Rethinking the Stretch Budget:
Time to Promise Less and Deliver More

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Far too many firms do a rather poor job of financial planning. In some cases this is because management believes that the future is simply too uncertain to predict with any accuracy. In an uncertain environment, detailed budgeting may be a wasted effort. Financial planning becomes a perfunctory exercise which is quickly forgotten or simply ignored.

Other firms take the process very seriously, but still develop plans that are unreasonable and are, on occasion, worse than no plan at all. The problem is not a lack of skill or interest. The problem is that the process yields an overreaching plan that virtually everyone knows cannot be met. They have fallen victim to the ubiquitous Stretch Budget.

This report will revue the challenge of stretch budgeting from two perspectives:

- **Stretch Budgeting as Self-Inflicted Failure—**An examination of how unrealistic budgets are created in the first place and their negative impact on the firm.
- **Profit-First Budgeting—**A suggested approach for setting meaningful profit targets and hitting them.

Stretch Budgeting as Self-Inflicted Failure

No firm wants to develop a plan that is destined to fail. However, the reality is that most firms start with the emotional perspective that “we can do a lot better next year than we did this year.” That point of view is then translated into a classic “what if” spreadsheet-based model to produce a plan that almost inevitably is unattainable.

As one example of this, consider how the sales goal is typically set. The entire sales team is encouraged to think about how many opportunities were missed and to consider all of the “low-hanging fruit” that can be exploited. The almost certain result is a sales goal that has a slim chance to be met, but only through a combination of real stretch performance and luck.

That process is duplicated with regard to gross margin, expense control, inventory management and accounts receivable collection. Every sector sets a goal that *might* be met. However, the stars really need to align properly to ensure actual goal attainment.

Individually, the goals are difficult to achieve. Collectively, they represent an invitation to failure. In addition, the goals may well be mutually exclusive. A serious shortfall in performance against the plan is close to inevitable.

The ultimate problem is not a failure to perform against plan this year. It is that the unattained plan will be replaced next year by a similarly unattainable one, followed by another unattainable one in perpetuity.

Eventually the company settles into a systematic approach to planning. Set a goal and miss it. Repeat annually. It is a sure prescription for failure

Profit-First Budgeting

There is no guaranteed inoculation against Stretch Budgeting. However, there is one approach that has proven effective in helping firms develop sensible goals that result in sustained improvement over time. It is commonly called Profit-First Budgeting. It is not without controversy.

Exhibit 1 looks at the process for a typical distributor. As can be seen in the Current Results column the firm generates $20,000,000 in sales and operates on a gross margin percentage of 25.0% of sales. It produces a pre-tax profit of 2.5% of sales, or $500,000. Total expenses are heavily weighted towards payroll which are 15.0% of sales, or 66.7% of total expenses.

To generate these income statement figures the firm had to invest $5,000,000 in total assets. The result is a return on assets (ROA) of 10.0%. It is adequate performance, but well below the firm’s full profit potential.

The Action Plan section at the bottom of the exhibit reflects the sequence of planning steps while the Planned Results columns at the top indicate the impact of the action plan. The key to the entire planning process is to start with a profit goal. That goal should be well thought out and completely justifiable. If it is achievable, then everything else in the plan will be as well.

In the case of the typical firm, the plan calls for increasing ROA from the current 10.0% to 12.0%, an obvious increase of 2.0 percentage points. Experience suggests that an increase in ROA of anywhere between 1.0 and 2.0 points requires the firm to stretch moderately, but is still realistic.

Making the large assumption that the total assets investment does not change, the higher ROA on the same asset base calls for an increase in profit to $600,000 (12.0% x $5,000,000). The firm is clearly moving forward, but is doing so in a systematic manner.

After setting the profit goal the firm has three more key items to plan—sales growth, the increase in the gross margin percentage and the dollar increase in payroll. All three should be planned with incremental improvements in mind.

The sales increase chosen by the firm is 7.0%. This should reflect what management feels can be accomplished with systematic effort. Management may still motivate the sales force by suggesting that 10.0% or even 15.0% is possible. However, 7.0% is what is the real target.

The gross margin percentage has increased from 25.0% to 22.5%. It should reflect the realities of the competitive situation in the firm's market. Combined with the increase in sales, the gross margin goal becomes $4,815,000.

Finally, the plan provides for an increase in payroll expenses of 5.0%; 2.0 percentage points slower than the projected increase in sales. This concept, commonly called a sales to payroll wedge, ensures that the firm achieves a reasonable level of productivity during the year. At the same time it allows for necessary increases in payroll.

The final two items in the plan are simply calculated. Total expenses must equal gross margin minus profit while non-payroll expenses, by definition, are equal to total expenses less payroll.

The profit-first approach has two advantages if implemented correctly. First, it tends to produce much more realistic performance goals. This allows the firm to get into a mode of setting plans and meeting them. That process has a positive impact throughout the organization.

Second, this planning process moves beyond just being a series of "what if" exercises that eventually produce a plan. The profit-first plan is based upon the intent to improve profitability in a way that is consistently successful.

Moving Forward

There is a genuine need for improved financial performance in distribution. A properly-developed and well-executed financial plan can be an integral part of the improvement process. However, in a fast-paced world there is often the desire to reach profit levels more quickly than is really possible. Management would be well served to retreat to a "slow but steady wins the race" philosophy.

About the Author:
Dr. Albert D. Bates is founder and president of Profit Planning Group. He is the author of the newly-released ***Breaking Down the Profit Barriers in Distribution***. It is a book every manager should read. It is available from Amazon and Barnes & Noble.

Exhibit 1
A Sample of a Profit-First Plan
for a Typical Distribution Firm

Sequence	Income Statement	--Current Results-- Dollars	Percent	--Planned Results-- Dollars	Percent
2	Net Sales	$20,000,000	100.0	$21,400,000	100.0
	Cost of Goods Sold	15,000,000	75.0	16,585,000	77.5
3	Gross Margin	5,000,000	25.0	4,815,000	22.5
	Expenses				
4	Payroll Expenses	3,000,000	15.0	3,150,000	14.7
5b	Non-Payroll Expenses	1,500,000	7.5	1,065,000	5.0
5a	Total Expenses	4,500,000	22.5	4,215,000	19.7
1b	Profit Before Taxes	$500,000	2.5	$600,000	2.8
	Total Assets	$5,000,000		$5,000,000	
1a	Return on Assets	10.0%		12.0%	

Action Plan

1a	New ROA	12.0%
1b	New profit based on the new ROA	$600,000
2	Sales increase	7.0%
3	New gross margin percentage	22.5%
4	Increase in payroll	5.0%
5a	Calculated total expenses (gross margin - profit).	$4,215,000
5b	Calculated non-payroll expenses (total expenses - payroll).	$1,065,000