

CHANGES IN BUDGETING

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Abstract

One of the most important issues for companies is how to implement their strategies. Companies implement strategies in a number of ways. Budgeting is described in academia as well as in practice as the corner stone of the management control process through which strategies are implemented. Almost all companies have a budgeting process central to their strategic plans. Yet the usefulness of budgets has generated much criticism and debate in recent years. Many business owners and managers are dissatisfied with budgets. A novel approach is proposed in the literature to displace classical budgeting. This novel approach is termed "Beyond Budgeting." The first part of the paper reviews the challenges that traditional planning and budgeting presents to companies. The second part discusses the novel approach to budgeting. The third part provides examples of companies budgeting practices. The fourth part presents the conditions for a successful implementation of the novel approach.

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1. INTRODUCTION

Change in budgeting does not come easily. When the accounting professional accepts dramatic changes, it is either novel or is significant. Such has happened with Beyond Budgeting. Classical budgeting is seen as an ineffective process that is too long, too costly, and does not provide sufficient value to users. Others see it as a bureaucratic process that stiffens innovations.

Neely et al, (2003) summarize criticisms of classical budgeting as follows:

Competitive strategy:

- budgets are rarely strategically focused and are often contradictory;
- budgets concentrate on cost reduction and not on value creation;
- budgets constrain responsiveness and flexibility, and are often a barrier to change;
- budgets add little value – they tend to be bureaucratic and discourage creative thinking.

Business process:

- budgets are time consuming to put together;
- budgets are developed and updated too infrequently – usually annually;
- budgets are based on unsupported assumptions and guesswork; and
- budgets encourage gaming and perverse (dysfunctional) behavior.

Organizational capability;

- budgets do not reflect the emerging network structures that organizations are adopting;
- budgets reinforce departmental barriers rather than encourage knowledge sharing; and
- budgets make people feel undervalued;
- budgets strengthen vertical command and control.

Hope and Frazer (2003) point out that such a perspective of budgeting (referred to as "fixed performance contract"):

- leads to only incremental improvements;
- instills fear of failure that could lead to fraud;
- forces managers to focus people on compliance;
- encourages budgetary slacks; and
- encourages myopic decision making that ignores market feedback.

Parmento's study (2003) concludes that budgets with fixed performance contract

"have led to dysfunctional behavior with dire consequences....

behavior that generated many of the recent 'managed earnings' scandals."

Dissatisfaction with any system is reasonable evidence that it is not efficient and usually leads individuals to explore alternatives. One approach advocates improving the budgeting process (The U.S

based Consortium for Advanced Manufacturing-International (CAM-I) Activity-Based Budgeting (ABB), the other advocating abandoning it (The European-based CAM-I) Beyond Budgeting (BB). (See Hansen, Otley, and Van der Stede (2003).

2. THE ACTIVITY-BASED BUDGETING APPROACH

Companies have explored various approaches to improve budgeting including “Activity-Based Budgeting”, “zero-base budgeting,” “rolling budget,” (See Table 1: Better Budgeting Approaches). Zero-

base budgeting is an approach in which the budget for each activity is reset to zero. An activity’s continuing existence must be justified at each beginning budgeting cycle, before resources can be allocated to it. Rolling budgets, (also called revolving or continuous budgets), tend to have a 12-month time horizon that is updated quarterly. Under the activity-based budgeting approach, there is a shift from traditional product-market, responsibility center or departmental focus to developing budgets from activities.

Table 1. Better Budgeting Approaches

Activity-Based Budgeting	<ul style="list-style-type: none"> - Similar to activity-based costing (ABC) and activity-based management (ABM) - Involves planning and controlling along the lines of value adding activities and processes - Resource and capital allocation decisions are consistent with ABM analysis, which involves structuring the organization’s activities and business processes so that they better meet customers and external needs
Zero Base Budgeting	<ul style="list-style-type: none"> - Expenditures must be re-justified during each budgeting cycle, rather than basing budgets on previous period - Avoids building on the inefficiencies and inaccuracies of previous history - Value of this approach depends on stability of operating environment shareholder value over time - All expenditure plans evaluated as project appraisals and assessed in terms of shareholder value they will create - Helps to link strategy and shareholder value to planning and budgeting
Profit Planning	<ul style="list-style-type: none"> - Profit ‘wheel’ method for planning future financial cash flows of profit centers - Assesses whether an organization or unit generates sufficient cash, creates economic value and attracts sufficient resources for investment - Ensures consideration of an organization’s short and long term prospects when preparing its financial plans
Rolling Budgets and Forecasts	<ul style="list-style-type: none"> - Solve problems associated with infrequent budgeting and hence result in more accurate forecasts - More responsive to changing circumstances but requires permanent resources to administer - Also overcomes problems linked to a fixed point in time that is the year-end sand, the often dubious practices that such cut-offs encourage.

Source: Neely et al., (2003)

The ABB approach is described by Hansen, Otley, and Van der Stede (2003) as a two stage process. In stage I, activity-based concepts are used to “Convert the estimated demand for products and services into activity requirements using activity consumption rates, and then translates activity requirements into resources requirements using resources consumption rates. Once the activity and resource consumption requirements are known, the ABB-approach works to achieve an operational balance between the resources required to fulfill demand and the resource available capacity. If the initial plan leads to an imbalance, the organization can

adjust the quantity of demand, resource capacity, resource consumption rates, or activity consumption rates.”

In stage II, a financial plan is developed based

“on the operational plan. Financial balance is achieved when the financial plan meets a predetermined financial target. Once the organization knows the demand, activities, and resources, it determines the cost of resources, traces them to activities, and then to products/services....If the initial financial plan is not balanced, the ABB-approach

allows the organization to adjust five possible elements to achieve the budget target: (1) activity and resource consumption rates, (2) resource capacity, (3) resource cost, (4) product/service demand quantity, and (5) product/service price.”

However, despite the shift to manage activities, “managing” the year-end rather than supporting medium-term strategy remains still the main focus. Player (2003) concludes:

“most of these “improvements” have been aimed at reducing the costs and increasing the relevance of budgeting. But few have attempted to break free from the fixed-performance contract and the annual trap it creates.”

3. THE BEYOND BUDGETING APPROACH

The most accepted and championed idea to date is the CAM-I Europe’s Beyond Budgeting Model. The purpose of beyond budgeting is to displace the existing budgeting process. It seeks to avoid the annual performance trap that “involves dysfunctional behaviors that stem from evaluating line managers vis-à-vis budget targets that are set without reference to a credible (outside) source and remain fixed for the next budget year”(Hansen, Otley, and Van der Stede (2003). The rationale is to influence changes in the business organization. This is done through changing corporate culture as governing, value creating, and coordinating. Beyond Budgeting transforms the organization from a central hierarchy, to a network of autonomous units. These organizational changes introduce dispersed responsibilities, and strong values. That is an approach toward autonomy. Beyond Budgeting is based on the idea of greater empowerment of lower-level managers and spending less time and energy of explaining deviations from fixed budgets. The purpose of the change is to affect the interrelationships, in several ways: implement strategy using the balanced scorecard approach, from bottom-up, to a directional change, and to correct imbalances.

Balanced budgets are not totally novel, in the budgeting area. Analysis shows that Beyond Budgeting is a merging of the various prior budgeting approaches. This merging is not merely an addition, but is a re-engineering of different approaches to the budgeting task. The result is a unique combination of the form. Also, it brings the attributes of the methods into a flexible method. That combination reduces the manipulation (gaming) of budgeting.

Beyond Budgeting covers many aspects of the organization (business). In this over-reaching aspect, it can be considered as an intellectual exercise. The intellectual aspect comes from the challenge of a moving target. That indeed is a challenge, compared to classical budgeting.

Hope and Frazer (2003) present the elements of a relative performance contract as:

- relative targets push employees to outdo themselves;
- rewards based on relative performance give people the confidence to take risks;
- continuous planning focuses people on value creation;
- on-demand allocations of resources minimize costs, and
- decision making, by local units in touch with one another, makes full use of market feedback.

As a result, the reward system should be designed with the following in mind:

- do not base rewards on a fixed performance contract;
- evaluate and reward performance against peers, benchmarks, and principles;
- use a few simple, clear and transparent measures;
- align rewards with strategic goals;
- align rewards with interdependent groups;
- make rewards fair and inclusive.

4. BETTER BUDGETING PRACTICES

Decades have been spent on efforts to coordinate operations with finance (Joo, 2003). The essence of Beyond Budgeting model is to bring together all the functions of the organization, including research and development, design, finance, operations, logistics, and human resources, and to change their focus from top-down control to bottom-up empowerment. A main contribution of the approach is then the continuous up-to-date information that allows the organization to adapt quickly to changing market conditions and to focus more on customer value creation (Hope and Fraser, 2003). This is a natural attribute of the Beyond Budgeting model. It is likely a main reason why management in practice has been open to the innovations suggested by the Beyond Budgeting (de Waal, 2005).

A recent survey by Libby and Lindsay (2010) found that 46% of the Canadian respondents planned to change or adapt their budgeting systems within the next two years. The reasons given by the respondents (Libby and Lindsay (2010) include:

- preparing budgets is time consuming and the benefits may not be worth the cost;
- the lack of flexibility inherent in budgeting does not fit well with a constantly changing environment;
- budgets can be manipulated and provide incentives for the “wrong” (i.e., self-interested) behavior on the part of the managers;
- budgetary reporting is not meaningful to front-line employees;
- budgeting eliminates the drive for constant improvement; and

- the budget is not aligned with strategy.

These findings are consistent with those of other surveys of practice referenced earlier. In addition, the respondents indicated the types of changes expected to be made:

- incorporate a bottom-up orientation and gather more information from line managers;
- use rolling forecasts;
- better align strategic planning with budgeting;
- prepare less detailed budgets initially and update them regularly using ongoing forecasts.

In the US, Johnson and Johnson, Emerson Electric are examples of successful U.S. companies whose traditional use of budgets lies at the heart of their management control system (Libby and Murray, 2007) (See Table 2. New Tool Box to replace Traditional Budgeting).

In Northern Europe on the other hand, there are many companies that have adopted Beyond Budgeting, most notably, Svenka Handelsbanken, one of the most profitable Scandinavian banks over the last 20 years. Borealis A/S, Park Nicollet Health services, Volvo cars, SKF, Schlumberger are other examples of European successful companies who adopted beyond budgeting model.

Borealis is a European producer of plastics. It abandoned its use of traditional budgeting because it felt the system was time-consuming and was ineffective because of rapidly changing market conditions.

Borealis introduced several tools to replace its budgeting system, including:

- rolling financial forecasts;
- balanced scorecard;
- activity-based costing; and
- decentralized investment management.

Table 2. New Tool Box to replace Traditional Budgeting

<p>Rolling Financial Forecast</p> <ul style="list-style-type: none"> - Used for financial and tax planning at group level - Updated quarterly, covering next 5 quarters - High level P&L projection, few details - Few people involved - “honest” forecast about what the future holds 	<p>Balanced Scorecard for Performance management</p> <ul style="list-style-type: none"> - Corporate objectives are cascaded down into local objectives, which lead to KPIs - “balance” between financial and non-financial, leading and lagging - Scorecard is used for personal target-setting and reporting progress - Focus is on trends compared to benchmarking based on best performers
<p>Controlling Fixed (Operating) Costs</p> <ul style="list-style-type: none"> - ABC/M methods used to understand and manage resources - Moving averages replace calendar year focus - Costs, small investments tracked by trends - Everyone is expected to manage within first quartile benchmarks - Capacity management is monitored 	<p>Investment management</p> <ul style="list-style-type: none"> - Small investment (below 1 m EUR) Trend reporting Decentralized decision making - Medium (between 1 and 7 m EUR) Various hurdle rates depending upon resources available Prioritized according to strategic fit - Strategic (above 7 m EUR) Executive board decides

5. CHANGE OR NO CHANGE

Proponents indicate that Beyond Budgeting is the proper model for the next decades. The underlying rationale is that beyond budgeting eliminates a real free-for-all. This elimination includes the annual budget, as well as preliminary meetings and agreements on the budgeting process.

These contributions eliminate contentious meeting with operating units, and accountants (Hope and Frazer, 2003). It moves the authorization to a higher level of management where decisions of this kind are made; that is also the level to make

modifications to operations, and in the overall process (Verschoor, 2005).

Also the Beyond Budgeting approach is amenable to a wide-ranging management accounting system. The flexibility of Beyond Budgeting provides that capability.

So then the question is whether the organization is ready to make the change. From an organizational stance, the main questions are (de Waal, 2005):

- (1) is the structure of the organization set for flexibility?
- (2) is the management decision process adaptable?

The change is viewed a change of “mindset.”

From corporations that have made the change, several pre-conditions have been uncovered:

- (1) organization is prepared to make the change;
- (2) alignment has been made, to comply with the change;
- (3) all resources requirements have been met.

Note the three are pre-conditions to a corporate decision to implement change. de Wal (2005) presents a test of the change. Included is the need for change, and the status of the organization for the change.

A condition for implementation is the knowledge of principles of Beyond Budgeting. Of course, this is secondary to the need for the change. Unless the firm detects the need for change, the effort is worthless. But with the need for change, Beyond Budgeting is invaluable.

6. CONCLUSION

The area of budgeting is viewed in several ways, inside of a company. The threshold view is the current state of the art. The thrust of this paper is to introduce Beyond Budgeting as an enhanced approach to budgeting. Various authors indicate that an improvement in accuracy is expected, and is delivered. However, one should note that all forecasts have a range of uncertainty. As budgeting is a forecast of company performance, with the market determining the outcome, forecasts are prone to failure.

However, Beyond Budgeting is noted as increasing accuracy of budget (and forecasts). While a measure of accuracy is not produced, the quality of accuracy is surely found.

With this nebulous conclusion, the change to Beyond Budgeting is warranted—even on a

qualitative basis. Users will find ways to further enhance the approach. At a further time, an evaluation of this way of budgeting will be available and its enhancement measured.

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