) calculation to see whether the future profits of the project would be greater than the costs, given the interest rate. We calculate NPV as a sum of discounted profits by the interest rate for each of the time period. While most companies use the market interest rate set by the central banks for the discounting value, we also recommend using WACC method as it represents the costs of capital for the organisation.

2) **External factors analysis:** There are many external risks and opportunities that should be considered when planning an initiative. These include market trends, macroeconomic situation, political stability and shifting consumers behaviours. They may either support or oppose the proposition and should be evaluated in detail. We recommend PESTLE, Porter's Five Forces or SWOT frameworks as the starting point in conducting the analysis.

3) **Internal factors analysis:** Very importantly, a company should be aware of its capability to implement the project. It should consider whether it has (or can acquire) a) the necessary talent, b) knowledge or know-how, c) tech

capacity for the initiative. It is also crucial to check whether the idea is aligned with a company's strategic vision.

Combining it all together, the leadership team should consider the profitability of the investment, whether it's supported by the external factors and the capability to implement the change. Additional factors to consider at that stage are reputation and downstream impact (non-direct contribution to the revenue of categories of business).

Governance and Cadence

Budgeting and planning process involves multiple stakeholders that should act in an organised way. Before starting the discussion, each team should have a clear budget owner, either a team manager or director (depending on the size of the company). In the most complex organisations, there might be multiple levels of budget owners consolidating at the top in the main HQ.

We recommend two-part planning process, including both divergence and convergence of the ideas and growth areas. The first phase takes place 4 to 5 months before the end of a financial year, when the company builds a baseline revenue and cost forecast. At the same time, the teams build proposals for growth, including additional headcount, investment required and planned projects. We recommend these include the return on the investment and detailed appraisal discussed earlier. Then, the leadership prioritises and chooses the top 3 to 5 initiatives, confirms the headcount, and sets the inputs and output goals based on the business model function. This is later revisited in the last month of the financial year to consider the most recent information. Once the leadership confirms the assumptions, they communicate both input and output goals to the corresponding teams.

Throughout the year, the agreed metrics should be monitored through weekly, monthly and quarterly business reviews, both in terms periodic changes (such as WoW, MoM, QoQ), last year comparison (YoY) and against the budgeted plan. This reporting allows to spot any divergence from the assumed scenario, analyse it and take a corrective action.

Agile Budgeting

Traditionally, leaders use budgeting as a tool for planning, commanding and controlling, however, in the ever-changing environment, business are increasingly required to revisit their numbers. For this reason, there is a growing interest in flexible budgeting to enable companies account for uncertainty and enable them to respond to the changing landscape.

We advise to start shifting the organisation's mindset about budgeting from the set rules to guidelines and allow teams to learn from the business operations. This agility results in taking adaptive actions when required. Moreover, we recommend that leaders consider strategic initiatives in the macro-level instead of repeating the old patterns to set the budget in favour of profitability targets. For example, they may be new and small niches worth investing it, while the big business units are declining. This reinforces the need for detailed appraisal methods.

In this section, it is necessary to cover the topic of flexible goal setting and scenario planning in the budget. There are three approaches to formalise this for agile budgeting: a) setting the limits, b) using ranges as goals and c) periodic rolling forecast. The former option recommends setting the limits for target metrics and preparing a plan for when the results are consistently (e.g., 2-3 consecutive weeks) breaching that level. A derivate to this approach is to set goals as ranges and prepare the plans for when the actual figures fall outside of it. The advantage of the limit setting is the fact that it is more intuitive to create multiple levels/floors of anomaly and plans for the scenarios. Lastly, there is a method of rolling budgeting, for example monthly or quarterly, which recommend for smaller organisations or startups. For medium and larger enterprises, we advise to implement limit setting approach in an annual budgeting process.

Model for Effective Budgeting

By combining the above recommendations, we arrive at the below model for effective budgeting (figure 1). This process increases the likelihood of greater accuracy of predictions and investments as well as business agility.

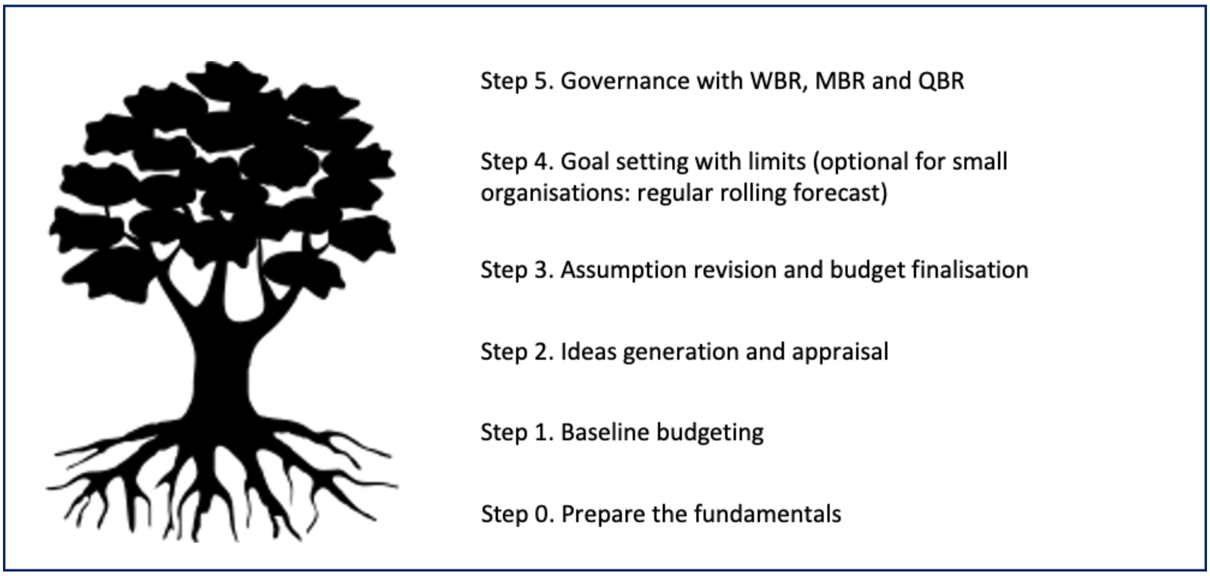

Fig. 1 Demkovitz Consulting's Model for Effective Budgeting

Step 0: In this step, the company needs to prepare the fundamentals, i.e., the revenue function describing its market and build the detailed cost structures. It is a time-consuming and conceptual process that enables greater effectiveness in the future. The desired outcome of this pre-work is an understanding of the variables that drive revenue and allocation of direct and indirect costs into the products and business units.

Step 1: Based on the above, we recommend setting the baseline forecast, applying the trendline to revenue and associated costs. This should also be based on the revenue function and assumptions made on the relevant input metrics.

Step 2: Next, an organisation gathers ideas and requirements from the teams about growth initiatives and required investments. These should be strategically evaluated with the discussed appraisal methods. Select 3 to 5 key priorities for the company and calculate the sales uplift and costs involved before incorporating it to the baseline forecast. We advise to complete the process at least 4 months before the end of the financial year (and it takes 6 to 8 weeks to perform).

Step 3: In the last month before the end of the financial year, we recommend revisiting the previous assumptions and finalising the projections for the budget.

Step 4: Based on that, we propose to set the output and input goals (for each of the variable that drives revenue) for the business units, teams and individuals. Additionally, to introduce the agile and resilient way of working, a company should set the limits for the key targets at the critical levels. We define a critical level as one that if it's broken, it invalidates budget assumptions and stops organisation from reaching its projections. For larger company structures, we advise to set multiple levels for different scenarios, while small organisations and startups, to use a rolling planning instead.

Step 5: Lastly, the process requires an adequate governance to monitor the progress and to validate the assumptions behind the budget. We recommend implementing Weekly (WBR), Monthly (MBR) and Quarterly (QBR) business reviews to compare the actuals of input and output metrics to previous period, previous year and budget plan. Any major variations should be analysed to propose a potential corrective action to improve performance or leverage a new arising opportunity.

Critical thinking

Finally, we ought to discuss the importance of critical thinking and cognitive biases in the process. Leaders might fall into traps that create unrealistic projections and disrupt subsequent business operations. The following are the most important biases to look out for.

- Confirmation bias – looking for and acknowledging only the information that supports one's belief.
- Affinity bias – supporting an idea that one is familiar with or is part of a certain group (the most common example is launching a product for oneself without testing the market).
- The halo effect – when one applies a success from a different sector or period to unrelated circumstances.
- Attribution error – when a leader attributes success or failure to the variables or factors not related to the outcome.
- Recency bias – attributing the impact on a result to only the most recent events or actions, or the ones that are most memorable.
- Duning-Kruger Effect – falsely believing in having a knowledge and expertise that is indeed lacked.

To mitigate the effects of those biases, we advise to have a challenging debate in a diverse group of people with different perspectives. Below, we present some of the questions that could be useful to make more informed decisions.

- What data do I need to see to support or invalidate my argument? What is the data showing?
- In what scenario are my assumptions wrong? What would be the outcome then?
- What direction is the market moving? What are the forces driving the change?
- What do I not know that could change my reasoning if I became aware of it?
- What are the strategic needs of my business and is the investment level optimised?
- What is realistic for us to achieve with the current team, technology and resources?

Conclusion

To conclude, budgeting is a necessary and complex process that companies undertake to allocate their resource and execute their strategies. In this work, we have stressed the importance of preparing the right financial and microeconomic data to allow for baseline planning. Then, we recommended several tools, such as project appraisal methods, agile budgeting methodology, regular governance and monitoring cadence as well as critical thinking approach to adapt the process for different companies' needs. Therefore, we arrived at the model for effective budgeting that aims to deliver an accurate yet responsive plan for organisations and increases their chance of focusing on the right priorities.