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Self-Interest Can Skew Budgets at Family Businesses

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Part 1 of a two-part series

Are you familiar with any of the following scenarios?

"My business unit leaders never set realistic budgets, I have to push them and prod them to get growth—did I hire a bunch of chicken hearts? How can I get them to be more entrepreneurial?"

"I am tired of the head of sales coming in here and giving us completely unrealistic sales numbers for our budgeting process."

"Why does our business keep promising and never delivering? I think we are owed a little return on our family business ownership."

These sentiments are ones we've heard over and over again from family owners and leaders. In my over 40 years of witnessing budgeting in and out of family business, I have been struck by the often-senseless variety of budgeting processes used. And in my role as a board member on more than 20 boards over the last 25 years, I have witnessed fear, frustration, and fracturing of relationships that developing budgets often brings.

The purpose of this piece is to explain where the frustration comes from and what can be done about it. Budgeting is, almost by design, a process fraught with disagreement because of so many divergent interests and motivations within the company. The biggest divide is the role of budgeting as a planning tool and budgeting as an expectation setting tool. The planning tool version of budgets start with an accurate number of how much we intend to sell, and that is expressed in terms of revenues (money) and units (cases, items, or hours). If we know these things, then it's easy to determine how much materials need to be ordered, how much money we will need to borrow, how many employees will be needed, the kind of sales programs that need to be created, and the advertising and marketing needed to support those sales figures – and ultimately, how much profit and how much cash will we generate. The more accurate the revenue number, the more the business can behave like an efficient machine[i].

On the other hand, the expectations version of budgeting often has more to do with what employees and leaders would like as targets that, if hit, will define success. And, if a leader wants to be well compensated, convincing those who set compensation to set lower targets will increase the likelihood that the target will be hit!

Planning vs. Expectations

One early example of budgeting is contained in the biblical story of Joseph, who urged that for seven years, 20% of all grain produced each year should be stored in reserves for the predicted subsequent seven bad years of crop growth. This 14-year budget was done for the purposes of survival. Most early budgets, whether more than 3,000 years ago in Mesopotamia[ii] or state budgeting in the United Kingdom in the 1700's,[iii] were created to make sure that what was produced would meet the needs of the organization and excess would be used to either increase productive capacity or stored for to bridge budget shortfalls. Sometime in the last 100 years or so[iv], as far as an unscientific search of the literature is concerned, incentive compensation became fused with budgets. Perhaps it was at that moment that the budget became a tool to set expectations as well as to plan.

My experience as a board member of more than two-dozen organizations has shown that planning is the most critical role for budgets. Planning budgets help assure us that we won't run out of something we need. They also help us be reasonably sure that we won't have too much of anything during any given time period. For example, too much inventory can completely kill a company by soaking up needed cash or when inventory ages and has to be written off. These write-offs often reduce our borrowing base, and if we don't have enough assets to cover our loans, banks can terminate our loans, sending the company into bankruptcy. Planning budgets should demonstrate that those creating the budget truly understand the fundamentals of their business as well as the current and near-term market and business conditions!

In the expectations mindset, leaders often are incentivized to budget as though they are creating a target they need to hit. So, for many, that means setting targets, or budgets that they believe they can comfortably deliver. This can be called the 100% probability level, meaning that the budget is set by the responsible person who is predicting with 100% certainty that the number(s) will be achieved. This can create a huge array of problems. For business unit leaders, the 100% number encourages them to set targets that often lead to under-planning for resources needed to fill actual demand (like cash and materials). This level generally results in many lost opportunities at best, and running into an existential cash crunch at worst (e.g., when orders must be fulfilled at last-minute pricing from suppliers). The 100% probability level as a basic assumption for budgeting is simply not good for business.

As stated above, budgets should generally grow from sales predictions. Pro tip: while most companies seem to rely on sales leaders and salespeople for a sales budget figure, this is not always wise, as will be explored below. Rather, when resources permit, a sophisticated statistical model should be created to guide actual sales budgeting. All other budgets can easily flow from a well-modeled sales budget (cash, purchasing, labor, etc.).

Expectation-based budgeting has as its main goal managing the expectations of those who might judge us. While planning-based budgeting is neutral as to judgment, expectation-based budgeting systems often use achieving the budget, particularly sales figures, as reason to cheer, and missing budgets as a reason to weep or to take corrective action like changing leadership, reducing leader compensation, or even selling a business unit.

As soon as a system begins to adopt any piece of expectation-based budgeting, then, as a good friend of mine says[v], the "dominos begin to fall." People start trying to set budgets so they won't disappoint anyone, or to make their jobs easier, or to stand the best shot of increasing their compensation in or after the budget period. Their motive is to set the budget so that their personal (and sometime their team's) interests will be served. More on this below.

Different Groups' Motivations Can Clash

Let's look at some of the reasons different groups in the family business system – even at family firms that are relatively free of internal conflicts -- might favor a budget being aggressive, realistic, or conservative. Conflict can influence these groups even more.

Sales

Let's start with perhaps the most complicated one, sales. On the one hand, they might want a low number so that they would always meet or exceed it, but if we go a bit deeper, we might realize that most sales teams are compensated on a commission on gross sales. That means there is almost no downside when they predict impossibly high sales goals, since there is no added incentive for achieving a sales target. So, between the tradeoff of disappointing senior leaders and earning a commission on sales, the sales group will opt for making sure they have enough product or services available so they would never miss a sale. If there is too much supply, it is easy enough to blame others and then take credit for selling the relatively easy to move excess inventory at a deep discount. But, what does the finance team thank about that?

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Finance

Unlike many parts of the organization, the finance team knows that not all profits are created equally. Some sales create more profit, while other sales create more cash more quickly. And this cash can be used more quickly, accelerating a business' internal multiplier effect. The finance team also knows that some revenues can threaten the very life of the company. For example, a distribution company that has to pay suppliers in 45 days, but whose customers pay in 90 or more days, has to think very carefully about each new sale and even more so about new product lines. Without careful consideration, the company could be very profitable and still run out of cash as they are profitably growing. Without profit and operating cash flow, a business cannot survive. With their acute understanding of money flows and profit flows, the finance group generally wants budgets that overstate expenses and accurately state everything else so that at the end of the period they can show both enhanced profits and enhanced operating cash flow.

Production

In a manufacturing operation, production can have two common desires depending on how they are compensated and the culture of the company. If the culture favors reduced unit costs, production will generally favor long runs (one product being built for a long period of time), which reduce unit costs for two reasons: 1) all manufacturing fixed costs are spread over more units (including manufacturing depreciation), and 2) the lack of changeover time (lost production time as the machines are being reconfigured from one product to the next) means more time is available to produce a single product in any given time period. Even if all the potential extra units manufactured are not sold, and even if they rot in inventory, a long run can show greater profits because a certain percentage of fixed manufacturing costs are in the inventory and on the balance sheet and not deducted from sales (at least not until they are written off or sold at a loss). On the other hand, if the culture of the company and compensation scheme understands the importance of cash flow and a tight balance sheet, then production will favor as accurate a budget as possible so they can plan all their activities around maximizing run time, minimizing labor costs, and generally balancing the profit and cash flow tradeoffs when it comes to managing production speed (how fast things are made), capacity (how many in total can be made), and yield (how many that are made are at standards where they can be sold).

Purchasing

This department might want a higher revenue number, which could enable them to purchase material in amounts that allow for greater discounts. While some purchasing managers are partially compensated on reducing unit prices of what is purchased, purchasing managers should be compensated in a way that encourages them to balance the possible excess material inventory with higher per-unit profit. What a company generally does not want is cost reduction that simply shifts the recognition of costs into future years (like inventory writedowns).

Marketing

Marketing, another group that may be easier to understand, generally would like a larger revenue numbers, as that implies that they will have a bigger budget to aid sales through their marketing efforts.

Operations

Since larger revenue numbers mean greater profits, the operations team generally seeks aggressive revenue targets, mainly because this means the operations team can increase their staff size. This both eases the existing workload and advances the politics of creating fiefdoms inside the company. Some people even believe that hiring more people shields them when the company needs to reduce staff, since the last hired are often the first fired.

Owners

Particularly in family business, owners are made aware of budgets, at least on a high level. Sometimes, owner desires are at odds with the natural inclinations of those who work in the business. Owners may want dividends and risk reduction through diversification. Furthermore, the owners should want unused assets out of the business since not doing so puts family wealth at risk. Any bizarre accident or unforeseen event could harm the balance sheet, especially in the case of litigation (for example, who knew of the risks dioxin, asbestos, lead, or talc?) Don't forget that, in the USA at least, assets on the balance sheet are available to people who successfully sue the firm, while assets independently in owners' hands are not. On the other hand, business leaders want to keep growing. Most leaders' salaries are set based on the top line and less so on the bottom line. Leaders also often want to keep the money in the business since they usually don't have any personal cash benefit from paying dividends and they often don't

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trust that owners will contribute capital in the event of a great business opportunity.

Self-Interest Leads to Manipulation

As you can see, infusing others' expectations into the budget planning process is very likely not in the best interests of any organization. Any time people have a self-interest that can be pursued by setting expectations one way or another, they will be prone to manipulate numbers on the front end (as in budgets and targets) or worse, on the back end (as in earnings management, taking expenses or revenues in periods where they arguably do not belong, or shifting expense into another period through building inventory).

The second part of this two-part series will share how to override these influences and create a responsible budget.

References

[i] Nonetheless, companies are wise to maintain some level of slack resources so as to be able to respond to quick changes in the market (supplies, service, people, technology, capital, and customers).

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[v] George E. Manners, Jr.

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