

BUDGETING FOR BEVERAGE DISTRIBUTOR VALUE

It is an understatement to say the budgeting process is certainly not viewed as one of the more exciting and stimulating activities involved in managing product distribution--or any other business for that matter. Many dread the process and view it more as a necessary evil--rather than as a regular opportunity for re-assessment of business strategy and tactics.

But as consolidation continues to impact distribution more companies with fresh acquisition debt and increasing relative operating costs are re-evaluating the methodology by which budgets are developed and used to manage bottom-line performance.

I've often heard a saying that I believe has some truth: some companies go over their budgets very carefully every month ... others just go *over* them. In fact, the value of the budget process is considerably diminished when treated as a "checklist" activity (*i.e. yes, we put together a budget, so check it off the list ...*).

The Re-active Budget

The approach to the budgeting process in many operations typically involves about three steps. **First**, historical performance is provided to the functional managers (usually this is either full-year information for the previous year or current year-to-date performance with end-of-year estimates). **Second**, the functional managers use the historical information in some fashion to develop estimates for the upcoming year. **Third**, the information is aggregated by the financial manager of the business and presented to ownership. A fourth step may or may not be included which involves a back-and-forth process of adjusting the numbers to incorporate ownership input-or simply to "force" the budget to meet ownership objectives for bottom-line returns.

This typical process is really a "*reactive*" approach to the budgeting process and has two fundamental problems.

First, managers tend to use historical performance to "drive" the budget. Usually, new budgetary line items are derived either by providing an inflationary adjustment to previous results, or by applying a percentage of sales factor to revenue projections. Of course, such methods have some validity ... using historical performance to estimate future performance is certainly relevant.

The second fundamental problem with the traditional approach is that it does not create an environment conducive to inquiry--or to knowledge exchange among functional managers. Think about it, if each manager is essentially inflating previous results to drive new estimates, what would be the point of a sales manager inquiring how an operations manager intends to manage overtime in the warehouse next year?

You can see how this approach is really more "reactive" in nature. Each functional manager tends to react to previous results using these numbers to create budgetary expectations. And ownership tends to react by simply accepting each functional manager's budgetary projections without serious inquiry.

Developing the *Pro-active Budget*

The zero-based budget (ZBB) has unfortunately developed a tarnished reputation over the years. Many entities in the public sector moved to the ZBB after discovering that bureaucrats operating within the constraints of traditional budget processes scrambled to spend money in the final quarter of each fiscal year knowing that if money in the budget was left unspent it would reduce the baseline by which future budgets would be developed (i.e. "spend it or lose it"). In their infinite wisdom, politicians began imposing ZBBs on public entities in theory forcing departmental heads to justify their spending each year. One can only imagine the difficulties faced by many governmental agencies with their staid bureaucrats and reduced management resources forced to tear apart their complex operating budgets each year. It is easy to see such a process bogging down an entire department. And with such detail to consider, people likely found themselves in "can't see the forest for the trees" situations with resulting budgets even less useful, and much more time consuming, than in the traditional method.

As in most things in life, the answer to the budget process is balance.

A pure ZBB is likely not warranted for many wholesale operations for the reasons described above. However, more companies should look at a modified version of a ZBB in effort to develop a more Pro-active Budget.

A modified ZBB would allow companies to benefit from the self-introspection necessitated by the ZBB without over-complicating--and perhaps burning out managers on--the budget process.

Generally, the following steps are critical for successful implementation of a modified Zero-Based Budget process.

For each functional department:

1. Identify and separate operating expenses between controllable and non-controllable.
2. Rank the controllable items according to importance and/or overall impact on the budget.
3. Develop accurate and relevant historical performance [i.e. multi-year] in as many of the highest ranking, controllable expense areas as possible.
4. Benchmark company performance against the industry in as many of the highest ranking, controllable expense areas as possible.
5. Direct functional managers to provide a detailed "build-up" as to how each of the highest ranking, controllable expenses are projected in the budget.
6. Allow and encourage an active dialogue between managers across functional areas as to how such expense "build-ups" are developed.
7. Develop specific performance objectives, financial and non-financial, for all of the key budget areas.
8. Develop an accurate and consistent methodology for tracking the key performance indicators (KPIs) that drive budget performance.

9. Consider tying formal management performance assessment and/or compensation to budget performance.

By separating and ranking expense items as described, management can focus the proper effort on areas having the most impact on overall returns--and on the items that managers can indeed influence. This reduces the potential for over-complicating the process which can happen. Such over-complication likely tarnished perceptions of the pure ZBB budget model.

Your Estimate Can't Be Right, We Don't Have the Budget for it

In a modified ZBB approach to budgeting, it is critical that ownership and management challenge each other in the assumptions used to justify the build-ups in each critical expense area. Always, questions should be asked along the lines of "is there a better way to build this mousetrap than how we have always done it?" As a part of this process, use the following questions to challenge your managers:

- ✓ How does our performance in this area compare to industry benchmarks?
- ✓ How are other companies similar to ours handling these activities?
- ✓ How do our local-market competitors handle this?
- ✓ If we had to do things with 10% greater efficiency, what strategies might we employ?

Summary

The budget process is often viewed as more a financial exercise than a strategic one. Owners with such perspectives miss opportunities to re-visit past assumptions and to challenge the management of all functional areas to be more innovative in making the total operation more effective and efficient.

Budgeting may never be one of the more exciting aspects of business management. But changing the approach to develop a more "proactive" budget process can have considerable positive impacts on company performance.

Managers tend to have greater "ownership" and "buy-in" to budgets that evolve from pro-active processes. Company owners with pro-active budgets therefore have better management tools to direct functional managers, and opportunities to more closely align executive compensation to actual performance.

Remember, history should be used as a guide to future performance, not as the *dictator of it*. For many companies, an effective budgeting process is a critical tool to drive profits and to build long-term value.

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Comparing Traditional and Zero-Based Budget Methodologies

	Budget Methodology - Traditional	Budget Methodology - Modified Zero-Based
Change Mechanism	% Increase from Previous Relative to Sales	“Build-Up” Justification
Responsibility	Top Manager/ Owner	Functional Managers
<u>Buy-In</u> Accountability	Tends to Reduce These	Tends to Increase These
Approach	Reactive	Pro-Active
<u>Orientation</u> Perspective	<u>Accounting</u> Financial	<u>Strategic</u> Planning
Management Participation	Perpetuates “Silo” Management	Encourages “Cross- Functional” Environment

Hitting the "Value" Target

