

# Systems Sleuth

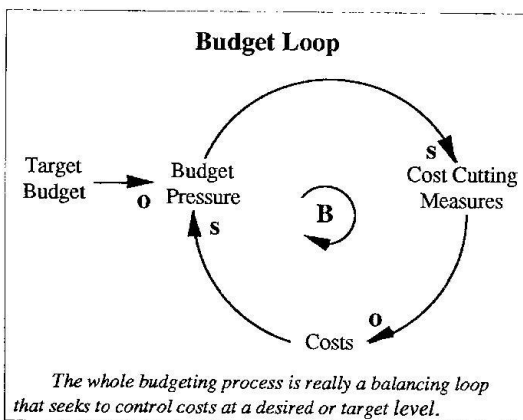


## Are Budgets Bad for Business?

Budgets are great for tracking money as it flows through a company. But when they are used for other purposes—long-range planning or gauging performance—they can distort reality and mislead managers. When

Budgets often pit one part of the company against another. Each division tries to maximize its own bottom line, often to the detriment of the company as a whole. For example, a company may become overloaded

usually are the target budget (costs), the actual costs, and corrective actions taken to eliminate discrepancies (see “Budget Loop” diagram). As costs increase, budget pressure also increases, triggering cost-cutting measures and reducing costs in the hopes of meeting the target budget.



with slow-moving inventory—often a sign that each department is pursuing its own agenda. At this point the finance department steps in, putting its priorities over everyone else’s by mandating across the board cuts in inventory. But, as the article explains, “[o]nly the hot items move out fast. The rest sits there.

When it’s all over, inventories are down 10%, the CFO declares victory—and the only items left are the ones nobody wants, so customer service goes to pot.”

The whole budgeting process is really a balancing loop that seeks to control costs at a desired or preset level. The key variables in this loop

### Discussion Questions

- Using the Budget Loop diagram, how would you include the various cost-cutting measures that were mentioned in the article or additional ones that have been taken in your own organization?

- The costs reductions that result from such actions are relatively easy to identify. What about some of the negative consequences mentioned in the article—how would you add them into the picture and tell a compelling story about the downside of focusing on costs to meet the budget?

- Where does Revenue come in, and how does it affect the picture?

- What are some high-leverage actions that can lessen the tendency to be ruled by budgets?

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budgets become an end in themselves, the company suffers, according to a recent article in *Fortune* magazine (“Why Budgets Are Bad For Business,” June 4, 1990). The result: managers end up managing the budget rather than managing the company.

Budgets, the article contends, focus attention on short-term fluctuations in the bottom line, rather than on long-term planning and corporate development. They can only account for hard, quantitative data, not “soft” variables such as quality of service and customer satisfaction which can be crucial to the long-term health of a company.

In addition, what is good for the budget may be very bad for the company. Investing in R&D during a business downturn may seem suicidal from a budgetary standpoint, but it could be the key to the firm’s recovery once bad times pass.

## System Dynamics '90

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also practice their scientific thinking skills by running many quick experiments via repeated simulations.

The rate and quality of learning depends heavily on the skills we bring to a new problem or situation. Hence, the identification and development of critical thinking skills is vital. Systems thinking encompasses at least five

critical thinking skills that must operate simultaneously, but be mastered one at a time. Much has been done to address the need for transferring those skills to a broader audience; much remains to be done. The 1991 International System Dynamics Conference will undoubtedly deliver many more responses to the challenge. ↻

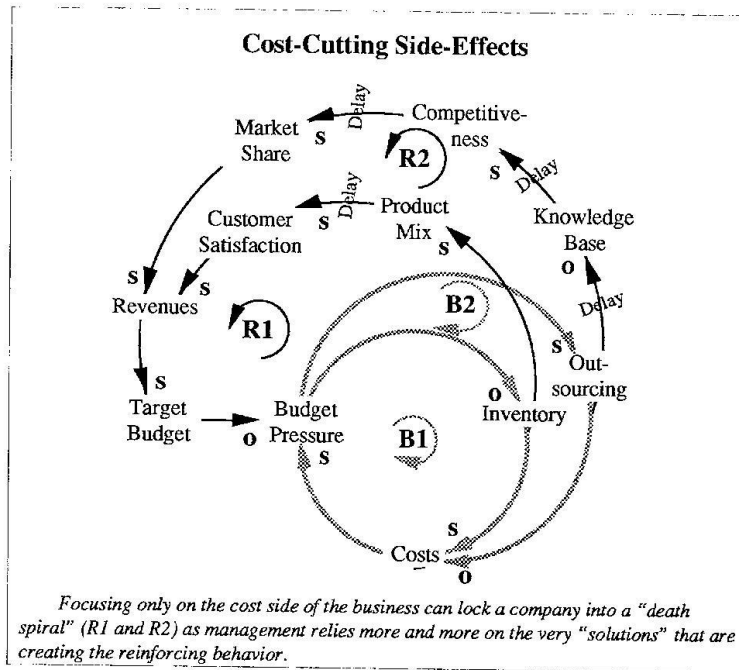
# Systems Sleuth...

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As managers we generally have no trouble coming up with cost-cutting alternatives—we live in the world of budget crunches and cost-cutting imperatives. The Cost-Cutting Measures diagram shows two typical measures that might be taken during a budget squeeze. Reducing inventories (loop B1) is one of the options discussed in the *Fortune* article. Outsourcing more work and shutting down departments (loop B2) is another way to make a quick impact on the bottom line. Of course, many other measures could be taken—decreasing staff, cutting new programs, reducing R&D, slashing advertising and marketing, limiting training programs, etc. All of these measures have an immediate effect on costs.

As the article suggests, cost-cutting also has negative consequences—especially when it is carried out with the single-minded purpose of meeting the budget. The Cost-Cutting Side Effects diagram illustrates some of the harmful results of broad “slash and burn” programs. Reductions in inventory lead to poorer product mix, lower customer satisfaction, and lower revenues. Lower revenues in turn



mean a lower target budget which increases the budget pressure to slash inventories even more (loop R1) since it worked so well the first time!

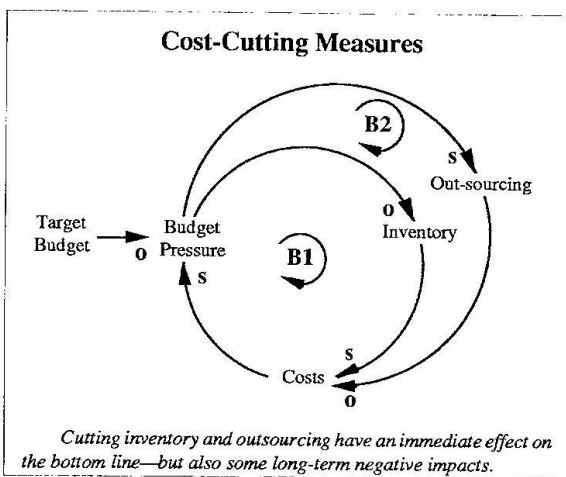
Similarly, increased out-sourcing reduces the opportunity to accumulate

knowledge about products and processes. This can erode competitiveness and market share, resulting in lower revenues. Again, this leads to a lower target budget and increases budget pressure—seducing us into more out-sourcing because we’ve “discovered”

how cost-effective it is to move work outside of the company (loop R2).

Both of the above loops (R1 and R2) are reinforcing loops—they aggravate the budget pressures that initiated their implementation in the first place. But the negative effects of these loops appear only gradually due to the significant delays in the system. For example, the erosion of knowledge about products and processes happens over a period of years (after many “successful” cycles of meeting the budget). The same holds true for deteriorating service quality that results from years of sparse training and development. Focusing only on the cost side of the business can lock a company into a “death spiral” as management relies more and more on the very “solutions” that are creating the reinforcing behavior.

There is a positive side to this story



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## Calendar

- August 22-24. **Leadership and Mastery**, Toronto, Ontario. This three-day workshop offers executives, senior managers and middle managers insights into how people and organizations can be led and structured for inspired performance. Contact: Stephanie Ryan, *Innovation Associates*—(508) 879-8301.
- September 6. **The Art and Practice of Learning Organizations—A Conversation with Peter Senge**, Toronto, Ontario. Co-hosted by Innovation Associates and Doubleday, publisher of Peter's new book *The Fifth Discipline: The Art and Practice of the Learning Organization*. Informal dialogue will revolve around the issues raised in the book and their applications within organizations. Copies of the book will be available. Contact: Sheryl Erickson, *Innovation Associates*—(508) 879-8301.
- September 10. **The Art and Practice of Learning Organizations—A Conversation with Peter Senge**, San Francisco, CA.
- September 13. **The Art and Practice of Learning Organizations—A Conversation with Peter Senge**, Minneapolis, MN.
- September 14. **The Art and Practice of Learning Organizations—A Conversation with Peter Senge**, Chicago, IL.
- September 17. **The Art and Practice of Learning Organizations—A Conversation with Peter Senge**, Boston, MA.
- September 19-21. **Leadership and Mastery**, Wellesley, MA.
- September 23-26. **Leadership and Mastery**, Boston, MA. Co-sponsored by The Healthcare Forum and Innovation Associates. Contact: Laura Woodburn, *The Healthcare Forum*—(415) 421-8810.
- October 8-12. **Introduction to Systems Thinking**, Cambridge, MA. This course will introduce managers to the basic principles of systems thinking. Managers will also gain hands-on experience in system dynamics modeling using STELLA and other modeling languages. Contact: *Gould-Kreutzer Associates*—(617) 497-2926.
- October 9-12. **Visionary Leadership: Building the 21st Century Healthcare Organization**, Tarpon Springs, FL. The third annual conference, co-sponsored by 3M, is The Healthcare Forum's first systems thinking-related event held outside the West. Peter Senge and Leland Kaiser will be the lead faculty. Contact: *The Healthcare Forum Foundation Leadership Center*—(415) 421-8810.
- October 10-12. **Leadership and Mastery**, Wellesley, MA.
- October 17-19. **Business Thinking: A Systems Perspective**, Framingham, MA. This two-and-a-half day working session teaches managers how to apply systems thinking to their own work issues. No prior understanding of systems thinking is required. Contact: Stephanie Ryan, *Innovation Associates*—(508) 879-8301.
- October 23. **The Art and Practice of Learning Organizations—A Conversation with Peter Senge**, Cincinnati, OH.
- November 7-9. **Leadership and Mastery**, Toronto, Ontario.
- November 12-16. **Advanced Systems Thinking**. A follow-up course for managers who have already been introduced to systems thinking. Course participants will build their own simulation models with professional guidance. Contact: *Gould-Kreutzer Associates*—(617) 497-2926.

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as well. These same reinforcing loops (R1 and R2) can also produce a virtuous cycle of continued revenue growth (i.e., *less* out-sourcing can lead to greater product knowledge and increased competitiveness which will lead to higher revenues). But the payoff usually comes in the long term and often requires either holding the line or increasing investments in the short term—a hard sell in a time of budgetary crisis.

The article offers some suggestions for how to get out of the budget trap by basing corporate performance measures on standards other than budget targets. "The great budget game is the result of trying to control negative behavior, like spending too much, while largely ignoring positive behavior, like building the business," says the author. Changing the game means shifting the emphasis from cutting costs to boosting profits—focusing on the reinforcing loops that will generate more revenues rather than seeking to control the short-term oriented budget loop. Asking the question "what investments *must* we make?" then becomes a more important question than "what can we afford to do?"

Cost reductions are often better handled as part of a long-term plan, rather than as part of yearly budgets. This tends to cut down on quick fixes that defer costs rather than eliminate them. Designing the corporate structure to prevent or minimize "turf wars" will also help ease some of the ill-effects of budget plans. When divisions rely heavily on each other, they are less likely to foist work and costs onto other parts of the organization in order to improve their own bottom line.



*Further Reading: Bruce G. Posner, "Squeeze Play: How the simplest cost-cutting programs can lead in the most unexpected directions," Inc., July 1990.*