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Behaviorally-Based Budgeting – Or Will You Miss your Forecasts - Again

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Budget Detective Time Again

It's that time of the year at least for those companies who have a December fiscal year. Financial managers and budget officers will be doing their usual thing to get the budgets together. They will be working with managers on the business side to pare, slash, tweak or even discard them. In so doing they will draw on a variety of approaches ranging form the "scientific", the intuitive and the forensic. Their approach will, or should be, to come up with a budget that they think most accurately reflects what is going to happen.

Of course, budgets rarely meet this objective. More often, revenues come in under budget, and expenses go over. Business units try to beat the system by under-forecasting revenues and overstating expenses. Budget managers are aware of this and argue to boost revenues and reduce expenses. Each side plays a game based on, for the business side, how much they think they can sandbag revenues and expenses while the budget side, wise to this system, tries to figure out how much they need to boost revenues and reduce expenses to at least match, and preferably exceed, the level of sandbagging.

This scenario is played out in countless companies in countless ways but the main lines are very familiar for both sides. As we all know, the actual correlation with real world results one year later is at best problematic and at worst has no relation whatsoever. Of course the real world also intervenes in numerous ways to inject unpredictable events – like the oil shock, the Russia-Georgia conflict, the Chinese earthquake – into the process. These have the effect of both making budget estimates even more unlikely to be met, but at the same time providing air cover for business mangers – and financial managers too – to avoid accountability for budgets that are not met.

Behavioral Budgeting – How to Beat the Business Guys?

The conventional view of the budget process is that you can't do much about it, other than just to try harder, look at the figures even more deeply, try to catch out the most egregious abuses of the sandbagging system, and to bluff, whether you are on the business or the budgeting side. But there is a better way, albeit, it takes a paradigm shift on the part of both business and budget managers.

The new way is behaviorally-based budgeting (BBB). BBB takes as its intellectual basis the new disciplines of behavioral finance and behavioral economics. These disciplines have been emerging over the past 15 or so years and have been recognized by several Nobel prizes.

Behavioral finance and economics are based on the notion that both consumers and business managers do not always act rationally in matters financial and economic, hence the existence of financial manias and panics, stock market and South Seas bubbles, housing booms and busts all thrown in with a soupcon of credit crises. Once we accept that people are not necessarily rational in their buying, consuming and investment decisions, we open up a whole new world of analysis that leads to explanations of booms, bubbles and busts (the Bad BBBs).

A whole new literature has been spawned on those disciplines which shows why people act as irrationally as they always do. In their early years of development they were focused mostly on consumers. However it has more recently become clear that managers are, of course, just as irrational as managers as they are as consumers or investors. Thus the academic literature now analyses something we have all known for many years, that business managers too often act irrationally and that in order to predict the future and analyze the past we must take this phenomenon into explicit account.

Know Your Man (or Woman)

It must be obvious from the above where we are going. Most managers in most companies make budgeting decisions based on factors that are other than totally rational. These factors range from ego, recognition, the desire to get promoted, get more compensation and so on, of which we are all aware. Sandbagging and other managerial phenomena in budgeting are just one aspect of these behaviors.

In other words, the message is that if you want to truly understand the budget process and its likely validity, you must understand the behavior of the people doing the budgeting. This includes not just the business managers but also the budget managers since, under the disciplines of behavioral economics and behavioral finance, they are just as likely to make decisions based on extra-rational factors as are business managers.

This is where BBB comes in. If you can have a model which analyses the financial behaviors of people and mangers and which takes explicit account of the non-rational factors, you can understand the non-rational financial behaviors and will therefore understand their likely outcomes in financial and budgeting terms. Because financial behaviors are very predictable this allows us to explain not only the behaviors themselves but also their impact in the budgeting process and on the likely outcomes.

This sounds a little bit like financial smoke and mirrors but it is grounded in research and data. Recent research shows that financial traits and behaviors affect the budgeting process in predictable and measurable ways. Some of this research is from the Perth Leadership Institute (see Prince, E. Ted. "Research Note: How the Financial Styles of Managers Impact Financial and Valuation Metrics" Review of Accounting and Finance, Vol. 7, Issue 2, 2008, pp. 193-205).

The Trick is Financial Personality

The basic idea is this. In making decisions, some (actually most) managers tend to use more rather than less resources and this will be reflected not only in their financial and other decisions but also in their estimates of the resources they need to carry out a specific task. This results in higher spending and higher expense estimates than managers who do not have this tendency or to a lesser degree.

Other managers tend to make decisions which systematically lead to the creation of more commercial value than other managers. These managers tend to have higher gross margins in their units and their estimates on the margin side will be more reliable that managers who do not have this behavioral tendency or do not have it to the same degree.

In other words, if you understand these traits in the managers who are providing the budget estimates, you are more likely to know what their systematic bias is and to be able to counter-act it more accurately. You can also be more likely to see who is sandbagging and who is not if you have this information. In other words, you have to understand their financial personality.

In fact, seasoned and experience budget and business managers are usually well aware that individual managers will tend to be better or worse on budgeting based on their estimate of the personality and character of the manager involved. However up until now there has never been a formal model which explains these factors and puts them into a formal model with measurable outcomes.

Budget Managers Human Too…..

Bye the way, it should not be assumed that budget managers are immune to this process. In fact, the biases of budget managers will be just as pronounced – after all they are humans too. So in this model you also need to know the financial traits of the budget managers if you want to get a handle on the likely accuracy and validity of budget estimates and the likely outcome of the whole process.

The message is clear: know the people if you want to know the budget and its reliability. Financial mangers need to understand that behavior, not just analytical forensics, are a key factor in the budget process and that they perfom better if they understand this model.

Recommendations

- Get a handle on the people in the budget process if you want to understand the figures
- Read some behavioral finance so as to be up with the times
- Understand your own finacial personality and biases
- Don't diss psychology

Dr. E. Ted Prince, the founder of the Perth Leadership Institute (www.perthleadership.org) has been CEO of several other companies, both public and private. He is the author of 'The Three Financial Styles of Very Successful Leaders (McGraw-Hill, 2005; published in Chinese by Ewin Books, Beijing 2006) and numerous other publications in this area. He is a frequent speaker at industry conferences. He works with corporations globally on leadership development programs, financial leadership programs and coaches top executives worldwide.